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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 44

[Docket No. OCC–2014–0003]

RIN 1557–AD79

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

12 CFR Part 248

[Docket No. R–1480]

RIN 7100 AE–11

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 351

RIN 3064–AE11

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 255

[Release No. BHCA–2]

RIN 3235–AL52

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 75

RIN 3038–AE13

Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

AGENCY: Office of the Comptroller of the Currency, Treasury (''OCC''); Board of Governors of the Federal Reserve System (''Board''); Federal Deposit Insurance Corporation (''FDIC''); Commodity Futures Trading Commission (''CFTC'') and Securities and Exchange Commission (''SEC'').

ACTION: Interim final rule.

SUMMARY: The OCC, Board, FDIC, CFTC and SEC (individually, an ''Agency,'' and collectively, ''the Agencies'') are each adopting a common interim final rule that would permit banking entities to retain investments in certain pooled investment vehicles that invested their offering proceeds primarily in certain securities issued by community banking organizations of the type grandfathered under section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''). The interim final rule is a companion rule to the final rules adopted by the Agencies to implement section 13 of the Bank Holding Company Act of 1956 (''BHC Act''), which was added by section 619 of the Dodd-Frank Act.

DATES: *Effective date:* The interim final rule is effective on April 1, 2014. *Comment date:* Comments on the interim final rule should be received on or before March 3, 2014.

ADDRESSES: Interested parties are encouraged to submit written comments jointly to all of the Agencies. Commenters are encouraged to use the title ''Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds'' to facilitate the organization and distribution of comments among the Agencies.

Office of the Comptroller of the Currency: Because paper mail in the Washington, DC area and at the OCC is subject to delay, commenters are encouraged to submit comments by the Federal eRulemaking Portal or email, if possible. Please use the title ''Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds'' to facilitate the organization and distribution of the comments. You may submit comments by any of the following methods:

- *Federal eRulemaking Portal—''Regulations.gov'':* Go to *http://www.regulations.gov.* Enter ''Docket ID OCC–2014–0003'' in the Search Box and click ''Search.'' Results can be filtered using the filtering tools on the left side of the screen. Click on ''Comment Now'' to submit public comments.
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- *Mail:* Legislative and Regulatory Activities Division, Office of the Comptroller of the Currency, 400 7th Street SW., Suite 3E–218, Mail Stop 9W–11, Washington, DC 20219.
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Instructions: You must include ''OCC'' as the agency name and ''Docket ID ''OCC–2014–0003'' in your comment. In general, OCC will enter all comments received into the docket and publish them on the Regulations.gov Web site without change, including any business or personal information that you provide such as name and address information, email addresses, or phone numbers. Comments received, including attachments and other supporting materials, are part of the public record and subject to public disclosure. Do not enclose any information in your comment or supporting materials that you consider confidential or inappropriate for public disclosure.

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

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- Click on the ''Help'' tab on the Regulations.gov home page to get information on using Regulations.gov, including instructions for viewing public comments, viewing other supporting and related materials, and

viewing the docket after the close of the comment period.

• *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 400 7th Street SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 649–6700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

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

Board of Governors of the Federal Reserve System:

You may submit comments, identified by Docket No. R–1480 and RIN 7100 AE–11, by any of the following methods:

• *Agency Web site: http://www.federalreserve.gov.* Follow the instructions for submitting comments at *http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm.*

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

• *Email: regs.comments@federalreserve.gov.* Include the docket number in the subject line of the message.

• *Fax:* (202) 452–3819 or (202) 452–3102.

• *Mail:* Address to Robert deV. Frierson, Secretary, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue NW., Washington, DC 20551.

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

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

• *Agency Web site: http://www.fdic.gov/regulations/laws/federal/propose.html.* Follow instructions for submitting comments on the Agency Web site.

• *Email:* Comments@fdic.gov. Include the RIN number 3064–AE11 on the subject line of the message.

• *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

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

Public Inspection: All comments received must include the agency name and RIN 3064–AE11 for this rulemaking. All comments received will be posted without change to *http://www.fdic.gov/regulations/laws/federal/propose.html,* including any personal information provided. Paper copies of public comments may be ordered from the FDIC Public Information Center, 3501 North Fairfax Drive, Room E–I002, Arlington, VA 22226 by telephone at 1 (877) 275–3342 or 1 (703) 562–2200.

Commodity Futures Trading Commission: You may submit comments, identified by RIN number 3038–AE13 by any of the following methods:

• *Agency Web site: http://comments.cftc.gov.*

• *Mail:* Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

• *Hand Delivery:* Same as mail above.

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow instructions for submitting comments.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to *www.cftc.gov.* You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedure established in § 145.9 of the CFTC's regulations (17 CFR 145.9).

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse, or remove any or all of your submission from *http://www.cftc.gov* that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

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

Electronic Comments

• Use the Commission's Internet comment form (*http://www.sec.gov/rules/interim-final-temp.shtml*); or

• Send an email to *rule-comments@sec.gov.* Please include File Number S7–01–14 on the subject line; or

• Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

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

All submissions should refer to File Number S7–01–14. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The SEC will post all comments on the SEC's Internet Web site (*http://www.sec.gov/rules/interim-final-temp.shtml*). Comments are also available for Web site viewing and printing in the SEC's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

OCC: Tiffany Eng, Legislative and Regulatory Activities Division, (202) 649–5490, Office of the Comptroller of the Currency, 400 7th Street SW., Washington, DC 20219.

Board: Christopher M. Paridon, Counsel, (202) 452–3274, or Anna M. Harrington, Senior Attorney, (202) 452–6406, Legal Division, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

FDIC: Bobby R. Bean, Associate Director, *bbean@fdic.gov.* or Karl R. Reitz, Chief, Capital Markets Strategies Section, *kreitz@fdic.gov,* Capital Markets Branch, Division of Risk Management Supervision, (202) 898–6888; Michael B. Phillips, Counsel, *mphillips@fdic.gov,* or Gregory S. Feder, Counsel, *gfeder@fdic.gov,* Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

CFTC: Erik Remmler, Deputy Director, Division of Swap Dealer and

Intermediary Oversight (''DSIO''), (202) 418–7630, *eremmler@cftc.gov;* Paul Schlichting, Assistant General Counsel, Office of the General Counsel (''OGC''), (202) 418–5884, *pschlichting@cftc.gov;* Mark Fajfar, Assistant General Counsel, OGC, (202) 418–6636, *mfajfar@cftc.gov;* Michael Barrett, Attorney-Advisor, DSIO, (202) 418–5598, *mbarrett@cftc.gov,* Commodity Futures Trading Commission, 1155 21st Street NW., Washington, DC 20581.

SEC: W. Danforth Townley, Attorney Fellow, Jane H. Kim or Brian McLaughlin Johnson, Senior Counsels, Division of Investment Management, (202) 551–6787, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Background

Section 619 of the Dodd-Frank Act added a new section 13 to the BHC Act (codified at 12 U.S.C. 1851) that generally prohibits banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions and definitions.

Section 13 of the BHC Act expressly authorizes the Board, OCC, FDIC, CFTC, and SEC to issue implementing regulations. Each Agency issued a common final rule implementing section 619 that becomes effective on April 1, 2014 (''Final Rule'').[1]

A separate provision of the Dodd-Frank Act, section 171, generally provides that trust preferred and certain other securities issued by depository institution holding companies must be phased-out of such companies' calculation of regulatory capital for purposes of determining Tier 1 capital. However, section 171 further provides for the permanent grandfathering of debt and equity securities issued before May 19, 2010, by any depository institution holding company that had total consolidated assets of less than $15 billion as of December 31, 2009, or was a mutual holding company on May 19, 2010 (''community banking organizations''). These grandfathered capital-raising instruments in the form of trust preferred securities or subordinated debt securities (collectively referred to herein as ''TruPS'') were issued by community banks frequently through securitization pools (''TruPS CDOs'') that were formed for the purpose of acquiring these TruPS.

II. Discussion

Section 619 generally prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a hedge fund or private equity fund, which are defined under the statute to mean an issuer that would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act, or ''such similar funds'' as the Agencies determine by rule. The Agencies have by separate rule implementing section 619, in relevant part, defined a hedge fund or private equity fund through the term ''covered fund'' to be any issuer that would be an investment company under the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act, with certain exceptions and additions.[2] This definition generally includes pooled investment vehicles, such as many TruPS CDOs, that use 3(c)(1) or 3(c)(7) but do not qualify for another exclusion under the Investment Company Act or the Final Rule.

Section 171 of the Dodd-Frank Act requires, among other things, that the appropriate Federal banking agencies establish minimum leverage and risk-based capital requirements for insured depository institutions and depository institution holding companies that are not less than the generally applicable capital requirements that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act.[3] The focus of this section on ensuring that depository institutions and their holding companies maintain strong minimum capital levels is one of the key prudential provisions included in the Dodd-Frank Act. Importantly in the current context and as noted above, section 171 specifically permits any community banking organization to continue to rely for regulatory capital purposes on any debt or equity instruments issued before May 19, 2010.[4]

A number of community banking organizations have recently expressed concern that the Final Rule conflicts with the Congressional determination under section 171(b)(4)(C) of the Dodd-Frank Act to grandfather TruPS issued as of May 19, 2010, by community banking organizations.[5] Many community banks and other market participants maintain that the issuance of TruPS using a pooled investment structure was the only practical way for community banking organizations to avail themselves of TruPS for regulatory capital purposes. Accordingly, the TruPS CDO structure was the tool that gave effect to the use of TruPS as a regulatory capital instrument prior to May 19, 2010 and was part of the status quo Congress preserved with the grandfathering provision of section 171. In order to avoid imposing restrictions that could adversely affect the TruPS CDO market in a manner that could undercut the grandfathering provisions that Congress provided in section 171, the Agencies believe that certain TruPS CDOs should be a permitted investment for all banking entities under section 619 of the Dodd-Frank Act.

The Agencies have determined to act together to adopt an interim final rule. This new interim final rule permits a banking entity to retain an interest in, or to act as sponsor (including as trustee) of, an issuer that is backed by TruPS so long as (i) the issuer was established before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in Qualifying TruPS Collateral (as defined below); and (iii) the banking entity's interest in the vehicle was acquired on or before December 10, 2013 (unless acquired pursuant to a merger or acquisition). Under the interim final rule, a ''Qualifying TruPS Collateral'' is defined by reference to the standards in section 171(b)(4)(C) to mean any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, for any reporting period during the 12 months immediately preceding the issuance of such instrument, had total consolidated assets of less than $15,000,000,000 or issued prior to May 19, 2010 by a mutual holding company. The Agencies have required that an issuer must have invested primarily in Qualifying TruPS

[1] The Final Rule will be codified at 12 CFR part 44 (OCC), 12 CFR part 248 (FRB), 12 CFR part 351 (FDIC), 17 CFR part 75 (CFTC), and 17 CFR part 255 (SEC). The Final Rule defines a covered fund as an issuer that would be an investment company as defined in the Investment Company Act of 1940 (the ''Investment Company Act'') but for section 3(c)(1) or 3(c)(7) of that Act, and also includes and excludes certain entities. This definition implements the definition of ''hedge fund'' and ''private equity fund'' in section 13(h)(2) of the BHC Act. *See* 12 U.S.C. 1851(h)(2).

[2] *See* Final Rule § __.10(b)(1)(i).

[3] *See* 12 U.S.C. 5371.

[4] *See* 12 U.S.C. 5371(b)(4)(C).

[5] The banking agencies recently provided guidance on the application of the Final Rule to TruPS CDOs. *See* FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Final Volcker Rule, *available at http://www.fdic.gov/news/news/press/2013/pr13123a.pdf. See also* Statement regarding Treatment of Certain Collateralized Debt Obligations Backed by Trust Preferred Securities under the Rules implementing Section 619 of the Dodd-Frank Act, available at *http://www.fdic.gov/news/news/financial/2013/fil13062.html* (the ''Statement'').

Collateral to meet the requirements of the interim final rule; this is intended to cover those securitization vehicles that have invested a majority of their offering proceeds in Qualifying TruPS Collateral. The interim final rule also provides clarification that the relief relating to these TruPS CDOs also extends to activities of a banking entity acting as a sponsor for these securitization vehicles since acting as a sponsor might otherwise be subject to the prohibitions or requirements of section 619. For the avoidance of doubt, notwithstanding clause (iii) above, a banking entity may act as a market maker with respect to the interests of an issuer that qualifies for the exemption, in accordance with the applicable provisions of §§ __.4 and __.11 of the Final Rule. The Agencies note that nothing in the interim final rule limits or restricts the ability of the appropriate agency to place limits on any activity conducted or investment held pursuant to the exemption in a manner consistent with their safety and soundness or other authority to the extent the agency has such authority.

The Agencies believe that the approach adopted in the interim final rule appropriately reconciles the policies of section 619 of the Dodd-Frank Act with its companion provision in section 171 of the Dodd-Frank Act and have attempted to encompass the class of instruments Congress intended to grandfather while limiting the scope of the interim final rule in keeping with the objectives of section 619. The Agencies have included a ''reasonable belief'' standard since the relevant CDOs were structured and made their investments many years ago and all of the relevant documentation may not be readily available to banking entities.[6] Based on discussions with major market participants involved in structuring and offering TruPS CDOs, the Agencies expect that the interim final rule will cover all of the issuers that were formed primarily for the purpose of investing in Qualifying TruPS Collateral. The Agencies request comment regarding whether a different approach is necessary to accomplish this objective.

III. Request for Comment

The Agencies invite comment from all members of the public regarding all aspects of the interim final rule. The request for comment is limited to this interim final rule. The Agencies request comment on whether the interim final rule is consistent with the purposes of sections 619 and 171 of the Dodd-Frank Act.

The Agencies will carefully consider all comments that relate to this interim final rule.

IV. Administrative Law Matters

A. Interim Final Rule

The Administrative Procedure Act generally requires an agency to publish notice of a proposed rulemaking in the **Federal Register**.[7] This requirement does not apply, however, when the agency ''for good cause finds . . . that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.''[8]

After the Agencies' adoption of the Final Rule implementing section 619, a number of community banking organizations reached out to the Agencies to express concerns about the Final Rule and, in particular, the implications for financial statement purposes relating to the banking organizations' holdings resulting from their previous capital-raising efforts involving TruPS issued by banking organizations for regulatory capital purposes. The Agencies requested comment in the Notices of Proposed Rulemaking issued by the Agencies[9] regarding the effects of the definition of covered fund and ownership interests on issuers of asset-backed securities, including the distinctions between debt and equity interests.[10] The Agencies also included a request for comment on trust preferred securities specifically in the context of the proposed rule's permitted activity for underwriting activities.[11] Notwithstanding such requests, the Agencies believe that the recently expressed concerns regarding the impact of including TruPS CDOs in the definition of covered fund or on investments by community banks in TruPS CDOs were not included in comments to the Agencies during the comment process.

The Agencies have considered carefully these recently identified concerns, particularly in light of the provisions in section 171 of the Dodd-Frank Act and the concerns raised by community banking organizations regarding the consistency of treatment regarding TruPS issued by community banking organizations, and grandfathered under section 171, and the TruPS CDOs that were used as capital access vehicles for the TruPS issuances. In light of the significant concerns expressed, the Agencies believe there is an urgent need to act in light of the uncertainty expressed by some community banking organizations about whether the Final Rule will require them to dispose of their holdings of TruPS CDOs, which they contend could have an immediate effect on their financial statements and their bank regulatory capital. The OCC, Board, FDIC and SEC noted in the Statement that their accounting staffs believe that, ''consistent with generally accepted accounting principles, any actions in January 2014 that occur before the issuance of December 31, 2013 financial reports, including the FR Y–9C and the Call Report, should be considered when preparing those financial reports.'' The Agencies' decision in this interim final rule to permit a banking entity to retain certain TruPS CDOs should be factored into the accounting analysis. Accordingly, the Agencies believe it necessary to take action at this time before banking entities are required to file their next financial reports.[12]

Accordingly, for the reasons discussed throughout, the Agencies find good cause to act immediately to adopt this rule on an interim final basis without prior solicitation of comment. With this interim final rule and request for comment, the Agencies are not reopening the final rules that have previously been adopted under section 619.

B. Use of Plain Language

Section 722 of the Gramm-Leach Bliley Act (Pub. L. 106–102, 113 Stat. 1338, 1471, 12 U.S.C. 4809) requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The Federal banking agencies believe that the interim final rule is written plainly and clearly, and request comment on whether there are ways the Federal banking agencies can make any final rule easier to understand.

C. Paperwork Reduction Act

The Agencies note that the new interim final rule does not create new regulatory obligations for banking entities, and therefore does not impose any new ''collections of information'' within the meaning of the Paperwork

[6] To minimize the burden of applying the interim final rule, the Board, the FDIC and the OCC will make public a non-exclusive list of issuers that meet the requirements of the interim final rule. A banking entity may rely on the list published by the Board, the FDIC and the OCC.

[7] *See* 5 U.S.C. 553(b).

[8] *Id.*

[9] *See* 76 FR 68,846 (Nov. 7, 2011) (''joint Notice of Proposed Rulemaking''); 77 FR 8332 (Feb. 14, 2012) (''CFTC Notice of Proposed Rulemaking'').

[10] *See* Questions 227–240 of the joint Notice of Proposed Rulemaking.

[11] *See* Question 78 of the joint Notice of Proposed Rulemaking.

[12] *See* Statement, supra note 5, stating that the Agencies' intend to address this matter no later than January 15, 2014.

Reduction Act of 1995 (''PRA''),[13] nor does it create any new filing, reporting, recordkeeping, or disclosure reporting requirements. Accordingly, the Agencies did not submit the interim final rule to the Office of Management and Budget for review in accordance with the PRA. The Agencies request comment on their conclusion that there are no collections of information.

D. Regulatory Flexibility Act

The interim final rule applies to banking entities that may have ownership interests in TruPS CDOs. The requirements of the Regulatory Flexibility Act are not applicable to this interim final rule.[14] Nonetheless, the Agencies observe that in light of the way the interim final rule operates, they believe that, with respect to the entities subject to the interim final rule and within each Agency's respective jurisdiction, the interim final rule would not have a significant economic impact on a substantial number of small entities. The Agencies request comment on their conclusion that the new interim final rule should not have a significant economic impact on a substantial number of small entities.

E. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA), 2 U.S.C. 1532, requires a Federal agency to prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of $100 million or more (adjusted annually for inflation) in any one year. The UMRA only applies when the Federal agency issues a general notice of proposed rulemaking. Since this rule is published as an interim final rule, it is not subject to section 202 of the UMRA.

V. Authority: 12 U.S.C. 1851

This interim final rule is issued under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S. 1851).

Common Text of the Interim Final Rule

Add new § ____.16 to read as follows:

Sec ____.16 Ownership of Interests in and Sponsorship of Issuers of Certain Collateralized Debt Obligations Backed by Trust-Preferred Securities.

(a) The prohibition contained in § ____.10(a)(1) does not apply to the ownership by a banking entity of an interest in, or sponsorship of, any issuer if:

(1) The issuer was established, and the interest was issued, before May 19, 2010;

(2) The banking entity reasonably believes that the offering proceeds received by the issuer were invested primarily in Qualifying TruPS Collateral; and

(3) The banking entity acquired such interest on or before December 10, 2013 (or acquired such interest in connection with a merger with or acquisition of a banking entity that acquired the interest on or before December 10, 2013).

(b) For purposes of this § ____.16, *Qualifying TruPS Collateral* shall mean any trust preferred security or subordinated debt instrument issued prior to May 19, 2010 by a depository institution holding company that, as of the end of any reporting period within 12 months immediately preceding the issuance of such trust preferred security or subordinated debt instrument, had total consolidated assets of less than $15,000,000,000 or issued prior to May 19, 2010 by a mutual holding company.

(c) Notwithstanding paragraph (a)(3) of this section, a banking entity may act as a market maker with respect to the interests of an issuer described in paragraph (a) of this section in accordance with the applicable provisions of §§ ____.4 and ____.11.

(d) Without limiting the applicability of paragraph (a) of this section, the Board, the FDIC and the OCC will make public a non-exclusive list of issuers that meet the requirements of paragraph (a). A banking entity may rely on the list published by the Board, the FDIC and the OCC.

End of Common Rule

List of Subjects

12 CFR Part 44

Administrative Practice and procedure, Banks, Banking, Compensation, Credit, Derivatives, Government securities, Insurance, Investments, National banks, Federal savings associations, Federal branches and agencies, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Trusts and trustees.

12 CFR Part 248

Administrative practice and procedure, Banks and banking, Capital, Compensation, Conflict of interests, Credit, Derivatives, Foreign banking, Government securities, Holding companies, Insurance, Insurance companies, Investments, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Trusts and trustees.

12 CFR Part 351

Banks, Banking, Capital, Compensation, Conflicts of interest, Credit, Derivatives, Government securities, Insurance, Insurance companies, Investments, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, State nonmember banks, State savings associations, Trusts and trustees.

17 CFR Part 75

Banks, Banking, Compensation, Credit, Derivatives, Federal branches and agencies, Federal savings associations, Government securities, Hedge funds, Insurance, Investments, National banks, Penalties, Proprietary trading, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Swap dealers, Trusts and trustees, Volcker rule.

17 CFR Part 255

Banks, Brokers, Dealers, Investment advisers, Recordkeeping, Reporting, Securities.

Department of the Treasury

Office of the Comptroller of the Currency

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency hereby amends chapter I of Title 12, Code of Federal Regulations as follows:

PART 44—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 1. The authority for part 44 continues to read as follows:

Authority: 7 U.S.C. 27 *et seq.,* 12 U.S.C. 1, 24, 92a, 93a, 161, 1461, 1462a, 1463, 1464, 1467a, 1813(q), 1818, 1851, 3101, 3102, 3108, 5412.

§ 44.16 [Amended]

■ 2. Section 44.16 is added as set forth at the end of the Common Preamble.

[13] 44 U.S.C. 3501 et seq.

[14] The requirements of the Regulatory Flexibility Act are not applicable to rules adopted under the Administrative Procedure Act's ''good cause'' exception, *see* 5 U.S.C. 601(2) (defining ''rule'' and notice requirements under the Administrative Procedure Act).

Board of Governors of the Federal Reserve

Authority and Issuance

For the reasons set forth in the Common Preamble, the Board of Governors of the Federal Reserve System is adding the text of the common rule as set forth at the end of the Common Preamble as § 248.16 to part 248, 12 CFR chapter II.

PART 248—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS (Regulation VV)

■ 3. The authority for part 248 continues to read as follows:

Authority: 12 U.S.C. 1851, 12 U.S.C. 221 *et seq.,* 12 U.S.C. 1818, 12 U.S.C. 1841 *et seq.,* and 12 U.S.C. 3103 *et seq.*

§ 248.16 [Amended]

■ 4. Section 248.16 is added as set forth at the end of the Common Preamble.

Federal Deposit Insurance Corporation

Authority and Issuance

For the reasons set forth in the Common Preamble, the Federal Deposit Insurance Corporation is adding the text of the common rule as set forth at the end of the Common Preamble as § 351.16 to part 351, chapter III of Title 12, Code of Federal Regulations.

PART 351—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 5. The authority for part 351 continues to read as follows:

Authority: 12 U.S.C. 1851; 1811 *et seq.;* 3101 *et seq.;* and 5412.

§ 351.16 [Amended]

■ 6. Section 351.16 is added as set forth at the end of the Common Preamble.

Commodity Futures Trading Commission

Authority and Issuance

For the reasons set forth in the Common Preamble, the Commodity Futures Trading Commission is adding the text of the common rule as set forth at the end of the Common Preamble as § 75.16 to part 75, chapter I of Title 17, Code of Federal Regulations.

PART 75—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 7. The authority for part 75 continues to read as follows:

Authority: 12 U.S.C. 1851.

§ 75.16 [Amended]

■ 8. Section 75.16 is added as set forth at the end of the Common Preamble.

Securities and Exchange Commission

Authority and Issuance

For the reasons set forth in the Common Preamble, the Securities and Exchange Commission is adding the text of the common rule as set forth at the end of the Common Preamble as § 255.16 to part 255, chapter II of Title 17, Code of Federal Regulations.

PART 255—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 9. The authority for part 255 continues to read as follows:

Authority: 12 U.S.C. 1851.

§ 255.16 [Amended]

■ 10. Section 255.16 is added as set forth at the end of the Common Preamble.

Dated: January 14, 2014.

Thomas J. Curry,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, January 14, 2014.

Robert deV. Frierson,

Secretary of the Board.

Dated at Washington, DC this 13th day of January 2014.

By delegated authority from the Board of Directors of the Federal Deposit Insurance Corporation.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

Dated: January 17, 2014.

By the Securities and Exchange Commission.

Elizabeth M. Murphy,

Secretary.

Issued in Washington, DC, on January 15, 2014, by the Commodity Futures Trading Commission.

Melissa D. Jurgens,

Secretary of the Commodity Futures Trading Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

Commodity Futures Trading Commission (CFTC) Appendices to Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds—Commission Voting Summary and Statements of Commissioners

Appendix 1—Commodity Futures Trading Commission Voting Summary

On this matter, Acting Chairman Wetjen and Commissioner Chilton voted in the affirmative, and Commissioner O'Malia concurred.

Appendix 2—Statement of CFTC Acting Chairman Mark P. Wetjen

I support the interim final rule adopted by the CFTC and the other Volcker Rule agencies. The Commission believed it was important to join the other agencies in ensuring community banks are protected, as Congress directed, from restrictions in the Volcker Rule intended to lower the risk of large financial institutions.

Appendix 3—Statement of Concurrence by CFTC Commissioner Scott D. O'Malia

I support the interim final rule adopted by the Commission and the OCC, Federal Reserve Board, FDIC, and SEC (''Agencies''). When an unintended consequence of a regulation is discovered, it is imperative that it be expeditiously corrected to avoid unintentional harm to affected parties. Broken rules must be fixed, and I applaud the work of the Agencies to quickly respond to the public's concerns and comments regarding the holding of TruPS CDOs by community banks affected by the Volcker Rule.

[FR Doc. 2014–02019 Filed 1–30–14; 8:45 am]

BILLING CODE 6210–01–P; 6741–01–P; 6351–01–P; 8011–01–P; 4810–33–P

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 703, 715, and 741

RIN 3133–AD90

Derivatives

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final rule.

SUMMARY: This final rule permits credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. This rule applies only to Federal credit unions. The final rule addresses permissible derivatives and

characteristics, limits on derivatives, operational requirements, counterparty and margining requirements, and the procedures a credit union must follow to apply for derivatives authority.

DATES: This final rule is effective March 3, 2014.

FOR FURTHER INFORMATION CONTACT: Justin M. Anderson, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540; or Tom Fay, Senior Capital Markets Specialist, Office of Examination and Insurance, at the above address or telephone (703) 518–1179.

SUPPLEMENTARY INFORMATION:

I. Notice of Proposed Rule Making
II. Summary of Comments
III. Section-by-Section Analysis of the Final Rule
IV. Regulatory Procedures

I. Notice of Proposed Rule Making

In May 2013 the NCUA Board (Board) issued a proposed rule to permit Federal credit unions (FCUs or credit unions) to engage in derivatives transactions for the purpose of mitigating interest rate risk (IRR). The proposal also required federally insured, state-chartered credit unions (FISCUs) permitted by state law to engage in derivatives to follow the requirements of NCUA's rule. The proposed rule required a credit union seeking derivatives authority to meet minimum eligibility criteria and included two levels of authority, Level I and Level II. The two levels had different permissible limits of derivatives and regulatory requirements. To obtain Level I or Level II authority, the proposed rule required a credit union to apply to NCUA or, in the case of a FISCU, its state supervisory authority (SSA). In addition, the proposed rule described requirements on derivatives processes, systems, and personnel; experience requirements; and restrictions on the use of external service providers (ESPs). The proposed rule also addressed credit unions in NCUA's pilot program and regulatory violations. Finally, the Board specifically requested comment on the possibility of requiring credit unions that apply for derivatives authority to pay an application and/or supervision fee. The Board issued the proposed rule with a 60-day comment period.

II. Summary of Comments

The Board received 75 comments on the proposed rule: 28 from FCUs; 16 from FISCUs; 13 from state credit union leagues; 9 from credit union service organizations or third-party vendors, including investment advisors and brokers; 3 from trade associations; 3 from SSAs; 2 from law firms; and 1 from a Federal Home Loan Bank.

In general, commenters supported permitting credit unions to engage in derivatives transactions. However, all commenters opposed at least one aspect of the proposed rule. While most provisions of the rule elicited comments, commenters focused on fees, permissible derivatives, limits, processes, and experience requirements.

Most commenters believed the proposed requirements imposed high costs and regulatory burdens on credit unions. Virtually all of the commenters, however, believed that credit unions would be able to use derivatives as a meaningful IRR mitigation tool if the Board did not include application or supervisory fees and reduced the regulatory requirements. The Board addresses comments on the proposed rule in more detail in the following section.

III. Section-by-Section Analysis of the Final Rule

(a) General

The Board has made several changes in the final rule based on public comments. Most notably, the Board has condensed and simplified the rule and reduced the overall regulatory burden. The Board also decided not to include, in this final rule, fees associated with using derivatives. The final rule also addresses swap clearing regulations issued in early 2013 by the Commodities and Futures Trading Commission (CFTC). The following is a brief summary of the final rule:

- The rule allows limited derivatives authority comprising of plain vanilla interest rate derivatives for balance sheet management and risk reduction.
- Derivatives exposure is limited by two related measures, a measure of notional amount of derivatives outstanding and a fair value loss limit. The limits are designed to work in tandem, with the notional limit a prospective limit on a credit union's derivatives activity and the fair value loss limit based on the actual performance of the derivatives held by a credit union.
  - ○ The limit on notional amount of derivatives outstanding takes into account the type of derivative and the time to maturity, two key components that determine an instrument's sensitivity to interest rate changes. This innovation provides significant flexibility under the rule and improves the relationship between the notional limit and the fair value limit.
  - ○ The fair value threshold, if breached, will require a participating credit union to cease new derivative investments, provide notification and develop a corrective action plan.
- Credit unions are required to apply for derivatives authority. Generally the application process will be conducted in two-stages. In the first stage, the credit union will present to NCUA an IRR mitigation plan, which demonstrates how derivatives fit within that plan and how it will acquire the appropriate resources, controls and systems to implement a sound derivatives program. In the second stage of the approval process, NCUA will evaluate the credit union on its actual readiness to engage in derivatives transactions based on the personnel, controls, and systems it has put in place. Credit unions new to derivatives authority must operate safely for one year under limited authorities before moving to full authority.
- The rule outlines the appropriate resources, controls and systems required for an effective derivatives program.

The Board believes the changes between the proposed and final rules will significantly lower the cost and burden for credit unions to use derivatives as part of their IRR mitigation strategy.

(b) Changes to Part 703

The proposed rule divided part 703 into two subparts, subpart A and subpart B. Subpart A consisted of the current part 703, with minor modifications, and subpart B consisted of rules and requirements related the use of derivatives. The Board did not receive any comments on the changes to Part 703, but is amending the definition of ''derivative'' in both subparts for accuracy. The Board has not made any other changes to the structure of Part 703.

In addition, the Board notes that the requirements of new subpart B do not apply to derivatives transactions that are permitted under § 703.14, which include European call options, interest rate lock commitments, certain embedded options, and certain options associated with the sale of loans on the secondary market.

(c) Purpose and Scope (§ 703.100)

The purpose and scope section of the proposed rule indicated that the rule applied to FISCUs that are permitted to engage in derivatives by state law. The purpose and scope section also outlined which sections of the rule applied specifically to the different levels of derivatives authority (Level I or Level II, as defined in the proposed rule). Based on public comment and other changes

to the rule, the Board has significantly revised this section.

(1) Applicability to FISCUs (§ 703.100)

The proposed rule required any FISCU permitted by state law to engage in derivatives to follow NCUA's rule, including the application process and regulatory limits. Approximately one-quarter of the commenters addressed this requirement. All but one commenter argued that NCUA is encroaching on states' rights and should not regulate FISCUs' derivatives use. Commenters maintained that such regulation is the province of the states, and that NCUA did not provide sufficient support for Federal regulation of derivatives transactions.

After consideration of the comments, the Board has removed this requirement from the rule. Given the absence to date of any problems specific to FISCUs' derivatives use, FISCUs may follow applicable state law (including a state parity provision) or other SSA authorization, rather than this final rule.

NCUA will closely supervise all federally insured credit unions that engage in derivatives, and will address any safety and soundness concerns through use of applicable enforcement actions. Given the complexity of, and risks associated with, derivatives activity, NCUA will be publishing supervisory guidance in this area. This guidance will address standards for the safe and sound operations of a derivatives program, including expectations for comprehensive policies and procedures, counterparty and collateral management practices, internal control, accounting, and reporting systems, personnel with appropriate levels of expertise, and asset-liability management modeling capabilities. As insurer, NCUA's supervisory guidance will apply to all federally insured credit unions. The final rule also requires that a FISCU engaging in derivatives—whether pursuant to authority granted under state law (including a state parity provision) or other SSA authorization—must notify the applicable field director in writing at least 30 days before it begins engaging in such transactions. This provision will open a dialog between the FISCU and NCUA about the objectives of each new derivatives program. It will also facilitate efforts between NCUA and SSAs to coordinate off-site monitoring and on-site supervision.

(2) Registered Investment Companies

The Board also wants to clarify application of this rule to § 703.14(c), which reads as follows:

(c) *Registered investment company.* A Federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for Federal credit unions.

The Board notes that this final rule will not allow FCUs that are approved for derivatives to invest in a registered investment company or collective investment fund that has derivatives. The Board does not believe it is appropriate for FCUs to invest in entities that may use derivatives for non-hedging purposes. The Board notes that derivatives are complex instruments that can pose significant risk.

The Board has taken steps to mitigate that risk for credit unions using derivatives, but does not have authority to do the same with respect to registered investment companies and collective investment funds. The Board is concerned that such entities using derivatives may put credit unions, and therefore the NCUSIF, at risk. Thus, NCUA has included a clarifying provision in the final rule stating that FCUs are not permitted to invest in registered investment companies or collective investment funds that allow derivatives to be in their investment portfolios. The Board also notes that the purpose of this rule is to permit credit unions to use derivatives for the very limited purpose of mitigating IRR. It never intended for this rule to be a vehicle for credit unions to take on additional risks through a registered investment company or a collective investment fund.

(d) Definitions (§ 703.101)

The proposed rule included several new definitions. The Board received three comments asking for clearer definitions of ''plain vanilla derivatives,'' ''leveraged derivative,'' and ''weighted average life.'' In addition to clarifying several of the definitions, the Board has added new definitions to correspond with other changes in the rule. The Board has also deleted definitions of terms that are no longer used in the rule.

(e) Permissible Derivatives and Characteristics (§ 703.102)

The proposed rule permitted credit unions that have derivatives authority to use interest rate swaps and interest rate caps. The proposal further limited the use of interest rate swaps and interest rate caps to those that are non-leveraged, based on domestic rates, denominated in U.S. dollars, are not used to create structured liability offerings, and settled within three days. The proposal further limited the use of interest rate swaps to those that did not have a fluctuating notional amount.

More than half of the commenters maintained that the list of permissible derivatives was too restrictive to allow credit unions to adequately hedge against IRR. Many of these commenters believed NCUA should allow interest rate floors as a means of hedging against falling rates. Other commenters suggested the list of permissible derivatives should include swaptions, basis swaps, forward settling swaps, swaps with amortizing features, interest rate collars, and interest rate futures. These commenters cited IRR mitigation and low levels of complexity as reasons for permitting these additional derivatives and characteristics.

The Board has considered all of the derivatives and characteristics suggested by commenters, and has expanded the list of permissible derivatives and characteristics in the final rule. In reviewing each suggested derivative, the Board compared the product's utility in mitigating IRR to the derivative's overall complexity and risk. After careful deliberation, the Board is permitting credit unions to apply for the following derivatives and characteristics:

Derivatives	Derivative characteristics
• Interest rate swaps • Interest rate caps. • Interest rate floors • Basis swaps. • Treasury futures.	• Amortizing notional amounts for swaps, caps, and floors. • Forward start date for swaps (90-day maximum).

The following is a description of each new derivative or characteristic that the Board has included in this final rule. The following discussion does not include plain vanilla interest rate swaps and interest rate caps, which the Board discussed in the proposed rule:

(1) Interest Rate Floors. An interest rate floor requires payment to the holder when an underlying interest rate (the ''index'' or ''reference'' interest rate) falls below a specified contract rate (the ''floor rate'').

(2) Basis Swaps. A basis swap is an interest rate swap in which the parties exchange two floating rate indices. For example, Party A enters into a five-year agreement with Party B in which Party A makes quarterly payments to Party B of the U.S. dollar Prime rate multiplied by $10,000,000 (the notional amount), and Party B makes quarterly payments to Party A of the Three-Month U.S. dollar LIBOR rate times $10,000,000. The Board believes that basis swaps can be a useful hedging tool and are commonly used when one party is active in two money markets and wishes to limit the exposure to the risk that the spread between the two interest rates fluctuates.

(3) Amortizing Notional Amounts. An amortizing notional amount is a characteristic of an interest rate cap, interest rate floor, or interest rate swap where the notional amount of the derivative decreases over time according to a predetermined, fixed schedule. The Board agrees the use of amortizing derivatives can potentially enhance hedge effectiveness, provided the amortizing schedule is set at the time of the derivative transaction. For example, a $5 million five-year interest rate swap where the notional amount is reduced $1 million each year after year one. However, the Board is not permitting derivatives with amortizing notional amounts in which the notional amount is indexed to another financial instrument. For example, a credit union cannot enter into an interest rate swap where the notional amount declines based on the amount and frequency of repayments of a reference mortgage pool or portfolio. In such circumstances, the reference index is known but the amounts are unknown and can vary throughout the term of the contract. This adds significant uncertainty to the performance of the derivative, resulting in modeling and pricing complexity that is inconsistent with the objectives of this final rule.

(4) Treasury Futures. A Treasury future is an IRR management tool and a contractual obligation to either buy (take delivery of) or sell (make delivery of) U.S. Treasury notes on a specified date in the future. The final rule restricts permissible Treasury futures to those that deliver Treasury notes (Treasury notes with maturities of up to 10 years, as compared to Treasury bonds which have maturities greater than ten years).

(5) Forward Starting. A forward start date is a characteristic of an interest rate swap that allows the start date of the exchange of interest rate payments to begin at some date in the future. The Board is permitting forward start dates of up to 90 days from the date the credit union executes the transaction. The Board believes that longer forward start dates can impose undue risk on a credit union.

As discussed in more detail below in the section on applications, a credit union must demonstrate that it has the need for, and capacity to manage, the type of derivatives and associated characteristics it is seeking. Accordingly, in its application for derivatives authority, a credit union must specify which type(s) of derivative(s) it is requesting, include a description of each type of derivative it seeks to use, a discussion of how the type of derivative(s) fits within its IRR mitigation plan, and a justification and statement of use for each type of derivative.

The Board notes that this requirement is different from the proposed rule, which permitted any approved credit union to use interest rate swaps or interest rate caps without specifically applying for these types of derivatives. With an expanded list of permissible derivatives and characteristics in the final rule, the Board believes it is necessary and prudent for credit unions to specify how each requested type of derivative fits in the credit union's unique asset-liability structure and IRR mitigation plan. The Board believes this system in the final rule appropriately balances an expanded list of permissible derivatives and safety and soundness.

The Board notes that a credit union may subsequently apply for additional types of derivatives or characteristics that it does not seek in its original derivatives authority application. The final rule includes procedures for applying for authority to use additional types of derivatives.

The Board believes the types of derivatives and characteristics in this final rule will provide credit unions with effective tools to hedge IRR. NCUA's analysis of other derivatives and characteristics suggested by commenters, in particular swaptions and interest rate collars, did not warrant inclusion of these derivatives transaction types at this time. The Board determined that the other types of derivatives suggested by commenters added higher levels of complexity and risk without adding to a credit union's IRR mitigation strategy. The Board believes the expanded list of derivatives it has included in the final rule will allow a credit union to successfully use derivatives as part of its IRR mitigation strategy.

The Board reiterates that derivatives are only one tool for credit unions to mitigate IRR and are not the only way credit unions should be managing this risk. The Board believes that the expanded list of derivatives and characteristics in the final rule will provide credit unions with additional, meaningful tools to mitigate IRR. The Board notes that as part of its annual review of one-third of all regulations, it will reconsider the requirements of this rule within 36 months from its effective date.

Finally, the Board notes that all derivatives under this final rule must have the characteristics adopted in this final rule, unless a credit union receives NCUA's approval for a differing characteristic.

In addition to the characteristics in the proposed rule, the Board is also including one new item and revising another. First, the final rule includes a requirement that all derivatives used by credit unions meet the definition of a derivative under generally accepted accounting principles (GAAP). This requirement will ensure that credit unions are using derivatives in such a way to be recognized as such under GAAP, and preclude transactions that result in a form of lending or borrowing.

Second, the Board is increasing the maximum maturity to 15 years. In the proposed rule, the Board set a maximum maturity limit for Level I authority of seven years and at ten years for Level II. The Board believes this change will allow credit unions to effectively hedge various points on the yield curve and allow for longer-term assets, like mortgages, while at the same time preventing an excessive exposure to very long maturities. As discussed below, the Board has imposed a new maturity weighted notional limit on the aggregate derivative portfolio, which will account for the risk of derivatives with longer maturities.

(f) Derivatives Authority (§ 703.103 and Appendix A)

(1) Structure

The final rule reflects the Board's determination that all credit unions using derivatives should adhere to one set of regulatory requirements. In the final rule, the Board has eliminated the

''Level I'' and ''Level II'' derivatives authority structure in the proposed rule. This structure permitted eligible credit unions to apply for either Level I or Level II authority; each level had different permissible limits and regulatory requirements. Many commenters believed that some of the regulatory requirements outlined in the proposed rule were overly burdensome and could restrict credit unions from effectively using derivatives.

Based on these comments, the Board determined that this structure does not efficiently administer a derivatives regulatory framework. Therefore, the Board has eliminated the two level authority structure and has adjusted many of the regulatory requirements. The Board believes the final rule is less prescriptive and more efficient for credit unions, but also retains the necessary safety and soundness provisions.

The final rule introduces ''entry'' and ''standard'' limit authorities. The two authorities differ only by the permissible limits under which a credit union must operate. The limits are as follows:

	Entry limits (% of net worth)	Standard limits (% of net worth)
Total fair value loss	15	25
Weighted Average Remaining Maturity Notional (WARMN)	65	100

When initially granted its authority, a credit union must first operate under the entry limits for one year before it can increase the volume of its activities under the standard limits. A credit union that has engaged in derivatives for a continuous period of one year (beginning on the trade date of its first derivatives transaction) will automatically progress from the entry limit to the standard limit, unless it has received written notice from NCUA of relevant safety and soundness concerns. It is not necessary for a credit union to submit an additional application to progress from the entry limits to the standard limits. The Board notes that relevant safety and soundness concerns are ones that undermine the credibility of the credit union's management of its derivatives program or expose the credit union to undue risk. NCUA will make this determination on a case-by-case basis, taking into account the overall condition of the credit union and the severity of the safety and soundness concerns.

The Board believes the one-year entry period will allow credit unions to obtain experience with derivatives to ensure their programs are safe and sound. This period also provides NCUA with an opportunity to examine a credit union's actual use of derivatives before that credit union begins using the higher limits in the standard limit authority. While credit unions in NCUA's derivatives pilot program must apply to maintain their derivatives authority under this final rule, most of them will meet the one year of activity threshold and may immediately use standard limit authority after they are approved. The following discussion provides a description of the fair value and notional limits.

(2) Description of Fair Value Loss and Notional Limits (§ 703.103 and Appendix A)

The proposed rule included a notional limit for interest rate swaps, a book value limit for interest rate caps, and a combined notional and book value for all derivatives positions. In addition, the Board also proposed a fair value loss limit for interest rate swaps and a maturity limit based on weighted average positions for all derivatives.

Approximately half of the commenters suggested ways the Board could improve the limit structure. Commenters focused on the measurements for interest rate swaps and interest rate caps, and on the problematic aspects of a mixed attribute limit methodology that combines a notional limit for interest rate swaps with a book value for interest rate caps.

Some commenters suggested using total assets as a notional limit versus a net worth percentage and recommended increasing the maximum maturity limits to account for longer duration assets, like mortgages. Other commenters suggested adjusting the notional amounts of derivatives for time to maturity to account for a lower degree of risk for shorter maturity transactions. Finally, with respect to the fair value loss limit, commenters requested NCUA include the changes in fair value in the underlying hedged item (i.e. the corresponding asset or liability) along with the derivative for the regulatory limit.

First, the Board has eliminated the proposed maximum weighted average maturity limits. Instead, it has adopted a single maximum maturity limit for all derivatives transactions of 15 years.

Second, the Board has replaced limits on individual derivative instruments with a consolidated fair value loss limit and weighted average remaining maturity notional (WARMN) limit for all derivatives transactions. The Board believes this approach holds risk exposures at a more constant degree regardless of maturity, and is more reasonable and effective to implement and monitor.

(i) Considerations for Notional and Fair Value Loss Limits

The Board recognizes that notional amounts, in and of themselves, do not constitute the economic risk exposure of derivatives. Rather, they serve as the reference principal amount upon which parties in a derivatives transaction calculate periodic payments. The notional amount of a derivative contract does not directly represent the actual amounts exchanged or the overall exposure to credit and market risk. In addition, the Board is aware that not all derivatives have the same price sensitivity to changes in interest rates and using a simple gross notional limit could be unduly restrictive.

The Board faced a similar challenge in determining how to implement a fair value loss limit for transactions that are presumed to be used as IRR hedges, where the change in the fair value of the hedged item (asset or liability) could potentially offset the change in the value of the derivative, which is not considered in the fair value loss limit.

However, derivatives can create incremental financial and operation risk. Thus, at this time, the Board believes that a well-constructed limit on total derivatives activity is a critical piece of an effective regulatory framework for derivatives.

The Board seeks a limit framework that is as simple as possible, while providing sufficient authority for credit unions to achieve meaningful reductions in their IRR and recognizing derivatives should not be the sole mitigation strategy for extraordinary levels of IRR. Therefore, the final rule limits derivatives exposure with two related measures, a measure of the notional amount of derivatives outstanding and a fair value loss limit.

The limits are designed to work in tandem, with the notional limit a prospective limit on a credit union's derivatives activity and the fair value loss limit based on the actual performance of the derivatives held by the credit union.

• Fair Value limit. The fair value loss limit for derivatives transactions in the final rule is 15 percent of net worth for ''entry'' authority, and 25 percent of net worth for ''standard'' authority. These limits are for all derivatives positions outstanding on the date a credit union reports its transactions. The fair value limit, if breached, requires a participating credit union to cease new derivatives transactions, provide written notification to NCUA, and develop and submit a corrective action plan to NCUA.

The proposed rule had established fair value loss limits for swaps only while limits for cap premiums were considered as part of the notional limit. The Board believes that simplifying the framework to have one fair value limit for all derivatives positions is an effective approach in governing credit union's derivatives activity.

Many of the commenters suggested that the Board consider a methodology that takes into account the offsetting effect of the hedged item. Commenters maintained that this approach would better align with the strategy of using derivatives for risk mitigation where the associated gain (loss) from the hedged item would have an offsetting gain (loss) to the derivative. The Board considered this approach and has concluded that doing so would add too much complexity. As such, the limit methodology is based upon the derivatives positions only. The Board believes this approach is more transparent and more straightforward to monitor, measure, and control.

Credit unions calculate the fair value loss by totaling the fair value gains and losses on all of its outstanding derivatives positions. If this sum results in an aggregate net loss, the credit union must compare the loss amount, expressed as a percentage of net worth, to the applicable fair value loss limit. Appendix A of the final rule defines what constitutes a gain or a loss and provides an example of how the fair value loss amount should be reported for each of the permissible derivative types (swaps, options, and futures).

Unlike the proposed rule, the final rule requires credit unions to calculate the aggregate gain (loss) for options. As noted above, the proposed rule only required this calculation for swaps. An option's gain or loss is the difference between the option's fair value and its corresponding unamortized premium on the date the credit union reports its transactions. The Board recognizes that credit unions may amortize the upfront premium paid to purchase a cap or floor over the life of the option. In order to determine a gain or loss on an option, credit unions should use the unamortized balance on an option at the reporting date to determine the gain (loss) amount.

• Weighted Average Remaining Maturity Notional (WARMN) limit. This limit on the notional amount of derivatives outstanding takes into account the type of derivative and time to maturity, two key components that determine an instrument's sensitivity to interest rate changes. This innovation provides significant flexibility under the rule and improves the relationship between the notional limit and the fair value limit. The WARMN calculation is designed to correspond to the net worth at risk (15% and 25% for entry and standard limits) in an interest rate shift of 300 basis points. While the WARMN limit corresponds to a fixed percentage of net worth (65% and 100% of net worth for entry and standard limits), the maturity weighting method provides for higher gross notional amounts for shorter duration derivatives portfolios, but lower gross notional amounts for longer duration derivatives portfolios.

The Board received several comments on the effectiveness of applying a notional limit to a derivatives program. Commenters expressed concern that a simple notional limit does not represent the true economic risk of a transaction, and requested that if it proceeded with this type of limit the Board consider weighting the notional exposure by time (maturity) and its respective price sensitivity. By doing so, it would make a notional limit more consistent with the actual price risk of the underlying transaction (shorter maturity derivatives could have higher permissible notional amounts than longer maturity ones).

The Board acknowledges that the notional amount of a derivatives contract does not directly represent the amount of risk in a transaction and other factors, such as the derivative type and its tenor, are key risk drivers. For example, interest rate floors and interest rate caps will have lower sensitivity to interest rate movements given the inherent structure of the instruments. To better account for the varying price sensitivities between interest rate options and interest rate swaps, the Board incorporated adjustment factors into the limit calculation methodology that keep these different product types roughly comparable from a risk exposure standpoint.

The notional limit methodology has been adjusted to take into account the impact of average life and maturity on a transaction's price sensitivity (its risk). The methodology scales exposure limits based on years and uses a ten-year maturity as the basis for assigning relative weights. The notional limit in the final rule has been designed to provide credit unions with a constant level of total risk assumption capacity. This allows for increased notional capacity for derivatives that have shorter terms and as they approach maturity by weighting notional amounts based on the underlying derivatives' remaining time to maturity. This better accounts for the risk and permits greater flexibility to replace maturing hedges. NCUA established the maximum transaction limits after taking into account the projected price sensitivity of options and swaps in the current market and stressed for an instantaneous, parallel, and sustained shock in the yield curve of 300 basis points. This allows for significant price moves over time and creates room within which credit unions can actively manage exposures.

The Board has adopted a conservative approach for calculating the WARMN by prohibiting the netting of offsetting transactions for limit measurement purposes (i.e. pay-fixed swap transactions which were offset with receive-fixed swap transactions must show the total notional amount of both transactions). Rather than netting offsetting transactions, the rule requires all transactions to be cumulatively aggregated. The notional limit in the final rule applies to all derivative transactions. Credit unions must calculate the WARMN limit to determine compliance as detailed in Appendix A of the final rule.

The following are definitions and a calculation example as follows:

(A) Interest rate swaps—The total of all notional amounts regardless of whether a pay fixed, receive fixed, or basis transaction are used. Netting or offsetting of transactions when done for risk reducing purposes are to be reported gross for the calculation of adjusted notional for limit purposes. Transactions with amortizing notional amounts must use the current notional amount as per the amortization schedule at the reporting date.

(B) Interest rate options—The total of all notional amounts for caps and floors are reduced by two-thirds (factored down to 33 percent of the total). Reducing the gross notional amounts for caps and floors by two-thirds approximates the reduced price

sensitivity of options compared to interest rate swaps.

(C) Futures—U.S. Treasury note futures will use the underlying contract size for notional limits. For example, a 5-year Treasury note futures contract with an underlying contract size of $100,000 will use $100,000 of notional as a five-year maturity.

An illustration with definitions and calculations is included in Appendix A of the rule.

The Board believes the limit structure described above balances ease of calculation for credit unions with a meaningful and accurate measure of risk associated with using derivatives.

(g) Collateral, Margining, and Counterparty Management (§ 703.104)

Two sections in the proposed rule addressed collateral and counterparty requirements for credit unions operating a derivatives program. The collateral requirements in the proposed rule specified the permissible types of collateral, the respective margining, and the minimum transfer requirements. In the section addressing counterparties, the proposed rule included requirements on who is a permissible counterparty and the requirements for the credit union to manage the counterparty credit risk.

Approximately half of the commenters addressed either or both of the proposed requirements for collateral or counterparties. All of the commenters that addressed the collateral requirements suggested a more expansive list of permissible collateral types. Some commenters suggested permissible collateral include agency pass-through residential mortgage-backed securities, callable agency debentures from government sponsored enterprises (GSEs), and collateralized mortgage obligations. Other commenters suggested that NCUA's collateral requirements align with the Chicago Mercantile Exchange's eligible collateral requirements for cleared swaps.

For collateral requirements, some commenters believed the requirement to support pricing collateral daily would be too costly and unnecessary and should be less stringent. Others urged NCUA not to impose margining rules at this point, but rather wait until relevant rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) *http://www.hblr.org/2013/04/margin-costs-of-otc-swap-clearing-rules/_ftn11* are promulgated.

Only a few commenters addressed the issue of counterparties. These commenters believed the rule should be expanded to include additional counterparties, like Federal Home Loan Banks.

Based on comments and the implementation of CFTC swap clearing regulations, the Board has amended the sections on collateral and counterparties to address swap clearing, expansion of the permissible types of collateral, and streamlining the requirements for credit unions.

(1) CFTC Swap Clearing

Since the promulgation of the proposed rule, the CFTC finalized rules that provide credit unions with an End-User Exception or Cooperative Exemption from swap clearing. The CFTC's final rules on derivatives clearing requirements were required by the Dodd-Frank Act. Title VII of the Dodd-Frank Act imposes comprehensive changes in the regulatory framework for derivatives and includes amendments to the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934. This new section makes it unlawful for any person (including financial institutions) to engage in a swap that the CFTC has determined requires clearing unless the person submits the swap for clearing to a derivatives clearing organization (DCO) or an exception applies. Clearing changes the traditional relationship between counterparties by placing a clearinghouse intermediary between counterparties.

The two CTFC exceptions are the End-User Exception, which applies to small financial institutions with total assets of $10 billion or less and the Cooperative Exemption, which applies to entities with assets greater than $10 billion where the entity is a cooperative. The CFTC's definition scope includes credit unions. Therefore, all credit unions have the exceptional right, as cooperatives, to elect to either clear swaps or engage in a traditional bilateral agreement. The Board notes that the clearing structure only applies to swaps as of the date of this rule.

For cleared derivatives transactions, each party to the swap submits the transaction to a DCO for clearing. This reduces counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the intermediary DCO as their counterparty. In addition, DCOs exist for the primary purpose of managing credit exposure from the swaps being cleared and therefore DCOs are effective at standardizing transactions and mitigating counterparty risk through the use of exchange-based risk management frameworks.

Finally, swap clearing requires both counterparties to post collateral (i.e. initial margin) with the clearinghouse when they enter into a swap. The clearinghouse can use the posted collateral to cover defaults in the swap. As the valuation of the swap changes, the clearinghouse determines the fair market value of the swap and may collect additional collateral (i.e. variation margin) from the counterparties in response to fluctuations in market values. The clearinghouse can apply this collateral to cover defaults in payments under the swap.

(2) Changes in the Final Rule

The Board has merged the two proposed sections addressing collateral and counterparties and made conforming changes in the final rule. First, the Board has included in the final rule that any credit union using exchange traded or cleared derivatives must comply with the applicable exchange or DCO regulations on these types of derivatives. Second, for non-centrally cleared derivatives, the Board has retained many of the requirements in the proposed rule, but has also made several changes to address comments it received.

(i) Collateral and Margining

Exchange traded or cleared swap transactions are subject to the clearing member's requirements, which is regulated by the respective exchange or DCO's eligible collateral requirements. The current eligible collateral by these exchanges are within the investment authority granted under the Federal Credit Union Act for credit unions. Margining requirements are also promulgated by the exchanges and DCO's, and would be consistent with an initial margin and daily variation margining with no minimum transfer amounts.

For non-centrally cleared transactions, the Board has retained all of the proposed requirements. However, the Board has expanded the list of permissible collateral types to include GSE issued agency residential mortgage-backed securities and GSE debentures. The Board agrees with commenters that these types of collateral may be useful for credit unions and do not pose significant liquidity risks when used for this purpose. The Board recognizes, however, that the counterparty may limit the eligible collateral list to less than the permissible authority. Margining for non-cleared transactions as part of a bilateral credit support annex must still have a minimum transfer amount of $250,000.

(ii) Counterparties

With respect to counterparties, the Board addresses the different arrangements a credit union may have given clearing requirements, the ability of credit unions to use exchange-traded derivatives, and applicable exemptions that credit unions can use for non-centrally cleared derivatives. The Board included in the final rule that credit unions must use CFTC registrant swap dealers, introducing brokers, and futures commission merchants whether using cleared or non-cleared derivatives clearing or non-clearing. However, the Board has eliminated major swap participants (MSP) as permissible counterparties. The Board notes that MSPs are substantial holders of derivatives positions and may not be in the market of dealing derivatives to other parties. Swap dealers and introducing brokers, however, regularly act as counterparties in the ordinary course of business as dealers to derivatives transactions. The Board believes swap dealers and introducing brokers are a sufficient universe of counterparties for credit unions to execute transactions, consistent with the safe and sound operation of a derivatives program.

(h) Reporting Requirements (§ 703.105)

The proposed rule required senior executive officers of a credit union with Level I or Level II authority to report to the credit union's board of directors at least monthly on the following topics: Noncompliance, utilization of limits, itemization of the credit union's positions, the credit union's financial condition, and the cost of executing new transactions. Less than a quarter of the commenters addressed the issue of reporting requirements. All of these commenters disagreed with the requirement of monthly reporting, instead favoring quarterly reporting.

After further evaluation, the Board is amending this section by requiring that senior executive officers, and, if applicable, the credit union's asset liability committee, receive derivatives reports from credit union staff on a monthly basis and the credit union's board of directors receive derivatives reporting from the credit union's senior executive officers at least quarterly. The Board is retaining the requirements of what must be included in these reports from the proposed rule, with a few minor technical amendments. The technical amendments conform to the other changes the Board has made throughout the rule. The Board believes these changes are less burdensome, while ensuring the proper credit union officials receive the reports that are necessary to oversee the credit union's derivatives program.

(i) Operational Requirements (§ 703.106)

The proposed rule contained requirements relating to a credit union's personnel, internal controls structure, transaction management, and asset liability management (ALM). The Board has made several changes to this section to simplify and consolidate the requirements, and make this section of the rule less burdensome while retaining elements necessary to ensure a safe and sound derivatives program.

(1) Personnel

(a) Board of Directors and Senior Management

The proposed rule set minimum knowledge and experience requirements for a credit union's board of directors and senior management. Specifically, the rule required that a credit union's board of directors complete derivatives training before a credit union could begin a derivatives program and annually thereafter. The proposed rule also required that senior executive officers have sufficient experience and knowledge to oversee the credit union's derivatives program.

Most commenters did not address the experience requirements for a credit union's board of directors and senior executive officers. However, a few commenters felt the training and experience requirements for credit union board members are excessive and unwarranted. These commenters requested that the Board eliminate this requirement, arguing that the board members do not need annual training on this topic.

The Board believes that a credit union's board of directors and senior executive officers need to have sufficient experience and knowledge to effectively oversee and effectuate a derivatives program. Therefore, the Board is retaining the proposed requirements. However, the Board is deleting the provision that requires a credit union to provide notification to NCUA when positions become vacant and documentation evidencing knowledge and experience for any new senior executive officer. This deletion is a reduction in regulatory burden that the Board believes will help credit unions administer a derivatives program more efficiently, without sacrificing safety and soundness.

(b) Qualified Derivatives Personnel

The proposal also required a credit union to have qualified derivatives personnel. The rule required the qualified derivatives personnel to have three or five years of direct transactional experience with derivatives based on the level of authority for which a credit union was approved. The qualified derivatives personnel are responsible for ALM, accounting and reporting, trade execution, and credit and collateral management.

The majority of the commenters that addressed the qualified derivatives personnel requirement argued against the proposed experience requirements. Commenters believed the proposed experience requirements would result in large expenses to a credit union in its attempt to attract and retain qualified individuals. Some commenters argued that the experience requirements were arbitrary, unrealistic, and unattainable. As alternatives, commenters suggested shorter experience requirements or allowing credit unions to substitute capital markets experience in place of derivatives experience. Some commenters also suggested that the final rule allow greater use of external service providers as an alternative to having qualified derivatives personnel (relaying on external service providers is addressed in additional detail in the section on ESPs).

After careful consideration, the final rule does not require a credit union to have one or more employees with a specific number of years of experience. Rather, the final rule addresses the overall experience of the credit union staff overseeing the credit union's derivatives program. To that end, the Board has replaced the specific years of experience requirement with a general requirement that a credit union have staff with commensurate experience in the following areas: ALM; accounting and financial reporting; derivatives trade execution and oversight; and counterparty, collateral, and margining.

With respect to the qualified derivatives personnel having experience with ALM and transaction management, the Board has retained the requirements on these topics from the proposed rule. The Board believes that the addition of an effective derivatives program should include enhanced capacity by the credit union staff to analyze and understand the credit union's IRR.

In particular, a derivatives program will require enhanced capacity to estimate the credit union's earnings and economic value based on the market's expectation of future interest rates and any potential changes from these expectations. While a projection of income over a short period of time is customarily used by credit unions for financial planning, the Board believes that the longer maturity and increased

complexity of permissible derivatives contracts will require credit unions to project their earnings over longer periods of time. In addition, because interest rate derivatives are priced using the forward interest rate curve, and the value of these contracts changes when there is a shift in the market's expectation of future interest rates, credit unions need to incorporate the forward interest rate curve into their baseline assumptions. It is important for the credit union to consider its earnings and economic value in the context of these forward rates, and how changes from these forward rates would affect the institution's projected financial performance. Moreover, analyses of the effects of changing interest rates should include both parallel and non-parallel changes in rates over the maturity spectrum (both a flattening and steepening of the yield curve).

The Board believes these changes reduce the overall expense and burden on the credit union, while ensuring that credit unions have adequate experience to manage a derivatives program. As discussed below, before a credit union can begin using derivatives, NCUA will ensure that the credit union has staff with the experience necessary to comply with this section. While credit unions are not required to obtain staff with a specific length of experience, the Board notes that it may be necessary for a credit union to hire outside staff to comply with this section of the rule.

(2) Internal Controls Structure

The proposed rule required credit unions engaging in derivatives to maintain adequate internal controls, including proper separation of duties, a written and schematic description of the derivatives decision process, an internal controls review, a financial statement audit, legal review, and a hedge review.

Few commenters addressed the internal controls structure requirements. However, the comments the Board did received argued that experience requirements for attorneys to conduct a legal review and the requirement for an internal controls review conducted by an external auditor were overly burdensome, costly, and unnecessary.

Based on comments and a reevaluation of the rule, the Board has significantly condensed and simplified the internal controls structure requirements. The Board has retained the requirement for a credit union to maintain a process and responsibility framework that visually demonstrates the derivatives decision process. The Board has also retained the required separation of duties without amendment.

In response to commenters, however, the Board is amending the section on internal controls review to indicate that a credit union must only obtain this review for the first two years of its derivatives program. The Board believes that an internal controls review is only needed for the first two years of a derivatives program, as that will be the time when the credit union is implementing and expanding its internal controls.

The final rule also provides that this review may be conducted by a credit union's internal auditor, if it has one. The Board believes that if credit union has an independent auditor on staff, it is not necessary for the credit union to bear additional expense to produce this review.

The Board has also moved the requirement for a legal review to the section addressing collateral and counterparties. The proposed rule required a credit union to obtain counsel with at least five years of experience with derivatives transactions. Based on public comment, the Board is not including this experience requirement in the final rule.

Finally, the Board is retaining the proposed requirements for a financial statement audit and a hedge review. However, the Board is eliminating the requirement that the person conducting the financial statement audit have at least two years of experience with derivatives. The Board has reconsidered this requirement and does not believe it is necessary for a financial statement auditor to have a specific number of years of experience with derivatives. However, the Board believes a credit union should use a person or persons that have relevant experience accounting for these instruments.

(3) Policies and Procedures

The proposed rule required credit unions to maintain and operate according to written, comprehensive policies and procedures. The proposal required that these policies and procedures cover the following topics: The scope of activities; risk management; accounting and reporting; limits; and oversight and responsibilities. In addition, the proposed rule required a credit union's board of directors to review the policies annually and update them when necessary.

One commenter maintained that credit union board members should not be required to review the policies and procedures for a derivatives program. This commenter did not provide a justification for the comment. The Board continues to believe that a credit union should operate according to written policies to govern the credit union's staff operations of the derivatives program. However, the Board does not believe the final rule needs to be as prescriptive as the proposed rule. The Board, therefore, has eliminated the list of specific items a credit union must have in its policies and procedures and moved this section to the section addressing operational requirements.

In the final rule, the Board requires credit unions to have policies and procedures that address everything in the rule, except for sections relating to applications, pilot program credit unions, regulatory violation, and eligibility. In addition, the Board is retaining the requirement that a credit union's board of directors reviews these policies at least annually, and updates them when necessary. The Board continues to believe that it is important for a credit union's board of directors to update the credit union's policies and procedures as the condition of the credit union and its market position change.

(j) External Service Providers (ESPs) (§ 703.107)

The proposed rule restricted who a credit union could use as an ESP and indicated what activities an ESP could conduct or support for the credit union. The proposal defined ''support'' as having the credit union conduct the function with assistance from an ESP and ''conduct'' as allowing an ESP to conduct a function with the credit union's oversight. Credit unions approved for Level I derivatives authority were permitted to have ESPs conduct more activities than credit unions approved for Level II derivatives authority. The proposed rule contemplated that credit unions with Level II authority would have less reliance on ESPs and be able to conduct more activities independently, in-house.

Several commenters argued that the restrictions on the use of ESPs were too great. These commenters argued that ESPs are an efficient and inexpensive means to safely and soundly conduct a derivatives program. These commenters sought to use ESPs for most of the functions needed to successfully carry out a derivatives program, as opposed to employing high cost internal derivatives personnel.

The Board agrees that, if properly managed, ESPs can be an efficient and cost effective way to carry out many of the functions of a derivatives program. Based on the comments and NCUA's staff evaluation, the Board is amending the section of the rule addressing ESPs.

Most notably, the Board is eliminating a majority of the provisions that

describe the activities an ESP can conduct and support. The final rule permits a credit union to use ESPs for most functions, provided the credit union complies with the other requirements related to ESPs. However, the Board is retaining the requirement that a credit union must internally and independently conduct ALM and liquidity risk management. The Board believes these two functions are fundamental to a credit union's understanding of derivatives and how they fit into its IRR mitigation strategy. The Board notes that while a credit union must conduct these functions internally it may obtain assistance from ESPs, for example use of ESP produced software and modeling tools. The Board believes this change makes the final rule clearer and easier for credit unions to follow, and also makes it less burdensome and costly for credit unions to administer a derivatives program.

The Board is also retaining the restrictions on who cannot be an ESP. The Board believes these restrictions are necessary to preclude conflicts of interest. The Board is also retaining requirements that a credit union have the internal capacity and experience to oversee and manage any ESP and that the credit union documents the specific use of ESPs in its process and responsibility framework. While the Board believes ESPs can be a safe and sound way to conduct many functions, the Board reiterates that NCUA considers anything produced by an ESP as the product of the credit union. Therefore, it is necessary that the credit union have the internal capacity and expertise to ensure the work done by ESPs is accurate and sufficient for its purposes. Also, NCUA staff will use the process and responsibility framework in conjunction with a credit union's application to determine if the use of ESPs is proper and if the credit union can effectively manage the use of ESPs.

(k) Credit Union Eligibility (§ 703.108)

The proposed rule required a credit union applying for either Level I or Level II authority to provide an IRR mitigation plan; have a CAMEL rating of 1, 2, or 3, with a management component of 1 or 2; and have assets of at least $250 million. In addition, any credit union applying for Level II had to demonstrate why the limits under Level I are insufficient.

As noted above, the eligibility requirements were one of the most commented on topics. Approximately half of the commenters addressed this issue. All but one commenter argued that the Board should reduce or eliminate the asset threshold in the proposed rule. These commenters argued that an asset threshold of $250 million is arbitrary and would exclude credit unions that need, and are capable of engaging in, derivatives transactions. Also, one commenter did not believe that the rule should contain a restriction on credit union participation based on CAMEL ratings. This commenter argued that some lower CAMEL rated credit unions may need, and be able to successfully manage, a derivatives program.

The Board continues to believe that a $250 million asset threshold and a CAMEL rating based eligibility requirement will ensure that well-managed credit unions that need derivatives to mitigate IRR are able to obtain this authority. However, the Board recognizes that there may be some credit unions with assets under $250 million that need and are capable of effectively managing a derivatives program.

The Board, therefore, is retaining the eligibility requirements in the proposed rule, but is including a provision in the final rule that provides an NCUA field director with the authority to permit a credit union that has assets under $250 million to apply for derivatives authority. The field director will only permit a credit union that does not meet the asset threshold to apply if he or she concludes that the credit union needs derivatives to manage its IRR and can effectively manage a derivatives program. Further, a field director may set additional stipulations or conditions related to the application of a credit union that is below the $250 million asset threshold. The Board believes this provision gives field directors flexibility to determine if a credit union that does not meet the asset threshold can benefit from and effectively manage derivatives. A field director may not, however, permit a credit union that does not meet the CAMEL code eligibility requirements to apply for derivatives authority. The Board believes it is crucial for a credit union to be well run and in sound financial condition to take on the additional complexity of derivatives.

(l) Application Process, Content, and Review (§ 703.109–§ 703.111)

The proposed rule included a detailed procedure for credit unions to apply for one of the two levels of authority. The proposed application process required credit unions to submit an IRR mitigation plan. In addition, credit unions were required to obtain all necessary personnel, systems, and infrastructure before the credit union could apply for Level II authority.

Approximately ten percent of the commenters addressed the application process. The majority argued against the upfront costs associated with applying for Level II derivatives authority. These commenters believed that a requirement to have systems, processes, and personnel in place before receiving approval was inefficient and could lead to a waste of institution resources. Several other commenters were in favor of a more streamlined application process. These commenters believed that the propensity for rising interest rates in the near term warrants a quicker application process.

In response to commenters, the Board has replaced the requirement that credit unions obtain all necessary personnel and infrastructure before NCUA grants approval with a more streamlined application process. The changes are highlighted below.

(1) Applying for Derivatives Authority

The Board is retaining the requirement that a credit union seeking derivatives authority must submit a detailed application to the appropriate field director.

(2) Application Content

The Board is retaining the required application content items, but has expanded on each to ensure clarity in the final rule. The Board has also included a requirement that the credit union include a list of the types of derivatives and characteristics it is applying for and a business justification for each. The Board believes the clarifying changes it made in this section will make it easier for credit unions to submit a complete and accurate application, which will help NCUA expedite its review.

(3) NCUA Approval

Consistent with amendments to the section on derivatives authority, the Board is amending this section to increase the efficiency of NCUA's application review process, as well as allow credit unions to receive an approved application before procuring all necessary resources.

In lieu of requiring a credit union to obtain all necessary personnel and systems before receiving final approval, the Board is amending the application review process. This process is made up of the following steps:

(i) Interim Approval

First, a credit union must submit a detailed application to NCUA. This application must include all of the information in the application content section, which NCUA may further

clarify through guidance. While the Board has eliminated a deadline for NCUA to review and approve or deny an application, the Board notes that NCUA's goal is to respond to every application within 60 days.

(ii) Acquisition of Infrastructure To Comply With the Rule

A credit union that receives approval of its application must then acquire all of the personnel and systems that are necessary to comply with this final rule. The Board recognizes that each credit union will have its own approach to establishing its infrastructure and that this acquisition period may vary from credit union to credit union.

(iii) Notice of Readiness

Once a credit union has acquired and implemented all of the necessary elements to comply with this rule, it must notify NCUA that it is ready to begin using derivatives.

(iv) Final Approval

After NCUA receives a notice of readiness, it will review the credit union's derivatives program to ensure the credit union is in compliance with this final rule. The Board notes that a credit union may not begin using derivatives until it receives this final approval. NCUA's goal is to provide approval or denial within 60 days from the date it receives the notice of readiness. In rendering a decision, NCUA may conduct an onsite review to verify the credit union is ready and able to start using derivatives. In addition, NCUA may permit a credit union it denies to remedy any deficiencies in its program and reapply. However, reapplication is solely at the discretion of the applicable field director and reapplication efforts do not ensure that a denied credit union will receive authority if deficiencies persist.

Finally, the Board notes that a credit union may choose to submit an application after acquiring all of the necessary resources. In this situation, it is not necessary for the credit union to submit a separate notice of readiness. NCUA's goal is to approve or deny these applications within 120 days from the date it receives the credit union's complete application and request for final approval. Again, the Board notes that this process will only apply to a credit union that has acquired all of the necessary resources and is ready to begin using derivatives when it applies.

The Board believes this new application structure is more efficient and streamlined and allows a credit union to receive interim approval of its application before expending resources to acquire the infrastructure necessary to operate a derivatives program in compliance with this final rule.

(m) Application for Additional Derivatives and Characteristics (§ 703.112)

Consistent with changes made to the permissible derivatives section, the Board has included in the final rule a description of how a credit union applies for additional derivatives and characteristics which it did not request in its initial application. This section requires that a credit union seeking an additional derivative type or characteristic submit an application to the applicable field director. The application must include a list of the additional derivatives and characteristics that the credit union is applying for, and justification and explanation of the need for each of the additional derivatives and/or characteristics. NCUA's goal is to issue a decision on a credit union's application for additional derivatives or characteristics within 60 days from date of receipt of the credit union's request. The Board believes this application system will allow NCUA to grant authority for additional derivatives only to credit unions that need and can manage these additional derivatives and characteristics, while providing credit unions with additional variations of derivatives transactions to mitigate their IRR. Similar to appeal rights granted in the final rule relative to entry level applications, if NCUA denies an application for additional derivatives and characteristics, a credit union may appeal any denial to the Board within 60 days of the denial from the field director.

(n) Pilot Program Participants (§ 703.113)

The proposed rule required that any credit union in NCUA's derivatives pilot program comply with the requirements of the rule within 12 months from its effective date. Any credit union that fails to comply within 12 months must stop entering into new derivatives transactions and, within 30 days, present a corrective action plan to the appropriate field director, explaining how it will come into compliance or safely unwind its program.

Several commenters addressed the issue of pilot program participants being required to apply for derivatives authority. All of these commenters argued that pilot program participants should be grandfathered into the rule without going through the application process. Commenters maintained that NCUA has been evaluating these credit unions for a considerable amount of time and, therefore, a separate application review process is not needed.

The Board believes the requirement for a pilot program credit union to apply for authority helps to ensure a continued safe and sound program in compliance with the final rule. Therefore, the Board is adopting the proposed section on pilot program credit unions without amendment.

(o) Regulatory Violation (§ 703.114)

The Board included a section in the proposed rule that provided a system of corrective action for a credit union with derivatives authority that fails to comply with the rule or has safety and soundness concerns. This corrective action system included a cessation of new transactions and a corrective action plan from the credit union to the applicable field director. The Board did not receive any comments on this section of the rule. However, the Board is amending this section to further explain the steps that a credit union must take if it fails to meet the requirements of this final rule or its approved strategy.

(1) Suspension

A credit union that no longer complies with the requirements of the final rule must immediately suspend all new derivatives activities. However, a credit union may terminate existing transactions. In addition, NCUA may permit a credit union to enter into new offsetting transactions if part of a corrective action strategy. The Board recognizes that it may be necessary for a credit union to terminate existing positions as a way to immediately come into compliance with the limits in the rule. Further, the Board believes that offsetting transactions are another means of coming into compliance with the limits in the rule. Offsetting transactions involve entering into another derivatives transaction that operates in the opposite way as a current position. For example, if a credit union has a pay-fixed swap, the offsetting position would be a receive-fixed swap with similar terms. These transactions essentially offset the risk of each other if constructed effectively. However, because this strategy involves entering into new transactions for credit unions that are already exceeding one of the rule's limits, the Board believes it is important for NCUA to approve these actions.

A credit union seeking to use offsetting transactions must make this request in its notice to the appropriate field director. As explained in the final

rule, a credit union must notify NCUA within three days from the date of the regulatory violation. In addition to including a request for offsetting transactions, if applicable, the notice must also provide a description of the violation and the immediate steps the credit union is taking. This notice will allow NCUA to begin working with the credit union to develop a corrective action plan for remedying the violation.

Within 15 days from the date the credit union provides a notice of violation, it must submit a corrective action plan to NCUA. This corrective action plan, to which NCUA must agree, must describe in detail how the credit union will remedy the violation. A credit union that submits a satisfactory corrective action plan must comply with that plan until it has remedied its violation. A credit union may enter into any new derivatives transactions while it is under a corrective action plan. The Board believes this structure will help to protect the NCUSIF and the credit union from continuing and compounding violations.

(2) Revocation

In addition to a suspension of activities, NCUA may also revoke a credit union's authority granted under this final rule. Revocation will require the credit union to immediately cease any new derivatives transactions and may require the termination of existing positions. The Board notes that NCUA will only require the termination of existing positions if it determines that doing so would not pose a safety and soundness concern. The Board believes it is necessary for NCUA to have the power to revoke authority for credit unions that demonstrate that they are not capable of successfully managing a derivatives program safely and soundly.

(3) Appeals

A credit union may appeal NCUA's revocation of its authority or NCUA's determination to require the termination of existing positions. The Board believes the finality of both of these actions and the impact they will have on the credit union and its members warrants additional scrutiny through an appeals process to the Board. Further, as a credit union may not enter into any new derivatives transactions during the pendency of an appeal, the Board does not believe the time associated with the appeals process will raise any additional safety and soundness concerns.

(p) Fees

In the proposed rule the Board specifically requested comment on including a fee structure for those credit unions that apply for derivatives. The Board considered having a fee structure that included an application and/or a supervision fee just for those credit unions utilizing derivatives.

Most of the commenters addressed the imposition of application and/or supervision fees. All of these commenters argued that NCUA should not charge a separate fee, in any form, for derivatives authority. Some commenters questioned the actual agency costs associated with derivatives, while other commenters believed the suggested fees would establish a negative precedent. All of the commenters on this subject argued that the fees suggested by the Board would make derivatives cost prohibitive, and that, by reducing risk to the share insurance fund, credit unions with derivatives would actually be saving the agency and the industry money.

In response to those comments, the Board is not instituting a fee structure for derivatives. While the Board notes that derivatives authority is cost and labor intensive for the agency, it does not believe singling out derivatives for an authority-based fee is appropriate at this time.

(q) Changes to Part 715

The proposed rule included an amendment to part 715, which clarifies that all credit unions engaging in derivatives must have a financial statement audit, regardless of asset size. As noted above, the Board is retaining this requirement in the final rule. Therefore, the Board is also adopting the proposed changes to part 715 without amendment.

(r) Changes to Part 741

The proposed rule contained changes to Part 741 to reflect application of the rule to FISCUs. The final rule will not apply to FISCUs, so the Board is only amending this section to require that any FISCU engaging in derivatives provide NCUA with written notice at least 30 days before it begins engaging in derivatives transactions.

IV. Regulatory Procedures

a. Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis of any significant economic impact any proposed regulation may have on a substantial number of small entities (primarily those under $50 million in assets).[1] The final rule allows credit unions to enter into certain derivatives transactions to reduce IRR. Since the final rule requires credit unions seeking derivatives authority to have at least $250 million in assets, it will not have a significant economic impact on a substantial number of small credit unions.

b. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or increases an existing burden.[2] For purposes of the PRA, a paperwork burden may take the form of a reporting or recordkeeping requirement, both referred to as information collections. The proposed changes to part 703 impose new information collection requirements. As required by the PRA, NCUA is submitting a copy of this final rule to OMB for its review and approval. NCUA also submitted a copy of the proposed rule to OMB for review.

1. Estimated PRA Burden

For the purposes of calculating the PRA burden, NCUA estimates that 43 credit unions will apply for and be granted derivatives authority. NCUA estimates for the final rule were modified from the proposed rule's estimates based on rule changes and feedback received during the comment period.

NCUA will grant entry limit authority to qualifying credit unions that NCUA recognizes meet the requirements of this rule. After a one year period of continuous risk mitigation with interest rate derivatives and no safety and soundness issues related to the activity, the credit union will be considered to have standard limit authority. Certain credit unions with experience mitigating risk with interest rate derivatives may be granted standard limit authority at the time of application. NCUA estimates that:

- 10 credit unions will qualify for and be granted standard limit authority;
- 33 credit unions will apply for and be granted entry limit authority;

Section 703.106(d) of the rule requires a credit union to operate according to written, comprehensive policies and procedures for control, measurement, and management of derivatives transactions. To do so, a credit union must first develop such policies and procedures. NCUA estimates that on average it will take a credit union seeking derivatives authority an average of 50 hours to develop appropriate policies and procedures. This is a one-time recordkeeping burden.

[1] 5 U.S.C. 603(a).

[2] 44 U.S.C. 3507(d); 5 CFR part 1320.

Section 703.106(d) of the rule requires a credit union's board of directors to review the derivatives policies and procedures annually and update them when necessary. NCUA estimates this ongoing recordkeeping burden will take an average of 10 hours per year per respondent.

Section 703.105(a) of the rule requires a credit union's senior executive officers to provide a quarterly, comprehensive derivatives report to the credit union's board of directors. Section 703.105(b) requires that at least monthly, credit union staff must deliver a comprehensive derivatives report to the credit union's senior executive officers. NCUA estimates this ongoing recordkeeping burden will take an average of 2 hours per respective reporting cycle (total of 8 hours per year for board reporting and 24 hours per year for senior management reporting).

Section 703.106(a)(1) of the rule requires that a credit union retain evidence of annual derivatives training for its board of directors. NCUA estimates this ongoing recordkeeping requirement will take an average of 4 hours per year per respondent.

Section 703.106(b)(1) of the rule requires that a credit union maintain a written and schematic description of the derivatives decision process. NCUA estimates that the one-time recordkeeping burden of creating the description will take 12.5 hours on average. The ongoing burden of maintaining the description will take 2 hours per year per respondent.

Section 703.106(b)(2) requires that for the first two years after commencement of its derivatives program, a credit union must have an internal controls review focused on the integration and introduction of derivatives functions. This review must be performed by an independent external unit or, if applicable, the credit union's internal auditor. NCUA estimates that an internal controls review for a credit union's derivatives program will cost approximately $50,000 each year for the first two years.

Section 703.106(b)(3) of the rule requires a credit union engaging in derivatives transactions to obtain an annual financial statement audit by a certified public accountant. Section 715.5(a) of NCUA's Regulations already requires FCUs with assets of $500 million or greater to obtain an annual financial statement audit. Currently, approximately 60 credit unions with assets between $250 million and $500 million that meet the proposed CAMEL ratings requirements do not obtain annual financial statement audits. Due to the overhead costs associated with derivatives activity, NCUA estimates that ten percent, or six, of these credit unions will apply for and be granted derivatives authority. NCUA further estimates that a financial statement audit for a credit union of this size would cost approximately $50,000.

Section 703.106(b)(4) of the rule requires a credit union, before executing any derivatives transaction, to identify and document the circumstances leading to the decision to hedge, specify the derivatives strategy the credit union will employ, and demonstrate the economic effectiveness of the hedge. NCUA estimates a credit union will execute an average of 2 transactions per year and that it will take an average of 2 hours per transaction to complete the pre-execution analysis. This results in an ongoing recordkeeping burden of 4 hours per year per respondent.

Sections 703.109, 703.110 and of the rule require a credit union seeking derivatives authority to submit a detailed application to NCUA. NCUA estimates that this one-time recordkeeping burden will take an average of 50 hours per respondent to prepare. This estimate does not include developing policies and procedures for operating a derivatives program and creating and maintaining a written and schematic description of the derivatives decision process, as those recordkeeping requirements are already accounted for above.

Section 703.114 of the proposed rule requires a credit union that no longer meets the requirements of subpart B of part 703 to submit a corrective action plan to NCUA. NCUA estimates that 3 credit unions may have to submit an action plan each year and that a plan will take an average of 10 hours to prepare.

Section 741.219 requires a FISCU to notify NCUA in writing at least 30 days before it begins engaging in derivatives. This notice will be a one-time burden. NCUA estimates that 30 FISCUs will have to prepare this notice, and that the notice will take an average of 0.5 hours to prepare.

Summary of Collection Burden

Written policies and procedures: 43 credit unions × 50 hours = 2,150 hours (one-time burden).

Board review of policies and procedures: 43 credit unions × 10 hours = 430 hours.

Derivatives reporting: 43 credit unions × 32 hours = 1,376 hours.

Evidence of board training: 43 credit unions × 4 hours = 172 hours.

Derivatives process description: 43 credit unions × 12.5 hours = 537.5 hours (one-time burden).

43 credit unions × 2 hours = 86 hours.

Independent internal controls review: 43 credit unions × $50,000/year for 2 years $4,300,000 (one-time burden).

Financial statement audit: 6 credit unions × $50,000 = $300,000.

Pre-execution analysis: 43 credit unions × 4 hours = 172 hours.

Application: 43 credit unions × 50 hours = 2,150 hours (one-time burden).

Corrective action plan: 3 credit unions × 10 hours = 30 hours.

FISCU notice: 30 credit unions × 0.5 hours = 15 hours (one-time burden).

Total Annual Hours Burden: 7,118.5 (4,852.5 one-time only).

Total Annual Cost Burden: $4,600,000 ($4,300,000 one-time only).

(c) Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This final rule applies only to FCUs, and only requires a FISCU to notify NCUA in writing at least 30 days before it begins engaging in derivatives transactions. Accordingly, the rule will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. NCUA has, therefore, determined that this proposal does not constitute a policy that has federalism implications for purposes of the executive order.

(d) Assessment of Federal Regulations and Policies on Families

NCUA has determined that this final rule will not affect family well-being within the meaning of § 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105–277, 112 Stat. 2681 (1998).

List of Subjects

12 CFR Part 703

Credit unions, Investments.

12 CFR Part 715

Audits, Credit unions, Supervisory committees.

12 CFR Part 741

Credit, Credit Unions, Reporting and recordkeeping requirements, Share insurance.

By the National Credit Union Administration Board, on January 23, 2014.

Gerard Poliquin,

Secretary of the Board.

For the reasons discussed above, the National Credit Union Administration is amending parts 703, 715, and 741 as follows:

PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 1. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), 1757 (15).

■ 2. In part 703, designate §§ 703.1 through 703.20 as subpart A under the following heading:

Subpart A—General Investment and Deposit Activities

* * * * *

■ 3. Amend § 703.2 by revising the definitions of ''derivative'' and ''fair value'' and adding definitions of ''forward sales commitment'' and ''interest rate lock commitment'' to read as follows:

§ 703.2 Definitions.

* * * * *

Derivative means a financial contract which derives its value from the value and performance of some other underlying financial instrument or variable, such as an index or interest rate.

* * * * *

Fair value means the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date, as defined by GAAP.

* * * * *

Forward sales commitment means an agreement to sell an asset at a price and future date specified in the agreement.

* * * * *

Interest rate lock commitment means an agreement by a credit union to hold a certain interest rate and points for a specified amount of time while a prospective borrower's application is processed.

* * * * *

■ 4. In § 703.14, add paragraph (k) to read as follows:

§ 703.14 Permissible investments.

* * * * *

(k) *Derivatives.* A Federal credit union may only enter into in the following derivatives transactions:

(1) Any derivatives permitted under § 701.21(i) of this chapter, § 703.14(g), or subpart B of this part;

(2) Embedded options not required under generally accepted accounting principles (GAAP) adopted in the United States to be accounted for separately from the host contract; and

(3) Interest rate lock commitments or forward sales commitments made in connection with a loan originated by a Federal credit union.

§ 703.16 [Amended]

■ 5. In § 703.16, remove paragraph (a) of and redesignate paragraphs (b) through (d) as (a) through (c), respectively.

■ 6. Add subpart B to read as follows:

Subpart B—Derivatives Authority

Sec.
703.100 Purpose and scope.
703.101 Definitions.
703.102 Permissible derivatives.
703.103 Derivative authority.
703.104 Requirements for derivative counterparty agreements, collateral and margining.
703.105 Reporting requirements.
703.106 Operational support requirements.
703.107 External service providers.
703.108 Eligibility.
703.109 Applying for derivatives authority.
703.110 Application content.
703.111 NCUA approval.
703.112 Applying for additional products or characteristics.
703.113 Pilot program participants with active derivatives positions.
703.114 Regulatory violation.

§ 703.100 Purpose and scope.

(a) *Purpose.* This subpart allows Federal credit unions to enter into certain derivatives transactions exclusively for the purpose of reducing interest rate risk exposure.

(b) *Scope.* (1) This subpart applies to all Federal credit unions. Except as provided in § 741.219, this rule does not apply to federally insured, state-chartered credit unions.

(2) *Mutual funds.* This subpart does not permit a Federal credit union to invest in registered investment companies or collective investment funds under § 703.14(c) of this part, where the prospectus of the company or fund permit the investment portfolio to contain derivatives.

§ 703.101 Definitions.

For purposes of this subpart:

Amortizing notional amount means a characteristic of a derivative, in which the notional amount declines on a predetermined fixed basis over the term of the contract, according to an amortization schedule to which the parties agree when executing the contract;

Basis swap means an agreement between two parties in which the parties make periodic payments to each other based on floating rate indices multiplied by a notional amount;

Cleared swap has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 22.1;

Counterparty means a swap dealer, derivatives clearing organization, or exchange that participates as the other party in a derivatives transaction with a Federal credit union;

Credit support annex means the terms or rules under which collateral is posted or transferred between a Federal credit union and a counterparty to mitigate credit risk that may result from changes in the fair value of derivatives positions;

Derivative means a financial contract which derives its value from the value and performance of some other underlying financial instrument or variable, such as an index or interest rate;

Derivatives clearing organization has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(d);

Economic effectiveness means the extent to which a derivatives transaction results in offsetting changes in the interest rate risk that the transaction was, and is, intended to provide;

Exchange means a central financial clearing market where end users can trade futures, as defined in this section of this subpart;

External service provider means any entity that provides services to assist a Federal credit union in carrying out its derivatives program and the requirements of this subpart;

Fair value has the meaning specified in § 703.2 of subpart A of this part;

Field director means an NCUA Regional Director or the Director of the Office of National Examinations and Supervision;

Forward start date means an agreement that delays the settlement date of a derivatives transaction for a specified period of time;

Futures commission merchant (FCM) has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(p);

Futures means a U.S. Treasury note financial contract that obligates the buyer to take delivery of Treasury notes (or the seller to deliver Treasury notes) at a predetermined future date and price. Futures contracts are standardized to facilitate trading on an exchange;

Hedge means to enter into a derivatives transaction to mitigate interest rate risk;

Interest rate cap means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate rises above the level specified in the contract;

Interest rate floor means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate falls below the level specified in the contract;

Interest rate risk means the vulnerability of a Federal credit union's earnings or economic value to movements in market interest rates;

Interest rate swap means an agreement to exchange future payments of interest on a notional amount at specific times and for a specified time period;

Introducing broker means a futures brokerage firm that deals directly with the client, while the trade execution is done by a futures commission merchant;

ISDA protocol means a multilateral contractual amendment mechanism that has been used to address changes to International Swap and Derivatives Association (ISDA) standard contracts since 1998;

Leveraged derivative means a derivative where the value of the transaction does not change in a one to one proportion with the contractual rate or index;

(x) *Margin* means the minimum amount of funds that must be deposited between parties to a derivatives transaction, as detailed in a credit support annex or clearing arrangement;

Master service agreement means a document agreed upon between two parties that sets out standard terms that apply to all derivatives transactions entered into between those parties. Each time the same two parties enter into a transaction, the terms of the master service agreement apply automatically and do not need to be re-negotiated. The most common form of a master service agreement is a master ISDA agreement;

Minimum transfer amount means the minimum amount of collateral that a party to a derivatives transaction will require, per transfer, to cover exposure in excess of the collateral threshold;

Net economic value means the economic value of assets minus the economic value of liabilities;

Net worth has the meaning specified in § 702.2 of this chapter;

Non-cleared means transactions that do not go through a derivatives clearing organization;

Notional amount means the contracted amount of a derivatives contract for swaps and options on which interest payments or other payments are based. For futures contracts, the notional amount is represented by the contract size;

Novation means the substitution of an old obligation with a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party;

Reference interest rate means the index or rate to be used as the variable rate for resetting derivatives transactions;

Reporting date means the end of the business day on the date used to report positions and fair values for limit compliance (e.g., daily, month-end, quarter-end and fiscal year-end);

Senior executive officer has the meaning specified in § 701.14 of this chapter and any other similar employee that is directly within the chain of command for the oversight of a Federal credit union's derivatives program, as identified in a Federal credit union's process and responsibility framework, as discussed in § 703.106(b)(1) of this subpart;

Structured liability offering means a share product created by a Federal credit union with contractual option features, such as periodic caps and calls, similar to those found in structured securities or structured notes;

Swap dealer has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(ggg);

Swap execution facility means a Commodities and Futures Trading Commission-registered facility that provides a system or platform for participants to execute cleared derivatives transactions;

Threshold amount means an unsecured credit exposure that a party to a derivatives transaction is prepared to accept before requesting additional collateral from the other party;

Trade date means the date that a derivatives order (new transactions, terminations, or assignments) is executed in the market; and

Unamortized premium means the balance of the upfront premium payment that has not been amortized.

§ 703.102 Permissible derivatives.

(a) *Products and characteristics.* A Federal credit union with derivatives authority may apply to use each of the following products and characteristics, subject to the limits in § 703.103 of this subpart:

(1) Interest rate swaps with the following characteristics:

(i) Settle within three business days, unless the Federal credit union is approved for a forward start date of no more than 90 days from the trade date; and

(ii) Do not have fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(2) Basis swaps with the following characteristics:

(i) Settle within three business days, unless the Federal credit union is approved for a forward start date of no more than 90 days from the trade date; and

(ii) Do not have fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(3) Purchased interest rate caps with no fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(4) Purchased interest rate floors with no fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(5) U.S. Treasury note futures (2-, 3-, 5-, and 10-year contracts).

(b) *Overall program characteristics.* A Federal credit union may only enter into derivatives, as identified and described in paragraph (a) of this section, that have the following characteristics:

(1) Not leveraged;

(2) Based on domestic rates, as defined in § 703.14(a) of subpart A of this part;

(3) Denominated in U.S. dollars;

(4) Except as provided in § 703.14(g) of subpart A of this part, not used to create structured liability offerings for members or nonmembers;

(5) Have contract maturity terms of equal to or less than 15 years, at the trade date; and

(6) Meet the definition of a derivative under GAAP.

§ 703.103 Derivative authority.

(a) *General authority.* A Federal credit union that is approved for derivatives authority under § 703.111 of this subpart may use any of the products and characteristics, described in § 703.102(a), subject to the following limits, which are described in more detail in Appendix A to this subpart:

(1) *Entry limits authority.* Unless a Federal credit union is permitted to use standard limits authority under this subpart, the aggregate fair value loss (as defined in Appendix A) on all of a Federal credit union's derivatives positions may not exceed 15 percent of net worth, and a Federal credit union's weighted average remaining maturity notional (as defined in Appendix A), may not exceed 65 percent of net worth.

(2) *Standard limits authority.* A Federal credit union that is permitted to use standard limits authority may not exceed an aggregate fair value loss on all

of the Federal credit union's derivatives positions of 25 percent of net worth, and a weighted average remaining maturity notional of 100 percent of net worth, provided:

(i) The Federal credit union has engaged in derivatives at the entry limits authority for a continuous period of one year (beginning on the trade date of its first derivatives transaction); and

(ii) The Federal credit union has not been notified in writing by NCUA of any relevant safety and soundness concerns while engaged in derivatives at the entry limits authority.

(b) *Limit description*—(1) *Fair value limit.* The fair value limit is calculated by aggregating the fair values for all derivatives positions at the reporting date. If an aggregate loss exists, it must be less than the limit set forth in this subpart. A further description of this limit and example calculations are detailed in Appendix A to this subpart.

(2) *Weighted average remaining maturity notional limit.* The weighted average remaining maturity notional limit is calculated by aggregating the notional amount for all derivatives positions based on each derivative's pricing sensitivity and maturity. A further description of this limit and example calculations are detailed in Appendix A to this subpart.

§ 703.104 Requirements for derivative counterparty agreements, collateral and margining.

(a) A Federal credit union may have exchange-traded, centrally cleared, or non-cleared derivatives, in accordance with the following:

(1) *Exchange-traded and cleared derivatives.* A Federal credit union with derivatives that are exchange-traded or centrally cleared must:

(i) Comply with the Commodity Futures Trading Commission's rules;

(ii) Use only swap dealers, introducing brokers, and/or futures commission merchants that are current registrants of the Commodity Futures Trading Commission; and

(iii) Comply with the margining requirements required by the futures commission merchant.

(2) *Non-cleared derivative transactions.* A Federal credit union with derivatives that are non-cleared must:

(i) Have a master service agreement and credit support annex with a registered swap dealer that are in accordance with ISDA protocol for standard bilateral agreements;

(ii) Utilize margining requirements contracted through a credit support annex and have a minimum transfer amount of $250,000 for daily margining requirements; and

(iii) Accept as collateral, for margin requirements, only cash (U.S. dollars), U.S. Treasuries, government-sponsored enterprise debt, and government-sponsored enterprise residential mortgage-backed security pass-through securities.

(b) *Counterparty, collateral, and margining management.* A Federal credit union must:

(1) Have systems in place to effectively manage collateral and margining requirements;

(2) Have a collateral management process that monitors the Federal credit union's collateral and margining requirements daily and ensures that its derivatives positions are collateralized at all times and in accordance with the collateral requirements of this subpart and the Federal credit union's agreement with its counterparty. This includes the posting, tracking, valuation, and reporting of collateral using fair value; and

(3) Analyze and measure potential liquidity needs related to its derivatives program and stemming from additional collateral requirements due to changes in interest rates. The Federal credit union must calculate and track contingent liquidity needs in the event a derivatives transaction needs to be novated or terminated, and must establish effective controls for liquidity exposures arising from both market or product liquidity and instrument cash flows.

§ 703.105 Reporting requirements.

(a) *Board reporting.* At least quarterly, a Federal credit union's senior executive officers must deliver a comprehensive derivatives report to the Federal credit union's board of directors. The report may be delivered separately or as part of the standard funds management or asset/liability report.

(b) *Senior executive officer and asset liability committee.* At least monthly, Federal credit union staff must deliver a comprehensive derivatives report to the Federal credit union's senior executive officers and, if applicable, the Federal credit union's asset liability committee.

(c) *Comprehensive derivatives report.* At a minimum, the reports required in paragraphs (a) and (b) of this section must include:

(1) Identification of any areas of noncompliance with any provision of this subpart or the Federal credit union's policies;

(2) Utilization of the limits in § 703.103 and any additional limits in the Federal credit union's policies;

(3) An itemization of the Federal credit union's individual positions and aggregate current fair values, and a comparison with the Federal credit union's fair value loss and notional limit authority, as described in Appendix A to this subpart;

(4) A comprehensive view of the Federal credit union's statement of financial condition, including, but not limited to, net economic value calculations for the Federal credit union's statement of financial condition done with derivatives included and excluded;

(5) An evaluation of the effectiveness of the derivatives transactions in mitigating interest rate risk; and

(6) An evaluation of effectiveness of the hedge relationship and reporting for derivatives in compliance with GAAP.

§ 703.106 Operational support requirements.

(a) *Required experience and competencies.* A Federal credit union operating with derivatives authority must internally possess the following experience and competencies:

(1) *Board.* Before entering into any derivatives transactions, and annually thereafter, a Federal credit union's board members must receive training that provides a general understanding of derivatives and the knowledge required to provide strategic oversight of the Federal credit union's derivatives program. This requirement includes understanding how derivatives fit into the Federal credit union's business model and risk management process. The Federal credit union must maintain evidence of this training, in accordance with its document retention policy, until its next NCUA examination.

(2) *Senior executive officers.* A Federal credit union's senior executive officers must be able to understand, approve, and provide oversight for the derivatives activities. These individuals must have a comprehensive understanding of how derivatives fit into the Federal credit union's business model and risk management process.

(3) *Qualified derivatives personnel.* To engage in derivatives transactions, a Federal credit union must employ staff with experience in the following areas:

(i) *Asset/liability risk management.* Staff must be qualified to understand and oversee asset/liability risk management, including the appropriate role of derivatives. This requirement includes identifying and assessing risk in transactions, developing asset/liability risk management strategies, testing the effectiveness of asset/liability risk management, determining the effectiveness of managing interest rate risk under a range of stressed rates and statement of financial condition

scenarios, and evaluating the relative effectiveness of alternative strategies. Staff must also be qualified to understand and undertake or oversee the appropriate modeling and analytics related to scope of risk to earnings and economic value over the expected maturity of derivatives positions;

(ii) *Accounting and financial reporting.* Staff must be qualified to understand and oversee appropriate accounting and financial reporting for derivatives transactions in accordance with GAAP;

(iii) *Derivatives execution and oversight.* Staff must be qualified to undertake or oversee trade executions; and

(iv) *Counterparty, collateral, and margining management.* Staff must be qualified to evaluate counterparty, collateral, and margining risk as described in § 703.104 of this subpart.

(b) *Required management and internal controls structure.* To effectively manage its derivatives activities, a Federal credit union must assess the effectiveness of its management and internal controls structure. At a minimum, the internal controls structure must include:

(1) *Transaction support.* Before executing any derivatives transaction, a Federal credit union must identify and document the circumstances that lead to the decision to hedge, specify the derivatives strategy the Federal credit union will employ, and demonstrate the economic effectiveness of the hedge;

(2) *Internal controls review.* For the first two years after commencing its derivatives program, a Federal credit union must have an internal controls review that is focused on the integration and introduction of derivatives functions. This review must be performed by an independent external unit or, if applicable, the Federal credit union's internal auditor. The review must ensure the timely identification of weaknesses in internal controls, modeling methodologies, risk, and all operational and oversight processes;

(3) *Financial statement audit.* Any Federal credit union engaging in derivatives transactions pursuant to this subpart must obtain an annual financial statement audit, as defined in § 715.2(d) of this chapter, and be compliant with GAAP for all derivatives-related accounting and reporting;

(4) *Process and responsibility framework.* A Federal credit union must maintain a written and schematic description (e.g., flow chart or organizational chart) of the derivatives management process in its derivatives policies and procedures. The description must include the roles of staff, qualified personnel, external service providers, senior executive officers, the board of directors, and any others involved in the derivatives program;

(5) *Separation of duties.* A Federal credit union's process, whether conducted internally or by an external service provider, must have appropriate separation of duties for the following functions defined in paragraph (a)(3) of this section:

(i) Asset/liability risk management;

(ii) Accounting and financial reporting;

(iii) Derivatives execution and oversight; and

(iv) Collateral, counterparty, and margining management.

(c) *Legal review.* A Federal credit union with derivatives authority must hire or engage legal counsel to reasonably ensure that all derivatives contracts adequately protect the legal and business interests of the Federal credit union. The Federal credit union's counsel must have legal expertise with derivatives contracts and related matters.

(d) *Policies and procedures.* A Federal credit union with derivatives authority must operate according to comprehensive written policies and procedures for control, measurement, and management of derivatives transactions. At a minimum, the policies and procedures must address the requirements of this subpart, except for those in §§ 703.108 through 703.114, and any additional limitations imposed by the Federal credit union's board of directors. A Federal credit union's board of directors must review the policies and procedures described in this section annually and update them when necessary.

§ 703.107 External service providers.

(a) *General.* A Federal credit union with derivatives authority may use external service providers to support or conduct aspects of its derivatives program, provided:

(1) The external service provider, including affiliates, does not:

(i) Act as a counterparty to any derivatives transactions that involve the Federal credit union;

(ii) Act as a principal or agent in any derivatives transactions that involve the Federal credit union; or

(iii) Have discretionary authority to execute any of the Federal credit union's derivatives transactions.

(2) The Federal credit union has the internal capacity, experience, and skills to oversee and manage any external service providers it uses; and

(3) The Federal credit union documents the specific uses of external service providers in its process and responsibility framework, as described in § 703.106(b)(1) of this subpart and the application.

(b) *Support functions.* A Federal credit union must perform the following functions internally and independently. A Federal credit union may have assistance and input from an external service provider, provided the external service provider does not conduct the following functions in lieu of the Federal credit union:

(1) Asset/liability risk management; and

(2) Liquidity risk management.

§ 703.108 Eligibility.

(a) A Federal credit union may apply for derivatives authority under this subpart if it meets the following criteria:

(1) The Federal credit union's most recent NCUA-assigned composite CAMEL code rating is 1, 2, or 3, with a management component of 1 or 2; and

(2) The Federal credit union has assets of at least $250 million as of its most recent call report.

(b) Notwithstanding paragraph (a)(2) of this section, a Federal credit union may request permission from the appropriate field director to apply for derivatives authority, subject to requirements imposed by the field director. If the field director grants such permission, the application will be subject to §§ 703.109 through 703.111.

§ 703.109 Applying for derivatives authority.

An eligible Federal credit union must receive written approval to use derivatives by submitting a detailed application, consistent with this subpart and any guidance issued by NCUA. A Federal credit union must submit its application to the applicable field director.

§ 703.110 Application content.

A Federal credit union applying for derivatives authority must document how it will comply with the requirements of this subpart and any guidance issued by NCUA, and must include all of the following in its application:

(a) An interest rate risk mitigation plan that shows how derivatives are one aspect of the Federal credit union's overall interest rate risk mitigation strategy, and an analysis showing how the Federal credit union will use derivatives in conjunction with other on-balance sheet instruments and strategies to effectively manage its interest rate risk;

(b) A list of the products and characteristics the Federal credit union

is seeking approval to use, a description of how it intends to use the products and characteristics listed, an analysis of how the products and characteristics fit within its interest rate risk mitigation plan, and a justification for each product and characteristic listed;

(c) Draft policies and procedures that the Federal credit union has prepared in accordance with § 703.106(d) of this subpart;

(d) How the Federal credit union plans to acquire, employ, and/or create the resources, policies, processes, systems, internal controls, modeling, experience, and competencies to meet the requirements of this subpart. This includes a description of how the Federal credit union will ensure that senior executive officers, board of directors, and personnel have the knowledge and experience in accordance with the requirements of this subpart;

(e) A description of how the Federal credit union intends to use external service providers as part of its derivatives program, and a list of the name(s) of and service(s) provided by the external service providers it intends to use;

(f) A description of how the Federal credit union will support the operations of margining and collateral; and

(g) A description of how the Federal credit union will comply with GAAP.

§ 703.111 NCUA approval.

(a) *Interim approval.* The field director will notify the Federal credit union in writing if the field director has approved or denied its application and, if applicable, the reason(s) for any denial. A Federal credit union approved for derivatives authority may not enter into any derivatives transactions until it receives final approval from NCUA under paragraph (c) of this section.

(b) *Notice of readiness.* A Federal credit union approved under paragraph (a) of this section must provide written notification to NCUA when it is ready to begin using derivatives.

(c) *Final approval.* NCUA will review every approved Federal credit union's derivatives program to ensure compliance with this subpart and evaluate the Federal credit union's implementation of the items in its application. This supervisory review may be conducted on site. After NCUA has completed its review, the field director will notify the Federal credit union in writing if the field director has granted final approval and the Federal credit union may begin entering into derivatives transactions. If applicable, the notification will include the reason(s) for any denial. A Federal credit union may not enter into any derivatives transactions under this subpart until it receives this determination from the applicable field director. At a field director's discretion, a Federal credit union may reapply under this subsection if the field director has determined that the Federal credit union has demonstrated compliance with this subpart and its application.

(d) *Right to appeal.* A Federal credit union may submit a written appeal to the NCUA Board within 60 days from the date of denial by NCUA under paragraph (b) or (c) of this section.

§ 703.112 Applying for additional products or characteristics.

(a) A Federal credit union with derivatives authority may subsequently apply for approval to use additional products and characteristics, described in § 703.102 of this subpart, that it did not request in its initial application, subject to the following:

(1) A Federal credit union must submit an application to NCUA;

(2) A Federal credit union's application must include a list of the products and/or characteristics for which it is applying; and

(3) A Federal credit union must include a justification for each product and/or characteristic requested in the application and an explanation of how the Federal credit union will use each product and/or characteristic requested.

(b) The field director will notify the Federal credit union in writing if the field director has approved or denied its application for additional products or characteristics. If applicable, the notification will include the reason(s) for denial.

(c) A Federal credit union may appeal any denial of an application for additional products and/or characteristics in accordance with § 703.111(d).

§ 703.113 Pilot program participants with active derivatives positions.

(a) A Federal credit union with outstanding derivatives positions under NCUA's derivatives pilot program as of January 1, 2013, must comply with the requirements of this subpart within 12 months of the effective date of this subpart, including the requirement to submit an application for derivatives authority. During the 12-month interim period, the Federal credit union may continue to operate its derivatives program in accordance with its pilot program terms and conditions.

(b) A Federal credit union with outstanding derivatives positions under NCUA's derivatives pilot program as of January 1, 2013, that does not comply with the requirements of this subpart within 12 months of the effective date of this subpart, or does not want to continue engaging in derivatives transactions, must:

(1) Stop entering into new derivatives transactions; and

(2) Within 30 days, present a corrective action plan to NCUA describing how the Federal credit union will cure any deficiencies or wind down its derivatives program.

§ 703.114 Regulatory violation.

(a) A Federal credit union with derivatives authority that no longer meets the requirements of this subpart or fails to comply with its approved strategy (including employing the resources, policies, procedures, accounting, and competencies that formed the basis for the approval) must:

(1) Immediately stop entering into any new derivatives transactions until the Federal credit union is in compliance with this subpart. During this period, however, the Federal credit union may terminate existing derivatives transactions. NCUA may permit a Federal credit union to enter into offsetting transactions if NCUA determines these transactions are part of a corrective action strategy.

(2) Within three business days from the regulatory violation, provide the appropriate field director notification of the regulatory violation, which must include a description of the violation and the immediate corrective action the Federal credit union is taking; and

(3) Within 15 business days after notifying the appropriate field director, submit a written corrective action plan to the appropriate field director.

(b) NCUA may revoke a Federal credit union's derivatives authority at any time if a Federal credit union fails to comply with the requirements of this subpart. Revocation will prohibit a Federal credit union from executing any new derivatives transactions under this subpart, and may require the Federal credit union to terminate existing derivatives transactions if, in the discretion of the applicable field director, doing so would not pose a safety and soundness concern.

(c) Within 60 days from the date of the related field director's action, a Federal credit union may appeal the following to the NCUA Board:

(1) NCUA's revocation of a Federal credit union's derivatives authority; and

(2) NCUA's order that a Federal credit union terminate existing derivatives positions.

(d) With respect to an appeal regarding revocation of a Federal credit

union's derivatives authority, the Federal credit union may not enter into any new derivatives transactions until the NCUA Board renders a final decision on the appeal. The Federal credit union may, however, elect to terminate existing derivatives positions. With respect to an appeal regarding an order to terminate a Federal credit union's existing derivatives positions, the Federal credit union is not required to terminate any existing positions until the NCUA Board renders a final decision on the appeal.

Appendix to Subpart B—Examples of Derivative Limit Authority Calculations

Limit authority. A Federal credit union that is approved for derivatives authority under § 703.111 may use any of the products and characteristics described in § 703.102(a), subject to the following position and risk limits:

TABLE 1—AUTHORITY LIMITS

Limit authority	Entry limits (first 12 months of transactions)	Standard limits
Fair Value Loss (See (a) below)	15% of net worth	25% of net worth.
Weighted Average Remaining Maturity Notional (WARMN) (See (b) below)	65% of net worth	100% of net worth.

(a) *Calculating the fair value loss limit for compliance with this subpart.* To demonstrate compliance with the fair value loss limit authority of this subpart, a Federal credit union must combine the total fair value (as defined by product group below) of all derivatives transactions. The fair value loss limit is exclusive to the derivatives positions (not net of offsetting gains and losses in the hedged item).

(1) The resulting figure, if a loss, must not exceed the Federal credit union's authorized fair value loss limit:

(i) *Options*—the gain or loss is the difference between the fair value and the unamortized premium at the reporting date;

(ii) *Swaps*—the gain or loss is the fair value at the reporting date; and

(iii) *Futures*—the gain or loss is the difference between the exchange closing price at the reporting date and the purchase or sales price.

(2) *Example calculations for compliance with this subpart: fair value loss limit.* The table below provides an example of the fair value loss limit calculations for a sample Federal credit union that has entry level authority. The sample Federal credit union has a net worth of $100 million and total assets of $1 billion; its fair value loss limit is −$15 million (15 percent of net worth).

TABLE 2—EXAMPLE FAIR VALUE LOSS CALCULATIONS

	Fair value gains (losses)				% of Net worth (percent)	Limit violation
	Options	Swaps	Futures	Total		
Scenario A	$1,000,000	$2,000,000	$200,000	$3,200,000	3	No.
Scenario B	5,000,000	10,000,000	2,000,000	17,000,000	17	No.
Scenario C	1,000,000	(3,000,000)	250,000	(1,750,000)	(2)	No.
Scenario D	1,000,000	(20,000,000)	(2,000,000)	(21,000,000)	(21)	Yes.
Scenario E	(2,000,000)	(10,000,000)	1,000,000	(11,000,000)	(11)	No.

(b) *Calculating the WARMN exposure for compliance with this subpart.* The WARMN calculation adjusts the gross notional of a derivative to take into account its price sensitivity and remaining maturity. The WARMN limit is correlated to the fair value loss limit, as described in paragraph (a) of this appendix, for a 300 basis point parallel shift in interest rates. To demonstrate compliance with the WARMN limit authority of this subpart, a Federal credit union must calculate the WARMN using the following reference table, definitions, and calculation steps:

TABLE 3—SUMMARY OF WARMN CALCULATION

Product	Step #1 gross notional	Adjustment factor (percent)	Step #2 adjusted notional	Step #3 WARM
Options (Caps)	Current notional	33	33% of current notional	Time remaining to maturity.
Options (Floors)	Current notional	33	33% of current notional	Time remaining to maturity.
Swaps	Current notional	100	100% of current notional	Time remaining to maturity.
Futures	Contract size	100	100% of contract size Sum = Total Adjusted Notional	Underlying contract. Sum = Overall WARM
Step #4 WARMN = Adjusted Notional x (WARM/10)				

(1) *Step #1—Calculate the gross notional of all outstanding derivative transactions.* (i) For options and swaps, all gross notional amounts must be absolute, with no netting (i.e., offsetting a pay-fixed transaction with a receive-fixed transaction). The gross notional for derivatives transactions with amortizing notional amounts is the current contracted notional amount, in accordance with the amortization schedule.

(ii) For futures, the gross notional is the underlying contract size as designated by the Chicago Mercantile Exchange (CME) product specifications (e.g., a five-year Treasury note futures contract will use $100,000 for each contract purchased or sold and reported here on a gross basis for limit purposes.)

(2) *Step #2—Convert each gross notional by its derivative adjustment factor to produce an adjusted gross notional.* The derivative adjustment factor approximates the price sensitivity for each of the product groups in order to weight the notional amount by sensitivity before weighting for maturity.

(i) For cap and floor options, the derivative adjustment factor is 33 percent. For example, an interest rate cap with a $1 million notional amount has an adjusted gross notional of $330,000 ($1,000,000 × 0.33 = $330,000).

(ii) For interest rate swaps and Treasury futures, the derivative adjustment factor is 100 percent. For example, an interest rate swap with a $1 million notional amount has an adjusted gross notional of $1,000,000 ($1,000,000 × 1.00 = $1,000,000).

(iii) The total adjusted notional for all derivatives positions is the sum of (i) and (ii) above.

(3) *Step #3—Produce the weighted average remaining time to maturity (WARM) for all derivatives positions.* (i) For interest rate caps, interest rate floors, and interest rate swaps, the remaining maturity is the time left between the reporting date and the contracted maturity date, expressed in years (round up to two decimals);

(ii) For Treasury futures, the remaining maturity is the underlying deliverable Treasury note's maximum maturity (e.g., a five-year Treasury note future has a five-year remaining maturity); and

(iii) Determine the WARM using the adjusted gross notional, as set forth in subsection (2) of this section, and the remaining time to maturity as defined for each product group above in paragraphs (b)(3)(i) and (ii) of this appendix.

(4) *Step #4—Produce the WARMN by converting the WARM to a percentage and then multiplying the percentage by the total adjusted gross notional.* (i) Divide the WARM, as calculated in paragraph (b)(3) of this appendix, by ten to convert it to a percentage (e.g., 7.75 WARMN is translated to 77.5 percent); and

(ii) Multiply the WARM converted to a percentage, as described in paragraph (c)(4)(i) of this appendix, by total adjusted gross notional, described in paragraph (c)(2) of this appendix.

(5) *Compare WARMN calculation to the WARNM limit for compliance.* The total in step four (4) must be less than the limit in paragraph (a)(1)(ii) or (a)(2)(ii) of this appendix, as applicable.

(6) *Example calculations for compliance with this subpart: WARMN.* The table below provides an illustrative example of the WARMN limit calculations for a sample Federal credit union that has entry level authority. The sample Federal credit union has a net worth of $100 million and total assets of $1 billion; its notional limit authority is $65 million (65 percent of net worth).

TABLE 4—EXAMPLE WARMN LIMIT CALCULATION

	Options	Swaps	Futures	Total
Gross Notional (Step #1)	$100,000,000	$50,000,000	$5,000,000	$155,000,000
Adjustment Factor	33%	100%	100%	.....
Adjusted Notional (Step #2)	$33,000,000	$50,000,000	$5,000,000	$88,000,000
Weighted Average Remaining Maturity (WARM) (Step #3)	7.00	8.50	5.00	7.74
		Weighted Average Remaining Maturity Notional (WARMN) (Step #4):		[1] $68,100,000
		Notional Limit Authority (65% of net worth)		$65,000,000
		Under/(Over) Notional Limit Authority		($3,100,000)

[1] (77.4% of Step #3.)

PART 715—SUPERVISORY COMMITTEE AUDITS AND VERIFICATIONS

■ 7. The authority citation for part 715 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), and 1781–1790; 31 U.S.C. 3717.

■ 8. In § 715.5, revise paragraph (a) to read as follows:

§ 715.5 Audit of Federal Credit Unions.

(a) Total assets of $500 million or greater. To fulfill its Supervisory Committee audit responsibility, a Federal credit union having total assets of $500 million or greater, except as provided in § 703.106(b)(3) of this chapter, must obtain an annual audit of its financial statements performed in accordance with Generally Accepted Auditing Standards by an independent person who is licensed to do so by the State or jurisdiction in which the credit union is principally located.

* * * * *

PART 741—REQUIREMENTS FOR INSURANCE

■ 9. The authority citation for part 741 is revised to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), 1781–1790, and 1790d; 31 U.S.C. 3717.

■ 10. Revise § 741.219 to read as follows:

§ 741.219 Investment requirements.

(a) Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 703 of this chapter concerning transacting business with corporate credit unions.

(b) Any credit union which is insured pursuant to Title II of the Act must notify the applicable NCUA Regional Director or the Director of the Office of National Examinations and Supervision in writing at least 30 days before it begins engaging in derivatives.

[FR Doc. 2014–01703 Filed 1–30–14; 8:45 am]

BILLING CODE 7535–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2013–0501; Directorate Identifier 2011–SW–036–AD; Amendment 39–17732; AD 2014–02–04]

RIN 2120–AA64

Airworthiness Directives; Eurocopter France Helicopters

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: We are adopting a new airworthiness directive (AD) for Eurocopter France (Eurocopter) Model EC 155B and EC155B1 helicopters. This AD requires repetitively inspecting the lower and upper front and rear fittings (fittings) that attach the upper fin to the fenestron for a crack and, if there is a crack, removing all four fittings from service. This AD also requires, within a specified time, removing all fittings from service, and the fittings would not be eligible to be installed on any

helicopter. This AD was prompted by the loss of an upper fin in flight. The actions of this AD are intended to detect a crack in the fittings to prevent loss of the upper fin and subsequent loss of control of the helicopter.

DATES: This AD is effective March 7, 2014.

The Director of the Federal Register approved the incorporation by reference of a certain document listed in this AD as of March 7, 2014.

ADDRESSES: For service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub*. You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the European Aviation Safety Agency (EASA) AD, any incorporated-by-reference service information, the economic evaluation, any comments received, and other information. The street address for the Docket Operations Office (phone: 800–647–5527) is U.S. Department of Transportation, Docket Operations Office, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

FOR FURTHER INFORMATION CONTACT: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov*.

SUPPLEMENTARY INFORMATION:

Discussion

On June 11, 2013, at 78 FR 34960, the **Federal Register** published our notice of proposed rulemaking (NPRM), which proposed to amend 14 CFR part 39 to include an AD that would apply to Model EC 155B and EC155B1 helicopters. The NPRM proposed inspecting certain part-numbered fittings for a crack and, if there is a crack, removing the fittings from service before further flight. Also, the NPRM proposed removing certain part-numbered fittings from service within 180 hours time-in-service (TIS) and prohibiting the fittings from being eligible for installation on any helicopter. The proposed requirements were intended to detect a crack in the fittings to prevent loss of the upper fin and subsequent loss of control of the helicopter.

The NPRM was prompted by AD No. 2011–0108, dated June 7, 2011, issued by EASA, which is the Technical Agent for the Member States of the European Union, to correct an unsafe condition for Eurocopter Model EC 155B and EC155B1 helicopters. EASA advises of an in-flight loss of a fin on a Model EC155B1 helicopter. According to EASA, a crack in the fittings attaching the upper fin to the fenestron (tail rotor assembly) was discovered during an investigation. As a result, EASA issued an emergency AD to mandate repetitive inspections of the upper fin attachment fittings. EASA states that Eurocopter developed modification (MOD) 0754B40 to increase the strength of the fuselage-fin junction fittings by installing two reinforced single-piece fittings to replace the affected fittings, which is terminating action for the repetitive inspection requirements. EASA subsequently issued AD No. 2011–0108, which superseded its emergency AD, to require installation of MOD 0754B40 and to retain the repetitive inspection requirements until the MOD is installed.

Comments

We gave the public the opportunity to participate in developing this AD, but we did not receive any comments on the NPRM (78 FR 34960, June 11, 2013).

FAA's Determination

These helicopters have been approved by the aviation authority of France and are approved for operation in the United States. Pursuant to our bilateral agreement with France, EASA, its technical representative, has notified us of the unsafe condition described in the EASA AD. We are issuing this AD because we evaluated all information provided by EASA and determined the unsafe condition exists and is likely to exist or develop on other helicopters of these same type designs and that air safety and the public interest require adopting the AD requirements as proposed.

Differences Between this AD and the EASA AD

This AD does not require replacing the upper fin to fenestron fittings with reinforced fittings in accordance with MOD 0754B40 within 6 calendar months as stated in the EASA AD, but rather requires removing the affected fittings from service within the equivalent 180 hours TIS.

Related Service Information

Eurocopter has issued Emergency Alert Service Bulletin No. 05A017, Revision 2, dated December 9, 2010, which specifies repetitively inspecting the fittings for a crack and replacing each fitting if there is a crack. Eurocopter has also issued Service Bulletin No. 53–029, Revision 1, dated March 10, 2011, which specifies replacing the fittings with reinforced fittings in accordance with MOD 0754B40.

Costs of Compliance

We estimate that this AD will affect 9 helicopters of U.S. Registry. We estimate that operators will incur the following costs in order to comply with this AD based on an average labor rate of $85 per work hour. It will take 1 work hour to inspect the fittings and about 3 inspections before replacement. It will take 8 work hours to replace the fittings, and required parts will cost $3,311. Based on these figures, the total cost will be $4,246 per helicopter and $38,214 for the U.S. fleet.

Authority for this Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. Subtitle VII: Aviation Programs, describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in Subtitle VII, Part A, Subpart III, Section 44701: ''General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on helicopters identified in this rulemaking action.

Regulatory Findings

This AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify that this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866;

(2) Is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);

(3) Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

2014–02–04 Eurocopter France Helicopters: Amendment 39–17732; Docket No. FAA–2013–0501; Directorate Identifier 2011–SW–036–AD.

(a) Applicability

This AD applies to Model EC 155B and EC155B1 helicopters with lower front fitting part number (P/N) 365A23–4240–01, upper front fitting P/N 365A23–4242–01, lower rear fitting P/N 365A23–4241–01, or upper rear fitting P/N 365A23–4243–01 (fittings), installed, certificated in any category.

(b) Unsafe Condition

This AD defines the unsafe condition as a crack in a fitting. This condition could result in loss of the upper fin during flight and subsequent loss of control of the helicopter.

(c) Effective Date

This AD becomes effective March 7, 2014.

(d) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(e) Required Actions

(1) Within 15 hours time-in-service (TIS) and thereafter at intervals not to exceed 55 hours TIS:

(i) Using an appropriate light source and a 10x or higher power magnifying glass, inspect each front (item c) and rear (item d) upper fitting and each front (item e) and rear (item f) lower fitting for a crack as depicted in Detail A of Figure 1 of Eurocopter Emergency Alert Service Bulletin No. 05A017, Revision 2, dated December 9, 2010 (ASB). Inspect the hatched area as depicted in Details B, C, and D of Figure 2 of the ASB. A high-resolution (more than 2 million pixels) digital camera or dye-penetrant inspection may be used to facilitate the crack inspection.

(ii) If there is a crack in any fitting, before further flight, remove all four fittings from service.

(2) Within 180 hours TIS, remove the fittings from service.

(3) Do not install lower front fitting P/N 365A23–4240–01, upper front fitting P/N 365A23–4242–01, lower rear fitting P/N 365A23–4241–01, and upper rear fitting P/N 365A23–4243–01 on any helicopter.

(f) Credit for Actions Previously Completed

Inspections accomplished before the effective date of this AD in accordance with the procedures specified in Eurocopter Emergency Alert Service Bulletin No. 05A017, Revision 2, dated December 9, 2010; Revision 1, dated January 27, 2010; and Revision 0, dated September 28, 2007, are considered acceptable for compliance with the initial inspection specified in paragraph (e)(1) of this AD.

(g) Special flight permits

Special flight permits will not be issued.

(h) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office, before operating any aircraft complying with this AD through an AMOC.

(i) Additional Information

(1) Eurocopter Service Bulletin No. 53–029, Revision 1, dated March 10, 2011, which is not incorporated by reference, contains additional information about the subject of this AD. For service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

(2) The subject of this AD is addressed in European Aviation Safety Agency AD No. 2011–0108, dated June 7, 2011, which can be found in Docket No. FAA–2013–0501 on the Internet at *http://www.regulations.gov.*

(j) Subject

Joint Aircraft Service Component (JASC) Code: 5530 Vertical Stabilizer Structure.

(k) Material Incorporated by Reference

(1) The Director of the Federal Register approved the incorporation by reference (IBR) of the service information listed in this paragraph under 5 U.S.C. 552(a) and 1 CFR part 51.

(2) You must use this service information as applicable to do the actions required by this AD, unless the AD specifies otherwise.

(i) Eurocopter Emergency Alert Service Bulletin No. 05A017, Revision 2, dated December 9, 2010.

(ii) Reserved.

(3) For Eurocopter service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub.*

(4) You may view this service information at FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137. For information on the availability of this material at the FAA, call (817) 222–5110.

(5) You may view this service information that is incorporated by reference at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call (202) 741–6030, or go to: *http://www.archives.gov/federal-register/cfr/ibr-locations.html.*

Issued in Fort Worth, Texas, on January 16, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01461 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2013–0525; Directorate Identifier 2011–SW–063–AD; Amendment 39–17730; AD 2014–02–02]

RIN 2120–AA64

Airworthiness Directives; Bell Helicopter Textron Canada Limited (Bell) Helicopters

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: We are adopting a new airworthiness directive (AD) for Bell Model 206L, L–1, L–3, and L–4 helicopters. This AD requires measuring each main rotor (M/R) blade spar space to determine whether it is oversized and reidentifying the M/R blade and

reducing the life limit of the blade if the spar spacer is oversized. This AD was prompted by the manufacture of certain blades with an oversized spar spacer and the determination to reduce the life limits of those blades. The actions of this AD are intended to prevent failure of an M/R blade and subsequent loss of control of the helicopter.

DATES: This AD is effective March 7, 2014.

The Director of the **Federal Register** approved the incorporation by reference of a certain document listed in this AD as of March 7, 2014.

ADDRESSES: For service information identified in this AD, contact Bell Helicopter Textron Canada Limited, 12,800 Rue de l'Avenir, Mirabel, Quebec J7J1R4; telephone (450) 437–2862 or (800) 363–8023; fax (450) 433–0272; or at *http://www.bellcustomer.com/files/.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the Transport Canada Civil Aviation (TCCA) AD, any incorporated-by-reference service information, the economic evaluation, any comments received, and other information. The street address for the Docket Operations Office (phone: 800–647–5527) is U.S. Department of Transportation, Docket Operations Office, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

FOR FURTHER INFORMATION CONTACT: Sharon Miles, Aerospace Engineer, FAA, Rotorcraft Directorate, Regulations and Policy Group, 2601 Meacham Blvd., Fort Worth, Texas 76137, telephone (817) 222–5110, email *sharon.y.miles@faa.gov.*

SUPPLEMENTARY INFORMATION:

Discussion

On June 20, 2013, at 78 FR 37152, the **Federal Register** published our notice of proposed rulemaking (NPRM), which proposed to amend 14 CFR part 39 by adding an AD that would apply to Bell Model 206L, L–1, L–3, and L–4 helicopters. The NPRM proposed measuring the M/R blade spar spacer. If a blade is fitted with an oversized spacer, the NPRM proposed reidentifying the blade, reducing the life limit for the blade from 3,600 hours time-in-service (TIS) to 2,300 hours TIS, and making an entry on the component history card or equivalent record. The proposed requirements were intended to prevent failure of an M/R blade and subsequent loss of control of the helicopter.

The NPRM was prompted by AD No. CF–2011–43, dated November 10, 2011, issued by TCCA, which is the aviation authority for Canada, to correct an unsafe condition for Bell Model 206L, L–1, L–3, and L–4 helicopters. TCCA advises that, during manufacturing, some M/R blades were inadvertently fitted with oversized spar spacers, which reduces the life of the blades from 3600 to 2300 hours ''air time.'' As a result, TCCA has mandated procedures to reidentify blades that have oversized spar spacers with new part numbers and reduce the life limit for such blades.

Comments

After our NPRM (78 FR 37152, June 30, 2013), was published, we received comments from one commenter.

Request

The one commenter stated that Bell has released Revision A of Alert Service Bulletin (ASB) No. 206L–09–163, dated April 19, 2012, and requested that both the original ASB and Revision A be included in the final AD.

We agree that the AD should reference Revision A of the ASB. This revision only updates Bell's warranty information and does not change the technical aspects or the corrective actions. Thus, performing the actions in either the original ASB or Revision A before the effective date of this AD would constitute prior compliance with this AD.

FAA's Determination

These helicopters have been approved by TCCA and are approved for operation in the United States. Pursuant to our bilateral agreement with Canada, TCCA, its technical representative, has notified us of the unsafe condition described in the TCCA AD. We are issuing this AD because we evaluated all information provided by TCCA, reviewed the relevant information, considered the comment received, and determined the unsafe condition exists and is likely to exist or develop on other helicopters of these same type designs and that air safety and the public interest require adopting the AD requirements as proposed with the change previously described. Also, under paragraph (f) of the NPRM, the TCCA AD is incorrectly referenced as No. ''CF–2011–41.'' We have corrected paragraph (f) in this AD to correctly identify the TCCA AD as ''CF–2011–43.'' These changes are consistent with the intent of the proposals in the NPRM and will not increase the economic burden on any operator nor increase the scope of this AD.

Differences Between this AD and the TCCA AD

TCCA requires compliance time within 100 hours air time or 30 days. This AD requires compliance within 100 hours TIS.

Related Service Information

Bell issued ASB No. 206L–09–163, dated November 13, 2009, which specifies inspecting certain M/R blades for oversized spar spacers and reidentifying and reducing the life limit of any blade with an oversized spar spacer from 3600 to 2300 flight hours. On April 19, 2012, Bell issued ASB No. 206L–09–163, Revision A, dated April 19, 2012, to update the warranty information.

Costs of Compliance

We estimate that this AD will affect 688 helicopters of U.S. Registry.

We estimate that operators may incur the following costs in order to comply with this AD. It will take about 2.5 work hours to measure the spar spacer and reidentify the blade at $85 per work hour for a total cost of $213 per helicopter.

According to Bell's service information some of the costs of this AD may be covered under warranty, thereby reducing the cost to affected individuals. We do not control warranty coverage by Bell. Accordingly, we have included all costs in our cost estimate.

Authority for this Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. Subtitle VII: Aviation Programs, describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in Subtitle VII, Part A, Subpart III, Section 44701: ''General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on

helicopters identified in this rulemaking action.

Regulatory Findings

This AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify that this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866;

(2) Is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);

(3) Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

2014–02–02 Bell Helicopter Textron Canada Limited: Amendment 39–17730; Docket No. FAA–2013–0525; Directorate Identifier 2011–SW–063–AD.

(a) Applicability

This AD applies to Model 206L, L–1, L–3, and L–4 helicopters with a main rotor (M/R) blade, part number (P/N) 206–015–001–115, –117, –119, or –121, with a serial number (S/N) listed in Table 1 or 2 of Bell Helicopter Alert Service Bulletin [No. 206L–09–163, Revision A, dated April 19, 2012 (ASB), certificated in any category.

(b) Unsafe Condition

This AD defines the unsafe condition as the manufacture of an M/R blade with an oversized spar spacer. This condition could result in failure of an M/R blade and subsequent loss of control of the helicopter.

(c) Effective Date

This AD becomes effective March 7, 2014.

(d) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(e) Actions Required

Within 100 hours time-in-service (TIS):

(1) For each M/R blade with an S/N listed in Table 1 of the ASB, measure the M/R blade spar spacer by following the Accomplishment Instructions, Part II A), paragraphs 1 through 3, of the ASB. If the spar spacer measures more than 1.018 inches (25.86 millimeters), reidentify the blade by following Part II A, paragraph 5.a. and Table 3, of the ASB.

(2) For each M/R blade with an S/N listed in Table 2 of the ASB, measure the M/R blade spar spacer by following the Accomplishment Instructions, Part II B, paragraphs 1 through 3, of the ASB. If the spar spacer measures more than 1.018 inches (25.86 millimeters), reidentify the blade by following Part II B, paragraph 5 and Table 4, of the ASB.

(3) For each reidentified blade, reduce the life limit from 3,600 hours TIS to 2,300 hours TIS, and make an entry on the component history card or equivalent record.

(4) Before further flight, remove any blade that exceeds the new retirement life of 2,300 hours TIS.

(f) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Sharon Miles, Aerospace Engineer, FAA, Rotorcraft Directorate, Regulations and Policy Group, 2601 Meacham Blvd., Fort Worth, Texas 76137, telephone (817) 222–5110, email *sharon.y.miles@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office before operating any aircraft complying with this AD through an AMOC.

(g) Additional Information

The subject of this AD is addressed in Transport Canada Civil Aviation (TCCA) AD CF–2011–43, dated November 10, 2011. You may view the TCCA AD on the internet at *http://www.regulations.gov* in Docket No. FAA–2013–0525.

(h) Subject

Joint Aircraft Service Component (JASC) Code: 6210 Main Rotor Blades.

(i) Material Incorporated by Reference

(1) The Director of the **Federal Register** approved the incorporation by reference (IBR) of the service information listed in this paragraph under 5 U.S.C. 552(a) and 1 CFR part 51.

(2) You must use this service information as applicable to do the actions required by this AD, unless the AD specifies otherwise.

(i) Bell Helicopter Alert Service Bulletin No. 206L–09–163, Revision A, dated April 19, 2012.

(ii) Reserved.

(3) For Bell Helicopter service information identified in this AD, contact Bell Helicopter Textron Canada Limited, 12,800 Rue de l'Avenir, Mirabel, Quebec J7J1R4; telephone (450) 437–2862 or (800) 363–8023; fax (450) 433–0272; or at *http://www.bellcustomer.com/files/.*

(4) You may view this service information at FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137. For information on the availability of this material at the FAA, call (817) 222–5110.

(5) You may view this service information that is incorporated by reference at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call (202) 741–6030, or go to: *http://www.archives.gov/federal-register/cfr/ibr-locations.html.*

Issued in Fort Worth, Texas, on January 15, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01466 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2013–0679; Directorate Identifier 2009–SW–015–AD; Amendment 39–17733; AD 2014–02–05]

RIN 2120–AA64

Airworthiness Directives; Eurocopter France (Eurocopter) Helicopters

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: We are adopting a new airworthiness directive (AD) for Eurocopter Model AS350B, AS350BA, AS350B1, AS350B2, AS350B3, AS350C, AS350D, and AS350D1 helicopters. This AD requires measuring the distance between the end of the main rotor collective pitch lever (collective) locking stud (locking stud) and the locking strip and repairing the locking stud if the clearance is insufficient. This

AD was prompted by a report that insufficient distance between the locking stud and the locking strip may cause the collective to become inadvertently locked in the low pitch (low) position. The actions of this AD are intended to prevent the collective from becoming inadvertently locked in the low position and subsequent loss of control of the helicopter.

DATES: This AD is effective March 7, 2014.

The Director of the Federal Register approved the incorporation by reference of a certain document listed in this AD as of March 7, 2014.

ADDRESSES: For service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

Examining the AD Docket

You may examine the AD docket on the Internet at http://www.regulations.gov or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the foreign authority's AD, any incorporated-by-reference service information, the economic evaluation, any comments received, and other information. The street address for the Docket Operations Office (phone: 800–647–5527) is U.S. Department of Transportation, Docket Operations Office, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

FOR FURTHER INFORMATION CONTACT: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov.*

SUPPLEMENTARY INFORMATION:

Discussion

On August 5, 2013, at 78 FR 47230, the **Federal Register** published our notice of proposed rulemaking (NPRM), which proposed to amend 14 CFR part 39 by adding an AD that would apply to Eurocopter Model AS350B, AS350BA, AS350B1, AS350B2, AS350B3, AS350C, AS350D, and AS350D1 helicopters. The NPRM proposed to require measuring the distance between the end of the collective locking stud and the locking strip and repairing the locking stud if the clearance is insufficient. The proposed requirements were intended to prevent the collective from becoming inadvertently locked in the low position and subsequent loss of control of the helicopter.

The NPRM was prompted by AD No. 2009–0019, dated February 3, 2009, issued by the European Aviation Safety Agency (EASA), which is the Technical Agent for the Member States of the European Union, to correct an unsafe condition for the Eurocopter Model AS350 helicopters. EASA advises that the clearance between the collective locking stud and the locking strip may be insufficient when the collective is positioned in the low pitch stop. During an autorotation test flight, the collective rubbed against the locking strip in the low pitch position. The rubbing was due to inadequate clearance and could result in the collective being inadvertently locked in the low pitch position.

Comments

We gave the public the opportunity to participate in developing this AD, but we did not receive any comments on the NPRM (78 FR 47230, August 5, 2013).

FAA's Determination

These helicopters have been approved by the aviation authority of France and are approved for operation in the United States. Pursuant to our bilateral agreement with France, EASA, its technical representative, has notified us of the unsafe condition described in the EASA AD. We are issuing this AD because we evaluated all information provided by EASA and determined the unsafe condition exists and is likely to exist or develop on other helicopters of these same type designs and that air safety and the public interest require adopting the AD requirements as proposed.

Differences Between This AD and the EASA AD

The EASA AD does not apply to Model AS350C or AS350D1 helicopters, and this AD applies to these models because they have a similarly-designed collective pitch lock. The EASA AD applies to the Model AS350BB, and this AD does not because that model does not have a U.S. type certificate. This AD requires an initial inspection within 100 hours time-in-service, while the EASA AD requires this inspection ''after the last flight of the day.''

Related Service Information

Eurocopter issued Service Bulletin No. 67.00.37, Revision 2, dated December 2, 2008, originally issued on September 27, 2007, and also identified as modification (MOD) 073237, which contains procedures for replacing the locking stud on the collective levers with a new locking stud with higher wear resistance. The new locking stud is longer than the previous one and has reduced the distance between the locking stud and the locking strip. In some cases, the reduced distance is insufficient when the collective is positioned in the low pitch position causing the collective to lock in that position. As a result, Eurocopter has issued one Emergency Alert Service Bulletin (EASB), Revision 0, dated January 12, 2008, with two numbers. EASB No. 05.00.58 is for civil Model AS350B, BA, BB, B1, B2, B3, and D helicopters and military Model AS350L1 helicopters. EASB No. 05.00.35 is for military Model AS550A2, C2, C3, and U2 helicopters. The EASB specifies measuring to ensure a required minimum distance between the locking stud and the locking strip and specifies a repair solution in case the distance is insufficient. As a precaution, Eurocopter extended the measure and repair to helicopters with locking studs before MOD 073237. Eurocopter also revised Service Bulletin No. 67.00.37 to include these procedures.

Costs of Compliance

We estimate that this AD will affect 651 helicopters of U.S. Registry. We estimate that operators may incur the following costs to comply with this AD. We estimate 1 work hour to measure the clearance and repair the locking stud and locking strip at $85 per work hour. Required parts will cost $95 per helicopter. Based on these estimates, the total cost per helicopter will be $180, and the total cost for the fleet will be $117,180.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. Subtitle VII: Aviation Programs, describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in Subtitle VII, Part A, Subpart III, Section 44701: ''General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority

because it addresses an unsafe condition that is likely to exist or develop on helicopters identified in this rulemaking action.

Regulatory Findings

This AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify that this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866;

(2) Is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);

(3) Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

2014–02–05 Eurocopter France Helicopters: Amendment 39–17733; Docket No. FAA–2013–0679; Directorate Identifier 2009–SW–015–AD.

(a) Applicability

This AD applies to Eurocopter Model AS350B, AS350BA, AS350B1, AS350B2, AS350B3, AS350C, AS350D, and AS350D1 helicopters, certificated in any category, without modification (MOD) 073175 installed; with MOD 073237 installed in accordance with Eurocopter Service Bulletin No. 67.00.37, Revision 0, dated September 27, 2007, or Revision 1, dated February 6, 2008; or with one of the following serial numbers: 3972, 3973, 3982, 3987, 4003, 4023, 4046, 4050, 4086, 4120, 4122, 4132, 4143, 4152, 4172, 4194, 4259, 4314, 4324, 4378, 4392, 4447, 4452, 4477, 4489, 4490, 4501, 4523, 4546, 4560, 4589, 4594, 4599, 4632, 4659, 4666, or 4671.

(b) Unsafe Condition

This AD defines the unsafe condition as the main rotor collective pitch lever (collective) locking stud (locking stud) inadvertently locking in the low pitch (low) position, which could result in subsequent loss of control of the helicopter.

(c) Effective Date

This AD becomes effective March 7, 2014.

(d) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(e) Required Actions

(1) For helicopters with MOD 073237 installed, within 100 hours time-in-service (TIS):

(i) With the collective (item b) in the low position but not locked on the locking strip (item a), measure the distance between the end of the locking stud (item c) and the locking strip as indicated by dimension ''J'' in Figure 2 of Eurocopter Emergency Alert Service Bulletin No. 05.00.58, Revision 0, dated January 12, 2008 (EASB 05.00.58).

(ii) If the distance between the end of the locking stud and the locking strip is equal to or more than 3 millimeters (mm), no further action is required.

(iii) If the distance between the end of the locking stud and the locking strip is less than 3 mm and MOD 073175 is not installed, inspect to determine whether the grommet in the locking strip is seated against the console as shown in Figure 2 of EASB 05.00.58.

(A) If the grommet is not seated against the console, restore the original profile of the locking strip by doing the following:

(*1*) Clamp the locking strip in a vice with soft jaws and apply load progressively to the locking strip to restore the original profile of the locking strip.

(*2*) With the collective in the low position but not locked on the locking strip, measure the distance between the end of the locking stud and the locking strip as indicated by dimension ''J'' in Figure 2 of EASB 05.00.58.

(*3*) If the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm, no further action is required.

(*4*) If the distance between the end of the locking stud and the locking strip is less than 3 mm, adjust the length of the locking stud and re-identify the locking stud by following the Accomplishment Instructions, paragraph 2.B.2.c., of EASB 05.00.58, except you are not required to comply with paragraph 2.B.4 of EASB 05.00.58.

(B) If the grommet is seated against the console, adjust the length of the locking stud and re-identify the locking stud by following the Accomplishment Instructions, paragraph 2.B.2.c, of EASB 05.00.58, except you are not required to comply with paragraph 2.B.4 of EASB 05.00.58.

(iv) If the distance between the end of the locking stud and the locking strip is less than 3 mm and MOD 073175 is installed, adjust the length of the locking stud and re-identify the locking stud by following the Accomplishment Instructions, paragraph 2.B.2.c., of EASB 05.00.58, except you are not required to comply with paragraph 2.B.4 of EASB 05.00.58.

(v) After adjusting the length of the locking stud in accordance with paragraph 2.B.2.c of the EASB, determine whether the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm.

(A) If the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm, no further action is required.

(B) If the distance between the end of the locking stud and the locking strip is less than 3 mm, do not approve the helicopter for return to service until the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm.

(2) For helicopters without MOD 073237 installed, within 100 hours TIS:

(i) With the collective in the low position but not locked on the locking strip, measure the distance between the end of the locking stud and the locking strip as indicated by dimension ''J' in Figure 2 of EASB 05.00.58.

(ii) If the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm, no further action is needed.

(iii) If the distance between the end of the locking stud and the locking strip is less than 3 mm and MOD 073175 is not installed, inspect to determine whether the grommet in the locking strip is seated against the console as shown in Figure 2 of EASB 05.00.58.

(A) If the grommet is not seated against the console, restore the original profile of the locking strip by doing the following:

(*1*) Clamp the locking strip in a vice with soft jaws and apply load progressively to the locking strip.

(*2*) With the collective in the low position but not locked on the locking strip, measure the distance between the end of the locking stud and the locking strip as indicated by dimension ''J'' in Figure 2 of the EASB 05.00.58.

(*3*) If the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm, no further action is required.

(*4*) If the distance between the end of the locking stud and the locking strip is less than 3 mm, do not approve the helicopter for return to service until the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm.

(B) If the grommet is seated against the console, do not approve the helicopter for return to service until the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm.

(iv) If the distance between the end of the locking stud and the locking strip is less than 3 mm and MOD 073175 is installed, do not approve the helicopter for return to service until the distance between the end of the locking stud and the locking strip is equal to or more than 3 mm.

(3) Repeat the measurement requirement in paragraphs (e)(1) or (e)(2) of this AD as applicable to your helicopter each time the collective, locking stud, or locking strip is replaced; each time the locking strip setting is readjusted; or at intervals not exceeding 660 hours TIS or 2 years, whichever occurs first.

(f) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov*.

(2) For operations conducted under 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office before operating any aircraft complying with this AD through an AMOC.

(g) Additional Information

(1) Eurocopter Service Bulletin (SB) No. 67.00.21, Revision 1, dated June 21, 2006, and SB No. 67.00.37, Revision 2, dated December 2, 2008, which are not incorporated by reference, contain additional information about the subject of this AD. For service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub*. You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

(2) The subject of this AD is addressed in European Aviation Safety Agency (EASA) AD No. 2009–0019, dated February 3, 2009. You may view the EASA AD on the Internet at *http://www.regulations.gov* in Docket No. FAA–2013–0679.

(h) Subject

Joint Aircraft Service Component (JASC) Code: 6710 Main Rotor Control.

(i) Material Incorporated by Reference

(1) The Director of the Federal Register approved the incorporation by reference (IBR) of the service information listed in this paragraph under 5 U.S.C. 552(a) and 1 CFR part 51.

(2) You must use this service information as applicable to do the actions required by this AD, unless the AD specifies otherwise.

(i) Eurocopter Emergency Alert Service Bulletin No. 05.00.58, Revision 0, dated January 12, 2008.

(ii) Reserved.

Note 1 to paragraph (i)(2): Eurocopter Emergency Alert Service Bulletin (EASB) No. 05.00.58, Revision 0, dated January 12, 2008, is co-published in one document with Eurocopter EASB No. 05.00.35, Revision 0, dated January 12, 2008, which is not incorporated by reference in this AD.

(3) For Eurocopter service information identified in this AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775.

(4) You may view this service information at FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137. For information on the availability of this material at the FAA, call (817) 222–5110.

(5) You may view this service information that is incorporated by reference at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call (202) 741–6030, or go to: *http://www.archives.gov/federal-register/cfr/ibr-locations.html*.

Issued in Fort Worth, Texas, on January 16, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01467 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2013–0611; Directorate Identifier 2013–CE–019–AD; Amendment 39–17731; AD 2014–02–03]

RIN 2120–AA64

Airworthiness Directives; Beechcraft Corporation Airplanes

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: We are superseding Airworthiness Directive (AD) 2011–27–51 for certain Beechcraft Corporation Models 1900, 1900C, and 1900D airplanes. AD 2011–27–51 required inspecting the elevator bob-weight and attaching linkage for correct installation and for damage or deformation to the weight and/or weight bracket with corrective action as necessary. This AD requires installation of the secondary elevator bob-weight stop bolt. The elevator bob-weight (stabilizer weight) traveling past its stop bolt may allow the attaching linkage to move over-center and lead to reduced nose down elevator control. We are issuing this AD to correct the unsafe condition on these products.

DATES: This AD is effective March 7, 2014.

The Director of the Federal Register approved the incorporation by reference of a certain publication listed in this AD as of March 7, 2014.

The Director of the Federal Register approved the incorporation by reference of a certain other publication listed in this AD as of January 18, 2012 (77 FR 2439, January 18, 2012).

ADDRESSES: For service information identified in this AD, contact Beechcraft Corporation at P.O. Box 85, Wichita, Kansas 67201–0085; telephone: (800) 429–5372 or (316) 676–3140; Internet: *http://www.beechcraft.com*. Beechcraft Corporation publishes service information for the Beechcraft Corporation airplanes affected by this AD action. You may review copies of the referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* by searching for and locating Docket No. FAA–2013–0611; or in person at the Docket Management Facility between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the regulatory evaluation, any comments received, and other information. The address for the Docket Office (phone: 800–647–5527) is Document Management Facility, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

FOR FURTHER INFORMATION CONTACT: Don Ristow, Aerospace Engineer, Wichita Aircraft Certification Office, FAA, 1801 Airport Road, Room 100, Wichita, Kansas 67209; telephone: (316) 946–4120; fax: (316) 946–4107; email: *donald.ristow@faa.gov*.

SUPPLEMENTARY INFORMATION:

Discussion

We issued a notice of proposed rulemaking (NPRM) to amend 14 CFR part 39 to supersede AD 2011–27–51, Amendment 39–16915 (77 FR 2439, January 18, 2012), (''AD 2011–27–51''). AD 2011–27–51 applied to certain Beechcraft Corporation Models 1900, 1900C, and 1900D airplanes. The NPRM published in the **Federal Register** on July 17, 2013 (78 FR 42724). The NPRM proposed to retain all of the requirements of AD 2011–27–51 and add the requirement to install the secondary elevator bob-weight stop bolt, Kit 114–5060. We are issuing this AD to

prevent the elevator bob-weight (stabilizer weight) from traveling past its stop bolt and allowing the attaching linkage to move over-center and lead to reduced nose down elevator control, which could result in loss of control.

Comments

We gave the public the opportunity to participate in developing this AD. The following presents the comments received on the proposal and the FAA's response to each comment.

Requested Change to Compliance Time

Pat Kremer requested we change the compliance time for installing the secondary elevator bob-weight stop bolt Kit 114–5060 from 600 hours time-in-service (TIS) to 1,200 hours TIS or 24 months to coincide with the continuous inspection program for the Model 1900C airplanes. This requested change would minimize the impact or down time for the airplanes.

We disagree with this comment. We do not believe that 1,200 hours TIS or 24 months will adequately mitigate the unsafe condition on the entire affected airplane fleet. We determined that 600 hours TIS is the appropriate compliance time to address the identified unsafe condition. The proposed compliance time change may be adequate to address the unsafe condition on certain individual airplanes, and the FAA will evaluate any alternative method of compliance (AMOC) request we receive as specified in paragraph (j) of this AD.

We did not make any changes to this final rule AD action based on this comment.

Requested Clarification of Kit Instructions

Travis Reinhardt requested the service information specify that a collar be used with the optional Hi-Lok pin. He also requested the service information contain better instructions for inhibiting and un-inhibiting the control system during installation of the secondary elevator bob-weight stop bolt Kit 114–5060.

We agree with this comment. The collar should be specified to provide complete instructions for installation of the secondary elevator bob-weight stop bolt Kit 114–5060. The manufacturer has revised the kit installation instructions to specify the collar for use with the optional Hi-Lok pin and to clarify the intent for inhibiting the control system during installation of the kit. However, these clarification changes to the kit installation instructions do not affect the language used in this AD action or require any additional action for those airplanes that previously had the kit incorporated.

We did not make any changes to the actions required in this final rule AD action based on this comment.

Conclusion

We reviewed the relevant data, considered the comments received, and determined that air safety and the public interest require adopting this AD with the changes described previously and minor editorial changes. We have determined that these minor changes:

- Are consistent with the intent that was proposed in the NPRM (78 FR 42724, July 17, 2013) for correcting the unsafe condition; and
- Do not add any additional burden upon the public than was already proposed in the NPRM (78 FR 42724, July 17, 2013).

We also determined that these changes will not increase the economic burden on any operator or increase the scope of this AD.

Costs of Compliance

We estimate that this AD affects 165 airplanes of U.S. registry.

We estimate the following costs to comply with this AD:

ESTIMATED COSTS

Action	Labor cost	Parts cost	Cost per product	Cost on U.S. operators
Inspection of the elevator bob-weight and attaching linkage.	1 work-hour × $85 per hour = $85	Not applicable	$85	$14,025
Installation of the secondary elevator bob-weight stop bolt, Kit 114-5060.	4 work-hours × $85 per hour = $340	$2,740	3,080	508,200

The on-condition costs for any corrective action that may be necessary based on the above inspection would vary from airplane to airplane, and we have no way of determining that cost.

The cost of the inspection is a retained cost from AD 2011–27–51 (77 FR 2439, January 18, 2012) and does not add a burden over what was already imposed.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, Section 106, describes the authority of the FAA Administrator. Subtitle VII, Aviation Programs, describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in Subtitle VII, Part A, Subpart III, Section 44701, ''General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We have determined that this AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify that this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866,

(2) Is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979),

(3) Will not affect intrastate aviation in Alaska, and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by removing Airworthiness Directive (AD) 2011–27–51, Amendment 39–16915 (77 FR 2439, January 18, 2012), and adding the following new AD:

2014–02–03 Beechcraft Corporation: Amendment 39–17731 ; Docket No. FAA–2013–0611; Directorate Identifier 2013–CE–019–AD.

(a) Effective Date

This AD is effective March 7, 2014.

(b) Affected ADs

This AD supersedes AD 2011–27–51, Amendment 39–16915 (77 FR 2439, January 18, 2012).

(c) Applicability

This AD applies to the following Beechcraft Corporation airplanes in table 1 to paragraph (c) of this AD, certificated in any category:

TABLE 1 TO PARAGRAPH (C) OF THIS AD—APPLICABILITY

Models	Serial Nos.
(1) 1900	UA–3.
(2) 1900C	UB–1 through UB–74 and UC–1 through UC–174.
(3) 1900C (Military).	UD–1 through UD–6.
(4) 1900D	UE–1 through UE–439.

(d) Subject

Joint Aircraft System Component (JASC)/ Air Transport Association (ATA) of America Code 27, Flight Controls.

(e) Unsafe Condition

This AD was prompted by reports of the elevator bob-weight (stabilizer weight) traveling past its stop bolt and allowing the attaching linkage to move over-center, which could lead to reduced nose down elevator control. Also, Beechcraft Corporation designed a secondary elevator bob-weight stop bolt to reduce the possibility of the bob-weight from traveling past the stop bolt. We are issuing this AD to prevent the elevator bob-weight (stabilizer weight) from traveling past its stop bolt and allowing the attaching linkage to move over-center and lead to reduced nose down elevator control, which could result in loss of control.

(f) Compliance

Comply with this AD within the compliance times specified, unless already done. Paragraph (g) of this AD only applies to airplanes where the inspection required by AD 2011–27–51 (77 FR 2439, January 18, 2012) has not been done.

(g) Retained Inspections

Within the next 10 hours time-in-service (TIS) after January 18, 2012 (the effective date of AD 2011–27–51 (77 FR 2439, January 18, 2012)), inspect the elevator bob-weight installation for the following conditions specified in paragraphs (g)(1) through (g)(4) in this AD. Use Hawker Beechcraft Corporation Safety Communiqué No. 321, dated December 2011.

(1) *The correct positioning of the elevator control column link assembly, (part number (P/N) 101–524112–1 (1900/1900C) or P/N 101–524112–5 (1900D)).* With the elevator control column in the full nose down position (control column forward), the link must form an angle between the link attachment point at the control column and the bell crank pivot point as shown in the Hawker Beechcraft Corporation Safety Communiqué photo labeled ''Correct Link Orientation.'' The link should be trailing aft from the control column assembly. The term ''nose down'' corresponds to the airplane nose down, down elevator, and control column forward position as used in this AD and Hawker Beechcraft Corporation Safety Communiqué No. 321, dated December 2011.

(2) *The clearance of the bob-weight stop bolt.* With the elevator control column in the full nose down position (control column forward), the stabilizer weight stop bolt must have positive clearance with the face of the stabilizer weight.

(3) *The condition of the bob-weight and alignment with the stop bolt.* Inspect for evidence of scraping along either side of the weight by the stop bolt. With side pressure applied by hand to the stabilizer weight, no part of the stop bolt should protrude beyond the face of the stabilizer weight on either edge.

(4) *The condition of the bob-weight support bracket.* Inspect for evidence of damage or deformation by contact with the weight assembly.

(h) Installation of Kit 114–5060

Within the next 600 hours TIS after March 7, 2014 (the effective date of this AD), install the secondary elevator bob-weight stop bolt, Kit 114–5060, following Beechcraft Corporation Mandatory Service Bulletin No. SB 27–4119, dated June 2013.

(i) Corrective Actions

If any discrepancies are found during the inspection required in paragraph (g) of this AD, including all subparagraphs, and during the installation required in paragraph (h) of this AD, before further flight, contact Beechcraft Corporation Technical Support. If a deviation from FAA-approved type design is required, then request an alternative method of compliance (AMOC) as described in paragraph (j) of this AD. You may contact Beechcraft Technical Support by telephone at (800) 429–5372 or (316) 676–3140.

(j) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Wichita Aircraft Certification Office (ACO), FAA, has the authority to approve AMOCs for this AD, if requested using the procedures found in 14 CFR 39.19. In accordance with 14 CFR 39.19, send your request to your principal inspector or local Flight Standards District Office, as appropriate. If sending information directly to the manager of the ACO, send it to the attention of the person identified in the Related Information section of this AD.

(2) Before using any approved AMOC, notify your appropriate principal inspector, or lacking a principal inspector, the manager of the local flight standards district office/ certificate holding district office.

(3) AMOCs approved for AD 2011–27–51 (77 FR 2439, January 18, 2012) are approved as AMOCs for the corresponding provisions of this AD.

(k) Related Information

For more information about this AD, contact Don Ristow, Aerospace Engineer, Wichita ACO, FAA, 1801 Airport Road, Room 100, Wichita, Kansas 67209; telephone: (316) 946–4120; fax: (316) 946–4107; email: *donald.ristow@faa.gov*.

(l) Material Incorporated by Reference

(1) The Director of the **Federal Register** approved the incorporation by reference (IBR) of the service information listed in this paragraph under 5 U.S.C. 552(a) and 1 CFR part 51.

(2) You must use this service information as applicable to do the actions required by this AD, unless the AD specifies otherwise.

(3) The following service information was approved for IBR on March 7, 2014.

(i) Beechcraft Corporation Mandatory Service Bulletin No. SB 27–4119, dated June 2013.

(ii) Reserved.

(4) The following service information was approved for IBR on January 18, 2012 (77 FR 2439, January 18, 2012).

(i) Hawker Beechcraft Corporation Safety Communiqué No. 321, dated December 2011.

(ii) Reserved.

(5) For service information identified in this AD, contact Beechcraft Corporation at P.O. Box 85, Wichita, Kansas 67201–0085; telephone: (800) 429–5372 or (316) 676–3140; Internet: *http://www.beechcraft.com*.

(6) You may review copies of the referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

(7) You may view this service information that is incorporated by reference at the National Archives and Records Administration (NARA). For information on the availability of this material at NARA, call 202–741–6030, or go to: *http://www.archives.gov/federal-register/cfr/ibr-locations.html*.

Issued in Kansas City, Missouri, on January 15, 2014.

Steven W. Thompson,

Acting Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 2014–01832 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2013–0478; Directorate Identifier 2012–SW–092–AD; Amendment 39–17736; AD 2014–02–08]

RIN 2120–AA64

Airworthiness Directives; Agusta S.p.A. (Type Certificate Currently Held by AgustaWestland S.p.A.) (Agusta) Helicopters

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: We are adopting a new airworthiness directive (AD) for certain Agusta Model A109C, A109E, A109S, A109K2, and AW109SP helicopters. This AD requires inspecting the lock wires securing the tail rotor (T/R) duplex bearing locking nut (locking nut) to determine whether any lock wires are missing or damaged. This AD was prompted by reports of loosening T/R locking nuts. The actions of this AD are intended to prevent failure of the T/R and subsequent loss of control of the helicopter.

DATES: This AD is effective March 7, 2014.

ADDRESSES: For service information identified in this AD, contact Agusta Westland, Customer Support & Services, Via Per Tornavento 15, 21019 Somma Lombardo (VA) Italy, ATTN: Giovanni Cecchelli; telephone 39–0331–711133; fax 39–0331–711180; or at *http://www.agustawestland.com/technical-bullettins.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this AD, the European Aviation Safety Agency (EASA) AD, the economic evaluation, any comments received, and other information. The street address for the Docket Operations Office (phone: 800–647–5527) is U.S. Department of Transportation, Docket Operations Office, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.

FOR FURTHER INFORMATION CONTACT: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov.*

SUPPLEMENTARY INFORMATION:

Discussion

On June 5, 2013, at 78 FR 33768, the **Federal Register** published our notice of proposed rulemaking (NPRM), which proposed to amend 14 CFR part 39 to add an AD that would apply to Agusta Model A109C, A109S, and A109K2 helicopters, all serial numbers; Model A109E helicopters, serial number (S/N) 11002 through 11807 except S/N 11796; and Model AW109SP helicopters, S/N 22202 through 22278, except S/N 22239, 22264, 22266, 22272, 22273, 22275, and 22277. The NPRM proposed to require repetitively inspecting the lock wires that secure the T/R locking nut to the housing to determine whether both wires are present and not damaged. If only one wire is installed and it is not damaged, the NPRM proposed installing a second lock wire. If one or both lock wires are installed and either one or both are damaged, the NPRM proposed removing and reassembling the housing and slider group of the T/R rotating controls. The NPRM further proposed removing and reassembling the housing and slider group of the T/R rotating controls within 100 hours time-in-service (TIS) if not accomplished as a result of the inspections. Removing and reassembling the housing and slider group of the T/R rotating controls, either within 100 hours TIS or because a lock wire is damaged, was proposed as terminating action for the repetitive inspections. The proposed requirements were intended to prevent failure of the T/R and subsequent loss of control of the helicopter.

The NPRM was prompted by AD No. 2012–0195–E, dated September 24, 2012, and corrected September 25, 2012 (AD 2012–0195–E), issued by EASA, which is the Technical Agent for the Member States of the European Union. EASA issued AD 2012–0195–E to correct an unsafe condition for certain Agusta Model A109E, A109LUH, A109S, AW109SP, A109C, and A109K2 helicopters. EASA advised that they received reports of the T/R locking nut, part number (P/N) 109–0130–97, loosening on A109 helicopters. According to EASA, an investigation revealed that, in every occurrence, one or both of the lock wires securing the locking nut were either damaged or absent from the T/R, which could lead to failure of the T/R function and subsequent loss of control of the helicopter. AD 2012–0195–E requires repetitively inspecting the lock wires which secure the T/R locking nut for missing and damaged lock wires, and removing and reassembling the housing and slider group of the T/R rotating controls, which is terminating action for the repetitive inspections.

Comments

After our NPRM (78 FR 33768, June 5, 2013) was published, we received comments from one commenter.

Request

One commenter requested we include a statement that previous compliance with the applicable Agusta Bollettino Tecnico (BT) fulfills the requirements of the AD. We disagree that such a statement is necessary. Paragraph (d) of the AD states you are responsible for performing each AD action unless it has already been accomplished. This would include previous compliance with the portions of the service information that are consistent with the requirements of the AD.

The commenter also requested that we include a statement that the removal, disassembly, reassembly, and reinstallation of the T/R housing and slider group is to be accomplished in accordance with the pertinent part of the Agusta BT, as this would clarify the scope and detail of work required. We disagree. First, such a statement is not necessary, as the Agusta BT does not provide a greater level of scope and detail of work required. The BT only states that removal, disassembly, reassembly, and reinstallation is to be accomplished in accordance with the appropriate maintenance manual. Second, such a statement would not be appropriate because the Agusta BT is only one method of compliance for this AD. An operator may comply using other methods as long as all work is done in a manner acceptable to the FAA.

FAA's Determination

These helicopters have been approved by the aviation authority of Italy and are approved for operation in the United States. Pursuant to our bilateral agreement with Italy, EASA, its technical representative, has notified us of the unsafe condition described in the EASA AD. We are issuing this AD because we evaluated all information provided by EASA, reviewed the relevant information, considered the comments received, and determined the unsafe condition exists and is likely to exist or develop on other helicopters of these same type designs and that air

safety and the public interest require adopting the AD requirements as proposed, except we are including an additional reference for the actions constituting terminating action for the AD. This change will neither increase the economic burden on any operator nor increase the scope of the AD.

Differences Between This AD and the EASA AD

The EASA AD requires reassembling the housing and slider group within 100 flight hours or 7 months, while this AD requires this action within 100 hours TIS.

Related Service Information

Agusta has published BT No. 109–134 for Model A109C helicopters, BT No. 109EP–121 for Model A109E helicopters, BT No. 109S–48 for Model A109S helicopters, BT No. 109K–54 for Model A109K2 helicopters, and BT No. 109SP–051 for Model AW109SP helicopters. All of the BTs are dated September 21, 2012. The BTs specify procedures for inspecting the lock wires of the T/R locking nut and for removing and reassembling the housing and slider group of the T/R rotating controls.

Costs of Compliance

We estimate that this AD affects 146 helicopters of U.S. Registry. We estimate that operators may incur the following costs in order to comply with this AD. Based on an average labor rate of $85 per hour, inspecting the lock wire will require about 0.25 work-hour, for a cost per helicopter of $22 and a total cost to U.S. operators of $3,212 per inspection cycle. If necessary, installing a lock wire will require about 0.25 work-hour and the required parts cost are negligible, for a cost per helicopter of $22 and a total cost to U.S. operators of $3,212. Removing and reassembling the housing and slider group of the T/R rotating controls will require about 8 work-hours, for a cost per helicopter of $680 and a total cost to U.S. operators of $99,280.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. Subtitle VII: Aviation Programs, describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in Subtitle VII, Part A, Subpart III, Section 44701: ''General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on helicopters identified in this rulemaking action.

Regulatory Findings

This AD will not have federalism implications under Executive Order 13132. This AD will not have a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify that this AD:

(1) Is not a ''significant regulatory action'' under Executive Order 12866;

(2) Is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);

(3) Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

Adoption of the Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA amends 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

2014–02–08 Agusta S.p.A. Helicopters (Type Certificate currently held by AgustaWestland S.p.A.) (Agusta): Amendment 39–17736; Docket No. FAA–2013–0478; Directorate Identifier 2012–SW–092–AD.

(a) Applicability

This AD applies to Agusta Model A109C, A109S, and A109K2 helicopters, all serial numbers; Model A109E helicopters, serial number (S/N) 11002 through 11807 except S/N 11796; and Model AW109SP helicopters, S/N 22202 through 22278, except S/N 22239, 22264, 22266, 22272, 22273, 22275, and 22277, certificated in any category.

(b) Unsafe Condition

This AD defines the unsafe condition as a missing or broken lock wire securing the tail rotor (T/R) duplex bearing locking nut (locking nut). This condition could result in loosening of the locking nut, failure of the T/R, and subsequent loss of control of the helicopter.

(c) Effective Date

This AD becomes effective March 7, 2014.

(d) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(e) Required Actions

(1) Within 5 hours time-in-service (TIS), inspect each lock wire securing the T/R locking nut to the housing.

(i) If only one lock wire is installed and it is not damaged, before further flight, install a second lock wire.

(ii) If one or both lock wires are installed, and either one or both are damaged, before further flight, remove and reassemble the housing and slider group of the T/R rotating controls.

(2) Within 25 hours TIS from the inspection required by paragraph (e)(1) of this AD, and thereafter at intervals not exceeding 25 hours TIS, inspect the lock wires which secure the T/R locking nut to the housing. If either lock wire is missing or damaged, before further flight, remove and reassemble the housing and slider group of the T/R rotating controls.

(3) Within 100 hours TIS, remove and reassemble the housing and slider group of the T/R rotating controls.

(4) Removing and reassembling the housing and slider group of the T/R rotating controls as required by paragraph (e)(1)(ii), (e)(2), or (e)(3) is terminating action for this AD.

(f) Special Flight Permit

Special flight permits are prohibited.

(g) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Robert Grant, Aviation Safety Engineer, Safety Management Group, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone 817–222–5110; email *robert.grant@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office, before

operating any aircraft complying with this AD through an AMOC.

(h) Additional Information

(1) Agusta Bollettino Tecnico (BT) No. 109–134 for Model A109C helicopters, BT No. 109EP–121 for Model A109E helicopters, BT No. 109S–48 for Model A109S helicopters, BT No. 109K–54 for Model A109K2 helicopters, and BT No. 109SP–051 for Model AW109SP helicopters, all dated September 21, 2012, which are not incorporated by reference, contain additional information about the subject of this AD. For service information identified in this AD, contact Agusta Westland, Customer Support & Services, Via Per Tornavento 15, 21019 Somma Lombardo (VA) Italy, ATTN: Giovanni Cecchelli; telephone 39–0331–711133; fax 39 0331 711180; or at *http://www.agustawestland.com/technical-bullettins.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

(2) The subject of this AD is addressed in European Aviation Safety Agency (EASA) AD No. 2012–0195–E, dated September 24, 2012, and corrected September 25, 2012. You may view the EASA AD on the internet in the Docket No. FAA–2013–0478 at *http://www.regulations.gov.*

(i) Subject

Joint Aircraft Service Component (JASC) Code: 6400: Tail Rotor System.

Issued in Fort Worth, Texas, on January 16, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01953 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket No. USCG–2013–1081]

Drawbridge Operation Regulation; Inner Harbor Navigation Canal, New Orleans, LA

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulation.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the L & N Railroad/Almonaster Road drawbridge across the Inner Harbor Navigation Canal, mile 2.9 at New Orleans, Orleans Parish, Louisiana. The deviation is necessary in order to conduct repair and replacement of electrical system components of the bridge. These repairs are essential for the continued safe operation of the bridge. This deviation allows the bridge to remain temporarily closed to navigation for three consecutive days with four scheduled openings to facilitate the movement of vessel traffic.

DATES: This deviation is effective from 7 a.m. on Monday, February 10, 2014 through 11:59 p.m. on Wednesday, February 12, 2014.

ADDRESSES: The docket for this deviation, [USCG–2013–1081] is available at *http://www.regulations.gov.* Type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on Open Docket Folder on the line associated with this deviation. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation West Building, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary deviation, call or email David Frank, Bridge Administration Branch, Coast Guard; telephone 504–671–2128, email *David.M.Frank@uscg.mil.* If you have questions on viewing the docket, call Cheryl F. Collins, Program Manager, Docket Operations, telephone 202–366–9826.

SUPPLEMENTARY INFORMATION: Coastal Bridge Company, on behalf of the Board of Commissioners of the Port of New Orleans, requested a temporary deviation from the operating schedule on the L & N Railroad/Almonaster Road drawbridge across the Inner Harbor Navigation Canal, mile 2.9 at New Orleans, Orleans Parish, Louisiana.

The bridge has a vertical clearance of one foot above high water in the closed-to-navigation position and unlimited clearance in the open-to-navigation position. Navigation on the waterway consists of tugs with tows, small ships, fishing vessels, sailing vessels, and other recreational craft. Presently, in accordance with 33 CFR 117.5, the draw shall open on signal for the passage of vessels.

This temporary deviation allows the bascule bridge to remain closed to navigation from 7 a.m. on Monday, February 10, 2014 through 11:59 p.m. on Wednesday, February 12, 2014, except that the bridge will open to pass all waiting vessels at 6:45 a.m., 12 noon, 4 p.m. and 12 midnight daily during the closure period. During this time, repairs will be performed to the electrical systems of the bridge.

During the closure period, the bridge will not be able to open for the passage of vessels except during the scheduled periods of operation. Alternate routes are available via the Chef Menteur Pass and the Rigolets.

In accordance with 33 CFR 117.35, the draw bridge must return to its regular operating schedule immediately at the end of the effective period of this temporary deviation.

This deviation from the operating regulations is authorized under 33 CFR 117.35.

Dated: January 13, 2014.

David M. Frank,

Bridge Administrator.

[FR Doc. 2014–01940 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket No. USCG–2013–1080]

Drawbridge Operation Regulation; Dulac Bayou, Terrebonne Parish, LA

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulation.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the SR 57 drawbridge across the Dulac Bayou, mile 0.6, at Dulac, Terrebonne Parish, Louisiana. The deviation is necessary in order to conduct repair and replacement of parts associated with the wedge-drive system hydraulic unit. These repairs are essential for the continued safe operation of the bridge. This deviation allows the bridge to remain temporarily closed to navigation for 20 consecutive days with three openings per day during daylight to facilitate the movement of vessel traffic.

DATES: This deviation is effective from 6 a.m. on Monday, March 10, 2014 through 5 p.m. on Saturday, March 29, 2014.

ADDRESSES: The docket for this deviation, [USCG–2013–1080] is available at *http://www.regulations.gov.* Type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on Open Docket Folder on the line associated with this deviation. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation West Building, 1200 New Jersey Avenue SE., Washington,

DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary deviation, call or email David Frank, Bridge Administration Branch, Coast Guard; telephone 504–671–2128, email *David.M.Frank@uscg.mil.* If you have questions on viewing the docket, call Cheryl F. Collins, Program Manager, Docket Operations, telephone 202–366–9826.

SUPPLEMENTARY INFORMATION: Coastal Bridge Company, on behalf of the Louisiana Department of Transportation and Development, requested a temporary deviation from the operating schedule on the SR 57 drawbridge across the Dulac Bayou, mile 0.6, at Dulac, Terrebonne Parish, Louisiana.

The bridge has a vertical clearance of 7 feet above mean high water in the closed-to-navigation position and unlimited in the open-to-navigation position. In accordance with 33 CFR 117.5, the draw shall open on signal for the passage of vessels.

This temporary deviation allows the swing bridge to remain closed to navigation for a total of 20 days from 6 a.m. on Monday, March 10, 2014 through 5 p.m. on Saturday, March 29, 2014, except that the bridge will open to pass all waiting vessels at 6 a.m., 12 noon, and 5 p.m. daily. During this time, repairs will be performed to the hydraulic system of the bridge to include removing and replacing the end wedge-drive system hydraulic pressure unit, all end wedge-drive system hydraulic piping, and four end wedge-drive hydraulic cylinders.

During the closure period, the bridge will not be able to open for the passage of vessels except during the scheduled periods of operation. No alternate routes are available during this deviation; however, the bridge owner will attempt to contact all waterway users to keep them abreast of the repair work. Navigation on the waterway consists of small tugs with tows, fishing vessels, and other recreational craft.

In accordance with 33 CFR 117.35, the draw bridge must return to its regular operating schedule immediately at the end of the effective period of this temporary deviation.

This deviation from the operating regulations is authorized under 33 CFR 117.35.

Dated: January 13, 2014.

David M. Frank,

Bridge Administrator.

[FR Doc. 2014–01937 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket Number USCG–2013–1076]

Drawbridge Operation Regulation; Upper Mississippi River, Rock Island, IL

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulations.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the Rock Island Railroad and Highway Drawbridge across the Upper Mississippi River, mile 482.9, at Rock Island, Illinois. The deviation is necessary to allow the River Bandits 5K Run/Walk to cross the bridge. This deviation allows the bridge to be maintained in the closed-to-navigation position for one and a half hours.

DATES: This deviation is effective from 8 a.m. to 9:30 a.m., April 12, 2014.

ADDRESSES: The docket for this deviation, [USCG–2013–1076] is available at *http://www.regulations.gov.* Type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on Open Docket Folder on the line associated with this deviation. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation, West Building, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary deviation, call or email Eric A. Washburn, Bridge Administrator, Western Rivers, Coast Guard; telephone 314–269–2378, email *Eric.Washburn@uscg.mil.* If you have questions on viewing the docket, call Cheryl F. Collins, Program Manager, Docket Operations, telephone 202–366–9826.

SUPPLEMENTARY INFORMATION: The U.S. Army Rock Island Arsenal requested a temporary deviation for the Rock Island Railroad and Highway Drawbridge, across the Upper Mississippi River, mile 482.9, at Rock Island, Illinois to remain in the closed-to-navigation position for a one and a half hour period from 8 a.m. to 9:30 a.m., April 12, 2014, while the River Bandits 5K Run/Walk is held between the cities of Davenport, IA and Rock Island, IL.

The Rock Island Railroad and Highway Drawbridge currently operates in accordance with 33 CFR 117.5, which states the general requirement that drawbridges shall open promptly and fully for the passage of vessels when a request to open is given in accordance with the subpart.

There are no alternate routes for vessels transiting this section of the Upper Mississippi River.

The Rock Island Railroad and Highway Drawbridge, in the closed-to-navigation position, provides a vertical clearance of 23.8 feet above normal pool. Navigation on the waterway consists primarily of commercial tows and recreational watercraft. This temporary deviation has been coordinated with waterway users. No objections were received.

In accordance with 33 CFR 117.35(e), the drawbridge must return to its regular operating schedule immediately at the end of the effective period of this temporary deviation. This deviation from the operating regulations is authorized under 33 CFR 117.35.

Dated: January 15, 2014.

Eric A. Washburn,

Bridge Administrator, Western Rivers.

[FR Doc. 2014–01935 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket No. USCG–2013–1079]

Drawbridge Operation Regulation; Falgout Canal, Terrebonne Parish, LA

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulation.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the LA 315 drawbridge across the Falgout Canal, mile 3.1, in Terrebonne Parish, Louisiana. The deviation is necessary in order to conduct repair and replacement of parts associated with the wedge-drive system hydraulic unit. These repairs are essential for the continued safe operation of the bridge. This deviation allows the bridge to remain temporarily closed to navigation for 20 consecutive days with three openings per day during daylight to facilitate the movement of vessel traffic.

DATES: This deviation is effective from 6 a.m. on Monday, February 10, 2014

through 5 p.m. on Saturday, March 1, 2014.

ADDRESSES: The docket for this deviation, [USCG–2013–1079] is available at *http://www.regulations.gov.* Type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on Open Docket Folder on the line associated with this deviation. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation West Building, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary deviation, call or email David Frank, Bridge Administration Branch, Coast Guard; telephone 504–671–2128, email *David.M.Frank@uscg.mil.* If you have questions on viewing the docket, call Cheryl F. Collins, Program Manager, Docket Operations, telephone 202–366–9826.

SUPPLEMENTARY INFORMATION: Coastal Bridge Company, on behalf of the Louisiana Department of Transportation and Development, requested a temporary deviation from the operating schedule on the LA 315 drawbridge across the Falgout Canal, mile 3.1, in Terrebonne Parish, Louisiana.

The bridge has a vertical clearance of 3.5 feet above mean high water in the closed-to-navigation position and unlimited in the open-to-navigation position. Presently, in accordance with 33 CFR 117.444, the draw of the LA 315 bridge across Falgout Canal, mile 3.1, shall open on signal; except that from 15 August to 5 June, the draw need not be opened from 7 a.m. to 8 a.m. and from 3 p.m. to 4 p.m. Monday through Friday except Federal holidays. The draw shall open on signal for an emergency aboard a vessel.

This temporary deviation allows the swing bridge to remain closed to navigation for a total of 20 days from 6 a.m. on Monday, February 10, 2014 through 5 p.m. on Saturday, March 1, 2014, except that the bridge will open to pass all waiting vessels at 6 a.m., noon, and 5 p.m. daily. During this time, repairs will be performed to the hydraulic and electrical systems of the bridge.

No alternate routes are available during this deviation; however, the bridge owner will attempt to contact all waterway users to keep them abreast of the repair work. Navigation on the waterway consists of small tugs with tows, fishing vessels, and other recreational craft. The bridge opens an average of 426 times per month for the passage of vessels. This deviation has been coordinated with waterway users.

In accordance with 33 CFR 117.35, the draw bridge must return to its regular operating schedule immediately at the end of the effective period of this temporary deviation.

This deviation from the operating regulations is authorized under 33 CFR 117.35.

Dated: January 13, 2014.

David M. Frank,

Bridge Administrator.

[FR Doc. 2014–01933 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 151

[Docket No. USCG–2004–19621]

RIN 1625–AA89

Dry Cargo Residue Discharges in the Great Lakes

AGENCY: Coast Guard, DHS.

ACTION: Final rule.

SUMMARY: The Coast Guard is finalizing its existing interim rule regulating the operation of U.S. and foreign vessels carrying bulk dry cargo such as limestone, iron ore, and coal on the U.S. waters of the Great Lakes, and the operation of U.S. bulk dry cargo vessels anywhere on the Great Lakes. Specifically, the Coast Guard is publishing new requirements for the discharge of bulk dry cargo residue (DCR) on the U.S. waters of the Great Lakes. The rule will continue to allow non-hazardous and non-toxic discharges of bulk DCR in limited areas of the Great Lakes. However, vessel owners and operators will need to minimize DCR discharges using methods they will be required to document in DCR management plans. The rule will prohibit limestone and clean stone DCR discharges in some waters where they are now permitted. The final rule promotes the Coast Guard's maritime safety and stewardship missions.

DATES: This final rule is effective March 3, 2014 except for the management plan requirement of 33 CFR 151.66(b)(5), which is a collection of information requirement that has not yet been approved by the Office of Management and Budget (OMB). The Coast Guard will publish a document in the **Federal Register** announcing the effective date of that requirement.

ADDRESSES: Comments and material received from the public, as well as documents mentioned in this preamble as being available in the docket, are part of docket USCG–2004–19621 and are available for inspection or copying at the Docket Management Facility (M–30), U.S. Department of Transportation, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. You may also find this docket on the Internet by going to *http://www.regulations.gov*, inserting USCG–2004–19621 in the ''Keyword'' box, and then clicking ''Search.''

FOR FURTHER INFORMATION CONTACT: If you have questions on this rule, call or email John A. Meehan, Office of Operating and Environmental Standards (CG–OES–3), U.S. Coast Guard; telephone 202–372–1429, email *John.A.Meehan@uscg.mil.* If you have questions on viewing or submitting material to the docket, call Ms. Cheryl Collins, Program Manager, Docket Operations, telephone 202–366–9826.

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I. Abbreviations

AB Able Body Seaman
APPS Act to Prevent Pollution from Ships
CFR Code of Federal Regulations
COMDTINST COMMANDANT INSTRUCTION 7310.1M
DCR Dry Cargo Residue
DEIS Draft Environmental Impact Statement
EIS Environmental Impact Statement
E.O. Executive Order
EPA Environmental Protection Agency
FEIS Final Environmental Impact Statement
FR Federal Register
GLWQA Great Lakes Water Quality Agreement of 2012
ICR Information Collection Request
IR Interim Rule
MARPOL 73/78 International Convention for the Prevention of Pollution from Ships
NAICS North American Industry Classification System

NOAA National Oceanic and Atmospheric Administration
NPRM Notice of proposed rulemaking
OMB Office of Management and Budget
ROD Record of Decision
PIC Person in charge
SBA U.S. Small Business Administration
SNPRM Supplemental notice of proposed rulemaking
§ Section symbol
the Act the Coast Guard and Maritime Transportation Act of 2004
U.S.C. United States Code

II. Basis and Purpose

This final rule replaces the interim rule (73 FR 56492, Sep. 29, 2008) that has been in effect since 2008. The legal basis for this rulemaking is section 623(b) of the Coast Guard and Maritime Transportation Act of 2004 *(''the Act,''* Pub. L. 108–293). Section 623(b) of the Act gives the Coast Guard the authority, ''notwithstanding any other law . . . to promulgate regulations governing the discharge of dry bulk cargo residue on the Great Lakes.''

The purpose of this rulemaking, as a whole, is to exercise the authority conferred on the Coast Guard by the Act in a way that appropriately balances the needs of maritime commerce and environmental protection, by determining how, if at all, the discharge of dry cargo residue (DCR) can continue in the Great Lakes within a regulatory framework that imposes environmentally appropriate conditions on DCR discharges. The purpose of this final rule is to provide that regulatory framework.

III. Background

Prior to opening this rulemaking, we published a notice of inquiry requesting information about the then-current status of dry cargo operations in the Great Lakes (69 FR 77147; correction, 70 FR 1400) on December 27, 2004 and January 7, 2005, respectively. The regulatory history for this rulemaking began with a March 9, 2006 announcement of our intent to prepare an Environmental Impact Statement (EIS) in support of the rulemaking and a request for public comments on the scope of the EIS (''scoping notice,'' 71 FR 12209). On June 8, 2006, we published a notice for a public meeting on the scope of the EIS, and again requested public comments (71 FR 33312). We held a scoping meeting in Cleveland, OH, on July 6, 2006. We published a notice of proposed rulemaking (NPRM) and notice of the availability of the accompanying draft environmental impact statement (DEIS) on May 23, 2008 (73 FR 30014). We announced public meetings on the NPRM and DEIS on June 6, 2008 (73 FR 32273), and held those meetings in Duluth, MN, and Cleveland, OH, on July 15 and 17, 2008, respectively. With the Environmental Protection Agency (EPA), we announced the availability of the final environmental impact statement (FEIS) on August 22, 2008 (EPA at 73 FR 49667; Coast Guard at 73 FR 49694), and the Record of Decision (ROD) adopting the findings of the FEIS was signed September 23, 2008. We published an interim rule on September 29, 2008 (73 FR 56492). On December 29, 2008 (73 FR 79496), we published a second scoping notice announcing our intent to prepare a new ''tiered'' (updated) EIS in support of a final rule, requested public comments, and announced a public scoping meeting, which was held in Chicago, IL, on January 28, 2009. We published a supplemental notice of proposed rulemaking (SNPRM) on July 30, 2012 (77 FR 44528). With the EPA, we announced the availability of the FEIS for this final rule on November 1, 2013 (78 FR 65643).

A vessel loading or unloading bulk dry cargo often accumulates small amounts of dry cargo residue on its deck, and more substantial amounts in cargo tunnels within the vessel, where the DCR mixes with sump water. If these accumulations are not addressed, the deck residue can adversely affect crew safety, and the tunnel residue can adversely affect vessel stability, which in turn risks the safety of the entire vessel, its crew, and the maritime environment. DCR accumulation can be mitigated or reduced through the use of DCR control equipment or procedures, but it is not always operationally feasible or economically practical to deploy that equipment or procedures only while the vessel is in port. Consequently, a bulk dry cargo vessel may find it advantageous to sweep residue from the deck, or to discharge tunnel sump water, while the vessel is in transit. For oceangoing vessels on the high seas, this is generally permissible under international maritime law, but it is generally prohibited within each country's navigable waters, including a country's navigable rivers and lakes. For most bulk dry cargo vessels operating on rivers and lakes, the general prohibition against in-transit DCR discharges does not impose special hardships on the vessel operator, because transit time is short and the sheltered river and lake waters limit any risk to the vessel from conducting DCR control measures only while the vessel is in port.

However, Great Lakes vessel operators may experience special difficulties with DCR accumulation. The Great Lakes support a significant volume of bulk dry cargo shipping that remains within the land-locked Great Lakes system. All Great Lakes waters are considered either U.S. or Canadian navigable waters, and hence are subject to the general prohibition against in-transit DCR discharges. Transits on the Great Lakes can be many hours long, through waters that can be very deep, very wide, and subject to severe weather risks. Thus, in some ways Great Lakes bulk dry cargo vessels are more like vessels in oceangoing trade than they are like vessels on most rivers or lakes. In recognition of these special factors, the Coast Guard's Ninth District adopted an ''interim enforcement policy'' in 1995, which allowed continued and ''incidental'' discharges of non-toxic, non-hazardous DCR in defined areas of the Great Lakes. On three occasions between 1998 and 2004, Congress required the Coast Guard to continue enforcing the interim enforcement policy.

In 2004, Congress prepared a legislative conference report in support of section 623(b) of the Act, which provides the authority for this rulemaking, expressing Congress's expectation that in regulating Great Lakes DCR discharges, given the special characteristics of the Great Lakes, the Coast Guard would adopt an approach ''that appropriately balances the needs of maritime commerce and environmental protection.'' House Report 108–617.

Our interim rule amended 33 CFR 151.66, a Coast Guard regulation that implements the Act to Prevent Pollution from Ships (APPS) 33 U.S.C. 1901 *et seq.* That regulation generally prohibits the discharge of DCR—an ''operational waste'' and, hence, ''garbage'' as both terms are defined in 33 CFR 151.05—in all U.S. navigable waters. The interim rule amended that prohibition with respect to the U.S. waters of the Great Lakes. It allowed non-hazardous and non-toxic DCR discharges in limited areas of the Great Lakes, provided that carriers observed recordkeeping and reporting requirements, and it encouraged carriers to adopt voluntary control measures for minimizing discharges. The interim rule applied to the owners and operators of U.S., Canadian, and other foreign vessels carrying bulk dry cargo on the U.S. waters of the Great Lakes, and also to the owners and operators of U.S. vessels carrying bulk dry cargo when they are on the Canadian waters of the Great Lakes. Non-self-propelled barges were excluded from the interim rule amendment unless they are part of an integrated tug-and-barge unit.

Our ROD in support of the interim rule concluded that the interim rule's only adverse environmental impacts would be minor and indirect, and that an outright ban of DCR discharges could cause an adverse economic impact for carriers and related industries in the Great Lakes region. Therefore, we found that allowing DCR discharges in the Great Lakes, under the conditions imposed by the interim rule, struck ''the best balance between economic and environmental concerns that can be achieved, given currently available information.'' ROD, p. 4. The conditions the interim rule imposed on DCR discharges were intended to limit even minor and indirect impacts of DCR discharges, and to give us the regulatory tools we needed to monitor discharges in the future.

We stated in the interim rule that, before taking final action in this rulemaking, we would ''determine if, in the long term, the optimal balancing of commercial and environmental interests requires the mandatory use of DCR control measures, the adjustment of the geographical boundaries within which those discharges are currently allowed, or other regulatory changes'' (73 FR at 56495). We have now made that determination and accordingly, we are issuing this final rule. The final rule's provisions are identical to those we proposed in the SNPRM, except insofar as we have decided to retain existing reporting and recordkeeping requirements for the final rule's first year in effect, as a transitional measure. For a detailed discussion, see part V of this preamble.

IV. Discussion of Comments to SNPRM

We received eight public comments from seven commenters on the SNPRM. Two of the commenters were individuals, three were industry associations, one was an alliance of advocacy groups with a shared interest in ensuring ''that commercial navigation practices in the Great Lakes and St. Lawrence River do not have a deleterious impact on the basin's freshwater ecosystem and dependent communities and economies,'' and one was the Michigan Department of Environmental Quality. The commenters raised the following issues.

Legal basis. The advocacy alliance said our interim rule and our final rule, are inconsistent with APPS and that section 623(b) of the Act does not provide an exception from APPS. We disagree that the Act provides no exception from APPS. In passing APPS, Congress gave the Secretary of the Department in which the Coast Guard is operating sufficient regulatory authority to implement it (33 U.S.C. 1903(c)(1)) and the Secretary delegated that authority to the Coast Guard (DHS Delegation No. 0170.1(77)). Section 1903(c)(1) was last amended in 1996, and there was no logical reason for Congress to do more if Congress intended the general language of that provision to govern Coast Guard rulemaking on any topic and in any waters to which APPS might be applicable. Nevertheless, on three subsequent occasions, in 1998, 2000, and 2004, the 105th, 106th, and 108th Congresses saw fit to legislate three specific exceptions to section 1903(c)(1) with respect to the discharge of DCR in the Great Lakes: Public Law 105–383, section 415; Public Law 106–554, section 1117; and Public Law 108–293, section 623. Not one of these subsequent specific enactments can be logically explained in any other way than by inferring that Congress intends for the Coast Guard to take into account factors unique to the handling of DCR on the Great Lakes in regulating DCR discharges in those waters, notwithstanding how APPS would apply to other topics involving the Great Lakes, and notwithstanding how APPS would apply to DCR discharges in other waters.

Need for further regulatory measures. The three industry associations questioned the need for further regulatory measures. They said the current interim rule's requirements already achieve the balance between environmental protection and commercial interests that Congress intended. They also reminded us of the relatively small volume of DCR discharges given the volume of bulk dry cargo shipments, and of our previous finding of only minor and indirect adverse environmental impacts from DCR discharges. We agree with these statements, but we also recognize that in the absence of Coast Guard regulations allowing limited discharges, discharges of any kind would be prohibited and industry would have to bear the cost of eliminating any DCR discharges. In our view, the additional measures imposed by this final rule will help minimize adverse environmental impacts, without exposing industry to unreasonable regulatory costs. One of the three associations commented that effective DCR minimization procedures, including DCR management plans are already in general use. To the extent that is the case, the incremental cost of this final rule will be minimized and will be felt only by parties who are not currently operating at the general level.

Environmental analysis. The advocacy alliance made several comments about the DEIS that accompanied the SNPRM.

First, the alliance said our characterization of the environmental impacts of permitted DCR discharges as ''minor and indirect'' is not supported with sufficient evidence in the record and should be reconsidered. We disagree with this statement. Our analysis shows that the DCR deposition rate in open Great Lakes waters is within natural deposition rates—0.2 percent or less of the natural deposition rate even in areas of highest DCR discharge activity. Only port and nearshore areas experience deposition rates higher than the natural deposition rate. The DCR-discharge impact in those areas must be mitigated as we described in the DEIS's preferred alternative. The criteria for determining the effects on environmental and human resources for each of the alternatives were established through collaboration with experienced National Environmental Policy Act practitioners and with the EPA as a cooperating agency. The evaluation of the impacts was based on scientific studies, vetted through expert panels. The results were published in draft and final environmental impact statements issued prior to publication of the interim rule, resulting in further refinement of the analysis.

Second, the alliance said we should reassess the effects of DCR discharges on the physical sediment of the Great Lakes rather than rely on the findings in the interim rule's FEIS and ROD. The Coast Guard did, in fact, reassess the effects on the physical sediment evaluated in the FEIS based on the analysis of vessel DCR records and direct observations subsequent to publication of the interim rule. We did not find a significant change in the results stated in the interim rule's FEIS.

Third, the alliance said we had not adequately estimated the volume of DCR discharge so as to permit informed decision making on the direct, indirect, and cumulative environmental impacts to the Great Lakes. We disagree with this statement. To determine the volume of DCR discharge we conducted in-depth studies outlined in Appendix N of the interim rule's FEIS. Subsequent to publication of the interim rule, we analyzed vessel DCR records and made direct observations.

Fourth, the alliance said the SNPRM's DEIS predicted DCR discharge reductions that are inconsistent with our statement that the majority of vessels already effectively minimize DCR discharge. There is no inconsistency. The predicted DCR discharge reductions from this rulemaking do not conflict with the

already low current discharge rates from vessels. However, further reductions in the discharge rates are feasible with limited impacts to industry.

Finally, the alliance said that, with respect to the potential introduction of toxic components into the Lakes' sediments, the issue is not only whether those sediments are currently contaminated at levels sufficient to adversely affect the natural communities of the Great Lakes, but also whether those levels might be reached if DCR discharges are allowed to continue. The alliance said this possibility is not fully explored in the SNPRM's DEIS, and that we have ignored the recommendation of the National Oceanic and Atmospheric Administration (NOAA) to undertake a rigorous front-end analysis of the potential for toxic constituents in the types of cargo that produce DCR. We disagree. Under the Clean Water Act, vessels are prohibited from discharging DCR that is toxic, hazardous, or both. The 1995 interim enforcement policy allowed incidental DCR discharges only if the DCR was non-toxic and non-hazardous, and our 2008 interim rule also applied only to non-toxic, non-hazardous DCR. We addressed NOAA's recommendations in the 2008 FEIS. (See U.S. Coast Guard 2002, ''A Study of Dry Cargo Residue Discharges in the Great Lakes'' and U.S. Coast Guard 2006, ''Study of Incidental Dry Cargo Residue Discharges in the Great Lakes'' referenced in the 2008 FEIS and posted on the Docket). We have extensively and thoroughly evaluated the direct, indirect, and cumulative effects of DCR discharges, including toxicity. Our FEIS finds that while sediment concentrations exceeded some threshold effect concentrations in DCR sweeping areas and some toxicity was observed, the sediment concentrations were similar to those in areas used as a control group for sampling purposes, and the toxicity does not appear to be associated with any chemical constituent attributable to DCR, indicating that our long-standing restriction of DCR discharges to non-toxic and non-hazardous DCR is being observed. We do not expect the predicted rates and composition of DCR discharges to contribute to raising sediment toxicity levels such that they will adversely affect the ecosystems.

Federalism. All three industry associations and the Michigan Department of Environmental Quality commented on the interaction between the interim rule and final rule, as Federal regulations, and the water quality laws of States in the Great Lakes region. The associations pointed out that we have not preempted States from adopting or enforcing their own laws affecting DCR discharges in their waters. They are concerned that the lack of Federal preemption will lead to a patchwork of different State requirements. One of these associations said that the imposition of more stringent restrictions or even discharge bans by individual States would also result in severe hardship on vessels and economic harm to commerce on the Great Lakes, while providing no additional environmental benefit.

The Michigan agency said that DCR discharges in Michigan waters would be in violation of section 324.9502 of the State's Natural Resources and Environmental Protection Act. While acknowledging that the lack of Federal preemption leaves Michigan free to enforce this statute in its waters, the agency said this could leave industry confused, that it places a significant potential burden for enforcement on Michigan, and is contrary to the Coastal Zone Management Act.

Neither the interim rule nor this final rule expressly preempts State laws relating to DCR discharges. As we stated in the interim rule, 73 FR 56492 at 56497, col. 2, carriers must comply not only with Coast Guard DCR discharge regulations, but with ''all applicable Federal and State laws regulating DCR discharges,'' and we ''will work with States and carriers to make sure carriers are informed of any State laws that could impose more restrictions on DCR discharges'' than are imposed by our regulations. We do not believe the final rule will confuse the industry because it allows for continuing the current industry practices with regard to dry cargo residues, which have been in place for decades. It incorporates recordkeeping requirements that are similar to regulations with which industry already must and does comply. This final rule does not frustrate or conflict with the laws of any State; nor is it inconsistent with any State coastal management program that may impose additional restrictions on DCR discharges.

Vessel operations. Two of the industry associations commented on the affected industry's importance to the regional and national economies. Both expressed concern over the cost implications of delaying a vessel's voyage to remove DCR while in port, in light of the high hourly cost of vessel operation and the short Great Lakes shipping season. One of the two associations observed that DCR discharges are not in the industry's interest, since vessels are paid to deliver cargo, not wash it overboard. The other said this places shipping at a disadvantage when compared to rail or road transportation.

We agree that Great Lakes shipping is an important industry and that the cost implications of this rulemaking must be kept as low as possible, consistent with our interpretation of the mandate Congress gave us in the 2004 Act. The new DCR management plan requirement leaves industry free to determine, for each vessel, how best to minimize DCR without compromising a vessel's economics, safety, or other operational considerations. We are confident this can be done without delaying any vessel's operations, because we found from our own direct observations that it is existing industry practice to maintain DCR-free decks and that crew members can retrieve significant amounts of DCR from cargo tunnels while the vessel is under way for later disposal. We discuss minimization requirements more fully in connection with the comments we received on minimization.

Elimination of DCR discharges. The advocacy alliance and an individual commenter wrote in favor of eliminating DCR discharges in the Great Lakes. As we stated in the SNPRM, 77 FR 44528 at 44533, col. 1, this remains our ideal. The individual commenter remarked that ''profiteers . . . sneak what they dump.'' We disagree, at least insofar as the industry affected by this rulemaking is concerned, because they have openly acknowledged their discharges and because we agree with the industry that discharge of DCR is contrary to their profit motive.

The alliance said we should adopt regulations that move industry toward eventual elimination of DCR discharges. They suggested we ''reconsider an alternative that incorporates the following measures: A timeline for reaching zero-discharge; periodic review of DCR best management practices followed by regulations that require implementation of such practices; and in the interim, incremental reductions in the volume of DCR discharged by vessels.'' They also said the Great Lakes Water Quality Agreement of 2012 (GLWQA) between the U.S. and Canada ''directs the attention of each party to the task of developing reasonable regulations minimizing the discharge of cargo residue into the Great Lakes,'' and requires ''the parties to produce progress reports every three years after implementation,'' which would provide a natural timeframe for us to periodically review and improve our DCR regulations.

We decline to adopt the alliance's suggestion for a timeline to incrementally reduce and eventually

eliminate all DCR discharges. We lack any factual basis for establishing such a timeline, of whatever length, without triggering the direct and adverse socioeconomic impacts that justified our rejecting the imposition of a zero-discharge requirement in our interim rule; see the ROD for the interim rule's FEIS, pp. 2, 3, Sept. 23, 2008. As we stated in the SNPRM, 77 FR at 44533, col. 1, ''we continue to believe, as we did when we issued the interim rule, that a 'zero discharge' requirement would be more costly than necessary to protect the environment against adverse impacts, and because the adverse impacts that can be associated with DCR discharges are only minor and indirect.''

We disagree with the alliance on setting any schedule specifically for the periodic review of our DCR regulations. This is not required by the GLWQA, which discusses triennial progress reviews in the overall context of Great Lakes water quality rather than with respect to reviewing specific statutes or regulations. Also, as we stated in the SNPRM, 77 FR at 44531, col. 3, we are already ''subject to statutes, executive orders, and agency policies that require the periodic reevaluation of existing regulations'' including our DCR regulations. However, as we also stated in the SNPRM, 77 FR at 44533, col. 3, ''[w]e expect that industry standard practices for the management of dry cargo residue will evolve'' and that, as they do, each vessel will have to keep pace or risk a Coast Guard inspector's determination that its DCR management plan no longer compares adequately ''with the current industry standard practices employed by the majority of vessels with comparable characteristics, cargoes, and operations.''

Minimization of DCR discharges—Decks. All three industry associations commented on our minimization proposals, in particular the ''broom clean'' standard for decks, and expressed concern over the costly delays in port that attaining broom cleanliness might entail (costs are addressed in the regulatory analyses section of this final rule).

One of the associations said we should set a ''shovel clean'' standard instead, because shovels are operationally preferable to brooms and can attain the same performance level (elimination of visible DCR, other than dust, powder, or isolated and random pieces, none of which exceeds 1 inch in diameter). We chose the term ''broom clean'' because of its descriptive value in conveying an image of the performance level we want vessels to achieve. This final rule does not prescribe the actual tools or procedures by which a vessel achieves it; that information will be set out in the vessel's DCR management plan.

One association pointed out that ''the goal of this provision is standard practice. Spilled cargo is shoveled back into the hold to the degree possible.'' We agree that this is standard practice because usually it serves the carrier's economic interest. This association also mentioned conditions under which it could be difficult or impossible to attain broom cleanliness without unacceptably long and expensive delays in port. We agree that in bad or very cold weather, or because of operational conditions, it may be more difficult than usual to attain broom cleanliness. As the association observed, however, we acknowledged in the SNPRM that cargo is loaded and discharged in different environments: ''[w]e assume . . . an Able Body Seaman (AB) would be tasked with maintaining the broom clean standard . . . during loading and unloading operations, to the best of the AB's ability under current vessel conditions,'' 77 FR at 44536, col. 1. The association continued by granting ''that it would be difficult to define 'the best of an individual's ability under varying vessel conditions,' '' but expressed the hope that ''Coast Guard inspectors will agree that what is possible on a summer day is unachievable with snow falling and temperatures below freezing.'' We agree. We have tried to design a reasonable requirement that can be executed by people of varying physical capabilities under widely varying conditions, in what is fundamentally an industrial setting. We have also tried to design a regulation that can be easily and fairly enforced by our inspectors without the use of scales or micrometers. As stated in the regulatory definition of ''broom clean'' adopted by this final rule, 33 CFR 151.66(b)(2), what we want to see on a vessel's deck is evidence that ''care has been taken to prevent or eliminate'' deck DCR. We understand and expect that the results of that care will vary, but we expect that the results will indicate that the vessel's DCR management plan has been written and carried out to obtain the best DCR minimization results across the full range of variables that affect the vessel.

A second association said that maintaining the broom clean standard ''is likely to cause vessel delays as compliance with hours-of-rest regulations would prevent critical crew members from participating in departure or navigation tasks.'' The association provided no data to show that the interaction of our broom clean requirement with work hour laws will necessarily lead to any appreciable interference with critical crew duties. We know of no reason to assume this will happen, and once again we emphasize that it is up to each vessel to determine, for inclusion in its DCR management plan, what arrangements it chooses to make to comply with our DCR regulations.

This second association also said that ''[c]onsidering variability in weather conditions and the requirement to vacate docks as soon as possible for commercial and trade reasons . . . the requirement [should] be modified to allow for broom cleaning operations, if not complete before departure, to continue as soon as work related to departure is completed, or at sunrise the next morning should the vessel depart at night.'' As stated in our response to the first association, we understand that a vessel's ability to attain broom cleanliness will vary according to conditions. However, were we to make the change this association suggests, vessels would have little guidance for distinguishing when in-port compliance is essential from when it can be deferred until the vessel is in transit on the Great Lakes. Since the goal of our final rule is to minimize DCR discharges into the Great Lakes, we think this would undermine the purpose of the broom clean requirement, and we therefore, decline to make the suggested change.

Minimization of DCR discharges—Tunnels. One industry association and the advocacy alliance commented on DCR minimization with respect to vessel tunnels.

The association referred to the safety hazard that can be posed by the accumulation of significant amounts of water in tunnels, and said we should therefore, make it clear that nothing in our minimization requirement or other parts of our DCR regulation ''is intended to preclude the master or person-in-charge (PIC) from taking or executing any decision which, in his/her professional judgment, is necessary to maintain the safety of the crew and vessel.'' We decline to add the suggested language. We believe that the vessel-specific DCR management plan our rule requires is a more direct and effective way to address the safety concerns posed by the accumulation of excess water in vessel tunnels.

In an apparent reference to our statement in the SNPRM, 77 FR at 44532, col. 3, that ''[w]ithin tunnels, large pieces of DCR that remain after unloading should be easy to recover. . . and to place on the conveyor belt with the rest of the cargo during the vessel's next unloading,'' the association said that opportunities to do this are ''somewhat limited and vary

significantly from vessel to vessel.'' Therefore, the ''current practice of sumping [sump pumping] tunnel DCR will have to continue.'' We agree that sump pumping is often necessary and our final rule does not preclude that pumping.

The alliance parenthetically urged us to consider whether the Clean Water Act applies to sump pump discharge of DCR-laden effluent. We take no position on that question, as it is outside the scope of this final rule.

The alliance also said that we should prohibit offshore sump pumping so that vessels can discharge it only at certified shoreside garbage reception facilities. There are two reasons a vessel pumps sump while in transit. One is economy; it is cheaper for the vessel to pump while it is in transit than to spend time in port doing so. However, the second reason is operational—to preserve the vessel's stability and safety in transit. We agree with the association that offshore pumping of ''DCR-laden effluent'' for reasons of economy alone would not be consistent with the discharge minimization we will require, but we disagree that offshore pumping can be prohibited altogether because that could interfere with vessel safety. We expect that a vessel's DCR management plan will describe under what conditions offshore pumping may take place, and what measures the vessel takes to minimize the volume of DCR discharged with the pumped effluent.

DCR management plans. Two industry associations commented on the vessel-specific DCR management plan requirement. Both said that industry has already put in place some sort of current fleet-wide DCR management policies and plans, and one association said that because of this, regulations for written vessel-specific plans are not needed and would only create unnecessary paperwork. The other association agreed with us that ''there are instances when a vessel-specific plan is necessary,'' but said ''there is so much commonality in terms of general vessel layout, cargo hold figurations and unloading systems'' that a single DCR management plan will likely work for all its members.

We believe the additional regulatory cost of documenting policies and practices that already exist in some form will be minimal, will be of benefit to vessel crews in complying with our DCR regulations, and will provide Coast Guard inspectors with an important means of ensuring compliance. The cost of documentation should be further minimized by the ''commonality'' one association referred to, and we agree some common documentation for similar vessels, cargoes, or operations should be possible. However, the same association also cited many reasons why certain minimization measures will have drawbacks for particular vessels carrying particular cargoes under particular conditions. For that reason, we will require each vessel to have a plan that specifically describes how DCR will be minimized in light of those particularities.

One of the associations said we should specify that a recognized certified management system that accounts for DCR management procedures is acceptable so long as it complies with the version of 33 CFR 151.66(b)(5) promulgated by this final rule. We acknowledge that such a system may provide a useful basis for the required vessel-specific DCR management plan, but we decline the association's suggestion, and we caution that ''turnkey'' use of a recognized certified management system's standards, without specific adaptations made for the specific vessel, may not be enough to meet the section 151.66(b)(5) requirements.

Shoreside facilities. All three industry associations and the advocacy alliance criticized our focusing on vessels even though, as we stated in the SNPRM (77 FR at 44533, col. 2), ''shoreside cargo loading and unloading facilities undoubtedly play a role in creating, or limiting the creation of, the shipboard DCR that is eventually discharged into the Great Lakes.''

One of the industry associations correctly pointed out that the Coast Guard has some shoreside regulatory authority, for example under the Maritime Transportation Security Act of 2002. However, whether or not we have legal authority to regulate shoreside facilities in connection with DCR, as a practical matter our marine inspectors lack the resources or training to regulate the relations between vessels and a variety of shoreside facilities.

As one industry association said, industry members also feel they lack ''the expertise, time, or authority to implement practices or install equipment on docks.'' One of the other associations also made this point. We agree with the first association that ''there is little contractual or formal interface between carriers and docks,'' that shippers rather than carriers decide where cargo will be shipped and pay shoreside facilities, and that ''[d]ocks and vessels are distinct and separate links in the supply chain.'' However, they are both components of the same supply chain and are, therefore, interdependent on the smooth and economical operation of that chain. In light of the frequent communication between vessel and dock crews that the association acknowledged, it is reasonable to expect the vessel-specific DCR management plan to outline how those communications will be managed to maximize coordination with shoreside facilities and minimize DCR.

The advocacy alliance said that because we have ''made arrangements to consider and issue certificates to reception facilities that meet other aspects'' of MARPOL Annex V requirements, we ''cannot credibly claim'' that we are ''not suited to do so as to garbage and DCR.'' The Coast Guard makes no such claim. As the alliance goes on to say, we certify garbage reception facilities under 33 CFR part 158 subpart D. If a vessel pumps tunnel sump water at a shoreside garbage reception facility, it must be certified under that subpart.

Enforcement. Two industry associations and one individual commented on how the Coast Guard will enforce this final rule. The associations commented that Coast Guard requirements for DCR discharges are unique to the Great Lakes ''and it will be important that inspectors transferred to the Lakes are familiarized with the practice and what constitutes compliance with the final rule before they begin their new duties.'' One of the associations also favorably mentioned, in this context, the use of photographs in our DEIS to illustrate shipboard conditions. We agree. Coast Guard inspectors routinely receive training to familiarize them with local conditions and practices. Training often includes, but is not limited to, the use of photographs like those in the DEIS.

The individual commenter asked how we plan to enforce compliance, specifically what happens to the vessel if it does not keep a DCR management plan. The commenter suggested we include more detail about ''the implementation of inspections and what penalties the vessels will incur if they do not comply.'' Coast Guard inspections are carried out in accordance with detailed protocols contained in our Marine Safety Manual (*http://www.uscg.mil/directives/cim/16000-16999/CIM_16000_7A.pdf*), which need not be duplicated in our regulations. Those protocols will likely be supplemented with additional guidance to inspectors who will enforce our regulations on the Great Lakes. However, as adopted by this final rule, 33 CFR 151.66(b)(6) generally lists the criteria inspectors will apply in determining the adequacy of a vessel's DCR management plan—how closely

the vessel has kept up with best practices, how well trained the crew is in operations described in the plan, whether equipment described in the plan is in good working order, and how the crew conforms to plan standards in performing actual loading and unloading operations. Violations of our DCR regulations are subject to the criminal and civil penalties described in 33 CFR 151.04 and could include seizure of a vessel found to be in violation.

Limestone and clean stone. The advocacy alliance and one industry association commented on the SNPRM's proposals for new restrictions on discharges of limestone or clean stone DCR within 3 miles of shore. The alliance said they see the new restrictions ''as a major improvement to the interim rule.'' The association said the new restrictions will impede some operations, ''specifically in situations where the vessel must unload a cargo of stone, then load a different cargo in the same port or at a nearby port.'' The association said these restrictions are unnecessary because limestone or clean stone DCR discharges do not deposit an appreciable quantity of stone over the lake bed, and therefore ''it is difficult to believe that it would create a mussel breeding ground.''

We disagree that limestone and clean stone discharges do not deposit an appreciable quantity of stone over the lake bed. Observations conducted for this final rule's FEIS revealed that under current regulations, the discharge of limestone and clean stone DCR can occur while vessels are stationary at loading and unloading docks. According to the FEIS, multiple discharges of stone at port and in near shore areas could create as much as one inch per year of DCR accumulation on the lake floor, which would completely alter the existing sediment's physical structure and potentially affect the ecosystems at the bottom of the lake. Thus, in port and near shore areas, stone DCR deposition could have a significant, long-term, and cumulative impact on sediment structure. Furthermore, in port and near shore areas, limestone and clean stone discharges could create an optimum habitat for invasive mussels. In these shallow waters, which the mussels prefer, depositing bottom substrate that is stone over the native soft bottom sediments creates an optimum anchoring medium for the invasive mussels. In summary, all of the predicted ''significant'' environmental impacts delineated in our FEIS are the result of limestone and clean stone DCR discharge in port and near shore areas. For this reason, the final rule generally prohibits limestone and clean stone DCR discharges within 3 miles of shore.

Specific regulatory language. One industry association objected to the SNPRM's proposed wording of 33 CFR 151.66(b)(5)(viii). The association said that requiring a vessel's DCR management plan to include the ''procedures used and the vessel's operating conditions to be maintained during any unavoidable discharge of bulk dry cargo residue into the Great Lakes'' implies that DCR discharge is prohibited, ''when in fact the expectation of the rule is that the discharge'' need only be minimized. Our final rule retains the SNPRM's language. As other industry associations have commented persuasively, industry has a profit motive not to discharge DCR. Our expectation, therefore, is that it would be illogical, as well as illegal, for vessels to discharge DCR except when doing so is operationally ''unavoidable.''

V. Discussion of Final Rule

The context in which we developed this rule. We stated in the interim rule that, before taking final action in this rulemaking, we would ''determine if, in the long term, the optimal balancing of commercial and environmental interests requires the mandatory use of DCR control measures, the adjustment of the geographical boundaries within which those discharges are currently allowed, or other regulatory changes.'' 73 FR at 56495, col. 2.

To help us achieve that long-term balance, we analyzed the DCR discharge records reported to us in accordance with the interim rule. This helped us describe and quantify DCR discharges, and to determine what control measures were common and effective in controlling DCR discharges. This information is available in the appendices to this final rule's FEIS. We also observed Great Lakes dry cargo operations firsthand. During the 2009 and 2010 shipping seasons, we visited vessels and facilities in the region, and observed cargo loading and unloading and DCR discharge operations. This enabled us to gather DCR data using a known consistent set of metrics and a process that was completely independent of any used by vessel owners or operators to complete and submit their DCR discharge reports.

From this analysis and observation, we drew the following conclusions:

There is significant variation in the amount of DCR that vessels discharge; a finding that is supported by results reported by the regulated industry. However, most vessels appear to be minimizing the volume of DCR they discharge. They treat their cargo as a commodity to be conserved and not wasted. They deal with shoreside facilities that take the same practical view. These vessels and facilities use best practices to prevent cargo spillage in the first place, and to clean it up when it occurs. Most best practices are simple, intuitive, and cost little: For example, lining conveyor belts with fabric skirts, communicating with the shoreside facility to shut down loading chutes while moving from one hold to the next, and using brooms and shovels to clean up DCR and return it to the hold before the hold is sealed.

Deck spillage is a relatively minor source of DCR, and easily addressed through simple measures. By far, the greater source of DCR is from cargo hold spillage into vessel tunnels. Tunnel spillage occurs predominantly during cargo unloading.

Within tunnels, large pieces of DCR that remain after unloading should be easy to recover while the vessel is underway, and to place on the conveyor belt with the rest of the cargo during the vessel's next unloading. Dust and small particles, however, inevitably make their way into the vessel's sump water. The sump must be pumped periodically, to preserve the vessel's trim and stability. Sump pumping can take several hours. If performed shoreside, under some conditions the pumping could delay the vessel, increasing its operating costs and making it more economically rational to perform sump pumping while the vessel is underway, though this would likely result in sump discharges being the main contributor to DCR discharges in the Great Lakes.

Our final rule makes the following four general changes to the current interim rule, all of which are supported by the final rule's FEIS, and otherwise finalizes the interim rule. The rule also revises the definitions of ''commercial vessel'' and ''mile'' to provide greater clarity.

First, we require the volume of DCR discharges to be minimized. Except for a new, objectively verifiable, ''broom clean'' standard applying to decks, discharge minimization will be achieved through methods of the vessel owner or operator's choice. ''Broom clean'' is defined in 33 CFR 151.66(b)(2) as a condition in which deck residues ''consist only of dust, powder, or isolated and random pieces, none of which exceeds 1 inch in diameter.'' ''Minimization'' is also defined, as the ''reduction, to the greatest extent practicable, of any bulk dry cargo residue discharge from the vessel.'' Reinforcing the concept of

minimization, we also redefine ''bulk cargo residues'' to emphasize that DCR can exist ''regardless of particle size.''

Second, we require discharge minimization methods to be documented in a vessel-specific DCR management plan, which is a written plan, subject to Coast Guard inspection, meeting at least the minimum criteria we describe in 33 CFR 151.66(b)(5).

Third, limestone and clean stone DCR discharges are no longer permitted within 3 miles of shore. In the Western Basin of Lake Erie, we provide an exception within the dredged navigation channel between Toledo Harbor Light and the Detroit River Light. This is the only section of the Great Lakes where known Lake carrier track lines for limestone and clean stone transport vessels do not extend more than 3 miles from land and the discharge of stone DCR in the dredged channel would not adversely affect native sediments or underwater life.

Fourth, one year after the remainder of the final rule takes effect, we will remove the requirements of 33 CFR 151.66(c) to record cargo loading and unloading operations and DCR discharge data on a Coast Guard form and to submit copies of those forms to us once each quarter.

Minimization and the DCR management plan. The final rule requires U.S. and foreign carriers conducting bulk dry cargo operations on the Great Lakes to minimize the amount of cargo residue discharged into the Great Lakes. Except for the new broom clean standard, our focus will be on discharge minimization, not on minimizing DCR. Nor will we require vessels to eliminate DCR discharges because we continue to believe, as we did when we issued the interim rule, that a ''zero discharge'' requirement would be more costly than necessary to protect the environment against adverse impacts, and because the adverse impacts that can be associated with DCR discharges are only minor and indirect. Nevertheless, the elimination of DCR discharges remains the ideal outcome, and we expect vessels to come as close to that ideal as practicable, given current industry standard practices for vessels of ''comparable characteristics, cargoes, and operations''—a term we define in 33 CFR 151.66(b)(2) as meaning ''similar vessel design, size, age, crew complement, cargoes, operational routes, deck and hold configuration, and fixed cargo transfer equipment configuration.''

Discharge minimization includes keeping the vessel's deck in broom clean condition. All vessels should be able to achieve the broom clean standard on deck, by sweeping spilled cargo back into holds before they are sealed, if not by some other method. However, as noted, deck DCR only accounts for a relatively small proportion of overall DCR discharges. For the more significant tunnel sump discharges, it is not possible for us to define a similar standard that could be applied to all vessels. We believe that the degree of minimization that will be practicable for those discharges will depend on the variables of a vessel's characteristics, cargoes, and operations, and on the technology or procedures used to compensate for those variables.

Rather than mandating the use of specific procedures or technologies that may be ineffective or impracticable for some vessels, each vessel's owner or operator will select the method or methods best suited for minimizing that vessel's DCR discharges. We believe that the great majority of vessels affected by the final rule are already effectively minimizing those discharges. However, by making minimization a regulatory requirement, we level the playing field to ensure that all affected vessels engage in responsible discharge minimization practices.

The requirement for each vessel to carry its own vessel-specific DCR management plan on board, and to have that plan available for inspection, is central to the enforceability of a discharge minimization requirement.

Coast Guard inspectors will enforce discharge minimization by making sure that the vessel has a DCR management plan on board, that the plan is complete and addresses all required items, and that the master or PIC ensures that the vessel and its crew operate according to the plan. The Coast Guard can infer the vessel's failure to minimize discharges from evidence such as:

- A missing plan;
- A plan that fails to address obvious DCR situations on the vessel that raise the probability of an eventual DCR discharge, such as obvious DCR buildup in the vessel's tunnels;
- Discharge minimization equipment that is called for in the plan but is not present on the vessel or is not maintained or operating properly; or
- A crewmember's inability to perform a discharge-minimization task for which the plan makes the crewmember responsible.

To ensure that the vessel's owner and operator exercise due diligence in writing the management plan, we require the plan to describe:

- The equipment and procedures the vessel uses to minimize cargo spillage during loading and unloading;
- The equipment and procedures the vessel uses to recover spilled cargo and place it in holds or on unloading conveyances;
- How the owner or operator ensures crew familiarity with management plan procedures;
- Who has onboard responsibility for the vessel's discharge minimization procedures;
- What arrangements, if any, the vessel has with specific ports or cargo terminals for unloading and disposing of the vessel's DCR ashore; and
- How unavoidable DCR discharges will be conducted.

Our regulatory focus has been, and remains, on the vessels that carry bulk dry cargo—even though shoreside cargo loading and unloading facilities undoubtedly play a role in creating, or limiting the creation of, the shipboard DCR that is eventually discharged into the Great Lakes. Focusing on vessels makes sense because Coast Guard's inspectors are specifically trained and equipped to inspect vessels and not shoreside facilities. We expect each vessel's DCR management plan to describe how the vessel works with shoreside facilities to facilitate the vessel's compliance with the requirements of 33 CFR 151.66.

Another important aspect of the management plan requirement is that the plan must be revised whenever there is a substantive change to the procedures or to the equipment the vessel uses to manage dry cargo residues. Although regular or periodic revisions of the management plan are not required under this rule, vessel owners must maintain the plan in a manner that assures it accurately reflects the current procedures, practices, and technology employed in managing DCR on the vessel.

We expect that industry standard practices for the management of dry cargo residue will evolve as existing dry cargo conveyance technologies are supplanted by those that are more efficient, effective, and reliable. ''Industry standard practices'' are specifically defined in 33 CFR 151.66(b)(2) and include practices for installation, maintenance, operation, training, and supervision relating to bulk dry cargo transfer and DCR control measures. A primary premise of this rule is that a vessel owner or operator will employ dry cargo residue management practices that are on par with the current industry standard for vessels of comparable characteristics, cargoes, and operations. ''Comparable characteristics, cargoes, and operations'' is defined in 33 CFR 151.66(b)(2) as meaning ''similar vessel design, size,

age, crew complement, cargoes, operational routes, deck and hold configuration, and fixed cargo transfer equipment configuration.'' A vessel's compliance with this requirement of the rule will be determined in part by how well the vessel's DCR management practices, as outlined in its management plan, compare with the current industry standard practices employed by the majority of vessels with comparable characteristics, cargoes, and operations. If, for example, a vessel's plan continues to rely on technology or procedures that have been supplanted by more recent, affordable, and easily implemented industry standard practices, a Coast Guard inspector can consider this as evidence of failure to maintain the plan, failure to minimize DCR discharges, or both.

Limestone and clean stone. While we retain the interim rule's approach toward the discharge of DCR in general, we are tightening restrictions on limestone and clean stone DCR discharges. For most substances, DCR discharges have been and remain subject to several geographic limitations, including a flat prohibition on discharges within a certain distance from shore and in special protected areas. For limestone and clean stone, however, the interim rule continued the prior policy, which allowed DCR from limestone and clean stone to be discharged close to shore, except where the nearest shore is in a special protected area or where the discharge would have an ''apparent impact'' on wetlands, fish spawning areas, or potable water intakes. We believe this standard is too subjective and that it could be difficult for vessel crews to determine whether or not a stone DCR discharge will have an apparent impact on the local environment. Therefore, we are making limestone and clean stone DCR discharges subject to the same 3-mile restriction we impose on other DCR discharges. Our 2009 and 2010 field research and the interim rule's FEIS indicated that limestone and clean stone vessels already avoid DCR discharges within 3 miles of shore because of near-shore operational hazards. Thus, those vessels should not incur any additional costs from the extension of the exclusion zone. (We will preserve the existing exception for a limited portion of Lake Erie's Western Basin because some vessels carrying limestone or clean stone never leave that area, and if such a vessel wanted to discharge DCR, it could be unusually and adversely affected by a complete prohibition on DCR discharges in the area.) This change ensures that near-shore wetlands, fish spawning areas, and potable water intakes within the entire Great Lakes ecosystem are protected from DCR discharges, and it simplifies understanding and compliance with the rule for the regulated industry. It should also mitigate an environmental impact identified in the interim rule's FEIS; that is, possible changes in the physical structure of the lake bottom sediment, which may cause a less than 10 percent increase in zebra and quagga mussels' attachment rates.

Recordkeeping and reporting. We are retaining the interim rule's requirement, in 33 CFR 151.66(c), for vessels to keep detailed records of their bulk dry cargo loading and unloading operations and their DCR discharges. However, effective February 28, 2015 we will relax the interim rule's requirement in section 151.66(c)(3)(iv), for these records to be kept on Coast Guard Form CG–33, and for copies of the records to be submitted to the Coast Guard on a quarterly basis. Our SNPRM, 77 FR at 44531, col. 1, stated that ''[w]e lack sufficient information to remove the reporting requirement at this time.'' Form CG–33 greatly facilitated our research in preparation for issuing this final rule, but we have since concluded that while reporting on Form CG–33 may have value in monitoring the first year of operation under the final rule, after that time it will no longer be necessary to use Form CG–33, and no longer necessary to submit reports. This should reduce industry's recordkeeping and reporting burden. We have also concluded that we have good cause to relieve this burden without additional public notice or opportunity to comment, because after the first year of operation under the final rule it will be unnecessary and contrary to the public interest, within the meaning of 5 U.S.C. 553, to impose that burden.

VI. Regulatory Analyses

We developed this rule after considering numerous statutes and executive orders related to rulemaking. Below we summarize our analyses based on these statutes or executive orders.

A. Regulatory Planning and Review

Executive Orders (E.O.s) 12866 (''Regulatory Planning and Review'') and 13563 (''Improving Regulation and Regulatory Review'') direct agencies to assess the costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distributive impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility.

This rule is not a significant regulatory action under section 3(f) of E.O. 12866 as supplemented by E.O. 13563 and does not require an assessment of potential costs and benefits under section 6(a)(3) of E.O. 12866. The Office of Management and Budget (OMB) has not reviewed it under E.O. 12866. Nonetheless, we developed an analysis of the costs and benefits of the rule to ascertain its probable impacts on industry. A final Regulatory Assessment follows:

We received public comments related to this rulemaking, which are summarized in part IV of this preamble. There was one comment addressing the possible costs incurred by vessels due to port delays in order to perform the broom clean standard. As mentioned in part IV, we observed the loading and unloading practices of vessels operating on the Great Lakes, and found their practice is to maintain a clear deck as loading or unloading operations are taking place. Therefore, we do not anticipate vessels having to be burdened with an additional $2,000 (as stated by the commenter) to perform broom cleaning at dockside.

The final rule will require vessels to minimize their DCR discharges, to document their DCR minimization methods, and to observe new restrictions on limestone and clean stone DCR discharges.

Table 1 compares components of the interim rule (the baseline used for this rulemaking) and the final rule. It summarizes any changes in the component that will be in effect in this final rule.

TABLE 1—NO-ACTION (IR) AND PREFERRED ALTERNATIVE COMPARISON SUMMARY

Provision description	IR Provision	IR Provision synopsis	Final rule provision	Final rule provision synopsis	Change from IR to final rule
Recordkeeping	33 CFR 151.66(c)(1)(iv).	Vessels must record all DCR loading, unloading, and sweeping on Form CG–33.	NA	.....	Recordkeeping requirement would remain in place. However, after the first year of implementation, vessel operators will have the option of continuing to use Form CG–33. The industry would not incur any change in cost.
Reporting/ Certification.	33 CFR 151.66 (c)(1)(iv).	The data collected are used to determine vessel practices in handling DCR, and the amount of DCR that is being managed by the vessels.	NA	.....	Vessels will continue to certify and submit reports on a quarterly basis for 13 months after the publication of the final rule (no cost added to the rule). After the 13 month period, this requirement will be eliminated, thereby giving industry a cost saving.
Limestone and clean stone.	33 CFR 151.66(b)	Limestone and clean stone are exempt from the 3-mile near-shore sweeping boundary. Under the IR, these commodities can be discharged anywhere along the shoreline, provided there is no apparent impact on environmentally-sensitive areas.	33 CFR 151.66(b)(2).	Limestone and clean stone DCR discharges, under the final rule, would not be allowed within 3 miles of shore.	There would be a no-cost change; our research indicates that vessels already avoid DCR discharges within 3 miles of shore because of near-shore operational hazards.
Voluntary minimization.	33 CFR 151.66(b)	Vessels are encouraged to minimize the amount of DCR going into the water and the use of control measures to reduce the amount of DCR falling on the decks and tunnels of vessels.	NA	The portion of 33 CFR 151.66(b) in the IR dealing with voluntary minimization would be removed in the final rule.	There is no cost associated with the removal of this IR requirement. (See the management plan below for details on mandatory minimization.)
Broom clean standard.	NA	.....	33 CFR 151.66(b)(3).	This requirement stipulates that vessels must show that decks have been swept to a standard that is in keeping with the mandatory minimization requirement of this final rule.	Vessels would realize a new cost for this requirement. We anticipate that vessels would see an annual cost increase ranging from $14,203 to $53,263 (undiscounted). Foreign vessels would incur an average annual cost of $28,847 (undiscounted). The benefit of this requirement is a reduction in the amount of discharge going into the waters of the Great Lakes.

TABLE 1—NO-ACTION (IR) AND PREFERRED ALTERNATIVE COMPARISON SUMMARY—Continued

Provision description	IR Provision	IR Provision synopsis	Final rule provision	Final rule provision synopsis	Change from IR to final rule
Management plan.	NA		33 CFR 151.66(b)(4).	The plan must describe the specific measures the vessel's crew employs to ensure the minimization of bulk DCR discharge.	The new requirement would have an initial year cost of $24,777 (undiscounted) to prepare a management plan. After the initial year, existing U.S. vessels would not incur additional costs (within the 10-year period of analysis) from this new requirement. Foreign vessels would incur a first-year cost of $17,340 and an annual cost of $1,530 (all undiscounted) from this new requirement. This requirement would ensure that vessels are minimizing the amount of DCR going into the waters of the Great Lakes, and provide the Coast Guard with the means of policing DCR discharge.

Costs

The final rule has costs associated with having vessel owners and operators develop and maintain a management plan that describes the specific measures the vessel employs to ensure the minimization of bulk DCR discharges in the waters of the Great Lakes. The final rule will not impose any additional capital expenditures on the U.S. bulk dry cargo fleet operating exclusively on the Great Lakes, since we believe that vessels will use equipment already available on board their vessels to comply with this rule (for further information on specific measures currently being used, see FEIS).

We estimated the annualized costs of the final rule for the U.S. fleet to range from $17,500 to $56,298 (with a per vessel average cost of $671), and the annualized costs to the foreign fleet to range from $13,922 to $48,697 (with a per-vessel average cost of $368). All costs are estimated using a 7 percent discount rate. The following table summarizes the affected population of vessels, costs, and benefits of the rule. We also estimated an annualized cost saving of $11,595 for the U.S. fleet and $8,442 for the foreign fleet; both costs are reported at 7 percent discount.

TABLE 2—SUMMARY OF AFFECTED POPULATION, COSTS AND BENEFITS OF THE FINAL RULE

Affected Population	
U.S.	55 Vessels (14 owners).
Foreign	85 Vessels.
Total	140 Vessels.
Costs [1]	
U.S.	Annualized = $17,500–$56,298. 10 year = $122,916–$395,413.
Foreign	Annualized = $13,922–$48,697. 10 year = $97,786–$342,029.
Total	Annualized = $31,423–$104,995. 10 year = $220,701–$737,444.
Savings [2]	
U.S.	Annualized = $11,959. 9 year cost savings = $83,992.
Foreign	Annualized = $8,442. 9 year cost savings = $59,295.
Benefits	
Minimizing the amount of DCR discharged into the waters of the Great Lakes would improve the aquatic environment.	

TABLE 2—SUMMARY OF AFFECTED POPULATION, COSTS AND BENEFITS OF THE FINAL RULE—Continued

Promotion of environmental stewardship among owners and operators.

[1] Costs are presented as ranges and estimated using a 7 percent discount rate.
[2] Savings do not occur until 13 months after the publication of the final rule.

The final rule will require all vessels loading or unloading bulk dry cargo at ports within the U.S. waters of the Great Lakes, and each U.S. bulk dry cargo vessel operating anywhere on the Great Lakes, to have a management plan on board and available for Coast Guard inspection that describes the specific measures the vessel employs to minimize DCR discharges. Foreign vessels greater than 400 GT can meet the management plan requirement under this final rule because they are required to meet the similar waste management plan requirement in Annex V of the International Convention for the Prevention of Pollution from Ships (MARPOL 73/78). However, since Annex V of MARPOL 73/78 does not cover all of the requirements in 33 CFR 151.66(b)(4), foreign vessels would be required to address any additional management plan requirements under this final rule.

We estimate that the final rule will affect 14 entities that currently manage the 55 U.S. dry bulk carrier vessels, and 85 foreign dry bulk carrier vessels (70 Canadian and 15 non-Canadian) operating within U.S. jurisdictional waters of the Great Lakes in any given year. We anticipate that the controlling entities of U.S. vessels would write the management plans. We assume that a management plan for a foreign vessel operating in the U.S. waters of the Great Lakes would be written by the vessel master.

We estimate the affected population of foreign dry bulk carriers to be 85 vessels based on the data obtained from reporting requirements established by the 2009 interim rule. We originally estimated the foreign vessel population to be 219 vessels for the 2008 NPRM and the 2009 interim rule. Our revised estimate of the foreign vessel population is based on recent data on foreign vessel dry cargo operations that was not available for the NPRM or the interim rule publications.

To maintain consistency with the cost methodology used in the interim rule, we continue to use Coast Guard reimbursable standard rates found in COMMANDANT INSTRUCTION 7310.1M (''COMDTINST'') to analyze the changes in wages for this rulemaking.[1] We have verified that the wages found in the COMDTINST are comparable to the loaded wages found in the Bureau of Labor Statistics. Therefore, that comparison between the interim rule and the final rule is straightforward.

Table 3 shows estimated costs for developing the management plan required by 33 CFR 151.66(b)(4) and for having a hard copy of the plan on board and available for Coast Guard inspection.

Table 3—Cost of Company Development of a Management Plan (non–discounted)

33 CFR 151.66 (b)(4)	Developer Rating	Labor Rate (loaded)	Time in Hours	Cost per Plan	Number of Plans	Total Initial Cost	Recurring Cost
U.S.							
Company management plan	GS-12	$69	25	$1,725	14	$24,150	
Cost of copies	GS-3	$28	.05	$11.40 [a]	55	$627	
Foreign							
Canadian vessels	O-6	$136	1.5 [b]	$204	70	$14,280	
Non-Canadian foreign vessels	O-6	$136	1.5 [b]	$204	15	$3,060	$1,530[c]
Total						$42,117	$1,530

Note: Values may not total due to rounding

(a) Assumes that companies would spend $10 on supplies for each copy of the management plan. The $10 is added to the labor and time estimated to be $1.40 ($28 * 0.05 hrs), therefore the total cost of copies per plan is $11.40.

(b) We assume that foreign vessels greater than 400 GT would develop a modified management plan, since foreign vessels greater than 400 GT are required to have a waste management plan in accordance with Annex V of MARPOL 73/78. Therefore, the time required by foreign vessels greater than 400 GT to develop a management plan would be less than the time estimated for the U.S. fleet. Time required for foreign vessels developing a management plan was provided by the USCG Environmental Standards Division.

(c) The recurring cost of the management plan is only for half of the non-Canadian foreign vessels entering the Great Lakes in any given year. We anticipate that half the number of these vessels would return the following year, while the other half would be new visitors to the Great Lakes.

[1] COMMANDANT INSTRUCTION 7310.1M, ''COAST GUARD REIMBURSABLE STANDARD RATES'', Feb. 28, 2011, *http://www.uscg.mil/directives/ci/7000–7999/CI_7310_1M.PDF* (begins on page 3).

In addition to the management plan, the final rule will require that the deck be maintained in a broom clean condition whenever a vessel is in transit (33 CFR 151.66(b)(4)). We assume for the purpose of this regulatory analysis that an AB would be tasked with maintaining the broom clean standard as required under this rule during loading and unloading operations, to the best of the AB's abilities under current vessel conditions. The requirement is intended to ensure that vessels are active in reducing the amount of DCR going into the waters of the Great Lakes. We do not expect that vessels would need to purchase additional brooms, shovels, etc., since these items are standard equipment on those vessels.

In order to determine the cost of maintaining decks in broom clean condition, we established that the surface area requiring broom cleaning would be those areas around the cargo hatches. During a site visit to the Great Lakes to observe vessel loading and unloading operations, we recorded the number of hatches for each vessel visited. We extrapolated the observed data to obtain an estimated number of total hatches for the Great Lakes bulk dry cargo fleet. We estimated the total number of hatches for the 55 U.S. vessels to be 1,169, while the total number of hatches for the 70 Canadian and 15 non-Canadian foreign vessels was estimated at 1,672. We estimate that 15 to 56 percent of the hatches would be affected by the broom clean standard after every loading and unloading event, and that it would take an AB three minutes per hatch (at a wage rate of $27 per hour) to meet the broom clean standard. Table 4 shows the annual estimated cost to the U.S. fleet for maintaining the broom clean standard. The cost range for this requirement is $14,203 to $53,001 (undiscounted). Costs are based on all vessels making an average of 60 trips per year.[2]

TABLE 4—U.S. FLEET COST FOR MEETING THE BROOM CLEAN STANDARD

33 CFR 151.66(b)(3)	Crew-member	Labor rate	Time req'd (%/Hr)	Total number of fleet hatches	% of hatches swept	% Vessels broom clean	Avg. number of trips/yr.	Number of crew	Total hrs/yr.	Total cost
Broom Clean (Low).	Deckhand (AB).	$27	0.05	1,169	15	100	60	1	526	$14,203
Broom Clean (High).	Deckhand (AB).	27	0.05	1,169	56	100	60	1	1,963	53,001

Note: Values may not total due to rounding.

The cost to Canadian and non-Canadian foreign vessels is shown in Tables 5(a) and (b). The combined cost of the broom clean standard for foreign vessels is estimated to range from $69 to $45,247 (undiscounted). Costs are based on Canadian vessels making an average of 45 trips per year and non-Canadian foreign vessels averaging only one trip per year.

TABLE 5(a)—CANADIAN FLEET COST FOR MEETING THE BROOM CLEAN STANDARD

33 CFR 151.66 (b)(3)	Crew-member	Labor rate	Time req'd (%/Hr)	Total number of fleet hatches	% of hatches swept	% Vessels broom clean	Avg. number of trips/yr.	Number of crew	Total hrs/yr.	Total cost
Broom Clean (Low).	Deckhand (AB).	$27	0.05	1,330	15	100	45	1	449	$12,120
Broom Clean (High).	Deckhand (AB).	27	0.05	1,330	56	100	45	1	1676	45,247

Note: Values may not total due to rounding.

TABLE 5(b)—NON-CANADIAN FOREIGN FLEET COST FOR MEETING THE BROOM CLEAN STANDARD

33 CFR 151.66 (b)(3)	Crew-member	Labor rate	Time req'd (%/Hr)	Total number of fleet hatches	% of hatches swept	% Vessels broom clean	Avg. number of trips/yr.	Number of crew	Total hrs/yr.	Total cost
Broom Clean (Low).	Deckhand (AB).	$27	0.05	342	15	100	1	1	3	$69
Broom Clean (High).	Deckhand (AB).	27	0.05	342	56	100	1	1	10	259

Note: Values may not total due to rounding.

The cost of complying with the management plan and broom clean requirements for the U.S. fleet is estimated to have a first-year cost range of $38,982 to $77,778 (undiscounted) and recurring annual costs ranging from $14,203 to $53,001 (undiscounted). Table 6 shows the U.S. fleet cost estimate for the 10-year period of analysis.

[2] Annual vessel trip information comes from the DEIS.

Table 6—U.S. Vessels High and Low Cost Estimates

	High Cost Estimate			**Low Cost Estimate**		
Year	**Undiscounted**	**3%**	**7%**	**Undiscounted**	**3%**	**7%**
1	$77,778	$75,513	$72,690	$38,982	$37,846	$36,432
2	$53,001	$49,959	$46,293	$14,203	$13,388	$12,406
3	$53,001	$48,503	$43,265	$14,203	$12,998	$11,594
4	$53,001	$47,091	$40,434	$14,203	$12,619	$10,836
5	$53,001	$45,719	$37,789	$14,203	$12,252	$10,127
6	$53,001	$44,388	$35,317	$14,203	$11,895	$9,464
7	$53,001	$43,095	$33,006	$14,203	$11,549	$8,845
8	$53,001	$41,839	$30,847	$14,203	$11,212	$8,266
9	$53,001	$40,621	$28,829	$14,203	$10,886	$7,726
10	$53,001	$39,438	$26,943	$14,203	$10,569	$7,220
Total Cost	**$554,787**	**$476,165**	**$395,413**	**$166,812**	**$145,214**	**$122,916**
Annualized Cost		**$55,821**	**$56,298**		**17,024**	**$17,500**

Note: Values may not total due to rounding

In addition, we estimate that foreign vessels would incur a first-year cost that ranges from $15,249 to $59,527 (undiscounted). All foreign vessels would incur an annual cost due to the broom clean standard; however, half of the 15 non-Canadian foreign vessels entering the U.S. waters of the Great Lakes would be anticipated to incur an additional cost for developing a management plan since the same non-Canadian foreign vessel is not expected to make the same trip every year. We estimate the recurring cost of all foreign vessels to range from $13,719 to $47,035 (undiscounted). Table 7 shows the U.S. fleet cost estimate for the 10-year period of analysis.

Table 7—Foreign Vessels High and Low Cost Estimates

	High Cost Estimate			Low Cost Estimate		
Year	**Undiscounted**	**3%**	**7%**	**Undiscounted**	**3%**	**7%**
1	$59,527	$57,793	$55,632	$15,249	$14,805	$14,251
2	$47,035	$44,335	$41,082	$13,719	$12,391	$11,983
3	$47,035	$43,044	$38,395	$13,719	$12,555	$11,199
4	$47,035	$41,790	$35,883	$13,719	$12,189	$10,466
5	$47,035	$40,573	$33,535	$13,719	$11,834	$9,781
6	$47,035	$39,391	$31,342	$13,719	$11,489	$9,141
7	$47,035	$38,244	$29,291	$13,719	$11,155	$8,543
8	$47,035	$37,130	$27,375	$13,719	$10,830	$7,985
9	$47,035	$36,049	$25,584	$13,719	$10,514	$7,462
10	$47,035	$34,999	$23,910	$13,719	$10,208	$6,974
Total Cost	**$482,843**	**$413,347**	**$342,029**	**$138,719**	**$118,510**	**$97,786**
Annualized Cost		**$48,457**	**$48,697**		**$13,893**	**$13,922**

Note: Values may not total due to rounding

The final rule will also prohibit all near-shore limestone and clean stone DCR discharges, except in the Western Basin of Lake Erie. Our research found that vessels carrying limestone and clean stone already avoid DCR discharges within 3 miles of shore because of near-shore operational hazards. Therefore, the prohibition of these discharges will not incur any additional cost to the fleet.

Savings

The costs estimated in the final rule will be offset by eliminating (13 months after the publication of the final rule) the requirement for vessel owners or operators to submit a master-certified report to the Coast Guard on a quarterly basis. The submission of the reports was a temporary requirement that provided needed information throughout the rulemaking process. Now that the final rule is being published, there is no need to continue having vessel owners or operators submit these documents to the Coast Guard. However, information regarding DCR discharge will still be maintained on board all vessels as part of the recordkeeping requirement. In addition, the vessel owner or operator will have the option of using or not using Form CG–33 to record DCR discharges.

We estimated an annual savings to the U.S. fleet at $13,794 (undiscounted), and a foreign savings of $9,738 (undiscounted). The total 9-year [3] savings for the U.S. fleet is estimated at $83,992 and foreign at $59,295, both discounted at 7 percent. The annualized savings for the U.S. fleet and foreign fleet is estimated at $11,959 and $8,442 respectively; both are discounted at 7 percent. Table 8 shows anticipated savings for both U.S. and foreign fleets.

[3] The decision to remove the requirement for submitting DCR discharge reports to the Coast Guard (13 months after the publication of this rule), causes the estimated industry saving to start in year 2. Hence, estimated cost savings are done using a 9-year estimate with the exception of the annualized cost which is taken over a 10-year period of analysis. Annualized savings uses a 10-year approach to appropriately measure total effective cost of this rulemaking on industry.

Table 8—Anticipated Savings for U.S. and Foreign Fleet

	U.S. Flag Feet			Foreign Flag Fleet		
Year	**Undiscounted**	**3%**	**7%**	**Undiscounted**	**3%**	**7%**
1	$-	$-	$-	$-	$-	$-
2	$13,794	$13,002	$12,048	$9,738	$9,179	$8,506
3	$13,794	$12,623	$11,260	$9,738	$8,912	$7,949
4	$13,794	$12,256	$10,523	$9,738	$8,652	$7,429
5	$13,794	$11,899	$9,835	$9,738	$8,400	$6,943
6	$13,794	$11,552	$9,192	$9,738	$8,155	$6,489
7	$13,794	$11,216	$8,590	$9,738	$7,918	$6,064
8	$13,794	$10,889	$8,028	$9,738	$7,687	$5,668
9	$13,794	$10,572	$7,503	$9,738	$7,463	$5,297
10	$13,794	$10,264	$7,012	$9,738	$7,246	$4,950
Total	**$124,146**	**$104,273**	**$83,992**	**$87,642**	**$73,613**	**$59,295**
Annualized		**$12,224**	**$11,959**		**$8,630**	**$8,442**

We estimate total annualized cost to industry (U.S. and foreign) of the final rule to be $9,206 to $66,551, and the total discounted 10-year costs to industry to be $64,656 to $467,427 (values discounted at 7 percent). We do not expect that there will be additional government costs required to implement the changes from this final rule.

Benefits

We examined the benefits of the rule and concluded that the benefits are qualitative. The requirement of the management plan causes all vessel owners and operators to become more active in preserving the Great Lakes' aquatic environment. The final rule sets a performance standard that allows the industry to determine its most efficient methods to minimize DCR discharges.

We anticipate that the final rule will change the current industry behavior of discharging DCR into the waters of the Great Lakes. The requirement for vessels to have and follow DCR management plans should increase overall compliance levels with today's industry best practices for preventing or minimizing DCR discharges. In enforcing the DCR management plan requirement, the Coast Guard will be able to consider how well a vessel's plan reflects then-current industry standard practices. This will ensure that if, over time, there is an improvement in most vessels' ability to manage DCR, all vessels will be measured against the improved standard. Although our environmental analysis has shown only minor and indirect adverse environmental impacts from DCR discharges, we assume that any reduction in those impacts will provide at least a qualitative benefit. In addition, the vessel owners and operators themselves could realize efficiency gains from maintaining and gradually improving their DCR management practices. The final rule will not impose a rigid prescriptive standard, but will give the industry the flexibility to develop vessel-specific performance standards that achieve the regulatory objectives in the most cost-effective way.

Alternatives

Alternative 1—no action. This alternative would simply keep the current DCR interim rule in place. We have re-evaluated the interim rule and concluded that our final rule will do more to minimize the volume of DCR discharge going into the waters of the Great Lakes and reduce the interim rule's regulatory costs. Therefore, we reject this alternative.

Alternative 2—modified regulations with DCR management plan requirement. This is the preferred alternative described in this final rule and evaluated here.

Alternative 3—baseline control measures. This alternative would enforce the existing DCR management baseline. Each vessel would be required to maintain its current practices or equipment for managing DCR. We closely evaluated this alternative, but rejected it because over time a vessel's baseline operational equipment will wear out and need replacement. Also, it would be difficult for inspectors to gauge how well the replacement equipment replicates the operational state attained by the original equipment. Moreover, this alternative provides inferior environmental protection by locking vessels into today's baseline. By contrast, the preferred alternative assumes that DCR management practices and technology will improve over time, and we want the regulatory compliance of vessels in the future to be measured against the best practices and technology then available, and not against today's baseline, which we assume will represent a lower level of DCR management capability.

B. Small Entities

Under the Regulatory Flexibility Act (5 U.S.C. 601–612), we have considered whether this rule would have a significant economic impact on a substantial number of small entities. The term ''small entities'' comprises small businesses, not-for-profit organizations that are independently owned and operated and are not dominant in their fields, and governmental jurisdictions with populations of less than 50,000.

The Coast Guard analysis did not find any non-profit or governmental small entities. However, we did find nine small entities affected by this rule classified under one of the following North American Industry Classification System (NAICS) 6-digit codes for water transportation. We have provided a summary table with all NAICS codes impacted by this rulemaking with a description of the NAICS codes and what constitutes a small business as per the U.S. Small Business Administration's (SBA) guidelines.

TABLE 9—SUMMARY OF SBA SMALL BUSINESS STANDARDS BY NAICS CODES

NAICS Codes	Descriptions	Small business by revenue	Small business by employee
238910	Site Preparation Constructor	$14 million	
483113	Coastal and Great Lakes Freight Transportation		500
484110	General Freight Trucking Local	$25 million	
487210	Scenic & Sightseeing Transportation Water	$7 million	
483212	Inland Water Passenger Transportation		500
483211	Inland Water Freight		500

According to the SBA's size standards, a U.S. company classified under one of the above mentioned NAICS codes with annual revenues not to exceed, as indicated in Table 9, $14 million, $25 million, and $7 million respectively, and have fewer than 500 employees is considered a small business. We estimate the cost of this final rule to be less than 1 percent of revenue for 100 percent of the small entities for both initial and recurring costs. The average estimated annual costs per small entity complying with the final rule is $4,797 discounted at 7 percent.

Therefore, the Coast Guard certifies under 5 U.S.C. 605(b) that this final rule will not have a significant economic impact on a substantial number of small entities.

C. Assistance for Small Entities

Under section 213(a) of the Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104–121), we offered to assist small entities in understanding the rule so that they could better evaluate its effects on them and participate in the rulemaking. The Coast Guard will not retaliate against small entities that question or complain about this rule or any policy or action of the Coast Guard.

Small businesses may send comments on the actions of Federal employees who enforce, or otherwise determine compliance with, Federal regulations to the Small Business and Agriculture Regulatory Enforcement Ombudsman and the Regional Small Business Regulatory Fairness Boards. The Ombudsman evaluates these actions annually and rates each agency's responsiveness to small business. If you wish to comment on actions by employees of the Coast Guard, call 1–888–REG–FAIR (1–888–734–3247).

D. Collection of Information

The final rule calls for a revision to an existing collection of information under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520). As defined in 5 CFR 1310.3(c), ''collection of information'' comprises reporting, recordkeeping, monitoring, posting, labeling, and other, similar actions. The title and description of the information collection, a description of those who must collect the information, and an estimate of the total annual burden follow. The estimate covers the time for reviewing instructions, searching existing sources of data, gathering and maintaining the data needed, and completing and reviewing the collection.

This rulemaking relates to an existing OMB-approved collection of information, 1658–0072, revisions for which are pending OMB approval.

OMB Control Number: 1625–0072.

Title: Waste Management Plans, Refuse Discharge Logs, Letters of Instruction for Certain Persons in Charge (PIC), and Great Lakes Dry Cargo Residue Recordkeeping.

Summary of the Collection of Information:

The Information Collection Request (ICR) is a collection of recordkeeping requirements that documents management of waste on board vessels. It also requires that persons on non-inspected vessels must carry a letter verifying the credential of the PIC, and that they have had instruction on the management of waste. Currently, the ICR covers waste management plans and refuse discharge logs for MARPOL 73/78 from ships' letters of instruction for certain PIC and the DCR recordkeeping.

This rule deals with section D of the current ICR, which addresses all dry bulk carrier vessels (foreign and domestic) operating on the Great Lakes. Under the interim rule, this population is required to report DCR quantities and the location of discharges into U.S. waters of the Great Lakes, in accordance with 33 CFR 151.66(c). We used the information collected from these reports to analyze and determine how best to regulate vessels in handling/managing DCR. The rule will require U.S. and foreign vessels to develop and maintain a management plan that describes the specific measures the vessel employs to ensure the minimization of bulk DCR discharges.

Need for Information: Since there is no uniformity as to the types of equipment used throughout the fleet, the management plan would provide a description of how the individual vessel ensures the minimization of DCR discharges.

Use of Information: The information in the management plan would provide the Coast Guard with the means to monitor how individual operators are effectively managing and minimizing their DCR discharges. In addition, the management plan would be used by Coast Guard inspectors to enforce the minimization requirement.

Description of the Respondents: We estimate that all U.S. bulk dry cargo vessels operating anywhere in the Great Lakes, and foreign commercial bulk dry cargo vessels operating on the U.S. waters of the Great Lakes, will be affected by the management plan requirement.

Number of Respondents: The management plan would have a total number of 99[4] (14 U.S. Firms + 70 Canadian vessels + 15 non-Canadian foreign vessels) respondents, which account for the total number of bulk dry cargo vessels operating on the waters of the Great Lakes in any given year.

Frequency of the Response: All vessels carrying bulk dry cargo on the Great Lakes are required to develop a management plan. The frequency in the development of the management plan would be subject to vessels modifying their vessels and/or equipment. We do not anticipate vessels modifying or adding a major equipment during the 10-year period of this analysis. We therefore assume that the development of the management plan would occur once for U.S. and Canadian vessels. However, 50 percent of non-Canadian foreign vessels would be required to develop a management plan each year, since we estimate that this percentage of vessels would be entering the Great Lakes for the first time. Therefore, we estimate that in the first year there would be 140 (55 U.S. vessels + 70

[4] The number of foreign vessels affected has been updated (from the interim rule) due to information being provided to the Coast Guard by Form CG–33.

Canadian vessels + 15 non-Canadian foreign vessels) total management plans developed by all bulk dry cargo vessels operating in U.S. waters, and 8 (rounded) reoccurring responses by non-Canadian foreign vessels.

Burden of Response: We estimate that there would be 55 management plans developed for the entire U.S. dry cargo vessel fleet operating on the Great Lakes, and that it would only affect the burden of response in the first year that the rule is in effect. The total estimated burden hours for the U.S. fleet is 352.75 (350 hours company section + 2.75 hours copies), at a cost to the fleet of $24,150 (undiscounted). The total foreign vessel fleet would have a burden of response in the first year of 128 hours (1.5 hours for management plan × 85 vessels), at a cost of $17,340 (undiscounted).

Estimate of Total Annual Burden: The rule will not have an annual cost burden for U.S. and Canadian vessels after the rule's first year of implementation (see ''BURDEN OF RESPONSE,'' earlier in this final rule). After the first year, non-Canadian foreign vessels will incur an annual burden. We anticipate non-Canadian vessels will incur an annual burden of 11 hours for management plan development at a cost of $1,530 (undiscounted).

After February 28, 2015, we will no longer require vessels to submit DCR discharge records to the Coast Guard each quarter, which will reduce the industry annual reporting burden by 18 hours.

As required by the Paperwork Reduction Act of 1995, we have submitted a copy of this rule to OMB for its review of the collection of information.

You need not respond to a collection of information unless it displays a currently valid control number from OMB. Before the Coast Guard can enforce the collection of information requirements in this rule, OMB must approve the Coast Guard's request to collect this information.

E. Federalism

A rule has implications for federalism under E.O. 13132 (''Federalism'') if it has a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. We have analyzed this rule under E.O. 13132 and have determined that it does not have implications for federalism.

As we discussed at length in part V of this preamble, we received comments from several States in response to our interim rule and are aware that some agencies in some States bordering the Great Lakes disagree with the Coast Guard's approach to the discharge of DCR in those waters. We encourage all such States, and any of their agencies with a stake in the outcome of this rulemaking, to continue sharing their input with us. We believe neither the interim rule nor this final rule necessarily preempts or conflicts with State laws that may prohibit DCR discharges or impose conditions on those discharges that differ from those imposed by the Coast Guard. We do not take the position that such State laws facially frustrate an overriding Federal purpose. Until such time as a cognizant court rules to the contrary, we caution carriers that they must comply with all applicable Federal and State laws regulating DCR discharges. We encourage States to make us aware of laws they think are applicable. As we are so informed, we will share that information with the public by placing it in the docket for this rulemaking.

F. Unfunded Mandates Reform Act

The Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) requires Federal agencies to assess the effects of their discretionary regulatory actions. In particular, the Act addresses actions that may result in the expenditure by a State, local, or tribal government, in the aggregate, or by the private sector of $100,000,000 (adjusted for inflation) or more in any one year. Though this rule will not result in such an expenditure, we do discuss the effects of this rule elsewhere in this preamble.

G. Taking of Private Property

This rule will not cause a taking of private property or otherwise have taking implications under E.O. 12630, Governmental Actions and Interference with Constitutionally Protected Property Rights.

H. Civil Justice Reform

This rule meets applicable standards in sections 3(a) and 3(b)(2) of E.O. 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden.

I. Protection of Children

We have analyzed this rule under E.O. 13045, Protection of Children from Environmental Health Risks and Safety Risks. This rule is not an economically significant rule and will not create an environmental risk to health or risk to safety that might disproportionately affect children.

J. Indian Tribal Governments

This rule does not have tribal implications under E.O. 13175, Consultation and Coordination with Indian Tribal Governments, because it does not have a substantial direct effect on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes. However, a group representing tribal interests requested consultation, and the Coast Guard agreed to brief that group on the rulemaking. The briefing is described in the docket (see docket item USCG–2004–19621–0182).

K. Energy Effects

We have analyzed this rule under E.O. 13211, Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use. We have determined that it is not a ''significant energy action'' under that order because it is not a ''significant regulatory action'' under E.O. 12866 and is not likely to have a significant adverse effect on the supply, distribution, or use of energy.

L. Technical Standards

The National Technology Transfer and Advancement Act (15 U.S.C. 272 note) directs agencies to use voluntary consensus standards in their regulatory activities unless the agency provides Congress, through OMB, with an explanation of why using these standards would be inconsistent with applicable law or otherwise impractical. Voluntary consensus standards are technical standards (e.g., specifications of materials, performance, design, or operation; test methods; sampling procedures; and related management systems practices) that are developed or adopted by voluntary consensus standards bodies. This rule does not use technical standards. Therefore, we did not consider the use of voluntary consensus standards.

M. Environment

We have analyzed this rule under Department of Homeland Security Management Directive 023–01 and Commandant Instruction M16475.lD, which guide the Coast Guard in complying with the National Environmental Policy Act of 1969 (NEPA)(42 U.S.C. 4321–4370f). The FEIS and ROD appear in the docket.

List of Subjects in 33 CFR part 151

Administrative practice and procedure, Oil pollution, Penalties, Reporting and recordkeeping requirements, Water pollution control.

For the reasons discussed in the preamble, the Coast Guard amends 33 CFR part 151 as follows:

PART 151—VESSELS CARRYING OIL, NOXIOUS LIQUID SUBSTANCES, GARBAGE, MUNICIPAL OR COMMERCIAL WASTE, AND BALLAST WATER

■ 1. The authority citation for part 151 continues to read as follows:

Authority: 33 U.S.C. 1321, 1902, 1903, 1908; 46 U.S.C. 6101; Pub. L. 104–227 (110 Stat. 3034); Pub. L. 108–293 (118 Stat. 1063), § 623; E.O. 12777, 3 CFR, 1991 Comp. p. 351; DHS Delegation No. 0170.1, sec. 2(77).

■ 2. Revise § 151.66 to read as follows:

§ 151.66 Operating requirements: Discharge of garbage in the Great Lakes and other navigable waters.

(a) Except as otherwise provided in this section, no person on board any ship may discharge garbage into the navigable waters of the United States. Cleaning agents or additives contained in deck and external surface wash water may be discharged only if these substances are not harmful to the marine environment.

(b)(1) On the U.S. waters of the Great Lakes, commercial vessels may discharge bulk dry cargo residues in accordance with and subject to the conditions imposed by this paragraph.

(2) As used in this paragraph and in paragraph (c) of this section—

Apostle Islands National Lakeshore means the site on or near Lake Superior administered by the National Park Service, less Madeline Island, and including the Wisconsin shoreline of Bayfield Peninsula from the point of land at 46°57′19.7″ N. 090°52′51.0″ W southwest along the shoreline to a point of land at 46°52′56.4″ N. 091°3′3.1″ W.

Broom clean means a condition in which the vessel's deck shows that care has been taken to prevent or eliminate any visible concentration of bulk dry cargo residues, so that any remaining bulk dry cargo residues consist only of dust, powder, or isolated and random pieces, none of which exceeds 1 inch in diameter.

Bulk dry cargo residues means non-hazardous and non-toxic residues, regardless of particle size, of dry cargo carried in bulk, including limestone and other clean stone, iron ore, coal, salt, and cement. It does not include residues of any substance known to be toxic or hazardous, such as nickel, copper, zinc, lead, or materials classified as hazardous in provisions of law or treaty.

Caribou Island and Southwest Bank Protection Area means the area enclosed by rhumb lines connecting the following coordinates, beginning on the northernmost point and proceeding clockwise:

47°30.0′ N, 085°50.0′ W
47°24.2′ N, 085°38.5′ W
47°04.0′ N, 085°49.0′ W
47°05.7′ N, 085°59.0′ W
47°18.1′ N, 086°05.0′ W.

Commercial vessel means a commercial vessel loading, unloading, or discharging bulk dry cargo in the U.S. waters of the Great Lakes, or a U.S. commercial vessel transporting bulk dry cargo and operating anywhere on the Great Lakes; but the term does not include a non-self-propelled barge unless it is part of an integrated tug and barge unit.

Comparable characteristics, cargoes, and operations means similar vessel design, size, age, crew complement, cargoes, operational routes, deck and hold configuration, and fixed cargo transfer equipment configuration.

Detroit River International Wildlife Refuge means the U.S. waters of the Detroit River bound by the area extending from the Michigan shore at the southern outlet of the Rouge River to 41°54.0′ N., 083°06.0′ W. along the U.S.-Canada boundary southward and clockwise connecting points:

42°02.0′ N, 083°08.0′ W
41°54.0′ N, 083°06.0′ W
41°50.0′ N, 083°10.0′ W
41°44.52′ N, 083°22.0′ W
41°44.19′ N, 083°27.0′ W.

Dry cargo residue (or DCR) management plan means the plan required by paragraph (b)(5) of this section.

Grand Portage National Monument means the site on or near Lake Superior, administered by the National Park Service, from the southwest corner of the monument point of land at 47°57.521′ N 089°41.245′ W. to the northeast corner of the monument point of land, 47°57.888′ N 089°40.725′ W.

Indiana Dunes National Lakeshore means the site on or near Lake Michigan, administered by the National Park Service, from a point of land near Gary, Indiana at 41°42′59.4″ N 086°54′59.9″ W eastward along the shoreline to 41°37′08.8″N 087°17′18.8″ W near Michigan City, Indiana.

Industry standard practices means practices that ensure the proper installation, maintenance, and operation of shipboard cargo transfer and DCR removal equipment, proper crew training in DCR minimization procedures and cargo transfer operations, and proper supervision of cargo transfer operations to minimize DCR accumulation on or in a commercial vessel.

Integrated tug and barge unit means any tug-barge combination which, through the use of special design features or a specially designed connection system, has increased sea-keeping capabilities relative to a tug and barge in the conventional pushing mode.

Isle Royale National Park means the site on or near Lake Superior, administered by the National Park Service, where the boundary includes any submerged lands within the territorial jurisdiction of the United States within 4½ miles of the shoreline of Isle Royale and the surrounding islands, including Passage Island and Gull Island.

Mile means a statute mile.

Milwaukee Mid-Lake Special Protection Area means the area enclosed by rhumb lines connecting the following coordinates, beginning on the northernmost point and proceeding clockwise:

43°27.0′ N 087°14.0′ W
43°21.2′ N, 087°02.3′ W
43°03.3′ N, 087°04.8′ W
42°57.5′ N, 087°21.0′ W
43°16.0′ N, 087°39.8′ W.

Minimization means the reduction, to the greatest extent practicable, of any bulk dry cargo residue discharge from the vessel.

Northern Refuge means the area enclosed by rhumb lines connecting the coordinates, beginning on the northernmost point and proceeding clockwise:

45°45.0′ N, 086°00.0′ W,

western shore of High Island, southern shore of Beaver Island:

45°30.0′ N, 085°30.0′ W
45°30.0′ N, 085°15.0′ W
45°25.0′ N, 085°15.0′ W
45°25.0′ N, 085°20.0′ W
45°20.0′ N, 085°20.0′ W
45°20.0′ N, 085°40.0′ W
45°15.0′ N. 085°40.0′ W
45°15.0′ N, 085°50.0′ W
45°10.0′ N, 085°50.0′ W
45°10.0′ N, 086°00.0′ W.

Pictured Rocks National Lakeshore means the site on or near Lake Superior, administered by the National Park Service, from a point of land at 46°26′21.3″ N 086°36′43.2″ W eastward along the Michigan shoreline to 46°40′22.2″ N 085°59′58.1″ W.

Six Fathom Scarp Mid-Lake Special Protection Area means the area enclosed by rhumb lines connecting the following coordinates, beginning on the northernmost point and proceeding clockwise:

44°55.0′ N, 082°33.0′ W
44°47.0′ N, 082°18.0′ W

44°39.0′ N, 082°13.0′ W
44°27.0′ N, 082°13.0′ W
44°27.0′ N, 082°20.0′ W
44°17.0′ N, 082°25.0′ W
44°17.0′ N, 082°30.0′ W
44°28.0′ N, 082°40.0′ W
44°51.0′ N, 082°44.0′ W
44°53.0′ N, 082°44.0′ W
44°54.0′ N, 082°40.0′ W.

Sleeping Bear Dunes National Lakeshore means the site on or near Lake Michigan, administered by the National Park Service, that includes North Manitou Island, South Manitou Island and the Michigan shoreline from a point of land at 44°42′45.1″ N, 086°12′18.1″ W north and eastward along the shoreline to 44°57′12.0″ N, 085°48′12.8″ W.

Stannard Rock Protection Area means the area within a 6-mile radius from Stannard Rock Light, at 47°10′57″ N 087°13′34″ W.

Superior Shoal Protection Area means the area within a 6-mile radius from the center of Superior Shoal, at 48°03.2′ N 087°06.3′ W.

Thunder Bay National Marine Sanctuary means the site on or near Lake Huron designated by the National Oceanic and Atmospheric Administration as the boundary that forms an approximately rectangular area by extending along the ordinary high water mark between the northern and southern boundaries of Alpena County, cutting across the mouths of rivers and streams, and lakeward from those points along latitude lines to longitude 83 degrees west. The coordinates of the boundary are:

45°12′25.5′ N, 083°23′18.6′ W
45°12′25.5′ N, 083°00′00′ W
44°51′30.5′ N, 083°00′00′ W
44°51′30.5′ N, 083°19′17.3′ W.

Waukegan Special Protection Area means the area enclosed by rhumb lines connecting the following coordinates, beginning on the northernmost point and proceeding clockwise:

42°24.3′ N, 087°29.3′ W
42°13.0′ N, 087°25.1′ W
42°12.2′ N, 087°29.1′ W
42°18.1′ N, 087°33.1′ W
42°24.1′ N, 087°32.0′ W.

Western Basin means that portion of Lake Erie west of a line due south from Point Pelee.

(3) Discharges of bulk dry cargo residue under paragraph (b) of this section are allowed, subject to the conditions listed in Table 151.66(b)(3) of this section.

TABLE 151.66(B)(3)—BULK DRY CARGO RESIDUE DISCHRGES ALLOWED ON THE GREAT LAKES

Location	Cargo	Discharge allowed except as noted
Tributaries, their connecting rivers, and the St. Lawrence River.	Limestone and other clean stone ..	Prohibited within 3 miles from shore.
	All other cargoes	Prohibited.
Lake Ontario	Limestone and other clean stone ..	Prohibited within 3 miles from shore.
	Iron ore	Prohibited within 6 miles from shore.
	All other cargoes	Prohibited within 13.8 miles from shore.
Lake Erie	Limestone and other clean stone ..	Prohibited within 3 miles from shore; prohibited in the Detroit River International Wildlife Refuge; prohibited in Western Basin, except that a vessel operating exclusively within Western Basin may discharge limestone or clean stone cargo residues over the dredged navigation channels between Toledo Harbor Light and Detroit River Light.
	Iron ore	Prohibited within 6 miles from shore; prohibited in the Detroit River International Wildlife Refuge; prohibited in Western Basin, except that a vessel may discharge residue over the dredged navigation channels between Toledo Harbor Light and Detroit River Light if it unloads in Toledo or Detroit and immediately thereafter loads new cargo in Toledo, Detroit, or Windsor.
	Coal, salt	Prohibited within 13.8 miles from shore; prohibited in the Detroit River International Wildlife Refuge; prohibited in Western Basin, except that a vessel may discharge residue over the dredged navigation channels between Toledo Harbor Light and Detroit River Light if it unloads in Toledo or Detroit and immediately thereafter loads new cargo in Toledo, Detroit, or Windsor.
	All other cargoes	Prohibited within 13.8 miles from shore; prohibited in the Detroit River International Wildlife Refuge; prohibited in Western Basin.
Lake St. Clair	Limestone and other clean stone ..	Prohibited within 3 miles from shore.
	All other cargoes	Prohibited.
Lake Huron, except Six Fathom Scarp Mid-Lake Special Protection Area.	Limestone and other clean stone ..	Prohibited within 3 miles from shore; prohibited in the Thunder Bay National Marine Sanctuary.
	Iron ore	Prohibited within 6 miles from shore and in Saginaw Bay; prohibited in the Thunder Bay National Marine Sanctuary; prohibited for vessels upbound along the Michigan thumb as follows: (a) Between 5.8 miles northeast of entrance buoys 11 and 12 to the track line turn abeam of Harbor Beach, prohibited within 3 miles from shore. (b) For vessels bound for Saginaw Bay only, between the track line turn abeam of Harbor Beach and 4 nautical miles northeast of Point Aux Barques Light, prohibited within 4 miles from shore and not less than 10 fathoms of depth.
	Coal, salt	Prohibited within 13.8 miles from shore and in Saginaw Bay; prohibited in the Thunder Bay National Marine Sanctuary; prohibited for vessels upbound from Alpena into ports along the Michigan shore south of Forty Mile Point within 4 miles from shore and not less than 10 fathoms of depth.

TABLE 151.66(B)(3)—BULK DRY CARGO RESIDUE DISCHRGES ALLOWED ON THE GREAT LAKES—Continued

Location	Cargo	Discharge allowed except as noted
	All other cargoes	Prohibited within 13.8 miles from shore and in Saginaw Bay; prohibited in the Thunder Bay National Marine Sanctuary.
Lake Michigan	Limestone and other clean stone	Prohibited within 3 miles from shore; prohibited within the Milwaukee Mid-Lake and Waukegan Special Protection Areas; prohibited within the Northern Refuge; prohibited within 3 miles of the shore of the Indiana Dunes and Sleeping Bear National Lakeshores; prohibited within Green Bay.
	Iron ore	Prohibited in the Northern Refuge; north of 45° N., prohibited within 12 miles from shore and in Green Bay; south of 45° N., prohibited within 6 miles from shore, and prohibited within the Milwaukee Mid-Lake and Waukegan Special Protection Areas, in Green Bay, and within 3 miles of the shore of Indiana Dunes and Sleeping Bear National Lakeshores; except that discharges are allowed at: (a) 4.75 miles off Big Sable Point Betsie, along established Lake Carriers Association (LCA) track lines; and (b) Along 056.25° LCA track line between due east of Poverty Island to a point due south of Port Inland Light.
	Coal	Prohibited in the Northern Refuge; prohibited within 13.8 miles from shore and prohibited within the Milwaukee Mid-Lake and Waukegan Special Protection Areas, in Green Bay, and within 3 miles of the shore of Indiana Dunes and Sleeping Bear National Lakeshores; except that discharges are allowed— (a) Along 013.5° LCA track line between 45° N. and Boulder Reef, and along 022.5° LCA track running 23.25 miles between Boulder Reef and the charted position of Red Buoy #2; (b) Along 037° LCA track line between 45°20′ N. and 45°42′ N.; (c) Along 056.25° LCA track line between points due east of Poverty Island to a point due south of Port Inland Light; and (d) At 3 miles from shore for coal carried between Manistee and Ludington along customary routes.
	Salt	Prohibited in the Northern Refuge; prohibited within 13.8 miles from shore and prohibited within the Milwaukee Mid-Lake and Waukegan Special Protection Areas, in Green Bay, and within 3 miles of the shore of Indiana Dunes and Sleeping Bear National Lakeshores, and in Green Bay.
	All other cargoes	Prohibited in the Northern Refuge; prohibited within 13.8 miles from shore and prohibited within the Milwaukee Mid-Lake and Waukegan Special Protection Areas, in Green Bay, and within 3 miles of the shore of Indiana Dunes and Sleeping Bear National Lakeshores.
Lake Superior	Limestone and other clean stone	Prohibited within 3 miles from shore; and prohibited within Isle Royale National Park and the Caribou Island and Southwest Bank, Stannard Rock, and Superior Shoal Protection Areas, and within 3 miles of the shore of the Apostle Islands and Pictured Rocks National Lakeshores or the Grand Portage National Monument.
	Iron ore	Prohibited within 6 miles from shore (within 3 miles off northwestern shore between Duluth and Grand Marais); and prohibited within Isle Royale National Park and the Caribou Island and Southwest Bank, Stannard Rock, and Superior Shoal Protection Areas, and within 3 miles of the shore of the Apostle Islands and Pictured Rocks National Lakeshores or the Grand Portage National Monument.
	Coal, salt	Prohibited within 13.8 miles from shore (within 3 miles off northwestern shore between Duluth and Grand Marais); and prohibited within Isle Royale National Park and the Caribou Island and Southwest Bank, Stannard Rock, and Superior Shoal Protection Areas, and within 3 miles of the shore of the Apostle Islands and Pictured Rocks National Lakeshores or the Grand Portage National Monument.
	Cement	Prohibited within 13.8 miles from shore (within 3 miles offshore west of a line due north from Bark Point); and prohibited within Isle Royale National Park and the Caribou Island and Southwest Bank, Stannard Rock, and Superior Shoal Protection Areas, and within 3 miles of the shore of the Apostle Islands and Pictured Rocks National Lakeshores or the Grand Portage National Monument.
	All other cargoes	Prohibited within 13.8 miles from shore; and prohibited within Isle Royale National Park and the Caribou Island and Southwest Bank, Stannard Rock, and Superior Shoal Protection Areas, and within 3 miles of the shore of the Apostle Islands and Pictured Rocks National Lakeshores or the Grand Portage National Monument.

(4) The master, owner, operator, or person in charge of any commercial vessel must ensure that the vessel's deck is kept broom clean whenever the vessel is in transit.

(5) The master, owner, operator, or person in charge of any commercial vessel must ensure that a dry cargo residue management plan is on board the vessel, is kept available for Coast Guard inspection, and that all operations are conducted in accordance with the plan. A waste management plan meeting the requirements of 33 CFR 151.57 satisfies this requirement, so long as it provides all the information required by this paragraph (b)(5). If the plan is maintained electronically, at least one paper copy of the plan must be on board for use during inspections. The plan must describe the specific measures the vessel employs to ensure the minimization of bulk dry cargo residue discharges, and, at a minimum, must list or describe—

(i) Equipment on board the vessel that is designed to minimize bulk dry cargo spillage during loading and unloading;

(ii) Equipment on board the vessel that is available to recover spilled cargo from the decks and transfer tunnels and return it to the holds or to unloading conveyances;

(iii) Operational procedures employed by the vessel's crew during the loading or unloading of bulk dry cargoes to minimize cargo spillage onto the decks and into the transfer tunnels and to achieve and maintain the broom clean deck condition required by paragraph (b)(4) of this section;

(iv) Operational procedures employed by the vessel's crew during or after loading or unloading operations to return spilled bulk dry cargo residue to the vessel's holds or to shore via an unloading conveyance;

(v) How the vessel's owner or operator ensures that the vessel's crew is familiar with any operational procedures described by the plan;

(vi) The position title of the person on board who is in charge of ensuring compliance with procedures described in the plan;

(vii) Any arrangements between the vessel and specific ports or terminals for the unloading and disposal of the vessel's bulk dry cargo residues ashore; and

(viii) The procedures used and the vessel's operating conditions to be maintained during any unavoidable discharge of bulk dry cargo residue into the Great Lakes.

(6) In determining whether a commercial vessel or person is in compliance with paragraph (b) of this section, Coast Guard personnel may consider—

(i) The extent to which the procedures described in the vessel's DCR management plan reflect current industry standard practices for vessels of comparable characteristics, cargoes, and operations;

(ii) The crew's demonstrated ability to perform tasks for which the DCR management plan holds them responsible;

(iii) Whether equipment described in the DCR management plan is maintained in proper operating condition; and

(iv) The extent to which the crew adheres to the vessel's DCR management plan during actual dry cargo loading and unloading operations and DCR discharge operations.

(c)(1) The master, owner, operator, or person in charge of any commercial ship loading, unloading, or discharging bulk dry cargo in the United States' waters of the Great Lakes and the master, owner, operator, or person in charge of a U.S. commercial ship transporting bulk dry cargo and operating anywhere on the Great Lakes, excluding non-self propelled barges that are not part of an integrated tug and barge unit, must ensure that a written record is maintained on the ship that fully and accurately records information on:

(i) Each loading or unloading operation on the United States' waters of the Great Lakes, or in the case of U.S. commercial ships on any waters of the Great Lakes, involving bulk dry cargo; and

(ii) Each discharge of bulk dry cargo residue that takes place in United States' waters of the Great Lakes, or in the case of U.S. commercial ships on any waters of the Great Lakes.

(2) For each loading or unloading operation, the record must describe:

(i) The date of the operation;

(ii) Whether the operation involved loading or unloading;

(iii) The name of the loading or unloading facility;

(iv) The type of bulk dry cargo loaded or unloaded;

(v) The method or methods used to control the amount of bulk dry cargo residue, either onboard the ship or at the facility;

(vi) The time spent to implement methods for controlling the amount of bulk dry cargo residue; and

(vii) The estimated volume of bulk dry cargo residue created by the loading or unloading operation that is to be discharged.

(3) For each discharge, the record must describe:

(i) The date and time the discharge started, and the date and time the discharge ended;

(ii) The ship's position, in latitude and longitude, when the discharge started and when the discharge ended; and

(iii) The ship's speed during the discharge.

(iv) Until February 28, 2015, records must be kept on Coast Guard Form CG–33, which can be found at *http://www.uscg.mil/hq/cg5/cg522/cg5224/dry_cargo.asp.* Copies of the records must be forwarded to the Coast Guard at least once each quarter, no later than the 15th day of January, April, July, and October. The record copies must be provided to the Coast Guard using only one of the following means:

(A) Email to DCRRecordkeeping@USCG.mil;

(B) Fax to 202–372–1928, ATTN: DCR RECORDKEEPING; or

(C) Mail to U.S. Coast Guard: Commandant (CG–OES), ATTN: DCR RECORDKEEPING, 2703 Martin Luther King Jr. Avenue SE., Stop 7126, Washington, DC 20593–7126.

(v) After February 28, 2015, the use of Form CG–33 is optional. However, records must still be certified by the master, owner, operator, or person in charge; must be kept in written form on board the ship for at least 2 years; and must be made available for Coast Guard inspection upon request.

Dated: January 24, 2014.

J.G. Lantz,

Director of Commercial Regulations and Standards, U.S. Coast Guard.

[FR Doc. 2014–01927 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 165

[Docket No. USCG–2012–1036]

Safety Zones & Special Local Regulations; Recurring Marine Events in Captain of the Port Long Island Sound Zone

AGENCY: Coast Guard, DHS.

ACTION: Notice of enforcement of regulation.

SUMMARY: The Coast Guard will enforce one safety zone for a fireworks display in the Sector Long Island Sound area of responsibility on the dates and times listed in the table below. This action is necessary to provide for the safety of life on navigable waterways during the

event. During the enforcement period, no person or vessel may enter the safety zone without permission of the Captain of the Port (COTP) Sector Long Island Sound or designated representative.

DATES: The regulations in 33 CFR 165.151 will be enforced on February 8 or February 9, 2014.

FOR FURTHER INFORMATION CONTACT: If you have questions on this notice, call or email Petty Officer Scott Baumgartner, Waterways Management Division, U.S. Coast Guard Sector Long Island Sound; telephone 203–468–4559, email *Scott.A.Baumgartner@uscg.mil.*

SUPPLEMENTARY INFORMATION: The Coast Guard will enforce the safety zone listed in 33 CFR 165.151 on the specified date and time as indicated in the Table below. If the event is delayed by inclement weather, the regulation will be enforced on the rain date indicated in the Table below. These regulations were published in the **Federal Register** on May 24, 2013 (78 FR 31402).

TABLE 1 TO § 165.151

2.1 Sag Harbor COC Winter Harbor Frost Fireworks	• Date: February 8, 2014. • Rain Date: February 9, 2014. • Time: 5 p.m. to 7 p.m. • Location: Waters of Sag Harbor off Long Wharf St. Pier in Sag Harbor, NY in approximate position 41°00′16.82″ N, 072°17′43.78″ W (NAD 83).

Under the provisions of 33 CFR 165.151, the fireworks display listed above is established as a safety zone. During the enforcement period, persons and vessels are prohibited from entering into, transiting through, mooring, or anchoring within the safety zone unless they receive permission from the COTP or designated representative.

This notice is issued under authority of 33 CFR 165 and 5 U.S.C. 552(a). In addition to this notice in the **Federal Register**, the Coast Guard will provide the maritime community with advance notification of this enforcement period via the Local Notice to Mariners or marine information broadcasts. If the COTP determines that the safety zone need not be enforced for the full duration stated in this notice, a Broadcast Notice to Mariners may be used to grant general permission to enter the regulated area.

Dated: January 15, 2014.

E.J. Cubanski, III,

Captain, U.S. Coast Guard, Captain of the Port Sector Long Island Sound.

[FR Doc. 2014–02049 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 165

[Docket Number USCG–2013–0509]

RIN 1625–AA00

Safety Zone for Ice Conditions; Baltimore Captain of the Port Zone

AGENCY: Coast Guard, DHS.

ACTION: Temporary interim rule and request for comments.

SUMMARY: The Coast Guard is establishing a temporary safety zone in all navigable waters of the Captain of the Port Baltimore Zone. The temporary safety zone restricts vessels from transiting the zone during the effective period, unless authorized by the Captain of the Port Baltimore or his designated representative. This safety zone is necessary to protect mariners from the hazards associated with ice in the navigable waterways.

DATES: This rule is effective without actual notice from January 31, 2014 until April 15, 2014. For the purposes of enforcement, actual notice will be used from the date the rule was signed, January 7, 2014 until January 31, 2014.

ADDRESSES: Documents mentioned in this preamble are part of Docket Number USCG–2013–0509. To view documents mentioned in this preamble as being available in the docket, go to *http://www.regulations.gov*, type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on ''Open Docket Folder'' on the line associated with this rulemaking. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation West Building, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

You may submit comments, identified by docket number, using any one of the following methods:

(1) Federal eRulemaking Portal: *http://www.regulations.gov*.

(2) Fax: (202) 493–2251.

(3) Mail or Delivery: Docket Management Facility (M–30), U.S. Department of Transportation, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590–0001. Deliveries accepted between 9 a.m. and 5 p.m., Monday through Friday, except federal holidays. The telephone number is 202–366–9329.

See the ''Public Participation and Request for Comments'' portion of the **SUPPLEMENTARY INFORMATION** section below for further instructions on submitting comments. To avoid duplication, please use only one of these three methods.

FOR FURTHER INFORMATION CONTACT: If you have questions on this rule, call or email Mr. Ronald L. Houck, Sector Baltimore Waterways Management Division, U.S. Coast Guard; telephone 410–576–2674, email *Ronald.L.Houck@uscg.mil*. If you have questions on viewing or submitting material to the docket, call Cheryl Collins, Program Manager, Docket Operations, telephone (202) 366–9826.

SUPPLEMENTARY INFORMATION:

Table of Acronyms

DHS Department of Homeland Security
FR Federal Register
NPRM Notice of Proposed Rulemaking

A. Public Participation and Request for Comments

We encourage you to participate in this rulemaking by submitting comments and related materials. All comments received will be posted without change to *http://www.regulations.gov* and will include any personal information you have provided.

1. Submitting Comments

If you submit a comment, please include the docket number for this rulemaking, indicate the specific section of this document to which each comment applies, and provide a reason for each suggestion or recommendation. You may submit your comments and material online at *http://www.regulations.gov*, or by fax, mail, or hand delivery, but please use only one

of these means. If you submit a comment online, it will be considered received by the Coast Guard when you successfully transmit the comment. If you fax, hand deliver, or mail your comment, it will be considered as having been received by the Coast Guard when it is received at the Docket Management Facility. We recommend that you include your name and a mailing address, an email address, or a telephone number in the body of your document so that we can contact you if we have questions regarding your submission.

To submit your comment online, go to *http://www.regulations.gov*, type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on ''Submit a Comment'' on the line associated with this rulemaking

If you submit your comments by mail or hand delivery, submit them in an unbound format, no larger than 8½ by 11 inches, suitable for copying and electronic filing. If you submit comments by mail and would like to know that they reached the Facility, please enclose a stamped, self-addressed postcard or envelope. We will consider all comments and material received during the comment period and may change the rule based on your comments.

2. Viewing Comments and Documents

To view comments, as well as documents mentioned in this preamble as being available in the docket, go to *http://www.regulations.gov*, type the docket number in the ''SEARCH'' box and click ''SEARCH.'' Click on Open Docket Folder on the line associated with this rulemaking. You may also visit the Docket Management Facility in Room W12–140 on the ground floor of the Department of Transportation West Building, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

3. Privacy Act

Anyone can search the electronic form of comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review a Privacy Act notice regarding our public dockets in the January 17, 2008, issue of the **Federal Register** (73 FR 3316).

4. Public Meeting

We do not now plan to hold a public meeting. But you may submit a request for one, using one of the methods specified under **ADDRESSES**. Please explain why you believe a public meeting would be beneficial. If we determine that one would aid this rulemaking, we will hold one at a time and place announced by a later notice in the **Federal Register**.

B. Regulatory History and Information

The Coast Guard is issuing this temporary interim rule without prior notice and opportunity to comment pursuant to authority under section 4(a) of the Administrative Procedure Act (APA) (5 U.S.C. 553(b)). This provision authorizes an agency to issue a rule without prior notice and opportunity to comment when the agency for good cause finds that those procedures are ''impracticable, unnecessary, or contrary to the public interest.'' Under 5 U.S.C. 553(b)(B), the Coast Guard finds that good cause exists for not publishing a notice of proposed rulemaking (NPRM) with respect to this rule because it is contrary to public interest to delay the effective date of this rule. Delaying the effective date by first publishing an NPRM would be contrary to the safety zone's intended objectives since immediate action is necessary to protect persons and vessels against the hazards associated with ice on navigable waters. Such hazards include vessels becoming beset or dragged off course, sinking or grounding, and creating hazards to navigation.

For similar reasons, under 5 U.S.C. 553(d)(3), the Coast Guard finds that good cause exists for making this rule effective less than 30 days after publication in the **Federal Register**. Due to the need for immediate action, the restriction of vessel traffic is necessary to protect life, property and the environment. Therefore, a 30-day notice is impracticable. Delaying the effective date would be contrary to the safety zone's intended objectives of protecting persons and vessels from becoming beset or dragged off course, sinking or grounding, and creating hazards to navigation.

C. Basis and Purpose

During an average or severe winter, frozen waterways present numerous hazards to vessels. Ice in a waterway may hamper a vessel's ability to maneuver, and could cause visual aids to navigation to be submerged, destroyed or moved off station. Ice abrasions and ice pressure could also compromise a vessel's watertight integrity, and non-steel hulled vessels would be exposed to a greater risk of hull breach.

When ice conditions develop to a point where vessel operations become unsafe, it becomes necessary to impose operating restrictions to ensure the safe navigation of vessels. A safety zone is a tool available to the Captain of the Port (COTP) to restrict and manage vessel movement when hazardous conditions exist. The COTP Baltimore is establishing a safety zone within all navigable waters of the COTP Baltimore Zone. This safety zone will restrict certain vessels meeting certain conditions specified from entering the navigable waters included within the COTP Baltimore Zone. Those vessels prohibited from entering the safety zone will be specified via broadcast notice to mariners and marine safety information bulletins.

Ice generally begins to form in the Upper Chesapeake Bay and its tributaries, including the C & D Canal, in late December or early January. During an average or severe winter, ice in navigable waters can become a serious problem, requiring the use of federal, state and private ice breaking resources. The Commander, Coast Guard Sector Baltimore will use his COTP authority to promote vessel safety in ice-congested waters and the continuation of waterborne commerce throughout the cold weather months.

Ice fields in the Upper Chesapeake Bay and its tributaries move with prevailing winds and currents. Heavy ice buildups can occur in the C & D Canal, from Town Point Wharf to Reedy Point. Other areas that are commonly affected by high volumes of ice are: The Elk River, Susquehanna River, Patapsco River, Nanticoke River, Wicomico River, Tangier Sound, Pocomoke River and Sound, and the Potomac River. Once ice buildup begins it can affect the transit of large ocean-going vessels. This regulation is intended to mitigate the threat ice in the COTP Baltimore Zone poses to the maritime public.

D. Discussion of the Interim Rule

A safety zone is being established encompassing the COTP Baltimore Zone, as described in 33 CFR 3.25–15. The COTP Baltimore anticipates only having to enforce certain parts of the regulated area at certain times. The purpose of this regulation is to promote maritime safety and to protect mariners transiting the area from the potential hazards due to ice conditions that become a threat to navigation. The COTP Baltimore will notify the maritime community, via marine broadcasts, of the location and thickness of the ice as well as the ability of vessels to transit through the safety zone depending on the prevailing ice conditions. Prevailing ice conditions will be categorized as Condition One, Condition Two, or Condition Three.

Ice Condition One is an emergency condition in which ice has largely covered the regulated area. Under these conditions, convoys may be required and restrictions based on shaft horsepower and a vessel's planned transit may be imposed by the COTP on certain vessels seeking to enter the safety zone.

Ice Condition Two is an alert condition in which at least 2 inches of ice begins to form in the regulated area. The COTP Baltimore may impose restrictions, including but not limited to, those based on shaft horsepower and hull type restrictions for certain vessels seeking to enter the safety zone.

Ice Condition Three is a readiness condition in which weather conditions are favorable for the formation of ice in the regulated area. Daily reports for the Coast Guard Stations and commercial vessels are monitored, and no limitations for vessels seeking to enter the zone based on vessel traffic, hull type or shaft horsepower are anticipated.

This rule has been enforced with actual notice since January 7, 2014 and it will be enforced until April 15, 2014, unless sooner terminated by the COTP Baltimore.

E. Regulatory Analyses

We developed this rule after considering numerous statutes and executive orders related to rulemaking. Below we summarize our analyses based on these statutes and executive orders.

1. Regulatory Planning and Review

This rule is not a significant regulatory action under section 3(f) of Executive Order 12866, Regulatory Planning and Review, as supplemented by Executive Order 13563, Improving Regulation and Regulatory Review, and does not require an assessment of potential costs and benefits under section 6(a)(3) of Executive Order 12866 or under section 1 of Executive Order 13563. The Office of Management and Budget has not reviewed it under those Orders. Although this regulation could hinder or prevent traffic from transiting the COTP Baltimore Zone, the effect of this regulation will not be significant because there is little vessel traffic associated with recreational boating and commercial fishing during the effective period.

2. Impact on Small Entities

The Regulatory Flexibility Act of 1980 (RFA), 5 U.S.C. 601–612, as amended, requires federal agencies to consider the potential impact of regulations on small entities during rulemaking. The Coast Guard certifies under 5 U.S.C. 605(b) that this rule will not have a significant economic impact on a substantial number of small entities. This rule will affect the following entities, some of which may be small entities: The owners or operators of vessels intending to operate, transit or anchor in the regulated area, from January 7, 2014 until April 15, 2014. This safety zone will not have a significant economic impact on a substantial number of small entities due to a lack of seasonal vessel traffic associated with recreational boating and commercial fishing during the effective period. Although the safety zone will apply to the entire COTP Baltimore Zone, the Captain of the Port Baltimore anticipates only having to enforce certain parts of the regulated area at certain times. Traffic will be allowed to pass through the zone with the permission of the COTP Baltimore. Also, the COTP Baltimore will notify the maritime community, via marine broadcasts, of the location and thickness of the ice, as well as the ability of vessels to transit through the safety zone.

3. Assistance for Small Entities

Under section 213(a) of the Small Business Regulatory Enforcement Fairness Act of 1996 (Public Law 104–121), we want to assist small entities in understanding this rule. If the rule would affect your small business, organization, or governmental jurisdiction and you have questions concerning its provisions or options for compliance, please contact the person listed in the **FOR FURTHER INFORMATION CONTACT**, above.

Small businesses may send comments on the actions of Federal employees who enforce, or otherwise determine compliance with, Federal regulations to the Small Business and Agriculture Regulatory Enforcement Ombudsman and the Regional Small Business Regulatory Fairness Boards. The Ombudsman evaluates these actions annually and rates each agency's responsiveness to small business. If you wish to comment on actions by employees of the Coast Guard, call 1–888–REG–FAIR (1–888–734–3247). The Coast Guard will not retaliate against small entities that question or complain about this rule or any policy or action of the Coast Guard.

4. Collection of Information

This rule will not call for a new collection of information under the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3520).

5. Federalism

A rule has implications for federalism under Executive Order 13132, Federalism, if it has a substantial direct effect on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. We have analyzed this rule under that Order and determined that this rule does not have implications for federalism.

6. Protest Activities

The Coast Guard respects the First Amendment rights of protesters. Protesters are asked to contact the person listed in the **FOR FURTHER INFORMATION CONTACT** section to coordinate protest activities so that your message can be received without jeopardizing the safety or security of people, places or vessels.

7. Unfunded Mandates Reform Act

The Unfunded Mandates Reform Act of 1995 (2 U.S.C. 1531–1538) requires Federal agencies to assess the effects of their discretionary regulatory actions. In particular, the Act addresses actions that may result in the expenditure by a State, local, or tribal government, in the aggregate, or by the private sector of $100,000,000 (adjusted for inflation) or more in any one year. Though this rule will not result in such an expenditure, we do discuss the effects of this rule elsewhere in this preamble.

8. Taking of Private Property

This rule will not cause a taking of private property or otherwise have taking implications under Executive Order 12630, Governmental Actions and Interference with Constitutionally Protected Property Rights.

9. Civil Justice Reform

This rule meets applicable standards in sections 3(a) and 3(b)(2) of Executive Order 12988, Civil Justice Reform, to minimize litigation, eliminate ambiguity, and reduce burden.

10. Protection of Children From Environmental Health Risks

We have analyzed this rule under Executive Order 13045, Protection of Children from Environmental Health Risks and Safety Risks. This rule is not an economically significant rule and does not create an environmental risk to health or risk to safety that may disproportionately affect children.

11. Indian Tribal Governments

This rule does not have tribal implications under Executive Order 13175, Consultation and Coordination

with Indian Tribal Governments, because it does not have a substantial direct effect on one or more Indian tribes, on the relationship between the Federal Government and Indian tribes, or on the distribution of power and responsibilities between the Federal Government and Indian tribes.

12. Energy Effects

This action is not a ''significant energy action'' under Executive Order 13211, Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use.

13. Technical Standards

This rule does not use technical standards. Therefore, we did not consider the use of voluntary consensus standards.

14. Environment

We have analyzed this rule under Department of Homeland Security Management Directive 023–01 and Commandant Instruction M16475.lD, which guide the Coast Guard in complying with the National Environmental Policy Act of 1969 (NEPA)(42 U.S.C. 4321–4370f), and have determined that this action is one of a category of actions that do not individually or cumulatively have a significant effect on the human environment. This rule involves establishing a temporary safety zone. This rule is categorically excluded from further review under paragraph 34(g) of Figure 2–1 of the Commandant Instruction. An environmental analysis checklist supporting this determination and a Categorical Exclusion Determination are available in the docket where indicated under **ADDRESSES**. We seek any comments or information that may lead to the discovery of a significant environmental impact from this rule.

List of Subjects in 33 CFR Part 165

Harbors, Marine safety, Navigation (water), Reporting and recordkeeping requirements, Security measures, Waterways.

For the reasons discussed in the preamble, the Coast Guard amends 33 CFR part 165 as follows:

PART 165—REGULATED NAVIGATION AREAS AND LIMITED ACCESS AREAS

■ 1. The authority citation for part 165 continues to read as follows:

Authority: 33 U.S.C. 1231; 46 U.S.C. Chapter 701, 3306, 3703; 50 U.S.C. 191, 195; 33 CFR 1.05–1, 6.04–1, 6.04–6, 160.5; Pub. L. 107–295, 116 Stat. 2064; Department of Homeland Security Delegation No. 0170.1.

■ 2. Add § 165.T05–0509 to read as follows:

§ 165.T05–0509 SAFETY ZONE FOR ICE CONDITIONS; BALTIMORE CAPTAIN OF THE PORT ZONE.

(a) *Regulated Area.* The following area is a safety zone: The navigable waters of the Captain of the Port Baltimore Zone, as described in 33 CFR 3.25–15.

(b) *Regulations.* The general safety zone regulations found in 33 CFR 165.23 apply to the safety zone created by this temporary section, § 165.T05.0509.

(1) All vessels and persons are prohibited from entering into or moving within the safety zone unless they meet the requirements set forth by the Captain of the Port (COTP) Baltimore for the prevailing ice conditions. Requirements for entry during periods when the safety zone is enforced will be described via Marine Safety Radio Broadcast on VHF–FM marine band radio, channel 22A (157.1 MHZ). Requirements may include, but are not limited to, the use of convoys, restrictions on shaft horsepower, and hull type restrictions, dependent on the prevailing ice conditions and vessel type.

(2) Persons desiring to transit in the safety zone not meeting the requirements established by the COTP Baltimore must contact the COTP Baltimore or his designated representative at telephone number 410–576–2693 or on VHF–FM channel 16 (156.8 MHZ) to seek permission prior to transiting the area. If permission is granted, all persons and vessels shall comply with the instructions of the COTP Baltimore or his designated representative.

(3) The Coast Guard vessels enforcing this safety zone can be contacted on VHF–FM marine band radio channel 16 (156.8 MHZ). Upon being hailed by a U.S. Coast Guard vessel, or other Federal, State, or local agency vessel operating under the authority of the COTP Baltimore, by siren, radio, flashing light, or other means, the operator of a vessel shall proceed as directed. The COTP Baltimore and his designated representatives can be contacted at telephone number 410–576–2693.

(4) The COTP Baltimore or his designated representative will notify the public of any changes in the status of this safety zone by Marine Safety Radio Broadcast on VHF–FM marine band radio channel 22A (157.1 MHZ).

(d) *Definitions.* As used in this section:

Captain of the Port Baltimore means the Commander, U.S. Coast Guard Sector Baltimore, Maryland.

Designated representative means any Coast Guard commissioned, warrant, or petty officer who has been authorized by the Captain of the Port Baltimore to assist in enforcing the safety zone described in paragraph (a) of this section.

(e) *Enforcement.* The U.S. Coast Guard may be assisted by Federal, State and local agencies in the patrol and enforcement of the zone.

(f) *Enforcement period.* This section will be enforced from January 7, 2014 until April 15, 2014.

Dated: January 7, 2014.

Kevin C. Kiefer,

Captain, U.S. Coast Guard, Captain of the Port Baltimore.

[FR Doc. 2014–01941 Filed 1–30–14; 8:45 am]

BILLING CODE 9110–04–P

POSTAL SERVICE

39 CFR Part 111

Implementation of Full-Service Intelligent Mail Requirements for Automation Prices; Correction

AGENCY: Postal Service™.

ACTION: Final rule; correction.

SUMMARY: This document corrects an error in the identification of a certain provision of *Mailing Standards of the United States Postal Service,* Domestic Mail Manual (DMM®), revised in a final rule published in the **Federal Register** of Thursday, April 18, 2013 (78 FR 23137). The misidentified provision relates to the availability of Intelligent Mail barcode (IMb™) Tracing as an additional mailing service.

DATES: *Effective Date:* January 31, 2014.

FOR FURTHER INFORMATION CONTACT: Lizbeth J. Dobbins at 202–268–3789.

SUPPLEMENTARY INFORMATION: As published on April 18, 2013 (78 FR 23137), the final rule concerning Implementation of Full-Service Intelligent Mail Requirements for Automation Prices misidentified one affected provision of the Domestic Mail Manual. Specifically, revisions to DMM 503.14.0, concerning Intelligent Mail Barcode Tracing, were erroneously numbered as revisions to DMM 503.15.0, which concerns Money Orders. In order to minimize the possibility of confusion, this error needs to be corrected.

List of Subjects in 39 CFR Part 111

Administrative practice and procedure, Postal Service.

The Postal Service adopts the following correcting amendments to the *Mailing Standards of the United States Postal Service,* Domestic Mail Manual (DMM), which is incorporated by reference in the *Code of Federal Regulations.* See 39 CFR 111.1. Accordingly, 39 CFR part 111 is corrected as follows:

PART 111—[AMENDED]

■ 1. The authority citation for 39 CFR part 111 continues to read as follows:

Authority: 5 U.S.C. 552(a); 13 U.S.C. 301–307; 18 U.S.C. 1692–1737; 39 U.S.C. 101, 401, 403, 404, 414, 416, 3001–3011, 3201–3219, 3403–3406, 3621, 3622, 3626, 3632, 3633, and 5001.

■ 2. Revise the following sections of *Mailing Standards of the United States Postal Service,* Domestic Mail Manual (DMM), as follows:

Mailing Standards of the United States Postal Service, Domestic Mail Manual (DMM)

* * * * *

500 Additional Mailing Services

503 Extra Services

* * * * *

[*Revise the title of 14.0 as follows:*]

14.0 Intelligent Mail Barcode Tracing

* * * * *

14.1 Basic Information

* * * * *

14.1.1 General Information

[*Revise the text of 14.1.1 as follows:*]

Participation in Intelligent Mail barcode (IMb) Tracing service is available at no charge without a subscription. Requirements for participation in IMb Tracing include:

- Use of an IMb on mailpieces entered as part of a full-service mailing under 705.24.0.
- Use of a Mailer Identifier that has been registered (through the Business Customer Gateway, accessible on *usps.com*) to receive scan data.
- Verification by the Postal Service that the IMb as printed meets all applicable postal standards.

* * * * *

Stanley F. Mires,

Attorney, Legal Policy & Legislative Advice.

[FR Doc. 2014–01974 Filed 1–30–14; 8:45 am]

BILLING CODE 7710–12—P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[EPA–R06–OAR–2006–0885; FRL—9906–03-Region 6]

Approval and Promulgation of Air Quality Implementation Plans; Texas; Approval of Texas Motor Vehicle Rule Revisions

AGENCY: Environmental Protection Agency (EPA).

ACTION: Direct final rule.

SUMMARY: The Environmental Protection Agency (EPA) is granting direct final approval of revisions submitted by the State of Texas that affect the Texas State Implementation Plan (SIP) concerning Texas' motor vehicle air pollution rules. Based upon the State's submitted Texas clean fuel fleet (TCFF) program equivalency demonstration that the new Tier 2 and 2007 heavy-duty diesel vehicles and engines meet or exceed the LEV requirement, we are approving the removal of the TCFF program's repealed low emission vehicle (LEV) rules and mobile emission reduction credit (MERC) rules from the Texas SIP. We also are approving the removal of the Transportation Control Measures (TCM) substitution repealed rules from the Texas SIP. We are approving as part of the SIP a new Texas Clean Fleet (TCF) program, with submitted revisions, to incentivize replacement of diesel vehicles and engines with alternatively fueled vehicles and engines, including hybrids.

DATES: This rule is effective on *April 1, 2014* without further notice, unless EPA receives relevant adverse comment by March 3, 2014. If EPA receives such comment, EPA will publish a timely withdrawal in the **Federal Register** informing the public that this rule will not take effect.

ADDRESSES: Submit your comments, identified by Docket No. EPA–R06–OAR–2006–0885, by one of the following methods:

- *www.regulations.gov.* Follow the on-line instructions.
- *Email:* John Walser at *walser.john@epa.gov.*
- *Mail or delivery:* Mr. Guy Donaldson, Chief, Air Planning Section (6PD–L), Environmental Protection Agency, 1445 Ross Avenue, Suite 1200, Dallas, Texas 75202–2733.

Instructions: Direct your comments to Docket ID No. EPA–R06–OAR–2006–0885. EPA's policy is that all comments received will be included in the public docket without change and may be made available online at *http://www.regulations.gov,* including any personal information provided, unless the comment includes information claimed to be Confidential Business Information (CBI) or other information the disclosure of which is restricted by statute. Do not submit information through *http://www.regulations.gov* or email, if you believe that it is CBI or otherwise protected from disclosure. The *http://www.regulations.gov* Web site is an ''anonymous access'' system, which means that EPA will not know your identity or contact information unless you provide it in the body of your comment. If you send an email comment directly to EPA without going through *http://www.regulations.gov,* your email address will be automatically captured and included as part of the comment that is placed in the public docket and made available on the Internet. If you submit an electronic comment, EPA recommends that you include your name and other contact information in the body of your comment along with any disk or CD–ROM submitted. If EPA cannot read your comment due to technical difficulties and cannot contact you for clarification, EPA may not be able to consider your comment. Electronic files should avoid the use of special characters and any form of encryption and should be free of any defects or viruses. For additional information about EPA's public docket, visit the EPA Docket Center homepage at *http://www.epa.gov/epahome/dockets.htm.*

Docket: The index to the docket for this action is available electronically at *www.regulations.gov* and in hard copy at EPA Region 6, 1445 Ross Avenue, Suite 700, Dallas, Texas. While all documents in the docket are listed in the index, some information may be publicly available only at the hard copy location (e.g., copyrighted material), and some may not be publicly available at either location (e.g., CBI). To inspect the hard copy materials, please schedule an appointment with the person listed in the **FOR FURTHER INFORMATION CONTACT** paragraph below or Mr. Bill Deese at 214–665–7253.

FOR FURTHER INFORMATION CONTACT: Mr. John Walser (6PD–L), Air Planning Section, telephone (214) 665–7128, email *walser.john@epa.gov.*

SUPPLEMENTARY INFORMATION: Throughout this document, whenever ''we'' ''us'' or ''our'' is used, we mean the EPA.

Outline

I. Background
II. Analysis of the State's Submittals

III. Final Action
IV. Statutory and Executive Order Reviews

I. Background

This action covers four separate submittals by the State of Texas. These include the State's repeal of its TCFF LEV rules (May 15, 2006); repeal of the TCFF MERC rules, and TCM substitution rule (July 25, 2007); new Texas Clean Fleet (TCF) rules (March 25, 2010); and revisions to the new TCF rules (April 13, 2012). These revisions address Title 30 of the Texas Administrative Code, Chapter 114 (denoted as 30 TAC 114), which provides for Control of Air Pollution from Motor Vehicles in Texas.

Repeal of the TCFF Low-Emission Vehicle Rules. Texas adopted LEV fleet rules to meet, in part, the federal Clean Fuel Fleet program (CFFP) requirements. The federal CFFP requirement is contained in the Clean Air Act (CAA), as amended November 15, 1990. The CAA requires certain States to adopt and submit to EPA SIP revisions containing a CFFP for nonattainment areas with 1980 populations greater than 250,000 that are classified as serious or worse for ozone, or which have a design value of at least 16.0 ppm for carbon monoxide (CO). Section 182(c)(4) of the CAA, 42 U.S.C. 7511a(c)(4), allows States to opt-out of the federal CFFP by submitting, for EPA approval, a SIP revision consisting of a substitute program resulting in as much or greater long term emissions reductions in ozone-producing and toxic air emissions as the federal CFFP. In Texas, four 1-hour ozone nonattainment areas were classified as serious and above and were required to implement a CFFP: the Houston/Galveston/Brazoria Severe 1-hour ozone nonattainment area; the Dallas/Fort Worth Serious 1-hour ozone nonattainment area; the El Paso Serious 1-hour ozone nonattainment area; and the Beaumont/Port Arthur Serious area that has been found to meet the 1-hour ozone standard and redesignated to attainment for the 1997 8-hour ozone standard [1].

For the Houston, Dallas, and El Paso areas, Texas complied with the federal CFFP requirement by opting to implement a substitute program. We approved a substitute program for these three areas as part of the Texas SIP on February 7, 2001 (66 FR 9203). The SIP's substitute program covers transit, local government and private fleets. It requires transit fleets to ensure that at least 50% of their fleet vehicles are certified to meet or exceed the LEV standards. In addition, local government and private fleets after September 1, 1998, have to ensure that certain percentages of their vehicle purchases be certified by EPA as LEVs. To make up the shortfall in emissions, the SIP relies upon excess emission reductions from state mandated reductions of VOC from transfer operations at gasoline terminals in nonattainment areas, and NO_X reductions from electric generating facilities. In this submittal, Texas has submitted its repeal of the LEV fleet portion of the TCFF program accompanied by an equivalency demonstration. The remaining substitute program emission reductions remain in place in state law and in the Texas SIP.

Motor Vehicle Emission Reduction Credit Rules, and Transportation Control Measures Substitution Rules. The July 25, 2007 submittal contains revisions to 30 TAC 114: Control of Air Pollution from Motor Vehicles in three specific areas: Repeal of the TCM substitution program; repeal of the MERC program portion of the TCFF program and associated fund and definitions; and repeal of the Light-duty Motor Vehicle Purchase or Lease Incentive Program Vehicle Emissions Information Brochure requirement for manufacturers rule (§ 114.618). The State of Texas accidentally submitted this brochure repeal since this particular Program is not part of the SIP; consequently, we are returning it to the State.[2]

Repeal of the TCM substitution program. Regulations to implement the Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (SAFETEA–LU) (January 24, 2008, 73 FR 4420) added a provision to the CAA to allow states to substitute or add TCMs into approved SIPs without the standard SIP revision process. Thus, states are no longer required to include a TCM substitution mechanism in their SIPs. The submitted revision includes the repeal of 30 TAC 114.270(f): The TCM substitution program.

Repeal of the TCFF MERC program. The TCFF MERC program was approved into the SIP as an element of the TCFF program on February 7, 2001 (66 FR 9203). The TCFF MERC program is unrelated and separate from the Mobile Emission Reduction Credit Generation and Certification program found in 30 TAC 101.304 which regulates MERCs that are generated under the state's banking and trading program.

In 2005, the Texas Legislature enacted Senate Bill (SB) 1032, which repealed the TCFF program but for the VOC rules governing transfer operations at gasoline terminals and the NO_X rules governing electric generating facilities. With the repeal of the TCFF program, the TCFF MERC program, the TCFF MERC fund, and associated definitions are no longer relevant. These repealed rules are found in the SIP rules at Chapter 114, Subchapter A—Definitions, and Subchapter F—Vehicle Retirement and Mobile Emission Reduction Credits; Division 1: Mobile Emission Reduction Credits.

New Texas Clean Fleet (TCF) Rules and Revisions. On March 25, 2010, the TCEQ submitted revisions to 30 TAC 114: Control of Air Pollution from Motor Vehicles, establishing a new, voluntary state grant program called the Texas Clean Fleet (TCF) Program. The revisions implement SB 1759, adopted by the 81st Legislature (2009, Regular Session) which created the TCF program. This program is designed to encourage eligible entities to replace on-road diesel-powered vehicles with vehicles powered by fuels other than gasoline or diesel. The TCF Program provides incentives to owners of large fleets in Texas to replace on-road diesel-powered vehicles with alternative fuel vehicles including hybrids. The TCF is a program under the umbrella of the Texas Emission Reduction Plan (TERP), which provides financial incentives to eligible individuals, businesses or local governments to reduce emissions from polluting vehicles and equipment.

The April 13, 2012 submittal makes revisions to the TCF program, including, but not limited to, the eligibility criteria and disposition of the replaced vehicles.

II. Analysis of the State's Submittals

For a detailed analysis of these submittals, see the Technical Support Document that accompanies this action.

[1] On October 20, 2010 (75 FR 64675), EPA approved as part of the BPA SIP, a Texas CFFP Program Equivalency Demonstration. This demonstration showed that relying upon EPA's data, beginning with the 2006 model year, Tier 2 Light-Duty Vehicles (LDVs), Light-Duty Trucks (LDTs 1–4), and Medium Duty Passenger Vehicles (MDPVs) certified to certain Tier 2 bin standards, to be equivalent to or more stringent than the CFFP program LEV emission standards. In addition, Texas demonstrated that Tier 2 LDVs, LDTs 1–4, and MDPVs certified to other Tier 2 bin standards, are equivalent to or more stringent than the CFFP program LEV emission standards. Texas performed a similar analysis, showing that standards for 2006 and later model years for Otto cycle and diesel heavy-duty vehicles ranging from 8501–14,000 Gross Vehicle Weight Rating are more stringent than the CFFP program LEV emissions standards for these vehicles.

[2] The State has confirmed that it never submitted the original Light-duty Motor Vehicle Purchase or Lease Incentive Program for approval into the SIP. This Program was never relied upon for any SIP credits or to meet any CAA requirement. Because this Program is not part of the SIP and has never been relied upon, the submitted repeal of a brochure requirement for this Program clearly was an inadvertent error by the State.

The TSD may be accessed online at *http://www.regulations.gov,* Docket No. EPA–R06–OAR–2006–0885.

The LEV rules portion of the TCFF program was repealed by the state and in the submittal requesting removal of these LEV rules from the SIP, the State demonstrates federal emission standards now are more stringent than the emission standards for low emission vehicles (LEV) established under the TCFF program. We can approve the removal of the TCFF program's associated repealed LEV rules from the Texas SIP because the submitted equivalency demonstration shows the new Tier 2 and 2007 heavy-duty diesel vehicles and engines meet or exceed the LEV requirement. See the TSD for further technical information about the equivalency demonstration. In addition, the State continues to meet the CAA requirement for a CFF program by retaining the emission reductions from stationary sources for NO_X and VOCs from the substitute program that more than cover all emission requirements for the entire TCFF program. The TCFF repealed MERC program, its MERC fund, and associated definitions, which also are in the SIP, are intertwined with the SIP's TCFF Program. The part D SIPs for the Texas ozone nonattainment areas did not rely upon any emissions reductions credits from the TCFF program and its associated MERC program in the attainment demonstrations or to meet reasonable further progress. We are approving the removal of the TCFF Program's repealed LEV rules and the TCFF Program's associated repealed rules for the MERC program, fund, and definitions from the Texas SIP. The repealed rules that are removed from the SIP are 30 TAC 114.4, and 30 TAC 114.201 and 114.202.

The EPA revised the transportation conformity rule (40 CFR parts 51 and 93) on January 24, 2008, to address the transportation conformity-related CAA amendments made by SAFETEA–LU (73 FR 4420). In addition to amendments to the transportation conformity provisions, the SAFETEA–LU added a provision to the CAA that allows states to substitute or add TCMs into approved SIPs without the standard SIP revision process; see section 176(c)(8) of the Act and 40 CFR 93.101. Under this Clean Air Act provision, states are no longer required to include a TCM substitution mechanism in their SIPs in order to expedite the process for making TCM substitutions. The provision also provides a streamlined process for adding TCMs to an approved SIP. EPA determined that it was not necessary to promulgate regulations in order to successfully implement the TCM substitution and additional statutory provision (73 FR 4420, 4432). See EPA's *Guidance for Implementing the Clean Air Act Section 176(c)(8) Transportation Control Measure Substitution and Addition Provision.*[3] We agree with the state that the change to the CAA requirements made by the SAFETEA–LU in 2008 renders a state TCM substitution program unnecessary. Therefore, we are approving the removal of the Texas repealed TCM substitution Program and its associated repealed rules from the Texas SIP. Texas now will rely solely on the federal statute for future actions. The repealed rule that is removed from the SIP is 30 TAC 114.270(f).

Because the submitted TCF program is a voluntary financial incentive program encouraging the replacement of large fleets of on-road diesel power engines with vehicles using fuels other than gasoline or diesel, to evaluate it, we used the EPA Guidance: *Improving Air Quality with Economic Incentive Programs* (EIP). An EIP achieves an air quality objective by providing market-based incentives or information to emission sources. Three fundamental principles apply to all approvable economic incentive programs: integrity, equity, and environmental benefit. Our analysis showed that the provisions of this new, voluntary incentive program, and the subsequent revisions, meet the three fundamental principles for an acceptable incentive program, and provide a framework for achieving emission reductions. See the TSD for the further analysis. If TCEQ includes emission reductions from this program in future attainment or RFP SIPs, EPA will evaluate the amount of reductions it achieves at that time. We are approving the TCF Program and its associated revisions as part of the Texas SIP. The rules being approved into the SIP are 30 TAC 114.650–114.658.

III. Final Action

Pursuant to section 110 of the Act, EPA is approving four revisions to the Texas SIP that were submitted on May 15, 2006; July 25, 2007 (but omitting revision to § 114.618 which was submitted accidentally and is being returned to the state); March 25, 2010; and April 13, 2012. We evaluated the State's submittals and determined that they meet the applicable requirements of the Clean Air Act (CAA) section 110 and applicable EPA guidance. Approval of these submittals will not result in any increase in ozone concentrations. In accordance with CAA section 110(l), these revisions will not interfere with attainment of the National Ambient Air Quality Standards (NAAQS), reasonable further progress, or any other applicable requirement of the CAA. EPA is approving the removal of the TCFF program's LEV and MERC rules from the Texas SIP. EPA also is approving the removal of the TCM substitution rules from the Texas SIP. Finally, EPA is approving into the Texas SIP, the new TCF program and revisions.

EPA is publishing this rule without prior proposal because we view this as a non-controversial amendment and anticipate no adverse comments. However, in the proposed rules section of this **Federal Register** publication, we are publishing a separate document that will serve as the proposal to approve the SIP revision if relevant adverse comments are received. This rule will be effective on *April 1, 2014* without further notice unless we receive adverse comment by *March 3, 2014.* If we receive adverse comments, we will publish a timely withdrawal in the **Federal Register** informing the public that the rule will not take effect. We will address all public comments in a subsequent final rule based on the proposed rule. We will not institute a second comment period on this action. Any parties interested in commenting must do so now. Please note that if we receive adverse comment on an amendment, paragraph, or section of this rule and if that provision may be severed from the remainder of the rule, we may adopt as final those provisions of the rule that are not the subject of an adverse comment.

IV. Statutory and Executive Order Reviews

Under the Clean Air Act, the Administrator is required to approve a SIP submission that complies with the provisions of the Act and applicable Federal regulations. 42 U.S.C. 7410(k); 40 CFR 52.02(a). Thus, in reviewing SIP submissions, EPA's role is to approve state choices, provided that they meet the criteria of the Clean Air Act. Accordingly, this action merely approves state law as meeting Federal requirements and does not impose additional requirements beyond those imposed by state law. For that reason, this action:

- Is not a ''significant regulatory action'' subject to review by the Office of Management and Budget under Executive Order 12866 (58 FR 51735, October 4, 1993);
- does not impose an information collection burden under the provisions

[3] The guidance is posted at *http://www.epa.gov/oms/stateresources/transconf/policy/420b09002.pdf.* The document ID number is EPA–420–B–09–002, January 2009.

of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*);

• is certified as not having a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*);

• does not contain any unfunded mandate or significantly or uniquely affect small governments, as described in the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4);

• does not have Federalism implications as specified in Executive Order 13132 (64 FR 43255, August 10, 1999);

• is not an economically significant regulatory action based on health or safety risks subject to Executive Order 13045 (62 FR 19885, April 23, 1997);

• is not a significant regulatory action subject to Executive Order 13211 (66 FR 28355, May 22, 2001);

• is not subject to requirements of Section 12(d) of the National Technology Transfer and Advancement Act of 1995 (15 U.S.C. 272 note) because application of those requirements would be inconsistent with the Clean Air Act; and

• does not provide EPA with the discretionary authority to address, as appropriate, disproportionate human health or environmental effects, using practicable and legally permissible methods, under Executive Order 12898 (59 FR 7629, February 16, 1994).

In addition, this rule does not have tribal implications as specified by Executive Order 13175 (65 FR 67249, November 9, 2000), because the SIP is not approved to apply in Indian country located in the state, and EPA notes that it will not impose substantial direct costs on tribal governments or preempt tribal law.

The Congressional Review Act, 5 U.S.C. section 801 *et seq.,* as added by the Small Business Regulatory Enforcement Fairness Act of 1996, generally provides that before a rule may take effect, the agency promulgating the rule must submit a rule report, which includes a copy of the rule, to each House of the Congress and to the Comptroller General of the United States. EPA will submit a report containing this action and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the United States prior to publication of the rule in the **Federal Register**. A major rule cannot take effect until 60 days after it is published in the **Federal Register**. This action is not a ''major rule'' as defined by 5 U.S.C. 804(2).

Under section 307(b)(1) of the Clean Air Act, petitions for judicial review of this action must be filed in the United States Court of Appeals for the appropriate circuit by April 1, 2014. Filing a petition for reconsideration by the Administrator of this final rule does not affect the finality of this action for the purposes of judicial review nor does it extend the time within which a petition for judicial review may be filed, and shall not postpone the effectiveness of such rule or action. This action may not be challenged later in proceedings to enforce its requirements. (See section 307(b)(2).)

List of Subjects in 40 CFR part 52

Environmental protection, Air pollution control, Carbon monoxide, Incorporation by reference, Intergovernmental relations, Lead, Nitrogen dioxide, Ozone, Particulate matter, Reporting and recordkeeping requirements, Sulfur oxides, Volatile organic compounds.

Dated: January 15, 2014.

Ron Curry,

Regional Administrator, Region 6.

40 CFR Part 52 is amended as follows:

PART 52–APPROVAL AND PROMULGATION OF IMPLEMENTATION PLANS

■ 1. The authority citation for part 52 continues to read as follows:

Authority: 42 U.S.C. 7401 *et seq.*

Subpart SS—Texas

■ 2. In § 52.2270, amend the table in paragraph (c) entitled ''EPA Approved Regulations in the Texas SIP'' is amended under Chapter 114 (Reg 4)—Control of Air Pollution from Motor Vehicles by:

■ a. Revising the entry for Section 114.1;

■ b. Removing the entry for Section 114.3;

■ c. Removing the centered heading ''Subchapter E—Low Emission Vehicle Fleet Requirements'' and removing the entries for Sections 114.150, 114.151, and 114.153 thru 114.157;

■ d. Removing the centered heading ''Subchapter F—Vehicle Retirement and Mobile Emission Reduction Credits'' and removing the centered heading ''Division 1: Mobile Emission Reduction Credits'' and removing the entries for Sections 114.201 and 114.202;

■ e. Immediately following the entry for Section 114.260, add a new entry for Section 114.270; and

■ f. Immediately following the entry for 114.648, add a centered heading for ''Division 5: Texas Clean Fleet Program'' followed by entries for Sections 114.650 to 114.658.

The revisions and additions read as follows:

§ 52.2270 Identification of plan.

* * * * *

(c) * * *

EPA APPROVED REGULATIONS IN THE TEXAS SIP

State citation	Title/subject	State approval/submittal date	EPA approval date	Explanation
*	*	*	*	*
Chapter 114 (Reg 4)—Control of Air Pollution from Motor Vehicles				
Subchapter A—Definitions				
Section 114.1	Definitions	6/27/2007	1/31/2014 [Insert FR page number where document begins].	

EPA APPROVED REGULATIONS IN THE TEXAS SIP—Continued

State citation	Title/subject	State approval/submittal date	EPA approval date	Explanation
* * *	*	*	*	*
Subchapter G—Transportation Planning				
* * *	*	*	*	*
Section 114.270	Transportation Control Measures.	6/27/2007	1/31/2014 [Insert FR page number where document begins].	
* * *	*	*	*	*
Subchapter K—Mobile Sources Incentive Programs				
* * *	*	*	*	*
Division 5: Texas Clean Fleet Program				
Section 114.650	Definitions	3/28/2012	1/31/2014 [Insert FR page number where document begins].	
Section 114.651	Applicability	3/28/2012	1/31/2014 [Insert FR page number where document begins].	
Section 114.652	Qualifying Vehicles	3/28/2012	1/31/2014 [Insert FR page number where document begins].	
Section 114.653	Grant Eligibility	3/28/2012	1/31/2014 [Insert FR page number where document begins].	
Section 114.654	Usage and Disposition	3/28/2012	1/31/2014 [Insert FR page number where document begins].	
Section 114.655	Grant Restrictions	2/24/2010	1/31/2014 [Insert FR page number where document begins].	
Section 114.656	Eligible Grant Amounts	2/24/2010	1/31/2014 [Insert FR page number where document begins].	
Section 114.657	Reporting Requirements	2/24/2010	1/31/2014 [Insert FR page number where document begins].	
Section 114.658	Implementation Schedule	2/24/2010	1/31/2014 [Insert FR page number where document begins].	

* * * * *

[FR Doc. 2014–01903 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[EPA–R05–OAR–2013–0502; FRL–9905–32–Region 5]

Approval and Promulgation of Air Quality Implementation Plans; Wisconsin; Total Suspended Particulate Matter SIP Revision

AGENCY: Environmental Protection Agency (EPA).

ACTION: Direct final rule.

SUMMARY: The Environmental Protection Agency (EPA) is taking direct final action to approve a revision to the Wisconsin State Implementation Plan (SIP). The SIP revision repeals an obsolete Total Suspended Particulate Matter (TSP) rule to align the State's air quality standards with the current National Ambient Air Quality Standards (NAAQS). This action makes no substantive changes to the SIP and imposes no new requirements.

DATES: This direct final rule is effective April 1, 2014, unless EPA receives adverse comments by March 3, 2014. If adverse comments are received, EPA will publish a timely withdrawal of the direct final rule in the **Federal Register**, informing the public that the rule will not take effect.

ADDRESSES: Submit your comments, identified by Docket ID No. EPA–R05–OAR–2013–0502, by one of the following methods:

1. *www.regulations.gov:* Follow the on-line instructions for submitting comments.

2. *Email: aburano.douglas@epa.gov.*

3. *Fax:* (312) 408–2279.

4. *Mail:* Douglas Aburano, Chief, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), U.S. Environmental Protection Agency,

77 West Jackson Boulevard, Chicago, Illinois 60604.

5. *Hand Delivery:* Douglas Aburano, Chief, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), U.S. Environmental Protection Agency, 77 West Jackson Boulevard, Chicago, Illinois 60604. Such deliveries are only accepted during the Regional Office normal hours of operation, and special arrangements should be made for deliveries of boxed information. The Regional Office official hours of business are Monday through Friday, 8:30 a.m. to 4:30 p.m., excluding Federal holidays.

Instructions: Direct your comments to Docket ID No. EPA–R05–OAR–2013–0502. EPA's policy is that all comments received will be included in the public docket without change and may be made available online at *www.regulations.gov*, including any personal information provided, unless the comment includes information claimed to be Confidential Business Information (CBI) or other information whose disclosure is restricted by statute. Do not submit information that you consider to be CBI or otherwise protected through *www.regulations.gov* or email. The *www.regulations.gov* Web site is an ''anonymous access'' system, which means EPA will not know your identity or contact information unless you provide it in the body of your comment. If you send an email comment directly to EPA without going through *www.regulations.gov*, your email address will be automatically captured and included as part of the comment that is placed in the public docket and made available on the Internet. If you submit an electronic comment, EPA recommends that you include your name and other contact information in the body of your comment and with any disk or CD–ROM you submit. If EPA cannot read your comment due to technical difficulties and cannot contact you for clarification, EPA may not be able to consider your comment. Electronic files should avoid the use of special characters, any form of encryption, and be free of any defects or viruses.

Docket: All documents in the docket are listed in the *www.regulations.gov* index. Although listed in the index, some information is not publicly available, *e.g.,* CBI or other information whose disclosure is restricted by statute. Certain other material, such as copyrighted material, will be publicly available only in hard copy. Publicly available docket materials are available either electronically in *www.regulations.gov* or in hard copy at the Environmental Protection Agency, Region 5, Air and Radiation Division, 77 West Jackson Boulevard, Chicago, Illinois 60604. This facility is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding Federal holidays. We recommend that you telephone Gilberto Alvarez, Environmental Scientist, at (312) 886–6143 before visiting the Region 5 office.

FOR FURTHER INFORMATION CONTACT: Gilberto Alvarez, Environmental Scientist, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), Environmental Protection Agency, Region 5, 77 West Jackson Boulevard, Chicago, Illinois 60604, (312) 886–6143, *alvarez.gilberto@epa.gov.*

SUPPLEMENTARY INFORMATION: Throughout this document whenever ''we,'' ''us,'' or ''our'' is used, we mean EPA. This supplementary information section is arranged as follows:

I. Introduction
II. Removal of Obsolete or Unnecessary Rule
III. Final Action
IV. Statutory and Executive Order Reviews

I. Introduction

The EPA is removing three sections from the State's air quality SIP, based on a rule change made by the State to repeal its TSP air quality standard. EPA originally regulated particulate matter (PM) measured using TSP, which is particulate up to 100 micrometers in diameter. EPA tightened the PM standards, as PM_{10} and $PM_{2.5}$ in 1987 and 1997, respectively, which replaced the TSP secondary standard. Particulate matter larger than 10 micrometers generally is not inhaled into the lungs and standards based on PM_{10} and $PM_{2.5}$ are found to adequately protect human health. This action removes the sections from 40 CFR part 52 that no longer have any use or legal effect because they have been superseded by subsequently approved SIP revisions.

II. Removal of Obsolete or Unnecessary Rule

The Wisconsin Department of Natural Resources (WDNR) has requested removal of three sections of the Wisconsin administrative code from the SIP, to align the State's air quality standards with the current NAAQS for PM. EPA has reviewed the request and finds that the three sections should be removed for the reasons set forth as follows:

Section NR 404.02(11) TSP Definition

Section NR 404.02(11) defines ''Total Suspended Particulates''. This definition is being removed because EPA has adopted air quality standards for PM_{10} and $PM_{2.5}$, which are particulates of 10 micrometers and 2.5 micrometers, respectively. The PM_{10} and $PM_{2.5}$ standards for smaller sized particles render the larger sized TSP particle standard obsolete.

Section NR 404.04(3) Particulate Matter Secondary Standard

The NAAQS consist of both primary standards and secondary standards. Primary NAAQS provide public health protection. Secondary NAAQS provide public welfare protection, including protection against decreased visibility and damage to animals, crops, vegetation, and buildings. Section NR 404.04(3) defines the TSP secondary standard as 150 micrograms per cubic meter, maximum 24-hour average concentration, not to be exceeded more than once per year. EPA replaced the TSP secondary standard with more protective PM_{10} and $PM_{2.5}$ standards in 1987 and 1997, respectively.

Section NR 484.04(3) TSP Reference Method

Section NR 484.04(3) incorporates by reference the test method for TSP. The reference method is used to determine particulate matter in the atmosphere. Because EPA replaced TSP air quality standards with PM_{10} and $PM_{2.5}$ standards, the reference method is obsolete.

III. Final Action

EPA has determined that the above-referenced sections should be removed at this time. EPA is publishing this rule without prior proposal because the Agency views this as a noncontroversial amendment and anticipates no adverse comment. However, in the proposed rules section of this **Federal Register**, EPA is publishing a separate document that will serve as the proposal to approve the SIP revision if relevant adverse comments are filed. This rule will be effective on April 1, 2014 without further notice, unless EPA receives relevant adverse comment March 3, 2014. If EPA receives relevant adverse comment, EPA will publish a timely withdrawal in the **Federal Register** informing the public that the rule will not take effect. EPA will address all public comments in a subsequent final rule based on the proposed rule. EPA will not institute a second comment period on this action. Any parties interested in commenting must do so at this time. Please note that if EPA receives adverse comment on an amendment, paragraph, or section of this rule and if that provision may be severed from the remainder of the rule, EPA may adopt as final those provisions

of the rule that are not the subject of an adverse comment.

IV. Statutory and Executive Order Reviews

Under the Clean Air Act, the Administrator is required to approve a SIP submission that complies with the provisions of the Clean Air Act and applicable Federal regulations. 42 U.S.C. 7410(k); 40 CFR 52.02(a). Thus, in reviewing SIP submissions, EPA's role is to approve state choices, provided that they meet the criteria of the Clean Air Act. Accordingly, this action merely approves state law as meeting Federal requirements and does not impose additional requirements beyond those imposed by state law. For that reason, this action:

- Is not a ''significant regulatory action'' subject to review by the Office of Management and Budget under Executive Order 12866 (58 FR 51735, October 4, 1993);
- Does not impose an information collection burden under the provisions of the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*);
- Is certified as not having a significant economic impact on a substantial number of small entities under the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*);
- Does not contain any unfunded mandate or significantly or uniquely affect small governments, as described in the Unfunded Mandates Reform Act of 1995 (Pub. L. 104–4);
- Does not have Federalism implications as specified in Executive Order 13132 (64 FR 43255, August 10, 1999);
- Is not an economically significant regulatory action based on health or safety risks subject to Executive Order 13045 (62 FR 19885, April 23, 1997);
- Is not a significant regulatory action subject to Executive Order 13211 (66 FR 28355, May 22, 2001);
- Is not subject to requirements of Section 12(d) of the National Technology Transfer and Advancement Act of 1995 (15 U.S.C. 272 note) because application of those requirements would be inconsistent with the Clean Air Act; and
- Does not provide EPA with the discretionary authority to address, as appropriate, disproportionate human health or environmental effects, using practicable and legally permissible methods, under Executive Order 12898 (59 FR 7629, February 16, 1994).

In addition, this rule does not have tribal implications as specified by Executive Order 13175 (65 FR 67249, November 9, 2000), because the SIP is not approved to apply in Indian country located in the state, and EPA notes that it will not impose substantial direct costs on tribal governments or preempt tribal law.

The Congressional Review Act, 5 U.S.C. 801 *et seq.,* as added by the Small Business Regulatory Enforcement Fairness Act of 1996, generally provides that before a rule may take effect, the agency promulgating the rule must submit a rule report, which includes a copy of the rule, to each House of the Congress and to the Comptroller General of the United States. EPA will submit a report containing this action and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the United States prior to publication of the rule in the **Federal Register**. A major rule cannot take effect until 60 days after it is published in the **Federal Register**. This action is not a ''major rule'' as defined by 5 U.S.C. 804(2).

Under section 307(b)(1) of the Clean Air Act, petitions for judicial review of this action must be filed in the United States Court of Appeals for the appropriate circuit by *April 1, 2014.* Filing a petition for reconsideration by the Administrator of this final rule does not affect the finality of this action for the purposes of judicial review, nor does it extend the time within which a petition for judicial review may be filed, and it shall not postpone the effectiveness of such rule or action. Parties with objections to this direct final rule are encouraged to file a comment in response to the parallel notice of proposed rulemaking for this action published in the proposed rules section of today's **Federal Register**, rather than file an immediate petition for judicial review of this direct final rule, so that EPA can withdraw this direct final rule and address the comment in the proposed rulemaking. This action may not be challenged later in proceedings to enforce its requirements. (See section 307(b)(2).)

List of Subjects in 40 CFR Part 52

Environmental protection, Air pollution control, Incorporation by reference, Intergovernmental relations, Particulate matter, Total Suspended Solids, Reporting and recordkeeping requirements.

Dated: December 23, 2013.

Susan Hedman,

Regional Administrator, Region 5.

40 CFR part 52 is amended as follows:

PART 52—APPROVAL AND PROMULGATION OF IMPLEMENTATION PLANS

■ 1. The authority citation for part 52 continues to read as follows:

Authority: 42 U.S.C. 7401 *et seq.*

■ 2. Section 52.2570 is amended by revising paragraphs (c)(64)(i)(A), (c)(65)(i)(A), (c)(73)(i)(J), and (c)(103)(i)(S), and by adding paragraph (c)(130) to read as follows:

§ 52.2570 Identification of plan.

* * * * *

(c) * * *

(64) * * *

(i) * * *

(A) Wisconsin revised rules NR 439.03, NR 439.09 and NR 484.04, Wisconsin's Administrative Code, effective October 1, 1987. Section NR 484.04(3) was repealed in 2011 and is removed without replacement; see paragraph (c)(130) of this section.

* * * * *

(65) * * *

(i) * * *

(A) The rule packages revise NR 400.02, 404.02, 404.04, 405.02, 406.04, and 484.03 of the Wisconsin Administrative Code. Sections NR 404.02(11), NR 404.04(3), and 484.04(3) were repealed in 2011 and are removed without replacement; see paragraph (c)(130) of this section.

* * * * *

(73) * * *

(i) * * *

(J) Chapter NR 484: INCORPORATION BY REFERENCE. NR 484.01 as published in the (Wisconsin) Register, May, 1992, No. 437, effective June 1, 1992. NR 484.02 as published in the (Wisconsin) Register, September, 1986, No. 369, effective October 1, 1986. NR 484.03 as published in the (Wisconsin) Register, May, 1993, No. 449, effective June 1, 1993. NR 484.04, 484.05 and 484.06 as published in the (Wisconsin) Register, December, 1993, No. 456, effective January 1, 1994. NR 484.08 and 484.09 as published in the (Wisconsin) Register, October, 1992, No. 442, effective November 1, 1992. Section NR 484.04(3) was repealed in 2011 and is removed without replacement; see paragraph (c)(130) of this section.

* * * * *

(103) * * *

(i) * * *

(S) NR 484.04 as published in the (Wisconsin) Register, August 2001, No. 548 and effective September 1, 2001. Section NR 484.04(3) was repealed in 2011 and is removed without

replacement; see paragraph (c)(130) of this section.

* * * * *

(130) On June 20, 2013, the Wisconsin Department of Natural Resources submitted a request to remove the state's TSP air quality standard, sections NR 404.02(11), NR 404.04(3), and NR 484.04(3) of the Wisconsin Administrative Code, from the state's air quality State Implementation Plan.

(i) [Reserved]

(ii) Additional material. Wisconsin Natural Resources Board October 6, 2011, Board Order AM–23–07B to repeal the state's TSP air quality standard, as published in the Wisconsin Administrative Register November 2011, No. 671, effective December 1, 2011.

[FR Doc. 2014–01900 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

Revisions to the California State Implementation Plan, South Coast Air Quality Management District

CFR Correction

■ In Title 40 of the Code of Federal Regulations, Part 52 (§§ 52.01 to 52.1018), revised as of July 1, 2013, on page 277, in § 52.220, the paragraph designation for paragraph (311)(A)(i)(*2*) is italicized and the paragraph is moved to before paragraph (311)(A)(i)(*3*).

[FR Doc. 2014–02088 Filed 1–30–14; 8:45 am]

BILLING CODE 1505–01–D

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 180

[EPA–HQ–OPP–2012–0515; FRL–9904–27]

Diflubenzuron; Pesticide Tolerances

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final rule.

SUMMARY: This regulation establishes tolerances for residues of diflubenzuron (*N*-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzimide) in or on fruit, citrus, group 10–10 and citrus, oil. Chemtura Corporation, requested these tolerances under the Federal Food, Drug, and Cosmetic Act (FFDCA).

DATES: This regulation is effective January 31, 2014. Objections and requests for hearings must be received on or before April 1, 2014, and must be filed in accordance with the instructions provided in 40 CFR part 178 (see also Unit I.C. of the **SUPPLEMENTARY INFORMATION**).

ADDRESSES: The docket for this action, identified by docket identification (ID) number EPA–HQ–OPP–2012–0515, is available at *http://www.regulations.gov* or at the Office of Pesticide Programs Regulatory Public Docket (OPP Docket) in the Environmental Protection Agency Docket Center (EPA/DC), EPA West Bldg., Rm. 3334, 1301 Constitution Ave. NW., Washington, DC 20460–0001. The Public Reading Room is open from 8:30 a.m. to 4:30 p.m., Monday through Friday, excluding legal holidays. The telephone number for the Public Reading Room is (202) 566–1744, and the telephone number for the OPP Docket is (703) 305–5805. Please review the visitor instructions and additional information about the docket available at *http://www.epa.gov/dockets.*

FOR FURTHER INFORMATION CONTACT: Lois Rossi, Registration Division, Office of Pesticide Programs, Environmental Protection Agency, 1200 Pennsylvania Ave. NW., Washington, DC 20460–0001; telephone number: (703) 305–7090; email address: *RDFRNotices@epa.gov.*

SUPPLEMENTARY INFORMATION:

I. General Information

A. Does this action apply to me?

You may be potentially affected by this action if you are an agricultural producer, food manufacturer, or pesticide manufacturer. The following list of North American Industrial Classification System (NAICS) codes is not intended to be exhaustive, but rather provides a guide to help readers determine whether this document applies to them. Potentially affected entities may include:

- Crop production (NAICS code 111).
- Animal production (NAICS code 112).
- Food manufacturing (NAICS code 311).
- Pesticide manufacturing (NAICS code 32532).

B. How can I get electronic access to other related information?

You may access a frequently updated electronic version of EPA's tolerance regulations at 40 CFR part 180 through the Government Printing Office's e-CFR site at *http://www.ecfr.gov/cgi-bin/text-idx?&c=ecfr&tpl=/ecfrbrowse/Title40/40tab_02.tpl.*

C. How can I file an objection or hearing request?

Under FFDCA section 408(g), 21 U.S.C. 346a, any person may file an objection to any aspect of this regulation and may also request a hearing on those objections. You must file your objection or request a hearing on this regulation in accordance with the instructions provided in 40 CFR part 178. To ensure proper receipt by EPA, you must identify docket ID number EPA–HQ–OPP–2012–0515 in the subject line on the first page of your submission. All objections and requests for a hearing must be in writing, and must be received by the Hearing Clerk on or before April 1, 2014. Addresses for mail and hand delivery of objections and hearing requests are provided in 40 CFR 178.25(b).

In addition to filing an objection or hearing request with the Hearing Clerk as described in 40 CFR part 178, please submit a copy of the filing (excluding any Confidential Business Information (CBI)) for inclusion in the public docket. Information not marked confidential pursuant to 40 CFR part 2 may be disclosed publicly by EPA without prior notice. Submit the non-CBI copy of your objection or hearing request, identified by docket ID number EPA–HQ–OPP–2012–0515, by one of the following methods:

- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the online instructions for submitting comments. Do not submit electronically any information you consider to be CBI or other information whose disclosure is restricted by statute.
- *Mail:* OPP Docket, Environmental Protection Agency Docket Center (EPA/DC), (28221T), 1200 Pennsylvania Ave. NW., Washington, DC 20460–0001.
- *Hand Delivery:* To make special arrangements for hand delivery or delivery of boxed information, please follow the instructions at *http://www.epa.gov/dockets/contacts.html.* Additional instructions on commenting or visiting the docket, along with more information about dockets generally, is available at *http://www.epa.gov/dockets.*

II. Summary of Petitioned-for Tolerance

In the **Federal Register** of September 12, 2013 (78 FR 56185) (FRL–9399–7), EPA issued a document pursuant to FFDCA section 408(d)(3), 21 U.S.C. 346a(d)(3), announcing the filing of a pesticide petition (PP 2F8015) by Chemtura Corporation,199 Benson Road, Middlebury, CT 06749. The petition requested that 40 CFR 180.377 be amended by establishing tolerances for residues of the insecticide diflubenzuron, (DFB) and its metabolites 4-chlorophenylurea (CPU) and 4-chloroaniline (PCA), in or on fruit, citrus, group 10–10 at 3.0 parts per million (ppm), and citrus, oil at 32.0

ppm. That document referenced a summary of the petition prepared by Chemtura Corporation, the registrant, which is available in the docket, *http://www.regulations.gov.* There were no comments received in response to the notice of filing.

In conjunction with this rulemaking, EPA has updated the tolerance expression to be consistent with the FFDCA. See Unit IV.D. EPA is also removing the existing tolerances for grapefruit, orange, pummelo, and tangerine that are made redundant by establishment of the crop group tolerance for citrus.

III. Aggregate Risk Assessment and Determination of Safety

Section 408(b)(2)(A)(i) of FFDCA allows EPA to establish a tolerance (the legal limit for a pesticide chemical residue in or on a food) only if EPA determines that the tolerance is ''safe.'' Section 408(b)(2)(A)(ii) of FFDCA defines ''safe'' to mean that ''there is a reasonable certainty that no harm will result from aggregate exposure to the pesticide chemical residue, including all anticipated dietary exposures and all other exposures for which there is reliable information.'' This includes exposure through drinking water and in residential settings, but does not include occupational exposure. Section 408(b)(2)(C) of FFDCA requires EPA to give special consideration to exposure of infants and children to the pesticide chemical residue in establishing a tolerance and to ''ensure that there is a reasonable certainty that no harm will result to infants and children from aggregate exposure to the pesticide chemical residue. . . .''

Consistent with FFDCA section 408(b)(2)(D), and the factors specified in FFDCA section 408(b)(2)(D), EPA has reviewed the available scientific data and other relevant information in support of this action. EPA has sufficient data to assess the hazards of and to make a determination on aggregate exposure for diflubenzuron including exposure resulting from the tolerances established by this action. EPA's assessment of exposures and risks associated with diflubenzuron follows.

A. Toxicological Profile

EPA has evaluated the available toxicity data and considered its validity, completeness, and reliability as well as the relationship of the results of the studies to human risk. EPA has also considered available information concerning the variability of the sensitivities of major identifiable subgroups of consumers, including infants and children.

The acute oral, dermal and inhalation toxicity of diflubenzuron is low. It is a mild eye irritant and not a skin irritant in laboratory animals. It is negative for sensitization in the guinea pig. In subchronic and chronic feeding studies, the primary endpoint of concern was methemoglobinemia and/or sulfhemoglobinemia. These effects were evident in both sexes of mice, rats, and dogs and were produced by more than one route of administration in rats (i.e., oral, dermal and inhalation). The general consequence of methemoglobinemia and/or sulfhemoglobinemia is the impairment of the oxygen transportation capacity of the blood, which is generally known to be caused by aromatic amines in both humans and animals. Degradates of diflubenzuron with aromatic amines, CPU and PCA, are also included in the diflubenzuron non-cancer risk assessment. CPU, an analog of monuron, does not effect methemoglobin formation but does produce tumors in the liver and kidneys of male rats. The toxicity of PCA is well understood with methemoglobin formation the primary systemic effect. PCA is similar in potency to diflubenzuron on methemoglobin formation. Therefore, the non-cancer assessment will include diflubenzuron, CPU and PCA. Since the toxicity of CPU and PCA is well understood, additional toxicity studies are not required.

The toxicity data provide no indication of an increased susceptibility to rats or to rabbits from *in utero* or postnatal exposure to diflubenzuron. Developmental and reproduction studies in rats and rabbits indicate a very low hazard potential for adverse effects. Developmental studies were tested at the limit dose of 1,000 milligrams/kilogram/day (mg/kg/day) without apparent effects in both dams and the fetuses. The reproduction study indicated that effects in offspring occurred at doses that were higher than the doses producing effects in parents. The requirement for acute and subchronic neurotoxicity studies were recently waived because there are no clear signs of neurotoxicity following subchronic or chronic dosing in multiple species in the diflubenzuron database. The toxicity profile of diflubenzuron shows that the principal toxic effects are the formation of methemoglobinemia and/or sulfhemoglobinemia in the blood. The immunotoxicity study has been reviewed and immunotoxicity was not observed above the limit dose.

The Agency concluded that diflubenzuron is not carcinogenic in humans based on lack of evidence of carcinogenicity in rats and mice. PCA, a plant metabolite of diflubenzuron, tested positive for splenic tumors in male rats and hepatocellular adenomas/carcinomas in male mice in a National Toxicology Program (NTP) study. Therefore, EPA has treated PCA as a probable human carcinogen. CPU is the major degradate found in water and is a significant metabolite in milk. CPU is structurally related to monuron (*N,N*-dimethyl-CPU), a compound producing tumors of the kidney and liver in male rats. EPA has assumed CPU is a probable human carcinogen as well.

Specific information on the studies received and the nature of the adverse effects caused by diflubenzuron as well as the no-observed-adverse-effect-level (NOAEL) and the lowest-observed-adverse-effect-level (LOAEL) from the toxicity studies can be found at *http://www.regulations.gov* in document, ''Diflubenzuron: Human Health Risk Assessment for an Amended Section 3 Registration for the Expanded Citrus Crop Group 10–10.'' in docket ID number EPA–HQ–OPP–2012–0515.

B. Toxicological Points of Departure/Levels of Concern

Once a pesticide's toxicological profile is determined, EPA identifies toxicological points of departure (POD) and levels of concern (LOC) to use in evaluating the risk posed by human exposure to the pesticide. For hazards that have a threshold below which there is no appreciable risk, the toxicological POD is used as the basis for derivation of reference values for risk assessment. PODs are developed based on a careful analysis of the doses in each toxicological study to determine the dose at which the NOAEL and the LOAEL are identified. Uncertainty/safety factors are used in conjunction with the POD to calculate a safe exposure level—generally referred to as a population-adjusted dose (PAD) or a reference dose (RfD)—and a safe margin of exposure (MOE). For non-threshold risks, the Agency assumes that any amount of exposure will lead to some degree of risk. Thus, the Agency estimates risk in terms of the probability of an occurrence of the adverse effect expected in a lifetime. For more information on the general principles EPA uses in risk characterization and a complete description of the risk assessment process, see *http://www.epa.gov/pesticides/factsheets/riskassess.htm.*

A summary of the toxicological endpoints for diflubenzuron used for human risk assessment is shown in Table 1 and 2 of this unit.

TABLE 1—SUMMARY OF TOXICOLOGICAL DOSES AND ENDPOINTS FOR DIFLUBENZURON FOR USE IN DIETARY HUMAN HEALTH RISK ASSESSMENTS

Exposure/scenario	POD	Uncertainty/ FQPA safety factors	RfD, PAD, LOC for risk assessment	Study and toxicological effects
Acute dietary all populations	N/A	N/A	No appropriate endpoint attributable to single exposure was available	
Chronic dietary all populations	NOAEL = 2 mg/kg/day	UF_A = 10X UF_H = 10X FQPA SF = 1X	cPAD = chronic RfD FQPA SF = 0.02 mg/kg/day.	Chronic dog study 00146174. LOAEL = 10 mg/kg/day based on methemoglobinemia and sulfhemoglobinemia.
Cancer (all routes) Diflubenzuron	Classification: "Group E" evidence of non- carcinogenicity for humans.			
Cancer (oral, dermal, inhalation)	PCA "Group B2" probable human carcinogen Q[1]*. 1.12×10^{-1} (mg/kg/day)$^{-1}$	N/A	NTP oral mouse study.	
Cancer (oral, dermal, inhalation)	CPU Q_1* based on monuron a structural analog and the Q_1* 1.52×10^{-2}.	N/A	NTP oral rat study.	

Point of Departure (POD) = A data point or an estimated point that is derived from observed dose-response data and used to mark the beginning of extrapolation to determine risk associated with lower environmentally relevant human exposures.

NOAEL = no observed adverse effect level. LOAEL = lowest observed adverse effect level. UF = uncertainty factor. UF_A = extrapolation from animal to human (interspecies). UF_H = potential variation in sensitivity among members of the human population (intraspecies). FQPA SF = Food Quality Protection Act Safety Factor. PAD = population adjusted dose (a = acute, c = chronic). RfD = reference dose. MOE = margin of exposure. LOC = level of concern. N/A = not applicable.

TABLE 2—SUMMARY OF TOXICOLOGICAL DOSES AND ENDPOINTS FOR DIFLUBENZURON FOR USE IN RESIDENTIAL AND OCCUPATIONAL HUMAN HEALTH RISK ASSESSMENTS

Exposure/scenario	POD	Uncertainty/ factors	Level of concern for risk assessment	Study and toxicological effects
Short- and intermediate-term incidental oral (1 day–6 months) (residential).	N/A	N/A	N/A	These endpoints were not evaluated. There are no registered uses of diflubenzuron which result in significant residential exposure.
Short-term dermal (1–30 days) (occupational).	NOAEL = 500 mg/kg/day.	UF_A = 10X UF_H = 10X	LOC for MOE = 100	21-day rat dermal LOAEL = 1,000 mg/kg/day based on methemoglobinemia.
Dermal intermediate term (1–6 months).	NOAEL = 2 mg/kg/day	UF_A = 10X UF_H = 10X dermal absorption: 0.5%.	LOC for MOE = 100	13—week oral dog LOAEL = 6.4 mg/kg/day based on methemoglobinemia.
Inhalation short term (1–30 days)	NOAEL = 0.109 mg/L NOAEL = 20.30[1] mg/kg/day	UF_A = 10X UF_H = 10X	LOC for MOE = 100	28-day Inhalation rat study. No effect at HDT[2], 0.109 mg/L.
Inhalation intermediate term (1–6 months).	NOAEL = 0.109 mg/L NOAEL = 20.30[1] mg/kg/day	UF_A = 10X UF_H =10X	LOC for MOE = 100	28-day Inhalation rat study. No effect at HDT, 0.109 mg/L.
Inhalation long term (1–6 months)	NOAEL = 2 mg/kg/day	UF_A = 10X UF_H = 10X	LOC for MOE = 100	Chronic dog study. LOAEL = 10 mg/kg/day based on methemoglobinemia and sulfhemoglobinemia.
Cancer (all routes)	Classification: "Group E" evidence of non- carcinogenicity for humans.			

[1] Conversion from mg/L to oral dose (mg/kg/day) = mg/L × absorption (1.0) × Respiratory Volume (Sprague-Dawley rats) for 6 hours/d × Duration of Exposure (5 d/week)/body weight × 7 d/week = 0.109 mg/L × 1.0 × (0.26(RV) × 6 hrs) × 5 d/wk ÷ 0.236 kg × 7 d/wk = 20.3 mg/kg/day (TXR 0050503).

[2] Highest Dose Tested.

C. Exposure Assessment

1. *Dietary exposure from food and feed uses.* In evaluating dietary exposure to diflubenzuron, EPA considered exposure under the petitioned-for tolerances as well as all existing diflubenzuron tolerances in 40 CFR 180.377. EPA assessed dietary exposures from diflubenzuron in food as follows:

i. *Acute exposure.* Quantitative acute dietary exposure and risk assessments are performed for a food-use pesticide if a toxicological study has indicated the possibility of an effect of concern occurring as a result of a 1-day or single exposure. No such effects were identified in the toxicological studies for diflubenzuron; therefore, a quantitative acute dietary exposure assessment is unnecessary.

ii. *Chronic exposure.* In conducting the chronic non-cancer dietary exposure assessment, EPA used the food consumption data from the United States Department of Agriculture (USDA) National Health and Nutrition Examination Survey, ''What We Eat in America'' (NHANES/WWEIA) from 2003 through 2008. As to residue levels in food, EPA used the assumption that diflubenzuron residues are present in most commodities at tolerance levels (including tolerances previously established as well as those established in this action) and that 100% of all crops are treated. Average field trial residues were assumed for grapefruit, lemon, and orange. Tolerances include residues of diflubenzuron, PCA, and CPU.

iii. *Cancer.* Based on the data summarized in Unit III.A., EPA has concluded that diflubenzuron does not pose a cancer risk to humans. However, metabolites CPU and PCA are considered probable carcinogens and have Q*s assigned to them. Individual cancer dietary exposure analyses were conducted for each metabolite. For PCA, average percent crop treated (PCT) was used for some commodities. One-half the Limit of Quantitation (LOQ) was used for estimating PCA residues on the majority of crops because most crops did not contain detectable residues of PCA. Average field trial residue was used for mushrooms. The CPU cancer dietary analysis focused on CPU residues in milk because metabolism studies indicate that diflubenzuron metabolizes to CPU in milk. EPA assumed that 100% of milk commodities contained CPU at ½ the LOQ. One-half the LOQ was used since detectable residues of CPU were not found in the feeding study.

iv. *Anticipated residue and PCT information.* Section 408(b)(2)(E) of FFDCA authorizes EPA to use available data and information on the anticipated residue levels of pesticide residues in food and the actual levels of pesticide residues that have been measured in food. If EPA relies on such information, EPA must require pursuant to FFDCA section 408(f)(1) that data be provided 5 years after the tolerance is established, modified, or left in effect, demonstrating that the levels in food are not above the levels anticipated. For the present action, EPA will issue such Data Call-Ins as are required by FFDCA section 408(b)(2)(E) and authorized under FFDCA section 408(f)(1). Data will be required to be submitted no later than 5 years from the date of issuance of these tolerances.

Section 408(b)(2)(F) of FFDCA states that the Agency may use data on the actual percent of food treated for assessing chronic dietary risk only if:

- Condition a: The data used are reliable and provide a valid basis to show what percentage of the food derived from such crop is likely to contain the pesticide residue.
- Condition b: The exposure estimate does not underestimate exposure for any significant subpopulation group.
- Condition c: Data are available on pesticide use and food consumption in a particular area, the exposure estimate does not understate exposure for the population in such area.

In addition, the Agency must provide for periodic evaluation of any estimates used. To provide for the periodic evaluation of the estimate of PCT as required by FFDCA section 408(b)(2)(F), EPA may require registrants to submit data on PCT.

The Agency estimated the PCT for existing uses as follows: Almond (10%), apricot (10%), artichoke (50%), cotton (1%), grapefruit (15%), oranges (5%), peach (5%), peanut (5%), pear (5%), pecan (2.5%), peppers (1%), rice (1%), soybeans (1%), tangerines (5%), and wheat (1%).

In most cases, EPA uses available data from USDA/National Agricultural Statistics Service (NASS), proprietary market surveys, and the National Pesticide Use Database for the chemical/crop combination for the most recent 6 to 7 years. EPA uses an average PCT for chronic dietary risk analysis. The average PCT figure for each existing use is derived by combining available public and private market survey data for that use, averaging across all observations, and rounding to the nearest 5%, except for those situations in which the average PCT is less than one. In those cases, 1% is used as the average PCT and 2.5% is used as the maximum PCT. EPA uses a maximum PCT for acute dietary risk analysis. The maximum PCT figure is the highest observed maximum value reported within the recent 6 years of available public and private market survey data for the existing use and rounded up to the nearest multiple of 5%.

The Agency believes that the three conditions discussed in Unit III.C.1.iv. have been met. With respect to Condition a, PCT estimates are derived from Federal and private market survey data, which are reliable and have a valid basis. The Agency is reasonably certain that the percentage of the food treated is not likely to be an underestimation. As to Conditions b and c, regional consumption information and consumption information for significant subpopulations is taken into account through EPA's computer-based model for evaluating the exposure of significant subpopulations, including several regional groups. Use of this consumption information in EPA's risk assessment process ensures that EPA's exposure estimate does not understate exposure for any significant subpopulation group and allows the Agency to be reasonably certain that no regional population is exposed to residue levels higher than those estimated by the Agency. Other than the data available through national food consumption surveys, EPA does not have available reliable information on the regional consumption of food to which diflubenzuron may be applied in a particular area.

2. *Dietary exposure from drinking water.* The Agency used screening level water exposure models in the dietary exposure analysis and risk assessment for diflubenzuron in drinking water. These simulation models take into account data on the physical, chemical, and fate/transport characteristics of diflubenzuron. Further information regarding EPA drinking water models used in pesticide exposure assessment can be found at *http://www.epa.gov/oppefed1/models/water/index.htm.*

Modeled estimates of drinking water concentrations were directly entered into the dietary exposure model.

Based on the Pesticide Root Zone Model/Exposure Analysis Modeling System (PRZM/EXAMS) and Screening Concentration in Ground Water (SCI–GROW) models, the Estimated Drinking Water Concentrations (EDWC) of 12.8 microgram/Liter (μg/L) (including diflubenzuron and CPU) was used to assess chronic non-cancer dietary risk. CPU cancer risk was assessed using the EDWC of 8.81 μg/L.

3. *From non-dietary exposure.* The term ''residential exposure'' is used in this document to refer to non-occupational, non-dietary exposure (e.g., for lawn and garden pest control, indoor pest control, termiticides, and flea and tick control on pets).

Although there are no registered homeowner uses, there are registered uses for professional applications to outdoor trees and ornamentals in residential areas. However, given the effects in the 21-day dermal toxicity study were only observed at the limit dose (1,000 mg/kg/day) and the dermal absorption is extremely low (0.5%) as well as the intermittent potential for post-application residential exposure to ornamentals (i.e., contact with ornamentals every day is not likely), a residential post-application assessment is not required at this time.

4. *Cumulative effects from substances with a common mechanism of toxicity.* Section 408(b)(2)(D)(v) of FFDCA requires that, when considering whether to establish, modify, or revoke a tolerance, the Agency consider ''available information'' concerning the cumulative effects of a particular pesticide's residues and ''other substances that have a common mechanism of toxicity.''

EPA has not found diflubenzuron to share a common mechanism of toxicity with any other substances, and diflubenzuron does not appear to produce a toxic metabolite produced by other substances. For the purposes of this tolerance action, therefore, EPA has assumed that diflubenzuron does not have a common mechanism of toxicity with other substances. For information regarding EPA's efforts to determine which chemicals have a common mechanism of toxicity and to evaluate the cumulative effects of such chemicals, see EPA's Web site at *http://www.epa.gov/pesticides/cumulative.*

D. Safety Factor for Infants and Children

1. *In general.* Section 408(b)(2)(C) of FFDCA provides that EPA shall apply an additional tenfold (10X) margin of safety for infants and children in the case of threshold effects to account for prenatal and postnatal toxicity and the completeness of the database on toxicity and exposure unless EPA determines based on reliable data that a different margin of safety will be safe for infants and children. This additional margin of safety is commonly referred to as the Food Quality Protection Act (FQPA) SF. In applying this provision, EPA either retains the default value of 10X, or uses a different additional SF when reliable data available to EPA support the choice of a different factor.

2. *Prenatal and postnatal sensitivity.* Based on the available developmental toxicity studies in rats and rabbits and the reproduction study, there is no increased susceptibility to fetuses exposed *in utero.*

3. *Conclusion.* EPA has determined that reliable data show the safety of infants and children would be adequately protected if the FQPA SF were reduced to 1X. That decision is based on the following findings:

i. The toxicological database for diflubenzuron is complete. The toxicity of CPU and PCA is well understood. CPU is less toxic and does not affect methemoglobin. PCA does cause methemoglobin formation but is similar in potency to diflubenzuron. Therefore, assuming equal toxicity of CPU and PCA to diflubenzuron is health protective, additional toxicity studies are not required.

ii. There are no clear signs of neurotoxicity following subchronic or chronic dosing in multiple species in the diflubenzuron database; therefore, there is no need for any neurotoxicity studies.

iii. There is no evidence that diflubenzuron results in increased susceptibility in *in utero* rats or rabbits in the prenatal developmental studies or in young rats in the 2-generation reproduction study.

iv. The dietary exposure assessment uses conservative assumptions which will not underestimate dietary exposure and EPA made conservative (protective) assumptions in the ground and surface water modeling used to assess exposure to diflubenzuron in drinking water. These assessments will not underestimate the exposure and risks posed by diflubenzuron.

E. Aggregate Risks and Determination of Safety

EPA determines whether acute and chronic dietary pesticide exposures are safe by comparing aggregate exposure estimates to the aPAD and cPAD. For linear cancer risks, EPA calculates the lifetime probability of acquiring cancer given the estimated aggregate exposure. Short-, intermediate-, and chronic-term risks are evaluated by comparing the estimated aggregate food, water, and residential exposure to the appropriate PODs to ensure that an adequate MOE exists.

1. *Acute risk.* An acute aggregate risk assessment takes into account acute exposure estimates from dietary consumption of food and drinking water. No adverse effect resulting from a single oral exposure was identified and no acute dietary endpoint was selected. Therefore, diflubenzuron is not expected to pose an acute risk.

2. *Chronic risk.* Using the exposure assumptions described in this unit for chronic exposure, EPA has concluded that chronic exposure to diflubenzuron from food and water will utilize 37% of the cPAD for children 1 to 2 years old, the population group receiving the greatest exposure. There are no residential uses for diflubenzuron.

3. *Short-term risk.* Short-term aggregate exposure takes into account short-term residential exposure plus chronic exposure to food and water (considered to be a background exposure level). A short-term adverse effect was identified; however, diflubenzuron is not registered for any use patterns that would result in short-term residential exposure; therefore, no further assessment of short-term risk is necessary.

4. *Intermediate-term risk.* Intermediate-term aggregate exposure takes into account intermediate-term residential exposure plus chronic exposure to food and water (considered to be a background exposure level). An intermediate-term adverse effect was identified; however, diflubenzuron is not registered for any use patterns that would result in intermediate-term residential exposure; therefore, no further assessment of intermediate-term risk is necessary.

5. *Aggregate cancer risk for U.S. population.* Based on the lack of evidence of carcinogenicity in two adequate rodent carcinogenicity studies, diflubenzuron is not expected to pose a cancer risk to humans. However, metabolites CPU and PCA are considered probable carcinogens and have Q*s assigned to them. Individual cancer dietary exposure analyses were conducted for each metabolite. The cancer assessment for PCA includes food only (not present in drinking water). The cancer assessment for CPU includes milk and water only. For PCA, the cancer dietary exposure estimate for the U.S. population is 1×10^{-6}. For CPU, the cancer dietary exposure estimate for the U.S. population is 3×10^{-6}.

EPA generally considers cancer risks in the range of 10^{-6} or less to be negligible. The precision which can be assumed for cancer risk estimates is best described by rounding to the nearest integral order of magnitude on the log scale; for example, risks falling between 3×10^{7} and 3×10^{-6} are expressed as risks in the range of 10^{-6}. Considering the precision with which cancer hazard can be estimated, the conservativeness of low-dose linear

extrapolation, and the rounding procedure described above, cancer risk should generally not be assumed to exceed the benchmark level of concern of the range of 10^{-6} until the calculated risk exceeds approximately 3×10^{-6}. This is particularly the case where some conservatism is maintained in the exposure assessment. Although the PCA and CPU exposure risk assessment are refined, they retain significant conservatism in that residues in food were estimated at ½ LOQ even though no residues were detected in field trials and feeding studies, and for some commodities EPA assumed 100 PCT. Accordingly, EPA has concluded the cancer risk for all existing diflubenzuron uses, and the uses associated with the tolerances established in this action fall within the range of 1×10^{-6} and are thus negligible.

6. *Determination of safety.* Based on these risk assessments, EPA concludes that there is a reasonable certainty that no harm will result to the general population, or to infants and children from aggregate exposure to diflubenzuron residues.

IV. Other Considerations

A. Analytical Enforcement Methodology

Adequate enforcement methodology (gas chromatography/electron capture detection (ECD) and high-performance liquid chromatography/ultraviolet (HPLC/UV)) is available to enforce the tolerance expression.

B. International Residue Limits

In making its tolerance decisions, EPA seeks to harmonize U.S. tolerances with international standards whenever possible, consistent with U.S. food safety standards and agricultural practices. EPA considers the international maximum residue limits (MRLs) established by the Codex Alimentarius Commission (Codex), as required by FFDCA section 408(b)(4). The Codex Alimentarius is a joint United Nations Food and Agriculture Organization/World Health Organization food standards program, and it is recognized as an international food safety standards-setting organization in trade agreements to which the United States is a party. EPA may establish a tolerance that is different from a Codex MRL; however, FFDCA section 408(b)(4) requires that EPA explain the reasons for departing from the Codex level.

The Codex has established MRLs for diflubenzuron, expressed in terms of diflubenzuron *per se,* for many including: Citrus, fruits 0.5 ppm. This MRL is different than the citrus crop group tolerance being established for diflubenzuron in this action.

Numerical compatibility with Codex is not possible as the good agricultural practices used for the Codex MRL are different from the proposed use pattern in the U.S. Additionally, the tolerance expression for the Codex MRL and the U.S. tolerance are not the same, only the U.S. tolerance contains the CPU and PCA metabolites. EPA is re-examining whether it can harmonize the U.S. tolerance expression with the Codex MRL, but making this change alone would not harmonize the numerical difference.

C. Revisions to Petitioned-For Tolerances

EPA is revising the tolerance expression to clarify that, as provided in FFDCA section 408(a)(3), the tolerance covers metabolites and degradates of diflubenzuron not specifically mentioned; and that compliance with the specified tolerance levels is to be determined by measuring only the specific compounds mentioned in the tolerance expression. Therefore, the tolerance expression for diflubenzuron will be revised under 40 CFR 180.377 (a)(1), (a)(2), and (b) (see the regulatory text of this document).

V. Conclusion

Therefore, tolerances are established for residues of diflubenzuron, (*N*-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzimide) in or on fruit, citrus, group 10–10 at 3.0 ppm; and citrus, oil at 32 ppm. The Agency is removing the currently established tolerances for grapefruit, orange, pummel, and tangerine from 40 CFR 180.377. These tolerances are being replaced by the tolerance for fruit, citrus, group 10–10.

VI. Statutory and Executive Order Reviews

This final rule establishes tolerances under FFDCA section 408(d) in response to a petition submitted to the Agency. The Office of Management and Budget (OMB) has exempted these types of actions from review under Executive Order 12866, entitled ''Regulatory Planning and Review'' (58 FR 51735, October 4, 1993). Because this final rule has been exempted from review under Executive Order 12866, this final rule is not subject to Executive Order 13211, entitled ''Actions Concerning Regulations That Significantly Affect Energy Supply, Distribution, or Use'' (66 FR 28355, May 22, 2001) or Executive Order 13045, entitled ''Protection of Children from Environmental Health Risks and Safety Risks'' (62 FR 19885, April 23, 1997). This final rule does not contain any information collections subject to OMB approval under the Paperwork Reduction Act (PRA) (44 U.S.C. 3501 *et seq.*), nor does it require any special considerations under Executive Order 12898, entitled ''Federal Actions to Address Environmental Justice in Minority Populations and Low-Income Populations'' (59 FR 7629, February 16, 1994).

Since tolerances and exemptions that are established on the basis of a petition under FFDCA section 408(d), such as the tolerance in this final rule, do not require the issuance of a proposed rule, the requirements of the Regulatory Flexibility Act (RFA) (5 U.S.C. 601 et seq.), do not apply.

This final rule directly regulates growers, food processors, food handlers, and food retailers, not States or tribes, nor does this action alter the relationships or distribution of power and responsibilities established by Congress in the preemption provisions of FFDCA section 408(n)(4). As such, the Agency has determined that this action will not have a substantial direct effect on States or tribal governments, on the relationship between the national government and the States or tribal governments, or on the distribution of power and responsibilities among the various levels of government or between the Federal Government and Indian Tribes. Thus, the Agency has determined that Executive Order 13132, entitled ''Federalism'' (64 FR 43255, August 10, 1999) and Executive Order 13175, entitled ''Consultation and Coordination with Indian Tribal Governments'' (65 FR 67249, November 9, 2000) do not apply to this final rule. In addition, this final rule does not impose any enforceable duty or contain any unfunded mandate as described under Title II of the Unfunded Mandates Reform Act of 1995 (UMRA) (2 U.S.C. 1501 *et seq.*).

This action does not involve any technical standards that would require Agency consideration of voluntary consensus standards pursuant to section 12(d) of the National Technology Transfer and Advancement Act of 1995 (NTTAA) (15 U.S.C. 272 note).

VII. Congressional Review Act

Pursuant to the Congressional Review Act (5 U.S.C. 801 *et seq.*), EPA will submit a report containing this rule and other required information to the U.S. Senate, the U.S. House of Representatives, and the Comptroller General of the United States prior to publication of the rule in the **Federal**

Register. This action is not a ''major rule'' as defined by 5 U.S.C. 804(2).

List of Subjects in 40 CFR Part 180

Environmental protection, Administrative practice and procedure, Agricultural commodities, Pesticides and pests, Reporting and recordkeeping requirements.

Dated: January 17, 2014.

Lois Rossi,

Director, Registration Division, Office of Pesticide Programs.

Therefore, 40 CFR chapter I is amended as follows:

PART 180—[AMENDED]

■ 1. The authority citation for part 180 continues to read as follows:

Authority: 21 U.S.C. 321(q), 346a and 371.

■ 2. In § 180.377:

■ a. Revise the introductory text in paragraph (a)(1).

■ b. Remove ''Grapefruit'', ''Orange sweet'', and ''Tangerine'' from the table in paragraph (a)(1).

■ c. Revise the introductory text in paragraph (a)(2).

■ d. Remove ''Pummelo'', from the table in paragraph (a)(2).

■ e. Add Citrus, oil, and Fruit, citrus, group 10–10 to the table in paragraph (a)(2).

■ f. Revise the introductory text in paragraph (b).

The amendments read as follows:

§ 180.377 Diflubenzuron; tolerances for residues.

(a) *General.* (1) Tolerances are established for residues of diflubenzuron, including its metabolites and degradates, in or on the commodities in the table below. Compliance with the tolerance levels specified below is to be determined by measuring only diflubenzuron (*N*-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzamide).

* * * * *

(2) Tolerances are established for residues of the insecticide diflubenzuron (N-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzamide), in or on the commodities in the table below. Compliance with the tolerance levels specified below is to be determined by measuring only the sum of diflubenzuron (N-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzamide), 4-chlorophenylyurea and 4-chloroaniline, calculated as the stoichiometric equivalent of diflubenzuron, in or on the commodity.

Commodity	Parts per million
* * * * *	
Citrus, oil	32
* * * * *	
Fruit, citrus, group 10–10	3.0
* * * * *	

(b) *Section 18 emergency exemptions.* Time-limited tolerances are established for residues of the insecticide diflubenzuron (*N*-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzamide) and its metabolites, in connection with use of the pesticide under section 18 emergency exemptions granted by EPA. Compliance with the tolerance levels specified below is to be determined by measuring only the sum of diflubenzuron (*N*-[[(4-chlorophenyl)amino]carbonyl]-2,6-difluorobenzamide), 4-chlorophenylyurea and 4-chloroaniline, calculated as the stoichiometric equivalent of diflubenzuron, in or on the commodity. The tolerances are specified in the following table, and will expire and are revoked on the dates specified.

* * * * *

[FR Doc. 2014–02064 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

50 CFR Part 622

[Docket No. 101206604–1758–02]

RIN 0648–XC464

Fisheries of the Caribbean, Gulf of Mexico, and South Atlantic; Coastal Migratory Pelagic Resources of the Gulf of Mexico and South Atlantic

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Temporary rule; closure.

SUMMARY: NMFS implements an accountability measure (AM) through this temporary final rule for commercial harvest of king mackerel in the southern Florida west coast subzone of the eastern zone of the Gulf of Mexico (Gulf) exclusive economic zone (EEZ) using run-around gillnet gear. NMFS has determined that the commercial annual catch limit (ACL) (equal to the commercial quota) for king mackerel using run-around gillnet gear in the southern Florida west coast subzone of the Gulf EEZ will have been reached by January 29, 2014. Therefore, NMFS closes the southern Florida west coast subzone to commercial king mackerel fishing using run-around gillnet gear in the Gulf EEZ. This closure is necessary to protect the Gulf king mackerel resource.

DATES: The closure is effective 12:01 p.m., eastern standard time, January 29, 2014, through 6 a.m., eastern standard time, January 20, 2015.

FOR FURTHER INFORMATION CONTACT: Susan Gerhart, telephone: 727–824–5305, email: *Susan.Gerhart@noaa.gov.*

SUPPLEMENTARY INFORMATION: The fishery for coastal migratory pelagic fish (king mackerel, Spanish mackerel, and cobia) is managed under the Fishery Management Plan for the Coastal Migratory Pelagic Resources of the Gulf of Mexico and South Atlantic (FMP). The FMP was prepared by the Gulf of Mexico and South Atlantic Fishery Management Councils and is implemented under the authority of the Magnuson-Stevens Fishery Conservation and Management Act (Magnuson-Stevens Act) by regulations at 50 CFR part 622.

Gulf migratory group king mackerel's Florida west coast subzone of the Gulf eastern zone is divided into northern and southern subzones, each with separate quotas. The southern subzone is that part of the Florida west coast subzone, which from November 1 through March 31, extends south and west from 25°20.4' N. lat. (a line directly east from the Miami-Dade/Monroe County, FL, boundary), north to 26°19.8' N. lat. (a line directly west from the Lee/Collier County, FL, boundary), *i.e.,* the area off Monroe and Collier Counties. From April 1 through October 31, the southern subzone is that part of the Florida west coast subzone that is between 26°19.8' N. lat. (a line directly west from the Lee/Collier County, FL, boundary) and 25°48' N. lat. (a line directly west from the Monroe/Collier County, FL, boundary), *i.e.,* the area off Collier County (50 CFR 622.384(b)(1)(i)(C)).

On January 30, 2012 (76 FR 82058, December 29, 2011), NMFS implemented a commercial ACL (commercial quota) for the Gulf migratory group king mackerel in the southern Florida west coast subzone of 551,448 lb (250,133 kg) for vessels using run-around gillnet gear (50 CFR 622.384(b)(1)(i)(B)(*1*)), for the current fishing year, July 1, 2013, through June 30, 2014.

Regulations at 50 CFR 622.8(b) require NMFS to close any segment of the king mackerel commercial sector when its ACL (quota) has been reached, or is projected to be reached, by filing a notification with the Office of the Federal Register. NMFS has determined that the commercial ACL (commercial quota) of 551,448 lb (250,133 kg) for Gulf group king mackerel for vessels using run-around gillnet gear in the southern Florida west coast subzone will be reached on [January 29, 2014. Accordingly, commercial fishing for such vessels in the southern Florida west coast subzone is closed at 12:01 p.m., eastern standard time, January 29, 2014, through 6 a.m., eastern standard time, January 20, 2015, the beginning of the next fishing season, *i.e.,* the day after the 2015 Martin Luther King Jr. Federal holiday. Accordingly, the operator of a vessel that has been issued a Federal commercial permit to harvest Gulf migratory group king mackerel using run-around gillnet gear in the southern Florida west coast subzone must have landed ashore and bartered, traded, or sold such king mackerel prior to 12:01 p.m., eastern standard time, January 29, 2014.

Except for a person aboard a charter vessel or headboat, during the closure, no person aboard a vessel for which a commercial permit for king mackerel has been issued may fish for or retain Gulf group king mackerel harvested using run-around gillnet gear in the southern Florida west coast subzone. Persons aboard a vessel for which a commercial permit for king mackerel has been issued, except persons who also possess a king mackerel gillnet permit, may fish for or retain Gulf group king mackerel harvested using hook-and-line gear in the southern Florida west coast subzone at this time. A person aboard a vessel that has a valid charter vessel/headboat permit for coastal migratory pelagic fish may continue to retain king mackerel in or from the closed zones or subzones under the bag and possession limits set forth in 50 CFR 622.382(a)(1)(ii) and (a)(2), provided the vessel is operating as a charter vessel or headboat. A charter vessel or headboat that also has a commercial king mackerel permit is considered to be operating as a charter vessel or headboat when it carries a passenger who pays a fee or when there are more than three persons aboard, including operator and crew.

During the closure, king mackerel harvested using run-around gillnet gear in the southern Florida west coast subzone, including those harvested under the bag and possession limits, may not be purchased or sold. This prohibition does not apply to king mackerel harvested using run-around gillnet gear in the southern Florida west coast subzone that were harvested, landed ashore, and sold prior to the closure and were held in cold storage by a dealer or processor.

Classification

The Regional Administrator, Southeast Region, NMFS, has determined this temporary rule is necessary for the conservation and management of Gulf migratory group king mackerel and is consistent with the Magnuson-Stevens Act and other applicable laws.

This action is taken under 50 CFR 622.8(b) and is exempt from review under Executive Order 12866.

These measures are exempt from the procedures of the Regulatory Flexibility Act because the temporary rule is issued without opportunity for prior notice and comment.

This action responds to the best available information recently obtained from the fisheries. The Assistant Administrator for Fisheries, NOAA (AA), finds that the need to immediately implement this action to close the fishery constitutes good cause to waive the requirements to provide prior notice and opportunity for public comment pursuant to the authority set forth in 5 U.S.C. 553(b)(B). Such procedures would be unnecessary because the rule implementing the ACL (quota) and the associated requirement for closure of the commercial harvest when the ACL (quota) is reached or projected to be reached has already been subject to notice and comment, and all that remains is to notify the public of the closure.

Providing prior notice and opportunity for public comment on this action would be contrary to the public interest because any delay in the closure of the commercial harvest could result in the commercial quota being exceeded. There is a need to immediately implement this action to protect the king mackerel resource because the capacity of the fishing fleet allows for rapid harvest of the quota.

For the aforementioned reasons, the AA also finds good cause to waive the 30-day delay in effectiveness under 5 U.S.C. 553(d)(3).

Authority: 16 U.S.C. 1801 *et seq.*

Dated: January 28, 2014.

Sean F. Corson,

Acting Deputy Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 2014–02010 Filed 1–28–14; 4:15 pm]

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Proposed Rules

Federal Register

Vol. 79, No. 21

Friday, January 31, 2014

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

BUREAU OF CONSUMER FINANCIAL PROTECTION

12 CFR Part 1090

[Docket No. CFPB–2014–0003]

RIN 3170–AA25

Defining Larger Participants of the International Money Transfer Market

AGENCY: Bureau of Consumer Financial Protection.

ACTION: Proposed rule; request for public comment.

SUMMARY: The Bureau of Consumer Financial Protection (Bureau or CFPB) proposes to amend the regulation defining larger participants of certain consumer financial product and service markets by adding a new section to define larger participants of a market for international money transfers. The Bureau proposes this rule pursuant to its authority, under the Dodd-Frank Wall Street Reform and Consumer Protection Act, to supervise certain nonbank covered persons for compliance with Federal consumer financial law and for other purposes. The Bureau has the authority to supervise nonbank covered persons of all sizes in the residential mortgage, private education lending, and payday lending markets. In addition, the Bureau has the authority to supervise nonbank ''larger participant[s]'' of markets for other consumer financial products or services, as the Bureau defines by rule. The proposal (Proposed Rule) would identify a nonbank market for international money transfers and define ''larger participants'' of this market that would be subject to the Bureau's supervisory authority.

DATES: Comments must be received on or before April 1, 2014.

ADDRESSES: Interested parties are invited to submit written comments electronically or in paper form. Because paper mail in the Washington, DC area and at the Bureau is subject to delay, commenters are encouraged to submit comments electronically. You may submit comments, identified by *Docket No. CFPB–2014–0003* or RIN 3170–AA25, by any of the following methods:

- *Electronic: http://www.regulations.gov.* Follow the instructions for submitting comments. In general, all comments received will be posted without change to their content.
- *Mail/Hand Delivery/Courier:* Monica Jackson, Office of the Executive Secretary, Bureau of Consumer Financial Protection, 1700 G Street NW., Washington DC 20552.

In addition, comments will be available for public inspection and copying at 1700 G Street NW., Washington, DC 20552, on official business days between the hours of 10 a.m. and 5 p.m. Eastern Time. You can make an appointment to inspect the documents by telephoning (202) 435–7275.

All comments, including attachments and other supporting materials, will become part of the public record and will be subject to public disclosure. Submit only information that you wish to make available publicly. Do not include sensitive personal information, such as account numbers or Social Security numbers. Comments will not be edited to remove any identifying or contact information, such as name and address information, email addresses, or telephone numbers.

FOR FURTHER INFORMATION CONTACT: Edna Boateng, Senior Consumer Financial Protection Analyst, (202) 435–7697, Amanda Quester, Senior Counsel, (202) 365–0702, or Brian Shearer, Attorney, (202) 435–7794, Office of Supervision Policy, Bureau of Consumer Financial Protection, 1700 G Street NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Overview

Section 1024 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), codified at 12 U.S.C. 5514,[1] gives the Bureau supervisory authority over all nonbank covered persons [2] offering or providing three enumerated types of consumer financial products or services: (1) Origination, brokerage, or servicing of consumer loans secured by real estate, and related mortgage loan modification or foreclosure relief services; (2) private education loans; and (3) payday loans.[3] The Bureau also has supervisory authority over ''larger participant[s] of a market for other consumer financial products or services,'' as the Bureau defines by rule.[4]

This Proposed Rule, if adopted, would be the fourth in a series of rulemakings to define larger participants of markets for other consumer financial products or services for purposes of 12 U.S.C. 5514(a)(1)(B).[5] The Proposed Rule would establish the Bureau's supervisory authority over certain nonbank covered persons participating in a market for international money transfers.[6]

The Bureau is authorized to supervise nonbank covered persons subject to 12 U.S.C. 5514 of the Dodd-Frank Act for

[1] Public Law 111–203, § 1024, 124 Stat. 1376, 1987 (2010) (codified at 12 U.S.C. 5514).

[2] The provisions of 12 U.S.C. 5514 apply to certain categories of covered persons, described in subsection (a)(1), and expressly exclude from coverage persons described in 12 U.S.C. 5515(a) or 5516(a). ''Covered persons'' include ''(A) any person that engages in offering or providing a consumer financial product or service; and (B) any affiliate of a person described [in (A)] if such affiliate acts as a service provider to such person.'' 12 U.S.C. 5481(6).

[3] 12 U.S.C. 5514(a)(1)(A), (D), (E). The Bureau also has the authority to supervise any nonbank covered person that it ''has reasonable cause to determine, by order, after notice to the covered person and a reasonable opportunity . . . to respond . . . is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services.'' 12 U.S.C. 5514(a)(1)(C); *see also* 12 CFR part 1091 (prescribing procedures for making determinations under 12 U.S.C. 5514(a)(1)(C)). In addition, the Bureau has supervisory authority over very large depository institutions and credit unions and their affiliates. 12 U.S.C. 5515(a). Furthermore, the Bureau has certain authorities relating to the supervision of other depository institutions and credit unions. 12 U.S.C. 5516(c)(1), (e). One of the Bureau's mandates under the Dodd-Frank Act is to ensure that ''Federal consumer financial law is enforced consistently without regard to the status of a person as a depository institution, in order to promote fair competition.'' 12 U.S.C. 5511(b)(4).

[4] 12 U.S.C. 5514(a)(1)(B), (a)(2); *see also* 12 U.S.C. 5481(5) (defining ''consumer financial product or service'').

[5] The first three rules defined larger participants of markets for consumer reporting, 77 FR 42874 (July 20, 2012) (Consumer Reporting Rule), consumer debt collection, 77 FR 65775 (Oct. 31, 2012) (Consumer Debt Collection Rule), and student loan servicing, 78 FR 73383 (Dec. 6, 2013) (Student Loan Servicing Rule).

[6] The Proposed Rule would describe one market for consumer financial products or services, which the Proposed Rule labels ''international money transfers.'' The proposed definition would not encompass all activities that could be considered international money transfers. Any reference herein to ''the international money transfer market'' means only the particular market for international money transfers identified by the Proposed Rule.

purposes of: (1) Assessing compliance with Federal consumer financial law; (2) obtaining information about such persons' activities and compliance systems or procedures; and (3) detecting and assessing risks to consumers and consumer financial markets.[7] The Bureau conducts examinations, of various scopes, of supervised entities. In addition, the Bureau may, as appropriate, request information from supervised entities without conducting examinations.[8]

The Bureau prioritizes supervisory activity among nonbank covered persons on the basis of risk, taking into account, among other factors, the size of each entity, the volume of its transactions involving consumer financial products or services, the size and risk presented by the market in which it is a participant, the extent of relevant State oversight, and any field and market information that the Bureau has on the entity. Such field and market information might include, for example, information from complaints and any other information the Bureau has about risks to consumers.

The specifics of how an examination takes place vary by market and entity. However, the examination process generally proceeds as follows. Bureau examiners contact the entity for an initial conference with management and often request records and other information. Bureau examiners will ordinarily also review the components of the supervised entity's compliance management system. Based on these discussions and a preliminary review of the information received, examiners determine the scope of an on-site examination and then coordinate with the entity to initiate the on-site portion of the examination. While on-site, examiners spend a period of time holding discussions with management about the entity's policies, processes, and procedures; reviewing documents and records; testing transactions and accounts for compliance; and evaluating the entity's compliance management system. Examinations may involve issuing confidential examination reports, supervisory letters, and compliance ratings. In addition to the process described above, the Bureau may also conduct off-site examinations.

The Bureau has published a general examination manual describing the Bureau's supervisory approach and procedures.[9] As explained in the manual, the Bureau will structure examinations to address various factors related to a supervised entity's compliance with Federal consumer financial law and other relevant considerations. On October 22, 2013, the Bureau released procedures specific to remittance transfers for use in the Bureau's examinations of entities within its supervisory authority.[10] If this Proposed Rule is adopted, the Bureau will use those examination procedures in supervising international money transfers. The procedures include instructions on examining for compliance with, among other laws and regulations, new requirements in subpart B of Regulation E relating to remittance transfers (Remittance Rule), which went into effect on October 28, 2013.[11]

The States have been active in regulation of money transmission, with forty-seven States and the District of Columbia requiring entities to obtain a license to engage in money transmission, as defined by applicable law. Many States also actively examine money transmitters. If the Proposed Rule is adopted, the Bureau would coordinate with appropriate State regulatory authorities in examining larger participants of the international money transfer market.

This Proposed Rule would establish a category of nonbank covered persons that is subject to the Bureau's supervisory authority under 12 U.S.C. 5514 by defining ''larger participants'' of a market for international money transfers.[12] The Proposed Rule pertains only to that purpose and would not impose new substantive consumer protection requirements. Nonbank covered persons generally are subject to the Bureau's regulatory and enforcement authority, and any applicable Federal consumer financial law, regardless of whether they are subject to the Bureau's supervisory authority.

II. Summary of Proposed Rule

The Bureau's existing larger-participant rule, 12 CFR part 1090, prescribes various procedures, definitions, standards, and protocols that apply with respect to all markets in which the Bureau has defined larger participants.[13] Those generally applicable provisions, which are codified in subpart A, would also be applicable for the international money transfer market described by this Proposed Rule. The definitions in § 1090.101 should be used, unless otherwise specified, when interpreting terms in this Proposed Rule.

The Bureau includes relevant market descriptions and larger-participant tests, as it develops them, in subpart B.[14] Accordingly, the Proposed Rule defining larger participants of the international money transfer market would become § 1090.107 in subpart B.

The Proposed Rule would define an international money transfer market that would cover certain electronic transfers of funds sent by nonbanks that are international money transfer providers. To be included in this proposed market, transfers would have to be requested by a sender in a State to be sent to a designated recipient in a foreign country. The Proposed Rule's definitions are modeled in part on the definition of ''remittance transfer'' and related terms in the Electronic Fund Transfer Act (EFTA) and its implementing regulation, Regulation E.[15] Some of the Proposed Rule's definitions also are modeled in part on definitions in prior larger-participant rules.[16] The definitions in existing § 1090.101 apply for terms that the Proposed Rule does not define, such as ''person'' and ''consumer.''[17]

[7] 12 U.S.C. 5514(b)(1).

[8] *See* 12 U.S.C. 5514(b) (authorizing the Bureau both to conduct examinations and to require reports from entities subject to supervision).

[9] CFPB Supervision and Examination Manual (Oct. 1, 2012), *available at http://www.consumerfinance.gov/guidance/supervision/manual/.*

[10] CFPB Supervision and Examination Manual, Remittance Transfer Examination Procedures (Oct. 22, 2013), *available at http://files.consumerfinance.gov/f/201310_cfpb_remittance-transfer-examination-procedures.pdf.*

[11] 77 FR 6194 (Feb. 7, 2012); 77 FR 40459 (July 10, 2012); 77 FR 50244 (Aug. 20, 2012); 78 FR 6025 (Jan. 29, 2013); 78 FR 30662 (May 22, 2013); 78 FR 49365 (Aug. 14, 2013) (codified at 12 CFR part 1005, subpart B). These changes implement the new Electronic Fund Transfer Act requirements imposed by the Dodd-Frank Act, Public Law 111–203, § 1073, 124 Stat. 1376, 2060 (2010). For additional information about the Remittance Rule, see *http://www.consumerfinance.gov/remittances-transfer-rule-amendment-to-regulation-e/.*

[12] The Bureau's supervisory authority also extends to service providers of those covered persons that are subject to supervision under 12 U.S.C. 5514(a)(1). 12 U.S.C. 5514(e); *see also* 12 U.S.C. 5481(26) (defining ''service provider'').

[13] 12 CFR 1090.100–.103.

[14] 77 FR 42874, 42875 (Consumer Reporting Rule); 77 FR 65775, 65777 (Consumer Debt Collection Rule); 78 FR 73383, 73384 (Student Loan Servicing Rule).

[15] 15 U.S.C. 1693o–1(g); 12 CFR 1005.2, 1005.30.

[16] 12 CFR 1090.104(a), 1090.105(a) (providing definitions of ''annual receipts,'' which the Bureau used in crafting the proposed definition of ''aggregate annual international money transfer'').

[17] As a result, some terms may have different definitions for purposes of the Proposed Rule than they do for purposes of Regulation E. The definition of ''consumer'' in § 1090.101 is ''an individual or an agent, trustee, or representative acting on behalf of an individual,'' 12 CFR 1090.101, while the definition of ''consumer'' in Regulation E is ''a natural person,'' 12 CFR 1005.2(e). The definition of ''person'' in § 1090.101 is ''an individual, partnership, company, corporation, association (incorporated or unincorporated), trust, estate, cooperative organization, or other entity,'' 12 CFR

Continued

The Proposed Rule also would set forth a test to determine whether a nonbank covered person is a larger participant of the international money transfer market. An entity would be a larger participant if it has at least one million aggregate annual international money transfers.[18] As prescribed by existing § 1090.102, any nonbank covered person that qualifies as a larger participant would remain a larger participant until two years after the first day of the tax year in which the person last met the applicable test.[19]

Pursuant to existing § 1090.103, a person would be able to dispute whether it qualifies as a larger participant in the international money transfer market. The Bureau would notify an entity when the Bureau intended to undertake supervisory activity; the entity would then have an opportunity to submit documentary evidence and written arguments in support of its claim that it was not a larger participant. Section 1090.103(d) provides that the Bureau may require submission of certain records, documents, and other information for purposes of assessing whether a person is a larger participant of a covered market; this authority would be available to the Bureau to facilitate its identification of larger participants of the international money transfer market, just as in other markets.

III. Legal Authority and Procedural Matters

A. Rulemaking Authority

The Bureau is issuing this Proposed Rule pursuant to its authority under: (1) 12 U.S.C. 5514(a)(1)(B) and (a)(2), which authorize the Bureau to supervise larger participants of markets for consumer financial products or services, as defined by rule; (2) 12 U.S.C. 5514(b)(7), which, among other things, authorizes the Bureau to prescribe rules to facilitate the supervision of covered persons under 12 U.S.C. 5514; and (3) 12 U.S.C. 5512(b)(1), which grants the Bureau the authority to prescribe rules as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of Federal consumer financial law, and to prevent evasions of such law.

B. Proposed Effective Date of Final Rule

The Administrative Procedure Act generally requires that rules be published not less than 30 days before their effective dates.[20] The Bureau proposes that the final rule arising from this Proposed Rule would be effective no earlier than 60 days after publication.

IV. Section-By-Section Analysis

Section 1090.107—International Money Transfer Market

Proposed § 1090.107 relates to international money transfers.[21] As a general matter, international money transfers are electronic transfers of funds sent by nonbanks from consumers in the United States to persons or entities abroad.

Many consumers who send money abroad do so through money transmitter companies that are nonbanks.[22] Many money transmitters operate through closed networks, receiving and disbursing funds through their own outlets or through agents such as grocery stores, neighborhood convenience stores, or depository institutions. Some money transmitters may send transfers of any size, while others cap the size of transfers they send.

For an international transfer conducted through a money transmitter, a consumer typically provides basic identifying information about himself and the recipient and often pays cash sufficient to cover the transfer amount and any fees charged by the money transmitter. The consumer may be provided a confirmation code, which the consumer relays to the recipient. The money transmitter sends an instruction to a specified payout location or locations in the recipient's country where the recipient may pick up the transferred funds, often in cash and local currency, upon presentation of the confirmation code and/or other identification on or after a specified date. These transfers generally are referred to as cash-to-cash transfers.

Many money transmitters provide other types of transfers. For example, money transmitters may permit transfers to be initiated using credit cards, debit cards, or bank account debits and may use Web sites, agent locations, stand-alone kiosks, or telephone lines to do so. Abroad, money transmitters and their partners may allow funds to be deposited into recipients' bank accounts, distributed directly onto prepaid cards, or credited to mobile phone accounts. Funds also can be transferred among consumers' nonbank accounts identified by individuals' email addresses or mobile phone numbers. According to one survey of companies that send funds from the United States to Latin America and the Caribbean, 75 percent permit consumers to send transfers of funds that can be deposited directly into recipients' bank accounts, including transfers initiated through the internet.[23]

Although this Proposed Rule would apply only to nonbank covered persons, depository institutions and credit unions, including those already subject to the Bureau's supervisory authority, also offer consumers international transfer services. This is often done by way of wire transfers.

International transfers play a critical role in the lives of many consumers in the United States. U.S. consumers send funds abroad for a number of reasons, including to assist family or friends with their expenses, to pay for purchases of goods, to pay the tuition of children studying abroad, or to purchase real estate. Data from the 2011 Current Population Survey (2011 CPS) show that more than 4 million households nationwide had used nonbanks to transfer funds to friends and family abroad in the preceding year, and more than 7 million households had used

1090.101, while the definition of ''person'' in Regulation E is ''a natural person or an organization, including a corporation, government agency, estate, trust, partnership, proprietorship, cooperative, or association,'' 12 CFR 1005.2(j).

[18] As the Bureau has explained in prior rulemakings, the criterion selected for one market in a larger-participant rulemaking is not necessarily appropriate for any other market that may be the subject of a future rulemaking. Instead, the Bureau expects to tailor each test to the market to which it will be applied. 77 FR 42874, 42876 (Consumer Reporting); 77 FR 65775, 65778 (Consumer Debt Collection); 78 FR 73383, 73384 n.16 (Student Loan Servicing).

[19] 12 CFR 1090.102.

[20] 5 U.S.C. 553(d).

[21] The term ''international money transfer'' is very similar to the term ''remittance transfer'' as defined in the Remittance Rule, 12 CFR 1005.30(e). However, the definitions differ in some substantive respects as specified below, including, for example, that transfers of $15 or less can be ''international money transfers'' but not ''remittance transfers.'' Other definitions in this Proposed Rule are similarly based on Regulation E. Usage, or omission, of specific language from the EFTA or Regulation E in the Proposed Rule is not an endorsement by the Bureau of any specific interpretation of the EFTA or Regulation E.

[22] CFPB, Report on Remittance Transfers 6 (July 20, 2011), *available athttp://www.consumerfinance.gov/wp-content/uploads/2011/07/Report_20110720_RemittanceTransfers.pdf.* Federal law requires money transmitters that meet certain criteria to register as a ''money services business'' with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). 31 U.S.C. 5330; 31 CFR 1010.100(ff), 1022.380. Most States also have licensing requirements for similar types of entities.

[23] Manuel Orozco et al., Inter-American Dialogue, *The Market for Money Transfers: Ranking of Remittance Service Providers in Latin America and the Caribbean* 4 (Oct. 23, 2012), *available at http://www.thedialogue.org/uploads/Remittances_and_Development/LatAm_Final_120712.pdf.* Like cash-to-cash transfers, some of the transfers to bank accounts rely on closed networks, though others rely on open networks (between an entity and non-agents or non-affiliates) or reflect some characteristics of both open and closed network transactions.

nonbanks to make such transfers at some time in the past.[24]

Transferring money to international recipients can present unique challenges for consumers and providers, many of which are addressed in the Remittance Rule recently issued by the Bureau. Pricing for transfers is complex and may depend not only on fees and taxes, but also on exchange rates. Because wholesale currency markets fluctuate constantly, the exchange rates applied to individual international transfers may change from day to day, or even over the course of the day, depending on how frequently providers update their retail rates. Providers may also vary their exchange rates and fees charged based on a range of other factors, such as the sending and receiving locations, and the size and speed of the transfer. Taxes may vary depending on the type of provider, the laws of the recipient country, and various other factors. As a result, determining how much money will actually be received and which provider offers the lowest price can be challenging for consumers, particularly when not provided with proper disclosures.[25] In some cases, language barriers may further complicate consumers' ability to obtain and understand transaction information from providers and their agents.[26]

The Bureau believes that compliance with recent legislative and regulatory changes will significantly improve the predictability of remittances and provide consumers with better price information. Congress amended the EFTA in the Dodd-Frank Act.[27] The Bureau then implemented the amendments to the EFTA by promulgating the Remittance Rule, which went into effect on October 28, 2013.[28] The Remittance Rule created a comprehensive new system of consumer protections for remittance transfers sent by consumers in the United States to individuals and businesses in foreign countries. First, the amendments generally require that information be disclosed prior to and at the time of payment by the sender for the transfer.[29] Second, under the Remittance Rule, consumers will generally have thirty minutes after making payment to cancel a transaction.[30] Third, the Remittance Rule increases consumer protections when transfers go awry by requiring providers to investigate disputes and remedy certain types of errors.[31] The Remittance Rule applies to any institutions that send remittance transfers in the normal course of their business, including banks, credit unions, money transmitters, broker-dealers, and others. The Bureau and prudential regulators can examine depository institutions and credit unions within their supervisory authority for compliance with Regulation E, including the new Remittance Rule.

Finalization of this Proposed Rule would bring nonbanks that are larger participants of the international money transfer market[32] within the Bureau's supervisory jurisdiction, thereby promoting the Bureau's objective of enforcing Federal consumer financial law consistently without regard to whether a person is a depository institution.[33] Supervision of larger participants of the international money transfer market would help to ensure that nonbank entities that provide a significant portion of the transactions to which the Remittance Rule applies are complying with these new and important consumer protections, as well as with other applicable requirements of Federal consumer financial law, including the prohibition on unfair, deceptive, or abusive acts or practices.

The Bureau lacks precise data on the international money transfer market. However, available data sources, including public information and confidential State supervisory data provided by three States,[34] enabled the

[24] Fed. Deposit Ins. Corp., *National Survey of Unbanked and Underbanked Households* 32 (Sept. 2012), *available at http://www.fdic.gov/householdsurvey/2012_unbankedreport.pdf* (2011 CPS Report) (stating that 3.7 percent of households used ''nonbank remittances'' as defined in the survey in the preceding year); *id* at 142–43 (providing estimate of 120 million U.S. households in 2011 for purposes of the survey); *id*. at 79 (estimating the number of households that have used ''nonbank remittances'' as defined in the survey at any time in the past).

[25] *See* CFPB, Report on Remittance Transfers 17–21 (July 20, 2011); *see also* 77 FR 6194, 6199 (Feb. 7, 2012).

[26] *See* 77 FR 6194, 6199 (Feb. 7, 2012).

[27] Public Law 111–203, § 1073, 124 Stat. 1376, 2060 (2010).

[28] 77 FR 6194 (Feb. 7, 2012); 77 FR 40459 (July 10, 2012); 77 FR 50244 (Aug. 20, 2012); 78 FR 6025 (Jan. 29, 2013); 78 FR 30662 (May 22, 2013); 78 FR 49365 (Aug. 14, 2013) (codified at 12 CFR part 1005, subpart B).

[29] Public Law 111–203, § 1073(a)(4). 124 Stat. 1376, 2060 (2010) (codified at 15 U.S.C. 1693o–1(a)); 12 CFR 1005.31–.32.

[30] Public Law 111–203, § 1073(a)(4), 124 Stat. 1376, 2060 (2010) (codified at 15 U.S.C. 1693o–1(d)(3)); 12 CFR 1005.34.

[31] Public Law 111–203, § 1073(a)(4), 124 Stat. 1376, 2060 (2010) (codified at 15 U.S.C. 1693o–1(d)); 12 CFR 1005.33.

[32] International money transfers are consumer financial products or services pursuant to the Dodd-Frank Act. *See* 12 U.S.C. 5481(15)(A)(iv) (defining ''financial product or service'' to include ''engaging in deposit-taking activities, transmitting or exchanging funds, or otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer''); 12 U.S.C. 5481(5)(A) (defining ''consumer financial product or service'' to include financial products or services that are offered or provided for use by consumers primarily for personal, family, or household purposes); *see also* 12 U.S.C. 5481(15)(A)(v) (defining ''financial product or service'' to include generally ''selling, providing, or issuing stored value or payment instruments,'' with specific exclusions); 12 U.S.C. 5481(15)(A)(vii) (defining ''financial product or service'' to include generally ''providing payments or other financial data processing products or services to a consumer by any technological means,'' with specific exclusions).

[33] 12 U.S.C. 5511(b)(4).

[34] The Bureau based its market estimates primarily on confidential State supervisory data for the year 2012 that it received from California, New York, and Ohio pursuant to memoranda of understanding. From New York and Ohio, the Bureau received national figures for per-licensee dollar volume and number of transfers that aggregate international transfers, domestic transfers, and some other regulated transactions. The data received from California on per-licensee dollar volume and number of transfers include only outbound international transfers. Therefore, the type of data that California provided most closely matches the market activity defined in the Proposed Rule. However, the California data do not include national figures for individual entities; instead, the data only include transfers initiated in California. None of the data sets obtained from the States distinguish between transfers initiated by consumers and those initiated by businesses.

In addition to the State data, the Bureau used the following sources: The FinCEN Money Services Business Registration List; public Web sites; CFPB market research; and the licensee lists from regulatory agencies in 47 States and the District of Columbia described below. The Bureau also used data on nonbank remittance use from the 2011 CPS's June 2011 Unbanked/Underbanked Supplement, which is available at *http://thedataweb.rm.census.gov/ftp/cps_ftp.html* and described at *http://www.census.gov/prod/techdoc/cps/cpsjun11.pdf*. The Bureau looked specifically at data for respondents who reported that they or someone in their household had gone to a nonbank to give or send money to relatives or friends living outside the United States at least once in the past 30 days (i.e., respondents who answered questions 20–22 positively and reported one or more instances in response to question 23). The Bureau sorted the responses by State using the Census State code (GESTCEN) and adjusted them to reflect each State's population using the CPS Supplement Person Weight (PWSUPWGT). The Bureau used the resulting figures to generate the following estimates of each State's share of all U.S. consumers living in households that had sent nonbank remittances in the last 30 days (''relative CPS shares''): Arkansas (0.17%); Alabama (0.89%); Arkansas (0.52%); Arizona (3.31%); California (22.70%); Colorado (0.97%); Connecticut (1.17%); District of Columbia (0.30%); Delaware (0.19%); Florida (8.37%); Georgia (3.73%); Hawaii (0.52%); Iowa (0.73%); Idaho (0.27%); Illinois (6.00%); Indiana (0.28%); Kansas (0.46%); Kentucky (0.16%); Louisiana (0.75%); Massachusetts (1.85%); Maryland (1.51%); Maine (0.08%); Michigan (0.21%); Minnesota (0.41%); Missouri (0.82%); Mississippi (0.10%); Montana (0.06%); North Carolina (2.91%); North Dakota (0.06%); Nebraska (0.25%); New Hampshire (0.04%); New Jersey (3.81%); New Mexico (0.62%); Nevada (1.35%); New York (8.49%); Ohio (1.48%); Oklahoma (1.30%); Oregon (0.51%); Pennsylvania (1.00%); Rhode Island (0.59%); South Carolina (0.25%); South Dakota (0.14%); Tennessee (0.44%); Texas (15.61%); Utah (0.57%); Virginia (1.20%); Vermont (0.03%); Washington (0.90%); Wisconsin (1.78%); West Virginia (0.03%); and Wyoming (0.08%). Thus, according to the Bureau's estimates, the three States from which it obtained confidential

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Bureau to conduct three analyses to gain a general understanding of the basic contours of this nonbank market. These analyses produced rough estimates of (1) the overall number of nonbanks that provide international money transfers; (2) the dollar volume and number of international money transfers market-wide; and (3) the dollar volume and number of international money transfers provided by nonbanks that provide at least 500,000, one million, or three million transactions per year.[35]

For its first analysis, the Bureau reviewed State licensing information and estimated that approximately 340 nonbanks provide international money transfers.[36] The Bureau's second analysis, an extrapolation of confidential supervisory data from California to generate nationwide estimates, indicates that the nonbank market of international money transfers, as defined here, accounted for roughly $50 billion transferred and 150 million individual transfers in 2012.[37]

supervisory data (California, New York, and Ohio) together accounted for 32.7 percent of U.S. consumers who reported that their households had sent nonbank remittances in the last 30 days in the 2011 CPS.

[35] The Bureau conducted entity-level analysis and produced highly approximated entity-by-entity estimates to inform its general understanding of the market and of the likely market coverage associated with potential activity thresholds. These entity-level approximations of dollar volume and number of transfers are not dispositive of whether the Bureau would ever seek to initiate supervisory activity or whether, in the event of a person's assertion that it is not a larger participant, the person would be found to be a larger participant under 12 CFR 1090.103.

[36] The following analysis will hereinafter be cited as ''*State License Review.*'' To arrive at the estimate that 340 nonbanks are international money transfer providers, the Bureau reviewed lists of licensees from 47 States and the District of Columbia. Most of the lists were publicly available online at the following addresses: Alaska Department of Commerce, Community, and Economic Development, *http://www.dced.state.ak.us/bsc/money_service_businesses.html;* Arizona Department of Financial Institutions, *http://azdfi.gov/Consumers/Licensees/licenses.asp?list=MT&name=Money%20Transmitters;* Arkansas Securities Department, *http://www.securities.arkansas.gov/page/339/money-services;* California Department of Business Oversight, *http://www.dbo.ca.gov/Licensees/money_transmitters/money_transmitters_directory.asp;* Colorado Division of Banking, *http://www.dora.state.co.us/pls/real/bidS_Search.Search_Page;* Connecticut Department of Banking, *http://www.ct.gov/dob/cwp/view.asp?a=2233&q=297862&dobNAV_GID=1663;* Delaware Office of the State Bank Commissioner, *http://banking.delaware.gov/information/nondepsearch.shtml;* Georgia Department of Banking and Finance, *https://dbfweb.dbf.state.ga.us/WebCCData.html; Hawaii Department of Commerce and Consumer Affairs, http://cca.hawaii.gov/dfi/;* Idaho Department of Finance, *http://finance.idaho.gov/MoneyTransmitter/MoneyTransmitterLicense.aspx;* Illinois Department of Financial and Profession Regulation, *http://www.idfpr.com/dfi/ccd/ccd_licensees.asp#trans;* Indiana Department of Financial Institutions, *http://extranet.dfi.in.gov/dfidb/nondepcalist.aspx;* Iowa Division of Banking, *http://www.idob.state.ia.us/;* State Bank Commissioner of Kansas, *http://www.osbckansas.org/;* Kentucky Department of Financial Institutions, *http://www.kfi.ky.gov/Pages/default.aspx;* Louisiana Office of Financial Institutions, *http://www.ofi.state.la.us/soclist.htm;* Maine Department of Professional and Financial Regulation, *http://www.maine.gov/pfr/consumercredit/rosters/index.htm;* Massachusetts Division of Banks, *http://license.dob.state.ma.us/licenseelist.asp;* Michigan Department of Insurance and Financial Services, *http://www.dleg.state.mi.us/fis/ind_srch/ConsumerFinance/Search.asp;* Minnesota Department of Commerce, *http://www.commerce.state.mn.us/LicenseLookupMain.html;* Mississippi Department of Banking and Consumer Finance, *http://www.dbcf.state.ms.us/documents/lists/moneytransmitter.pdf; Missouri Division of Finance, http://finance.mo.gov/licenseesearch/;* Nebraska Department of Banking and Finance, *http://www.ndbf.ne.gov/soc/soclicensees.shtml;* New Hampshire Banking Department, *http://www.nh.gov/banking/consumer-credit/information.htm;* New Jersey Department of Banking and Insurance, *https://www20.state.nj.us/DOBI_LicSearch/bnkSearch.jsp;* New York Department of Financial Services, *http://www.dfs.ny.gov/banking/moneytransmitter.htm;* North Carolina Commissioner of Banks, *https://www.nccob.org/Online/MTS/MTSCompanyListing.aspx;* North Dakota Department of Financial Institutions, *http://www.nd.gov/dfi/regulate/reg/consumer.asp?list1=MT&sort2=city&city3=&name4=&Submit=Search;* Ohio Department of Commerce, *http://www.com.state.oh.us/default.aspx;* Oklahoma Banking Department, *http://www.ok.gov/banking/Money_Transmitter_Listing.html;* Oregon Division of Finance and Corporate Securities, *http://www4.cbs.state.or.us/ex/all/mylicsearch/index.cfm?fuseaction=main.show_main&group_id=20&profession_id=23&profession_sub_id=23000%20;* Rhode Island Department of Business Regulation, *http://www.dbr.state.ri.us/documents/divisions/banking/program_operations/List_of_Electronic_Money_Transfers.pdf;* South Dakota Department of Labor and Regulation, *http://dlr.sd.gov/banking/money_transmitters.aspx;* Tennessee Department of Financial Institutions, *http://www.tennessee.gov/tdfi/banking/Lic_MT.shtml;* Texas Department of Banking, *http://www.banking.state.tx.us/supreglic_ent.asp; Utah Department of Financial Institutions, http://www.dfi.state.ut.us/MonTrans.htm;* Vermont Department of Financial Regulation, *http://www.dfr.vermont.gov/banking/verify-license;* Virginia Bureau of Financial Institutions, *http://www.scc.virginia.gov/bfi/reg_inst/trans.pdf;* Wisconsin Department of Financial Institutions, *http://www.wdfi.org/fi/lfs/licensee_lists/Default.asp?Browse=SOC;* Wyoming Division of Banking, *https://sites.google.com/a/wyo.gov/banking/home/areas-of-regulation/money-transmitters/licensee-list.* The Bureau obtained lists upon request from State agencies that do not publish this data but did not receive lists from Montana, New Mexico, or South Carolina because those States do not require licenses for money transmission. Approximately 500 entities were identified on these lists. Based on company-specific research regarding every entity identified in the lists, the Bureau estimated that about 340 entities either offered international money transfers to consumers in the United States or might offer such transfers. As with its other market estimates for this rulemaking, the Bureau emphasizes that the estimate of 340 international money transfer providers could be either high or low due to limitations in the available data. For instance, the estimate does not account for entities that may be operating without a license in any State. On the other hand, the estimate includes entities that the Bureau could not rule out as possible international money transfer providers, but some of these entities might not actually provide international money transfers.

[37] The analysis in this footnote will hereinafter be cited as ''*CA Extrapolation.*'' The Bureau used the information from California in estimating market size because it includes only outbound international transfers. In conducting the extrapolation, the Bureau included entities that are among the 340 entities identified by the *State License Review* and that do not have a significant number of business-initiated transfers and aggregated their total reported transfers and dollars transmitted. The Bureau used the relative CPS share for California calculated in the manner described above to estimate the percentage of international money transfers from the United States that originate in California. The Bureau thus divided the California totals by California's relative CPS share (0.227) to obtain estimates of the total size of the nationwide international money transfer market. This extrapolation was augmented by substituting for one entity the estimate it provided of its remittance transfers in a comment letter submitted in response to a prior Bureau rulemaking because the definition of ''remittance transfer'' closely aligns with the definition of ''international money transfer'' in the Proposed Rule. These calculations resulted in the Bureau's estimate that the international money transfer market transferred $49 billion through 152 million individual transfers in 2012.

Using the 2011 CPS data to estimate market size may result in some imprecision. For instance, the questions in the 2011 CPS related to remittance use ask about transactions that differ somewhat from the definition of ''international money transfer'' in this Proposed Rule. Additionally, the Bureau's relative CPS share calculations are based on CPS questions that asked whether consumers in each State had used nonbank remittances, not how many such transactions were sent from a State or how much money was sent from a State. Thus, the Bureau's market size figures assume that California's share of transfers and dollar volume sent from the United States is the same as California's share of U.S. consumers who live in households that send such transfers.

The data that the Bureau received from California also do not match perfectly the Proposed Rule's definition of ''international money transfers.'' Most significantly, the California data include some transactions initiated by businesses. The Bureau identified a few entities that the Bureau believes provide a significant number of business-initiated transfers, in addition to providing international money transfers initiated by consumers. The Bureau could not delineate between consumer-initiated and business-initiated transfers for these entities and has excluded figures attributable to those entities from the California data because including them could result in a large overstatement of the volume of dollars transmitted in the international money transfer market. This exclusion does not, however, have a significant effect on the Bureau's estimate of total market transfers because even when all of these entities' transfers are included, the total nationwide transfer estimate stills round to roughly 150 million transfers. The Bureau notes that even with this exclusion of entities that send a significant amount of business-initiated transfers, the estimates of market size may be inflated by business-initiated transfers sent by other entities.

Outside estimates suggest that the Bureau's estimate of total dollar volume, $49 billion, is reasonable. The Bureau of Economic Analysis estimates that the foreign-born population resident in the United States sent $36.5 billion in ''personal transfers'' to households abroad in 2012. Bureau of Econ. Analysis, Personal Transfers, 1992:I–2013:II, *available at http://www.bea.gov/international/supplemental_statistics.htm.* A private consulting firm estimates that in 2005, $42 billion in international transfers were made by money

The Bureau's third analysis developed entity-specific estimates of the number of international money transfers sent in 2012. Estimates were mostly derived using confidential supervisory data obtained from California, New York, and Ohio pursuant to memoranda of understanding. Using this analysis, the Bureau generated the following highly approximated estimates for the year 2012: (1) The highest tier of the market consists of about 10 nonbanks that each sent over 3 million international money transfers and together accounted for about three-fourths of all international money transfers; (2) The second tier of the market consists of about 15 nonbanks that each sent between 1 and 3 million international money transfers, accounting collectively for about one-sixth of all international money transfers; (3) Very few nonbanks sent between 500,000 and 1 million international money transfers, accounting collectively for about 1.5 percent of all international money transfers; and (4) The limited remaining market share is divided among a few hundred nonbanks that each sent less than 500,000 transfers in 2012.[38] These estimates do not include providers that are not licensed in California, New York, or Ohio, but based on market research and a review of licensing data the Bureau believes that most entities that provide over 500,000 international money transfers per year are licensed in at least one of those three States.[39]

The Bureau is proposing at this time to define a nonbank market consisting solely of international money transfers. As explained above, such transfers present challenges to providers and consumers that distinguish international money transfers from other transactions, such as domestic money transfers. These challenges may include, for example, foreign exchange rates, foreign taxes, and legal, administrative, and language complexities related to the fact that the funds are transferred to a foreign country. Many international money transfers are subject to new protections under the Dodd-Frank Act and the Remittance Rule.[40] The

transmitters in the United States. KPMG LLP Econ. & Valuation Servs., *2005 Money Services Business Industry Survey Study for Financial Crimes Enforcement Network* 5 (Sept. 26, 2005), *available at http://www.fincen.gov/news_room/rp/reports/pdf/FinCEN_MSB_2005_Survey.pdf.*

A 2008 U.S. Census Bureau survey, in contrast, suggested that monetary transfers from U.S. households to family and friends abroad totaled approximately $12 billion in one year. Elizabeth M. Grieco et al., *Who in the United States Sends and Receives Remittances? An Initial Analysis of the Monetary Transfer Data From the August 2008 CPS Migration Supplement,* U.S. Census Bureau Working Paper No. 87 (Nov. 2010), *available at http://www.census.gov/population/www/documentation/twps0087/twps0087.html.* All of these estimates, like the Bureau's estimates here, are based on assumptions that could limit their accuracy. Further, the transfers that were considered in each of the estimates do not match the Bureau's proposed definition of ''international money transfer.'' Therefore, variation in the estimates should be expected.

[38] The analysis listed in this footnote will hereinafter be referred to as ''*Analysis of State Supervisory Data.''* The Bureau used confidential State supervisory data and other sources to estimate the 2012 market share, dollars transferred, and number of transfers of entities in the proposed market that are licensed in California, New York, and Ohio. Two different methodologies were used to generate estimates for entities, depending on the States to which the entity reported and the nature of its business.

First, the Bureau used national figures reported to New York and Ohio to estimate an entity's number of transfers if the Bureau believed that the transaction figure for the entity reflected in the New York or Ohio data was likely to reflect only international money transfers. The assessment of whether a New York or Ohio figure for a given entity was likely to include any transactions beyond international money transfers was made based on FinCEN registration information and market research.

Second, where California data were available, the Bureau used the California data to extrapolate an estimate of the national number of transfers for entities for which (1) no New York or Ohio information was available or (2) the New York or Ohio data included product offerings that are not international money transfers. To scale up the California figures to nationwide estimates, the Bureau first determined the States in which each entity operated based on FinCEN registration information. The Bureau estimated the percentage of U.S. international money transfers that originated in each State by calculating the relative CPS shares described above, and for each entity aggregated the relative CPS shares for all of the States in which the entity operated to determine the entity's cumulative CPS share. The Bureau then multiplied the transfers reported to California for each entity by the ratio of the entity's cumulative CPS share to California's relative CPS share to get a nationwide estimate. For example, if California's relative CPS share made up half of an entity's cumulative CPS share, the California data for that entity would be multiplied by 2. Where the results of this process generated a figure for any one entity that exceeded the number that the entity had reported to New York or Ohio, the Bureau used the lower figure because the Bureau assumed that the entity's actual number and dollar volume of international money transfers did not exceed the inclusive figures reported to New York or Ohio. The Bureau recognizes that this methodology assumes that an entity's market share is constant in all States of operation, which is an assumption that may result in an over- or under-estimation of a particular entity's national volume or of the number of entities that provide a given number of international money transfers. Further, use of the FinCEN registration information to determine States of operation could lead to inaccuracies to the extent that a money services business provides international money transfers in some States but not in other States in which it operates.

The Bureau derived its estimates for one firm using information from a comment received in response to a previous rulemaking, as in the *CA Extrapolation* above. Additionally, in order to account for data limitations for certain entities that provide transactions that are not international money transfers, the Bureau did not estimate figures for possible international money transfer providers identified in the *State License Review* in two circumstances: First, because the Bureau could not differentiate business-initiated transactions from consumer-initiated transactions in the State licensing data it received, the Bureau excluded entities that appeared to provide a significant amount of business-initiated transactions. (Conversely, if an entity did not provide a significant amount of business-initiated transfers, the Bureau assumed that all transfers it provided were consumer-initiated.) Second, as mentioned above, the Bureau did not derive an estimate for an entity if it was not licensed in California and the Bureau believed that the transaction figure for the entity in the New York and Ohio data mixed international money transfers with other transactions. In all, there are 6 entities excluded for these reasons that reported over 1 million transfers to New York or Ohio or that accounted for over 1 million transfers when the California figure was scaled up. Given the over-inclusive nature of the figures reported to the States for these 6 entities, the Bureau has not derived estimates for these entities or included them or their transactions in its analysis, although some of these entities may be larger participants under the proposed threshold.

Aside from these 6 entities, the Bureau derived per-firm estimates for firms in the California, New York, and Ohio data and, in doing so, identified 10 entities that sent over 3 million international money transfers, 23 entities that sent over 1 million international money transfers, and 26 entities that sent over 500,000 international money transfers. Using the per-firm estimates and the overall market size estimate from the *CA Extrapolation,* the Bureau then estimated that: (1) The 10 entities with over 3 million transfers account for approximately 77 percent of market transactions, (2) The 23 entities with over 1 million transactions per year account for approximately 93 percent of market transactions, and (3) The 26 entities with over 500,000 transfers account for approximately 94 percent of market transactions. The Bureau recognizes that 94 percent may overestimate the combined market share of entities with over 500,000 transactions. For instance, the *State License Review* identified about 310 other entities that operate or may operate as international money transfer providers and, based on this estimate, such entities would together account for only 6 percent of transactions in the market. Although the Bureau's market share estimates are very inexact, it is nevertheless clear from the Bureau's analysis that firms providing over one million international money transfers per year account for the vast majority of transactions in the market.

[39] One rough indicator of the likelihood that an entity provides more than 500,000 international money transfers is the number of States in which the entity is licensed. More than three-fourths of the California, New York, and Ohio licensees that were found to provide over 500,000 international money transfers per year in the *Analysis of State Supervisory Data* are licensed in more than 10 States. At the same time, licensure in more than 10 States does not necessarily indicate that the entity provides more than 500,000 international money transfers. For instance, the Bureau estimates that less than three-fifths of the 42 entities that are both licensed in more than 10 States and licensed in California, New York, or Ohio provide more than 500,000 international money transfers. In contrast, the Bureau's *State License Review* indicates that only 6 entities are licensed in more than 10 States but not licensed in California, New York, or Ohio. This suggests that the data received from California, New York, and Ohio are likely to include most of the entities that send over 500,000 international money transfers per year.

[40] In light of the close similarity between the Remittance Rule's definition of ''remittance transfer'' and the Proposed Rule's international money transfer market, the Bureau expects that most transfers in the international money transfer market would be subject to the Remittance Rule.

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Proposed Rule would enable the Bureau to supervise nonbanks that are larger participants of the international money transfer market to assess compliance with these new protections and to evaluate risks that arise when consumers send money abroad.

Section 1090.107(a)—Market-Related Definitions

Unless otherwise specified, the definitions in § 1090.101 should be used when interpreting terms in this Proposed Rule. The Proposed Rule would define additional terms relevant to the proposed international money transfer market. These terms would include ''international money transfer,'' which delineates the scope of the identified market; ''designated recipient,'' ''international money transfer provider,'' ''sender,'' and ''State''; and ''aggregate annual international money transfers,'' which the Proposed Rule would use as the criterion for assessing larger-participant status.

In drafting definitions in the Proposed Rule, the Bureau has used the definition of ''remittance transfer'' and related definitions from the Remittance Rule as a model because remittance transfers make up a very substantial portion of the market activity in the international money transfer market the Bureau is seeking to define. Additionally, the Remittance Rule definitions are familiar to industry and the Bureau. The Bureau has made adjustments to the Remittance Rule definitions as discussed below to reflect the distinct needs of this larger-participant rulemaking. These adjustments stem in part from the fact that the Remittance Rule imposes substantive consumer protection requirements, while the larger-participant rule differentiates larger participants from other participants in the international money transfer market in order to establish a supervisory program. Thus, in some instances, the Proposed Rule's definitions diverge from those of the Remittance Rule to account for the different regulatory purposes.

The Bureau seeks comment on each of the definitions set forth in the Proposed Rule and any suggested additions, clarifications, modifications, or alternatives.

Aggregate annual international money transfers. The Bureau proposes to use aggregate annual international money transfers as the criterion that would be used in assessing whether an entity is a larger participant of the international money transfer market. The proposed definition of ''aggregate annual international money transfers'' was informed by the method of calculating ''annual receipts'' used by the Bureau in prior larger-participant rulemakings, which in turn is modeled in part on the method used by the U.S. Small Business Administration (SBA) in calculating ''annual receipts'' to determine whether an entity is a small business.[41] Proposed § 1090.107(a) would define the term ''aggregate annual international money transfers'' as the ''annual international money transfers'' of a nonbank covered person, aggregated with the ''annual international money transfers'' of its affiliated companies, as calculated according to instructions set forth in the definition and discussed below.

Calculating annual international money transfers. Similar to the calculations in the consumer reporting and consumer debt collection larger-participant rules, ''annual international money transfers'' of a nonbank covered person would be calculated in one of two ways depending on how long a person has been in business.[42] If the nonbank covered person has been in business for three or more completed calendar years, the Bureau would divide the total number of international money transfers provided by the nonbank covered person over the last three completed calendar years by three. If the nonbank covered person has been in business for less than three completed calendar years, the Bureau would calculate the total number of international money transfers provided by the nonbank covered person during the time that the nonbank covered person has been in business, divide by the total number of weeks the nonbank covered person has been in business, and multiply by 52. This calculation would provide a prorated figure that is comparable to the approach used for entities that have been in business for the entire three-year period.

Transfers involving agents. The proposed definition specifies how to count transfers provided with the assistance of an agent. The Bureau believes that agents play an important role in the proposed market for international money transfers. Under the Proposed Rule, the annual international money transfers of a nonbank covered person would include international money transfers in which an agent acts on that person's behalf. The annual international money transfers of a nonbank covered person would not include international money transfers in which another person provided the international money transfers and the nonbank covered person performed activities as an agent on behalf of that other person.[43] In other words, an international money transfer provided by an international money transfer provider with the help of an agent acting on the provider's behalf would count towards the annual international money transfers of the provider but not the agent.

For purposes of this part of the definition, an ''agent'' would include an agent or authorized delegate, as defined under State or other applicable law, or an affiliated company of a person that provides international money transfers when such agent, authorized delegate, or affiliated company acts for that person. The definition of ''affiliated company'' is found in 12 CFR 1090.101.

Including transactions conducted by an agent in calculating a provider's annual international money transfers is consistent with the Remittance Rule, which places liability on the remittance transfer provider for violations by an agent when the agent is acting for the provider.[44] Not counting transactions conducted solely as an agent for a provider in assessing the agent's annual international money transfers is also consistent with the Bureau's determination that, for purposes of the Remittance Rule, agents acting on behalf of a remittance transfer provider are not, in doing so, themselves acting as remittance transfer providers.[45] Although entities that act solely as agents would not normally be larger participants of the market under the Proposed Rule, the Bureau would have the authority to supervise service providers to larger participants of the

However, some transfers that would be in the international money transfer market under the Proposed Rule would not be ''remittance transfers.'' For instance, transfers of $15 or less are not be covered by the Remittance Rule. 12 CFR 1005.30(e)(2)(i).

[41] 12 CFR 1090.104(a) (Consumer Reporting Rule); 12 CFR 1090.105(a) (Debt Collection Rule); 13 CFR 121.104 (SBA).

[42] 12 CFR 1090.104(a) (Consumer Reporting Rule); 12 CFR 1090.105(a) (Debt Collection Rule).

[43] However, a nonbank covered person's aggregate annual international money transfers may include transfers in which the nonbank covered person acted as an agent on behalf of an affiliated company that provided the transfer. This is because such transfers would be included in the annual international money transfers of the affiliated company and a nonbank covered person's aggregate annual international money transfers would include the annual international money transfers of each of its affiliated companies due to the affiliate aggregation requirement discussed below.

[44] 15 U.S.C. 1693o–1(f); 12 CFR 1005.35. This is also consistent with the data obtained by the Bureau, which generally include transactions conducted by agents on behalf of a provider in the transaction total for the provider.

[45] *See* Official Interpretations to Regulation E, 12 CFR part 1005, Supp. I, comment 30(f)–1.

market.[46] Accordingly, where an agent acts as a service provider to a larger participant, the Bureau would have the authority to supervise the agent's performance of services for the larger participant.[47] In light of these considerations, the Bureau proposes to count transactions in which an agent acts on behalf of a provider towards the annual international money transfers of that provider, and not towards the annual international money transfers of the agent itself.

Affiliate aggregation. Under the Dodd-Frank Act, the activities of affiliated companies are to be aggregated for purposes of computing activity levels for rules—like this Proposed Rule—under 12 U.S.C. 5514(a)(1).[48] The ''aggregate annual international money transfers'' for each nonbank covered person would be the sum of the annual international money transfers of the nonbank covered person and the annual international money transfers of all affiliated companies. The annual international money transfers of each affiliated company would be calculated separately. For purposes of this calculation, each affiliated company would be treated as if it were an independent nonbank covered person. Accordingly, if the period of measurement for two affiliated companies differs because one affiliate has not been in business for at least three calendar years, the annual international money transfers of each entity would be calculated using the applicable period of measurement for each.

Paragraph (iii)(B) of the proposed definition of aggregate annual international money transfers sets forth the method of aggregating the annual international money transfers of a nonbank covered person and its affiliated companies when affiliation has started or ended within the nonbank covered person's period of measurement. As proposed, once a person is acquired by or acquires an affiliated company, the annual international money transfers from each affiliated company would be calculated for the entire period of measurement that is applicable to each affiliate, and then aggregated. The annual international money transfers of a formerly affiliated company would not be included in a nonbank covered person's aggregate annual international money transfer calculation if the affiliation ceased before the nonbank covered person's applicable period of measurement, but would be included for the full period of measurement if the affiliation ceased during the applicable period of measurement.

Designated recipient. Proposed § 1090.107(a) would define ''designated recipient'' to include any person specified by the sender as the authorized recipient of an international money transfer to be received at a location in a foreign country. This proposed definition is based on the definition of ''designated recipient'' in the Remittance Rule,[49] but replaces ''remittance transfer'' with ''international money transfer'' and incorporates the larger-participant definition of ''person'' from 12 CFR 1090.101. The Bureau intends the term ''designated recipient'' to be interpreted based on the interpretation of the term in the Remittance Rule, including its commentary,[50] to the extent appropriate given the definitions' different regulatory contexts. For example, the Official Interpretations to Regulation E provide that a remittance transfer is to be received at a location in a foreign country if funds are to be received at a location physically outside of any State.[51] The Bureau intends the same interpretation to apply to an international money transfer.

International money transfer. Proposed § 1090.107(a) would define the term ''international money transfer'' to mean the electronic transfer of funds requested by a sender that is sent by an international money transfer provider to a designated recipient. The term would apply regardless of whether the sender holds an account with the international money transfer provider, and regardless of whether the transaction also is an ''electronic fund transfer,'' as defined in Regulation E, 12 CFR 1005.3(b). The term would not include certain transfers related to the purchase or sale of a security or commodity that are excluded from the definition of ''electronic fund transfer'' under 12 CFR 1005.3(c)(4).

The proposed definition of ''international money transfer'' tracks the Remittance Rule's definition of ''remittance transfer,''[52] except for two deviations. First, the Bureau has replaced the term ''remittance transfer provider'' where it appears in 12 CFR 1005.30(e) with the term ''international money transfer provider.''[53]

Second, the Bureau is proposing to define ''international money transfer'' without regard to the amount of the transfer. By contrast, the Remittance Rule includes an exclusion for transfers of $15 or less[54] because the Dodd-Frank Act's definition of ''remittance transfer'' does not include transfers ''in an amount that is equal to or lesser than the amount of a small-value transaction determined, by rule, to be excluded from the requirements under section 906(a) [of the EFTA].''[55] While the Dodd-Frank Act's definition of ''remittance transfer'' is applicable to the Remittance Rule, it is not applicable to the Bureau's authority to supervise larger participants in markets for consumer financial products or services. The Bureau believes that small-value transactions comprise part of the same market as larger transactions and, as discussed below, the number of international money transfers provided by an international money transfer provider reflects the extent of a provider's market participation. Moreover, as defined in the Proposed Rule, international money transfers are consumer financial products or services regardless of the size of a particular transfer. The Bureau is not aware of substantial administrative challenges that would make it difficult to include small-value transactions when counting the total number of international money transfers provided by a nonbank covered person. Indeed, the State supervisory data obtained by the Bureau for this rulemaking do not exclude transfers of $15 or less. Accordingly, the Bureau believes that it would be appropriate to count all transactions regardless of dollar amount in the criterion for what constitutes a larger participant of the proposed market.

The Bureau intends the term ''international money transfer'' to be interpreted in the same manner as the term ''remittance transfer,'' with the terms ''electronic transfer of funds'' and ''sent by an international money transfer provider'' interpreted based on the interpretation of parallel terms in

[46] 12 U.S.C. 5514(e); *see also* 12 U.S.C. 5481(26)(A) (defining service provider).

[47] The Bureau also has the authority to supervise any nonbank covered person that it ''has reasonable cause to determine, by order, after notice to the covered person and a reasonable opportunity . . . to respond . . . is engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services.'' 12 U.S.C. 5514(a)(1)(C).

[48] 12 U.S.C. 5514(a)(3)(B).

[49] 12 CFR 1005.30(c).

[50] *See* Official Interpretations to Regulation E, comment 30(c).

[51] *See* Official Interpretations to Regulation E, comment 30(c)–2.

[52] 12 CFR 1005.30(e).

[53] Because an international money transfer provider must be a nonbank covered person, transfers are not international money transfers unless they are sent by a nonbank.

[54] 12 CFR 1005.30(e)(2)(i).

[55] 15 U.S.C. 1693o–1(g)(2)(B). The Board of Governors of the Federal Reserve System previously determined by rule that financial institutions are not subject to the EFTA section 906(a) requirement to provide electronic terminal receipts for small-value transfers of $15 or less. *See* 12 CFR 1005.9(e).

Regulation E,[56] to the extent appropriate given the definitions' different regulatory contexts. For example, the Bureau intends to interpret the ''international money transfer'' definition consistently with the discussion in comment 30(e)–3 to Regulation E of transactions that are and are not included within the definition of ''remittance transfer.'' [57]

International money transfer provider. Proposed § 1090.107(a) would define the term ''international money transfer provider'' to mean any nonbank covered person that provides international money transfers for a consumer, regardless of whether the consumer holds an account with such person. Consistent with the Proposed Rule's definition of ''international money transfer,'' the proposed definition of ''international money transfer provider'' tracks the definition of ''remittance transfer provider'' in the Remittance Rule closely,[58] with the following exceptions. First, the proposed definition replaces ''remittance transfer'' with ''international money transfer.'' Second, for consistency with the rest of the larger-participant rule, the proposed definition replaces the first reference to ''person'' with ''nonbank covered person'' [59] and incorporates the larger-participant rule's definition of ''consumer'' rather than the Regulation E definition. Third, the Bureau has not incorporated from the ''remittance transfer provider'' definition the requirement that transfers be provided ''in the normal course of business.'' [60] The Bureau believes that such a limitation is unnecessary in the definition of ''international money transfer provider'' because the Proposed Rule would not impose any new business conduct obligations and would require that an international money transfer provider have at least one million aggregate annual international money transfers to be a larger participant.

The Bureau intends the commentary to the Remittance Rule [61] to be used to guide interpretation of the term ''international money transfer provider'' in proposed § 1090.107(a), to the extent appropriate given the definitions' different regulatory contexts.

Sender. Proposed § 1090.107(a) would define the term ''sender'' to mean a consumer in a State who primarily for personal, family, or household purposes requests an international money transfer provider to send an international money transfer to a designated recipient. This proposed definition largely tracks the definition of ''sender'' in the Remittance Rule, but replaces ''remittance transfer'' with ''international money transfer'' and ''remittance transfer provider'' with ''international money transfer provider.'' [62] For consistency with the rest of the larger-participant rule, the Proposed Rule also incorporates the definition of ''consumer'' from the larger-participant rule rather than the definition from Regulation E. The Bureau intends the term ''sender'' to be interpreted in the same manner as the term ''sender'' in the Remittance Rule,[63] to the extent appropriate given the definitions' different regulatory contexts.

State. Proposed § 1090.107(a) would define the term ''State'' to mean any State, territory, or possession of the United States; the District of Columbia; the Commonwealth of Puerto Rico; or any political subdivision thereof. This proposed definition is drawn from the definition of ''State'' in Regulation E subpart A [64] and is intended to be interpreted accordingly.

1090.107(b)—Test To Define Larger Participants

Criterion. The Bureau has broad discretion in choosing a criterion for assessing whether a nonbank covered person is a larger participant of a market. For any specific market, there might be several criteria, used alone or in combination, that could be viewed as reasonable alternatives. For the international money transfer market, the Bureau is considering a number of criteria, including aggregate annual international money transfers, annual receipts, and annual transmitted dollar volume. The Bureau invites comment on these three possible criteria as well as suggestions for other criteria that commenters believe might be superior.

Among these three, the Bureau proposes to use aggregate annual international money transfers as the criterion that establishes which entities are larger participants of the international money transfer market. The definitions of ''international money transfers'' and ''aggregate annual international money transfers'' are discussed above. Aggregate annual international money transfers is an appropriate criterion because it measures in several meaningful ways the nonbank provider's level of participation in the proposed market and impact on consumers. First, the number of transfers reflects the extent of interactions an international money transfer provider has with consumers. Each transfer represents a single interaction with at least one consumer. Second, the number of transfers is a relatively durable metric in the face of changing market conditions such as exchange rates or inflation. Third, because international money transfer providers often are paid, in part, on a per-transfer basis, the number of transfers is related to the revenue received, another indicator of market participation.

The Bureau anticipates that aggregate annual international money transfers would be relatively straightforward and objective for an international money transfer provider to calculate, as the occasion to do so arises. The Bureau expects that many market participants already assemble data generally related to the number of international transactions that they provide for internal business purposes, particularly because many providers are compensated on a per-transfer basis. Moreover, many providers are required to report transaction data to State regulators. These existing practices will help providers to estimate their aggregate annual international money transfers. The Bureau expects that some market participants may choose to track the number of remittance transfers they provide each year, which could provide another source for estimates of aggregate annual international money transfers because the definition of the criterion roughly tracks the definition of ''remittance transfer'' used in the Remittance Rule. Accordingly, the Bureau believes that many market participants interested in doing so already would have sufficient data to estimate whether their aggregate annual international money transfers exceed a given transaction threshold.

The Bureau does not have precise and comprehensive data on the number of international money transfers provided by international money transfer

[56] *See* Official Interpretations to Regulation E, comment 30(e)–1, –2.

[57] Official Interpretations to Regulation E, comment 30(e)–3.

[58] 12 CFR 1005.30(f).

[59] ''Nonbank covered person'' includes (1) any person that engages in offering or providing a consumer financial product or service; and (2) any affiliate of a person that engages in offering or providing a consumer product or service if such affiliate acts as a service provider to such person, but does not include any persons described in 12 U.S.C. 5515(a) and 5516(a). 12 CFR 1090.101.

[60] 12 CFR 1005.30(f).

[61] Official Interpretations to Regulation E, comment 30(f).

[62] 12 CFR 1005.30(g).

[63] Official Interpretations to Regulation E, comment 30(g).

[64] The Bureau has proposed adopting the definition in Regulation E with minor stylistic changes to the last clause of the definition. *Cf.* 12 CFR 1005.2(*l*) (''''State' means any State, territory, or possession of the United States; the District of Columbia; the Commonwealth of Puerto Rico; *or any political subdivision of the thereof in this paragraph (l).*'') (emphasis added).

providers, as defined in this Proposed Rule, or on any of the other criteria that are being considered. However, as described above, the Bureau obtained confidential supervisory data from California, New York, and Ohio regulators, and has used the 2011 CPS, U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) data listing the States in which individual money services businesses operate, entity-level data from public Web sites, CFPB market research, and licensee lists from regulatory agencies in 47 States and the District of Columbia. The Bureau believes that these data sources can adequately inform the decision of setting a threshold using the criterion of aggregate annual international money transfers.[65]

Threshold. Under the Proposed Rule, a nonbank covered person would be a larger participant of the international money transfer market if the nonbank covered person has at least one million aggregate annual international money transfers. As stated above, the Bureau estimates the proposed threshold of one million aggregate annual international money transfers would bring within the Bureau's supervisory authority approximately 25 international money transfer providers.[66]

The Bureau anticipates that the proposed aggregate annual international money transfer threshold of one million would be consistent with the objective of supervising market participants that represent a substantial portion of the international money transfer market and have a significant impact on consumers. According to the Bureau's estimates, the approximately 25 international money transfer providers that meet the proposed threshold collectively provided about 140 million transfers in 2012, with a total volume of about $40 billion.[67] The Bureau estimates that these nonbanks are responsible for approximately 90 percent of transfers in the nonbank market for international money transfers.[68] They consist of both entities that send money to most of the countries in the world and entities that focus on sending money to particular recipient countries or regions. The proposed threshold would subject to the Bureau's supervisory authority only entities that can reasonably be considered larger participants of the proposed market.[69]

The Bureau is also considering a lower or higher threshold. For example, the Bureau estimates that a lower aggregate annual international money transfer threshold of 500,000 would allow the Bureau to supervise about 3 additional entities that together account for about 1.5 percent of transfers in this market.[70] Alternatively, the Bureau estimates that an aggregate annual international money transfer threshold of three million would likely allow the Bureau to supervise the 10 largest participants of the proposed market, which collectively provide approximately three-fourths of the transfers in this market.[71]

In proposing a threshold, the Bureau has used a global-market approach that would apply a single threshold regardless of destination. The Bureau is also considering, as an alternative, establishing different thresholds for different destination regions. Setting a threshold for each region would allow the Bureau to set lower thresholds for entities that transfer funds to regions where the overall number of international money transfers is lower and higher thresholds for destination regions for which the overall number of international money transfers is higher. Entities that dominate the market for transfers to lower-volume destination regions might be more likely to meet the larger-participant test if the Bureau used a regional approach in setting the threshold. However, the Bureau is not aware of data sources that would support regional segmentation of this nature at this time. Additionally, even if data were available to support regional segmentation, the Bureau is concerned that such an approach would be very difficult to administer over time, as regional boundaries and volumes could shift in response to any number of factors including market forces and geopolitical events, which could lead to frequent adjustments to the market definitions and corresponding thresholds.

V. Request for Comments

The Bureau invites comment on all aspects of this notice of proposed rulemaking and on the specific issues on which comment is solicited elsewhere herein, including on any appropriate modifications or exceptions to the Proposed Rule.

VI. Section 1022(b)(2)(A) of the Dodd-Frank Act

A. Overview

The Bureau is considering potential benefits, costs, and impacts of the Proposed Rule.[72] The Bureau requests comment on the preliminary analysis presented below as well as submissions of additional data that could inform the Bureau's analysis of the costs, benefits, and impacts of the Proposed Rule. In developing the Proposed Rule, the Bureau has consulted with or offered to consult with the Federal Trade Commission, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration, regarding, among other things, consistency with any prudential, market, or systemic objectives administered by such agencies.

The Proposed Rule defines a category of nonbanks that would be subject to the Bureau's nonbank supervision program pursuant to 12 U.S.C. 5514(a)(1)(B). The proposed category would include ''larger participants'' of a market for ''international money transfers'' described in the Proposed Rule. Participation in this market would be measured on the basis of aggregate annual international money transfers. If a nonbank covered person's aggregate annual international money transfers (measured as a three-year moving average of the number of annual international money transfers, aggregated with the annual international money transfers of affiliated companies)

[65] *Analysis of State Supervisory Data.*

[66] *Id.* As noted above, this estimate is based on the Bureau's review of confidential licensing data from California, New York, and Ohio and does not include entities that are not licensed in any of those States. In addition to the other possible sources of error identified in the *Analysis of State Supervisory Data,* the Bureau has not assessed affiliations of market participants. The Bureau's estimates therefore would not include entities that might have less than a threshold number of annual international money transfers on their own but that would meet the threshold when their transfers are aggregated with their affiliated companies' transfers.

[67] *Id.*

[68] *Id.*

[69] According to Bureau estimates, less than 10 percent of market participants would be larger participants using the proposed threshold. *See Analysis of State Supervisory Data* (approximately 25 larger participants); *State License Review* (approximately 340 market participants).

[70] *Analysis of State Supervisory Data.*

[71] *Id.*

[72] Specifically, 12 U.S.C. 5512(b)(2)(A) calls for the Bureau to consider the potential benefits and costs of a regulation to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services, the impact on depository institutions and credit unions with $10 billion or less in total assets as described in 12 U.S.C. 5516, and the impact on consumers in rural areas. In addition, 12 U.S.C. 5512(b)(2)(B) directs the Bureau to consult, before and during the rulemaking, with appropriate prudential regulators or other Federal agencies, regarding consistency with objectives those agencies administer. The manner and extent to which the provisions of 12 U.S.C. 5512(b)(2) apply to a rulemaking of this kind that does not establish standards of conduct are unclear. Nevertheless, to inform this rulemaking more fully, the Bureau performed the analysis and consultations described in those provisions of the Dodd-Frank Act.

equaled or exceeded one million, it would be a larger participant. If an entity has been in business for less than three completed calendar years, its annual international money transfers would be the average amount of international money transfers per year over the course of its time in business.

B. Potential Benefits and Costs to Consumers and Covered Persons

This analysis considers the benefits, costs, and impacts of the key provisions of the Proposed Rule against a baseline that includes the Bureau's existing rules defining larger participants in certain markets.[73] Many States have supervisory programs relating to money transfers, which may consider aspects of consumer financial protection law. However, at present, there is no Federal program for supervision of nonbanks that are international money transfer providers with respect to consumer financial protection law. The Proposed Rule extends the Bureau's supervisory authority over international money transfer providers that are larger participants of the international money transfer market. This includes the authority to supervise for compliance with the EFTA and the Remittance Rule.

The Bureau notes at the outset that limited data are available with which to quantify the potential benefits, costs, and impacts of the Proposed Rule. For example, although the Bureau has confidential supervisory data from California, New York, and Ohio from which it can estimate the number and size of international money transfer providers, the Bureau lacks detailed or comprehensive information about their rates of compliance or noncompliance with Federal consumer financial law and about the range of, and costs of, compliance mechanisms used by market participants.

In light of these data limitations, this analysis generally provides a qualitative discussion of the benefits, costs, and impacts of the Proposed Rule. General economic principles, together with the limited data that are available, provide insight into these benefits, costs, and impacts. Where possible, the Bureau has made quantitative estimates based on these principles and data as well as on its experience of undertaking supervision in other markets.

The discussion below describes three categories of potential benefits and costs. First, the Proposed Rule, if adopted, would authorize the Bureau's supervision of larger participants of the international money transfer market. Larger participants of the proposed market might respond to the possibility of supervision by changing their systems and conduct, and those changes might result in costs, benefits, or other impacts. Second, if the Bureau undertakes supervisory activity at specific international money transfer providers, those entities would incur costs from responding to supervisory activity, and the results of these individual supervisory activities might also produce benefits and costs. Third, the Bureau analyzes the costs that might be associated with entities' efforts to assess whether they would qualify as larger participants under the rule.

1. Benefits and Costs of Responses to the Possibility of Supervision

The Proposed Rule would subject larger participants of the international money transfer market to the possibility of Bureau supervision. That the Bureau would be authorized to undertake supervisory activities with respect to a nonbank covered person who qualified as a larger participant would not necessarily mean the Bureau would in fact undertake such activities regarding the covered person in the near future. Rather, supervision of any particular larger participant as a result of this rulemaking would be probabilistic in nature. For example, the Bureau would examine certain larger participants on a periodic or occasional basis. The Bureau's decisions about supervision would be informed, as applicable, by the factors set forth in 12 U.S.C. 5514(b)(2), relating to the size and transaction volume of individual participants, the risks their consumer financial products and services pose to consumers, the extent of State consumer protection oversight, and other factors the Bureau may determine are relevant. Each entity that believed it qualified as a larger participant would know that it might be supervised and might gauge, given its circumstances, the likelihood that the Bureau would initiate an examination or other supervisory activity.

The prospect of potential supervisory activity could create an incentive for larger participants to allocate additional resources and attention to compliance with Federal consumer financial law, potentially leading to an increase in the level of compliance. They might anticipate that by doing so (and thereby decreasing risk to consumers), they could decrease the likelihood of their actually being subject to supervisory activities as the Bureau evaluated the factors outlined above. In addition, an actual examination would be likely to reveal any past or present noncompliance, which the Bureau could seek to correct through supervisory activity or, in some cases, enforcement actions. Larger participants might therefore judge that the prospect of supervision increases the potential consequences of noncompliance with Federal consumer financial law, and they might seek to decrease that risk by taking steps to identify and cure or mitigate any noncompliance.

The Bureau believes it is likely that many market participants would increase compliance in response to the Bureau's supervisory activity authorized by the Proposed Rule. However, because finalization of the Proposed Rule itself would not require any international money transfer provider to alter its performance of international money transfers, any estimate of the amount of increased compliance would be both an estimate of current compliance levels and a prediction of market participants' behavior in response to a final rule. The data that the Bureau currently has do not support a specific quantitative estimate or prediction. But, to the extent that international money transfer providers allocate resources to increasing their compliance in response to the Proposed Rule, that response would result in both benefits and costs.[74]

a. Benefits From Increased Compliance

Increased compliance with consumer financial laws by larger participants in the international money transfer market would be beneficial to consumers who send international money transfers. The number of American consumers who could potentially be affected is significant. As noted above, data from the 2011 CPS show that more than 4 million U.S. households had used nonbanks to send money abroad to friends and family in the preceding year.[75] Increasing the rate of compliance with Federal consumer financial laws would benefit consumers and the consumer financial market by providing more of the protections mandated by those laws.

The EFTA and the Remittance Rule offer substantial consumer protections

[73] The Bureau has discretion in any rulemaking to choose an appropriate scope of analysis with respect to potential benefits and costs and an appropriate baseline. The Bureau, as a matter of discretion, has chosen to describe a broader range of potential effects to inform the rulemaking more fully.

[74] Another approach to considering the benefits, costs, and impacts of the Proposed Rule would be to focus almost entirely on the supervision-related costs for larger participants and omit a broader consideration of the benefits and costs of increased compliance. As noted above, the Bureau has, as a matter of discretion, chosen to describe a broader range of potential effects to inform the rulemaking more fully.

[75] 2011 CPS Report 32, 142–43.

for international money transfers that are also remittance transfers. Together, the EFTA and the Remittance Rule clarify the remittance process for consumers by requiring the provision of standardized disclosures about pricing as well as increased consumer protections when transfers do not go as planned. For consumers, this should increase the transparency of remittance prices and facilitate dispute resolution when errors occur.

More broadly, the Bureau would be examining for compliance with other Federal consumer financial laws, which would include examining for whether larger participants of the international money transfer market engage in unfair, deceptive, or abusive acts or practices (UDAAPs).[76] Conduct that does not violate an express prohibition of another Federal consumer financial law may nonetheless constitute a UDAAP.[77] To the extent that any international money transfer provider is currently engaged in any UDAAPs, the cessation of the unlawful act or practice would benefit consumers. International money transfer providers might improve policies and procedures in response to possible supervision in order to avoid engaging in UDAAPs.

The possibility of supervision also may help make incentives to comply with Federal consumer financial laws more consistent between the likely larger participants and banks, which are already subject to Federal supervision with respect to Federal consumer financial laws. Although some nonbanks are already subject to State supervision, introducing the possibility of Federal supervision could encourage nonbanks that are likely larger participants to devote additional resources to compliance. It could also help ensure that the benefits of Federal oversight reach consumers who do not have ready access to bank-provided international transfers. In 2011, approximately one-sixth of individuals who sent money abroad to friends and family through a nonbank did not have a bank account.[78]

b. Costs of Increased Compliance

To the extent that nonbank larger participants would decide to increase resources dedicated to compliance in response to the possibility of increased supervision, the entities would bear any direct cost of any changes to their systems, protocols, or personnel. Any such increase in costs could be passed on in part to consumers. Whether and to what extent entities would increase resources dedicated to compliance and/or pass those costs to consumers would depend not only on the entities' current practices and the changes they decide to make, but also on market conditions. The Bureau lacks detailed information with which to predict what portion of any cost of increased compliance would be borne by international money transfer providers or passed on to consumers. When or if such a cost were borne by consumers, consumers might respond by changing the frequency or amount of international money transfers sent.

In considering any potential price effect of the Proposed Rule, it is important to take into account the fact that nonbanks below the larger-participant threshold would not be subject to supervision as a result of this rule. Because their costs would be unaffected by the Proposed Rule, their pricing should also not be affected. To the extent that nonbank larger participants raise their prices in response to this rule, small international money transfer providers could potentially seem attractive relative to larger participants. This potential effect could reduce the likelihood that larger participants would choose to increase their prices in response to the Proposed Rule.

2. Benefits and Costs of Individual Supervisory Activities

In addition to the responses of market participants anticipating supervision, the possible consequences of the Proposed Rule would include the responses to and effects of individual examinations or other supervisory activity that the Bureau might conduct in the international money transfer market.

a. Benefits of Supervisory Activities

Supervisory activity could provide several types of benefits. For example, as a result of supervisory activity, the Bureau and an entity might uncover deficiencies in the entity's policies and procedures. The Bureau's examination manual calls for the Bureau generally to prepare a report of each examination, to assess the strength of the entity's compliance mechanisms, and to assess the risks the entity poses to consumers, among other things. The Bureau would share examination findings with the entity because one purpose of supervision is to inform the entity of problems detected by examiners. Thus, for example, an examination might find evidence of widespread noncompliance with Federal consumer financial law, or it might identify specific areas where an entity has inadvertently failed to comply. These examples are only illustrative of the kinds of information an examination might uncover.

Detecting and informing entities about such problems should be beneficial to consumers. When the Bureau notifies an entity about risks associated with an aspect of its activities, the entity is expected to adjust its practices to reduce those risks. That response may result in increased compliance with Federal consumer financial law, with benefits like those described above. Or it may avert a violation that would have occurred had Bureau supervision not detected the risk promptly. The Bureau may also inform entities about risks posed to consumers that fall short of violating the law. Action to reduce those risks would also be a benefit to consumers.

Given the obligations international money transfer providers have under Federal consumer financial law and the existence of efforts to enforce such law, the results of supervision also may benefit international money transfer providers under supervision by detecting compliance problems early. When an entity's noncompliance results in litigation or an enforcement action, the entity must face both the costs of defending its actions and the penalties for noncompliance, including potential liability for damages to private plaintiffs. The entity must also adjust its systems to ensure future compliance. Changing practices that have been in place for long periods of time can be expected to be relatively difficult because they may be severe enough to represent a serious failing of an entity's systems. Supervision may detect flaws at a point when correcting them would be relatively inexpensive. Catching problems early can, in some situations, forestall costly litigation. To the extent early correction limits the amount of consumer harm caused by a violation, it can help limit the cost of redress. In short, supervision might benefit international money transfer providers under supervision by, in the aggregate, reducing the need for other more expensive activities to achieve compliance.[79]

[76] 12 U.S.C. 5531.

[77] The CFPB Supervision and Examination Manual provides further guidance on how the UDAAP prohibition applies to supervised entities and is available at *http://www.consumerfinance.gov/guidance/supervision/manual.*

[78] Bureau estimate based on 2011 CPS data, which is available at *http://thedataweb.rm.census.gov/ftp/cps_ftp.html* and described at *http://www.census.gov/prod/techdoc/cps/cpsjun11.pdf.*

[79] Further potential benefits to consumers, covered persons, or both might arise from the Bureau's gathering of information during

Continued

b. Costs of Supervisory Activities

The potential costs of actual supervisory activities would arise in two categories. The first would involve any costs to individual international money transfer providers of increasing compliance in response to the Bureau's findings during supervisory activity and to supervisory actions. These costs would be similar in nature to the possible compliance costs, described above, that larger participants in general might incur in anticipation of possible supervisory actions. This analysis will not repeat that discussion. The second category would be the cost of supporting supervisory activity.

Supervisory activity may involve requests for information or records, on-site or off-site examinations, or some combination of these activities. For example, in an on-site examination, Bureau examiners generally contact the entity for an initial conference with management. That initial contact is often accompanied by a request for information or records. Based on the discussion with management and an initial review of the information received, examiners determine the scope of the on-site exam. While on-site, examiners spend some time in further conversation with management about the entity's policies, procedures, and processes. The examiners also review documents, records, and accounts to assess the entity's compliance and evaluate the entity's compliance management system. As with the Bureau's other examinations, examinations of nonbank larger participants in the international money transfer market could involve issuing confidential examination reports and compliance ratings. The Bureau's examination manual describes the supervision process and indicates what materials and information an entity could expect examiners to request and review, both before they arrive and during their time on-site.

The primary cost an entity would face in connection with an examination would be the cost of employees' time to collect and provide the necessary information. If the Proposed Rule is adopted, the frequency and duration of examinations of any particular entity would depend on a number of factors, including the size of the entity, the compliance or other risks identified, whether the entity has been examined previously, and the demands on the Bureau's supervisory resources imposed by other entities and markets. Nevertheless, some rough estimates may be useful to provide a sense of the magnitude of potential staff costs that entities might incur.

The cost of supporting supervisory activity may be calibrated using prior Bureau experience in supervision. The Bureau considers its nonbank payday lender examinations as a reasonable proxy for the duration and labor intensity of potential international money transfer provider examinations. Although there are many differences, the nonbank payday lending market is more like the nonbank market for international money transfers than other nonbank markets the Bureau currently supervises because both markets involve point-of-sale transactions involving similar dollar amounts.

The average duration of the on-site portion of Bureau nonbank payday exams is approximately 8 weeks.[80] Assuming that each exam requires 2 weeks of preparation time by international money transfer provider staff prior to the exam as well as on-site assistance by staff throughout the duration of the exam, the Bureau assumes that the typical examination in this nonbank market would require 10 weeks of staff time. The Bureau has not suggested that counsel or any particular staffing level is required during an examination. However, for purposes of this analysis, the Bureau assumes, conservatively, that an entity might dedicate the equivalent of one full-time compliance officer and one-tenth of a full-time attorney to the exam. The average hourly wage of a compliance officer in a nonbank entity that operates in activities related to credit intermediation is $31.53, and the average hourly wage of a lawyer in the same industry is $77.52.[81] Assuming that wages account for 67.1 percent of total compensation,[82] the total labor cost of an examination would be about $23,500.[83] The Bureau estimates that the cost for an entity that sends 1 million transfers per year, with an average transfer amount of $200, would be approximately 0.18 percent of total revenue from such transfers for that year.[84] Note that this is a conservative estimate in several respects because it reflects revenue only from this line of business and uses a relatively small average international money transfer size as well as the minimum number of transactions that a larger participant would provide.[85]

The overall costs of supervision in the international money transfer market would depend on the frequency and extent of Bureau examinations. Neither the Dodd-Frank Act nor the Proposed Rule specifies a particular level or

supervisory activities. The goals of supervision include informing the Bureau about activities of market participants and assessing risks to consumers and to markets for consumer financial products and services. The Bureau may use this information to improve regulation of consumer financial products and services and to improve enforcement of Federal consumer financial law, in order to better serve its mission of ensuring consumers' access to fair, transparent, and competitive markets for such products and services. Benefits of this type would depend on what the Bureau learns during supervision and how it uses that knowledge. For example, because the Bureau would examine a number of covered persons in the international money transfer market, the Bureau would build an understanding of how effective compliance systems and processes function in that market.

[80] This estimate was derived using confidential supervisory Bureau data on the duration of on-site payday loan examinations at nonbanks. For purposes of this calculation, the Bureau counted its payday loan examinations for which the on-site portion had been completed. The Bureau counted only the on-site portion of an examination, which included time during the on-site period of the examination that examiners spent examining the entity while off-site for holiday or other travel considerations. However, the Bureau did not count time spent scoping an examination before the on-site portion of the examination or summarizing findings or preparing reports of examination afterwards.

[81] Bureau of Labor Statistics Occupational Employment Statistics (OES) Survey, May 2012 estimates for NAICS code 522300, *available at http://www.bls.gov/oes/current/naics4_522300.htm.*

[82] Bureau of Labor Statistics series CMU2025220000000D, Quarters 2 and 3 2012, *available at http://data.bls.gov/timeseries/CMU2025220000000D?data_tool=XGtable.*

[83] Assuming that individuals are compensated for 40 hour work weeks, this is calculated as follows: [(0.1*77.52+31.53)/0.671]*40*10.

[84] This assumption is based on research on remittances suggesting that the average price of sending money abroad from the United States is roughly 6.42 percent of the total amount sent. World Bank, Remittance Prices Worldwide, An Analysis of Trends in the Average Total Cost of Migrant Remittance Services (Sept. 2013) 11 (percentage is average price of $200 transfers in Q3 2013), *available at https://remittanceprices.worldbank.org/sites/default/files/RPW_Report_Sep2013.pdf.* The Bureau measured proportion of revenues using the following equation: Proportion of revenues={[(0.1*77.52+31.53)/0.671]*40*10}/{1,000,000*200*0.0642}.

[85] A $200 average transfer size is a conservative estimate. Review of the *CA Extrapolation* figures ($49 billion total market dollar volume and 152 million total market transfers) suggests that the average transaction size is just over $300. For entities reporting to California, New York, and Ohio that sent over 500,000 transfers, the *Analysis of State Supervisory Data* suggests that the average transfer size is about $300. Using a $300 average transfer size, the cost of supervision would be approximately 0.12 percent of total revenues for an entity that sends 1 million transfers per year. Other sources from 2005 and 2008 also suggest a higher average transfer size. Ole E. Andreassen, Remittance Service Providers in the United States: How Remittance Firms Operate and How They Perceive Their Business Environment 15–16 (June 2006), *available at http://siteresources.worldbank.org/INTPAYMENTREMMITTANCE/Resources/Business modelsFSEseries.pdf* ($550); Bendixen & Amandi, Survey of Latin American Immigrants in the United States 23 (Apr. 30, 2008), *available at idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=35063818* ($325).

frequency of examinations.[86] The frequency of examinations would depend on a number of factors, including the Bureau's understanding of the conduct of market participants and the specific risks they pose to consumers; the responses of larger participants to prior examinations; and the demands that other markets make on the Bureau's supervisory resources. These factors can be expected to change over time, and the Bureau's understanding of these factors may change as it gathers more information about the market through its supervision and by other means. The Bureau therefore declines to predict, at this point, precisely how many examinations in the international money transfer market it would undertake in a given year.

3. Costs of Assessing Larger-Participant Status

The larger-participant rule does not require nonbanks to assess whether they are larger participants. However, the Bureau acknowledges that in some cases international money transfer providers might decide to incur costs to assess whether they qualify as larger participants or potentially dispute their status.

Larger-participant status would depend on a nonbank's aggregate annual international money transfers. As noted above, the Bureau expects that many market participants already assemble general data related to the number of international transactions that they provide for internal business purposes. Moreover, many providers are required to report transaction data to State regulators. Further, the definition of the criterion proposed in this rule roughly tracks the definition of ''remittance transfer'' used in the Remittance Rule, and the Bureau expects that some market participants may choose to track the number of remittance transfers they provide each year. These preexisting activities could assist entities in estimating whether they are larger participants.

To the extent that some international money transfer providers do not already know whether their transactions exceed the threshold, such nonbanks might, in response to the Proposed Rule, develop new systems to count their transactions in accordance with the proposed definition of ''international money transfer.'' The data that the Bureau currently has do not support a detailed estimate of how many international money transfer providers would engage in such development or how much they would spend. Regardless, international money transfer providers would be unlikely to spend significantly more on specialized systems to count transactions than it would cost to be supervised by the Bureau as larger participants. It bears emphasizing that even if expenditures on a counting system successfully proved that an international money transfer provider was not a larger participant, it would not necessarily follow that the entity could not be supervised. The Bureau can supervise specific international money transfer providers whose conduct the Bureau determines, pursuant to 12 U.S.C. 5514(a)(1)(C), poses risks to consumers. Thus, an international money transfer provider choosing to spend significant amounts on an accounting system directed toward the larger-participant test could not be sure it would not be subject to Bureau supervision notwithstanding those expenses. The Bureau therefore believes very few if any international money transfer providers would undertake such expenditures.

4. Consideration of Alternatives

The Bureau is considering two major alternatives: Using a measure other than number of international money transfers to define the market and choosing a different threshold to define larger participants.

First, the Bureau is considering various other criteria for assessing larger-participant status, including annual receipts from international money transfers and annual transmitted dollar volume. Calculating either of those metrics may be more involved than calculating the number of international money transfers. If so, a given nonbank might face greater costs for evaluating or disputing whether it qualified as a larger participant should the occasion to do so to arise. The Bureau expects that for both annual receipts and annual transmitted dollar volume it could choose a suitable threshold for which the number of larger participants, among those nonbanks participating in the market today, would be the same as the number of nonbanks expected to qualify under the Proposed Rule. Consequently, the costs, benefits, and impacts of supervisory activities should not depend on which criterion the Bureau uses.

The second possible alternative the Bureau is considering is selecting a different threshold. One alternative would be to set the threshold substantially higher—for example at three million aggregate annual international money transfers—and cover only the very largest nonbanks in the market. Under such an alternative, the benefits of supervision to both consumers and covered persons would likely be reduced because entities impacting a substantial number of consumers and/or consumers in important market segments might be omitted. On the other hand, the potential costs to covered persons would of course be reduced if fewer entities were defined as larger participants and thus fewer were subject to the Bureau's supervisory authority on that basis. Conversely, lowering the threshold would subject more entities to the Bureau's supervisory authority, but the total direct costs for actual examination activity might not change substantially because the Bureau conducts exams on a risk basis and would not necessarily examine more entities even if the rule's coverage were broader.[87]

C. Potential Specific Impacts of the Proposed Rule

1. Depository Institutions and Credit Unions With $10 Billion or Less in Total Assets, As Described in Dodd-Frank Act Section 1026

The Proposed Rule would not apply to depository institutions or credit unions of any size. However, it might have some impact on depository institutions or credit unions that provide international transfers. For example, if the relative price of nonbanks' international money transfers were to increase due to increased costs related to supervision, then depository institutions or credit unions of any size might benefit by the relative change in costs. These effects, if any, would likely be small.

[86] The Bureau declines to predict at this time precisely how many examinations it would undertake at each international money transfer provider if the Proposed Rule is adopted. However, if the Bureau were to examine each entity that would be a larger participant of the international money transfer market under the Proposed Rule once every two years, the expected annual labor cost of supervision per larger participant would be approximately $11,750 (the cost of one examination, divided by two). This would account for 0.09 percent of the international money transfer revenue of an entity that sends one million transfers in a year, assuming an average transaction amount of $200.

[87] Another alternative under consideration is setting different thresholds for each region. As alluded to earlier, international money transfer submarkets tend to be segmented by corridor: Individuals wishing to send remittances to El Salvador, for example, cannot easily substitute transfers to Moldova. One could define a larger-participant threshold for different geographic regions so that the entities that provide the most transfers to a given region could be supervised. Given the paucity of data on region-specific transactions, however, any definition of these thresholds might be more difficult to establish and to administer over time.

2. Impact of the Provisions on Consumers in Rural Areas

Because the rule applies uniformly to international money transfers of both rural and non-rural consumers, the rule should not have a unique impact on rural consumers. The Bureau is not aware of any evidence suggesting that rural consumers have been disproportionately harmed by international money transfer providers' failure to comply with Federal consumer financial law. The Bureau would welcome any comments that may provide information related to how international money transfers affect rural consumers.

VII. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996, requires each agency to consider the potential impact of its regulations on small entities, including small businesses, small governmental units, and small not-for-profit organizations.[88] The RFA defines a ''small business'' as a business that meets the size standard developed by the Small Business Administration pursuant to the Small Business Act.[89]

The RFA generally requires an agency to conduct an initial regulatory flexibility analysis (IRFA) of any proposed rule subject to notice-and-comment rulemaking requirements, unless the agency certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities.[90] The Bureau also is subject to certain additional procedures under the RFA involving the convening of a panel to consult with small entity representatives prior to proposing a rule for which an IRFA is required.[91]

The undersigned certifies that the Proposed Rule, if adopted, would not have a significant economic impact on a substantial number of small entities and that an IRFA is therefore not required.

The Proposed Rule would define a class of international money transfer providers as larger participants of the international money transfer market and thereby authorize the Bureau to undertake supervisory activities with respect to those nonbanks. The Proposed Rule adopts a threshold for larger-participant status of one million aggregate annual international money transfers. Under what the Bureau believes is the most relevant SBA threshold, an international money transfer provider is a small business only if its annual receipts are below $19 million.[92] Of the approximately 25 potential larger participants identified by the Bureau among the California, New York, and Ohio licensees, the Bureau estimates there are approximately 10 providers with annual receipts under $19 million.[93]

According to the 2007 Economic Census, there are more than 5,000 small firms in the North American Industry Classification System (NAICS) industry the Bureau believes is applicable to most international money transfer providers.[94] Therefore, according to the Bureau's analysis, this rule would impact less than one percent of the small businesses in the industry.[95] For these reasons, the Proposed Rule would not have a significant impact on a substantial number of small entities.[96]

[88] 5 U.S.C. 601 *et seq.* The term '''small organization' means any not-for-profit enterprise which is independently owned and operated and is not dominant in its field, unless an agency establishes [an alternative definition after notice and comment].'' *Id.* at 601(4). The term '''small governmental jurisdiction' means governments of cities, counties, towns, townships, villages, school districts, or special districts, with a population of less than fifty thousand, unless an agency establishes [an alternative definition after notice and comment].'' *Id.* at 601(5). The Bureau is not aware of any small governmental units or small not-for-profit organizations to which the Proposed Rule would apply.

[89] 5 U.S.C. 601(3). The Bureau may establish an alternative definition after consultation with SBA and an opportunity for public comment.

[90] 5 U.S.C. 605(b).

[91] 5 U.S.C. 609.

[92] 13 CFR 121.201 (NAICS code 522390). The Bureau believes that larger participants in the proposed international money transfer market are likely to be classified in North American Industry Classification System (NAICS) code 522390, ''Other Activities Related to Credit Intermediation.'' NAICS lists ''[m]oney transmission services'' as an index entry corresponding to this code. *See http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=522390&search=2012NAICSSearch.* The Bureau welcomes comment on whether this or any other NAICS code is most appropriate for this market. The Bureau is aware that a nonbank larger participant of the proposed international money transfer market might be classified in a NAICS code other than the one that includes money transmission services. For example, some larger participants may be classified under NAICS code 522320 for financial transactions processing, reserve, and clearing house activities. NAICS lists ''[e]lectronic funds transfer services'' as an index entry corresponding to code 522320. *See http://www.census.gov/cgi-bin/sssd/naics/naicsrch?code=522320&search=2012.*

[93] The Bureau was able to access revenue figures of potential larger participants from New York's confidential licensing data as well as the Nationwide Mortgage Licensing System & Registry (NMLS), a centralized licensing database used by many States to manage their license authorities with respect to various consumer financial industries, including money transmitters. The NMLS provided the Bureau with information regarding specific entities pursuant to a memorandum of understanding. The revenue figures that the Bureau used did not include annual receipts of affiliates, as those terms are defined by the SBA. 13 CFR 121.104 (annual receipts); 13 CFR 121.103 (affiliation). As mentioned above, the Bureau identified 23 entities among the California, New York, and Ohio licensees that it believes would be larger participants under the Proposed Rule. 9 of these entities had less than $19 million in receipts according to information from the NMLS and confidential licensing data from New York. As explained above in the *Analysis of State Supervisory Data,* there are an additional 6 entities for which the Bureau was not able to estimate international money transfers because the data received include a significant amount of business-initiated transactions or include other transactions that are not likely to constitute international money transfers. The Bureau believes it is possible that some of these 6 entities would be larger participants. Of the 6 entities, the Bureau estimates that 1 has annual receipts under $19 million based on data from the NMLS and New York. Although there may be additional larger participants that the Bureau has not identified because they are not licensed in California, New York, or Ohio, it is unlikely that there are many more small entities that would be subject to the Proposed Rule because as explained above the Bureau's market research suggests that most entities that provide one million or more transfers per year are licensed in at least one of those three States.

[94] U.S. Census Bureau, 2007 Economic Census, American FactFinder, Finance and Insurance: Subject Series—Estab. and Firm Size: Summary Statistics by Revenue Size of Firms for the United States, *available at http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN_2007_US_52SSSZ4&prodType=table* (NAICS code 522390).

[95] The Bureau believes that this a conservative estimate for the most applicable NAICS code (522390) because the Bureau estimates that only about 10 larger participants licensed in California, New York, or Ohio would be small businesses, accounting for approximately 0.2 percent of the roughly 5,000 small firms within NAICS code 522390. Alternatively, the Bureau notes that the SBA's size standard for NAICS code 522320, ''Financial Transactions Processing, Reserve, and Clearing House Activities,'' is $35.5 million in annual receipts. 13 CFR 121.201 (NAICS code 522320). Using that size standard, the Bureau estimates that 12 of the 23 entities that the Bureau identified as potential larger participants among the California, New York, and Ohio licensees might be small businesses. Among the 6 additional entities mentioned above for which the Bureau could not estimate transaction amounts, the Bureau estimates that 2 would be small businesses under this standard based on receipts information from NMLS and New York. There could be additional small entities that are larger participants but were not included in the foregoing estimates because they are not licensed in California, New York, or Ohio, but as noted above it is unlikely that there would be many such entities. According to the 2007 Economic Census, there are at least 1,800 small firms classified under NAICS code 522320. U.S. Census Bureau, 2007 Economic Census, American FactFinder, Finance and Insurance: Subject Series—Estab. and Firm Size: Summary Statistics by Revenue Size of Firms for the United States, *available at http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ECN_2007_US_52SSSZ4&prodType=table* (NAICS code 522320). Therefore, under the Bureau's analysis, this Proposed Rule would impact less than 1 percent of the small businesses in the industry under that NAICS code.

[96] Because the Bureau has not assessed the affiliations of potential larger participants, the Bureau's estimate of small entity larger participants may include some larger participants that are not in fact small entities due to the receipts of their affiliates, which are counted towards an entity's annual receipts for purposes of assessing whether

Additionally, and in any event, the Bureau believes that the Proposed Rule would not result in a ''significant impact'' on any small entities that could be affected. The rule does not itself impose any business conduct obligations. As previously noted, when and how often the Bureau would in fact engage in supervisory activity, such as an examination, with respect to a larger participant (and, if so, the extent of such activity) would depend on a number of considerations, including the Bureau's allocation of resources and the application of the statutory factors set forth in 12 U.S.C. 5514(b)(2). Given the Bureau's finite supervisory resources, and the range of industries over which it has supervisory responsibility for consumer financial protection, when and how often a given international money transfer provider would be supervised is uncertain. Moreover, when supervisory activity occurred, the costs that would result from such activity are expected to be minimal in relation to the overall activities of an international money transfer provider.[97]

Finally, 12 U.S.C. 5514(e) authorizes the Bureau to supervise service providers to nonbank covered persons encompassed by 12 U.S.C. 5514(a)(1), which includes larger participants. Because the Proposed Rule would not address service providers, effects on service providers need not be discussed for purposes of this RFA analysis. Even were such effects relevant, the Bureau believes that it would be very unlikely that any supervisory activities with respect to the service providers to the approximately 25 larger participants of the proposed nonbank market for international money transfers would result in a significant economic impact on a substantial number of small entities.[98]

Accordingly, the undersigned certifies that the Proposed Rule would not have a significant economic impact on a substantial number of small entities.

VIII. Paperwork Reduction Act

The Bureau has determined that this Proposed Rule would not impose any new recordkeeping, reporting, or disclosure requirements on covered entities or members of the public that would constitute collections of information requiring approval under the Paperwork Reduction Act, 44 U.S.C. 3501, *et seq.*

List of Subjects in 12 CFR Part 1090

Consumer protection, Credit.

Authority and Issuance

For the reasons set forth in the preamble, the Bureau proposes to amend 12 CFR Part 1090, subpart B, to read as follows:

PART 1090—DEFINING LARGER PARTICIPANTS OF CERTAIN CONSUMER FINANCIAL PRODUCT AND SERVICE MARKETS

■ 1. The authority citation for part 1090 continues to read as follows:

Authority: 12 U.S.C. 5514(a)(1)(B); 12 U.S.C. 5514(a)(2); 12 U.S.C. 5514(b)(7)(A); and 12 U.S.C. 5512(b)(1).

■ 2. Add a new § 1090.107 to subpart B to read as follows:

§ 1090.107 International Money Transfer Market.

(a) *Market-related definitions.* As used in this subpart:

Aggregate annual international money transfers means the sum of the annual international money transfers of a nonbank covered person and the annual international money transfers of each of the nonbank covered person's affiliated companies.

(i) *Annual international money transfers.* Annual international money transfers of a nonbank covered person are calculated as follows:

(A) Annual international money transfers of a nonbank covered person that has been in business for three or more completed calendar years means the international money transfers provided by the nonbank covered person over its three most recently completed calendar years divided by three.

(B) Annual international money transfers of a nonbank covered person that has been in business for less than three completed calendar years means the international money transfers provided by the nonbank covered person for the period the nonbank covered person has been in business divided by the number of weeks the nonbank covered person has been in business, multiplied by 52.

(ii) *Agents.*

(A) Annual international money transfers of a nonbank covered person include international money transfers in which another person acts as an agent on behalf of the nonbank covered person.

(B) Annual international money transfers of a nonbank covered person do not include international money transfers in which another person provided the international money transfers and the nonbank covered person performed activities as an agent on behalf of that other person.

(C) For purposes of this paragraph (ii), agent means an agent or authorized delegate, as defined under State or other applicable law, or affiliated company of a person that provides international money transfers when such agent, authorized delegate, or affiliated company acts for that person.

(iii) *Aggregating the annual international money transfers of affiliated companies.*

(A) The annual international money transfers of each affiliated company of a nonbank covered person are calculated separately in accordance with paragraphs (i) and (ii) of this definition, treating the affiliated company as if it were an independent nonbank covered person for purposes of the calculation. This may result in using a different period of measurement to calculate an affiliated company's annual international money transfers. Thus, for example, if an affiliated company has been in business for a period of less than three years, the affiliated company's international money transfers are to be annualized in accordance with paragraph (i)(B) of this definition even if the nonbank covered

an entity is a small business concern under the SBA's definition. 13 CFR 121.104(d). Conversely, it is possible there are additional small firms that have less than one million annual international money transfers on their own, but that would meet the proposed threshold of one million transfers when their transfers are aggregated with their affiliated companies' transfers. However, the Bureau anticipates no more than a very few such cases, if any, in the international money transfer market.

[97] As discussed above, the Bureau estimates that the cost of participating in an examination would be approximately 0.18 percent of annual revenue from international money transfers for an entity at the threshold of 1 million aggregate annual international money transfers.

[98] The Bureau is aware that there are likely thousands of service providers to potential larger participants of the international money transfer market. Many of these service providers might be considered to be in the industry with NAICS code 522390 for other activities related to credit intermediation. As discussed above, according to the 2007 Economics Census, there are more than 5,000 small firms in the industry. Other service providers may be classified in NAICS code 522320 for financial transactions processing, reserve, and clearing house activities, which includes at least 1,800 small firms. Still other service providers, including many retail agents, are likely to be considered in other NAICS codes corresponding to the service provider's primary business activities. As noted above with respect to larger participants themselves, the frequency and duration of examinations that would be conducted at any particular service provider would depend on a variety of factors. However, it is implausible that in any given year the Bureau would conduct examinations of a substantial number of the more than 5,000 small firms in NAICS code 522390, the more than 1,800 small firms in NAICS code 522320, or the small firm service providers that happen to be in any other NAICS code. Moreover, the impact of supervisory activities, including examinations, at such small firm service providers can be expected to be less, given the Bureau's exercise of its discretion in supervision, than at the larger participants themselves.

person with which it is affiliated has been in business for three or more completed calendar years.

(B) The annual international money transfers of a nonbank covered person and the annual international money transfers of its affiliated companies are aggregated as follows:

(1) If a nonbank covered person has acquired an affiliated company or been acquired by an affiliated company during the applicable period of measurement, the annual international money transfers of the nonbank covered person and the affiliated company are aggregated for the entire period of measurement (not just the period after the affiliation arose).

(2) The annual international money transfers of a formerly affiliated company are not included if affiliation ceased before the applicable period of measurement as set forth in paragraph (i) of this definition. The annual international money transfers of a formerly affiliated company are aggregated for the entire period of measurement if affiliation ceased during the applicable period of measurement as set forth in paragraph (i) of this definition.

Designated recipient means any person specified by the sender as the authorized recipient of an international money transfer to be received at a location in a foreign country.

International money transfer means the electronic transfer of funds requested by a sender to a designated recipient that is sent by an international money transfer provider. The term applies regardless of whether the sender holds an account with the international money transfer provider, and regardless of whether the transaction is also an electronic fund transfer, as defined in § 1005.3(b) of this Title. The term does not include any transfer that is excluded from the definition of ''electronic fund transfer'' under § 1005.3(c)(4) of this Title.

International money transfer provider means any nonbank covered person that provides international money transfers for a consumer, regardless of whether the consumer holds an account with such person.

Sender means a consumer in a State who primarily for personal, family, or household purposes requests an international money transfer provider to send an international money transfer to a designated recipient.

State means any State, territory, or possession of the United States; the District of Columbia; the Commonwealth of Puerto Rico; or any political subdivision thereof.

(b) *Test to define larger participants.* A nonbank covered person is a larger participant of the international money transfer market if the nonbank covered person has at least one million aggregate annual international money transfers.

Dated: January 23, 2014.

Richard Cordray,

Director, Bureau of Consumer Financial Protection.

[FR Doc. 2014–01606 Filed 1–30–14; 8:45 am]

BILLING CODE 4810–AM–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Chapter 1

[Docket No. FAA–2013–0988]

Policy and Procedures Concerning the Use of Airport Revenue; Proceeds From Taxes on Aviation Fuel

AGENCY: Federal Aviation Administration (FAA) DOT.

ACTION: Notice of proposed clarification of policy; Extension of comment period.

SUMMARY: In order to provide the public additional time to submit comments on the proposed Policy, the Federal Aviation Administration (''FAA'') is extending the public comment period for thirty days. This action proposes to amend the FAA Policy and Procedures Concerning the Use of Airport Revenue published in the **Federal Register** at 64 FR 7696 on February 16, 1999 (''Revenue Use Policy'') to clarify FAA's policy on Federal requirements for the use of proceeds from taxes on aviation fuel. Under Federal law, airport operators that have accepted Federal assistance generally may use airport revenues only for airport-related purposes. The revenue use requirements apply to certain state and local government taxes on aviation fuel as well as to revenues received directly by an airport operator. This notice publishes a proposed clarification of FAA's understanding of the Federal requirements for use of revenues derived from taxes on aviation fuel. Briefly, an airport operator or state government submitting an application under the Airport Improvement Program must provide assurance that revenues from state and local government taxes on aviation fuel are used for certain aviation-related purposes. These purposes include airport capital and operating costs, and state aviation programs. In view of the interests of sellers and consumers of aviation fuel, and of state and local government taxing authorities in limits on use of proceeds from taxes touching aviation fuel, this notice solicits public comment on the proposed policy clarification. This notice also solicits comments about whether there are other reasonable interpretations regarding local taxes that are not enumerated here and should be considered by the FAA. Finally, this proposed policy clarification, if finalized, would apply prospectively to use of proceeds from both new taxes and to existing taxes that do not qualify for grandfathering from revenue use requirements.

DATES: Comments period for the Notice published on November 21, 2013, at 78 FR 69789 and closed on January 21, 2014 is extended to March 3, 2014. Comments that are received after that date will be considered only to the extent possible.

ADDRESSES: To read background documents or comments received, go to *http://www.regulations.gov* at any time or to Room W12–140 on the ground floor of the DOT West Building, 1200 New Jersey Avenue SE., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

You may also send written comments by any of the following methods.

- *Federal eRulemaking Portal:* Go to *http://www.regulations.gov* and follow the instructions for sending your comments electronically. Docket Number: FAA 2013–0988.
- *Mail:* Docket Management Facility, U.S. Department of Transportation, 1200 New Jersey Avenue SE., West Building Ground Floor, Room W12–140, Washington DC 20590–0001.
- *Hand Delivery:* Deliver to mail address above between 9:00 a.m. and 5 p.m. EST, Monday through Friday, except Federal holidays.
- *Fax:* (202) 493–2251

Identify all transmission with ''Docket Number FAA 2013–0988'' at the beginning of the document.

FOR FURTHER INFORMATION CONTACT: Randall S. Fiertz, Director, Office of Airport Compliance and Management Analysis, Federal Aviation Administration, 800 Independence Avenue SW., Washington, DC 20591, telephone (202) 267–3085; facsimile (202) 267–5257.

SUPPLEMENTARY INFORMATION:

Authority for the Proposed Policy Clarification

This notice is published under the authority described in Subtitle VII, part B, chapter 471, section 47122, and the Federal Aviation Administration Authorization Act of 1994, § 112(a),

Pub. L. 103–305, 49 U.S.C. § 47107(l)(1) (Aug. 23, 1994).

Issued in Washington, DC, on January 17, 2014.

Randall S. Fiertz,

Director, Office of Airport Compliance and Management Analysis.

[FR Doc. 2014–02033 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2014–0041; Directorate Identifier 2013–CE–053–AD]

RIN 2120–AA64

Airworthiness Directives; Ballonbau Wörner GmbH Balloons

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: We propose to adopt a new airworthiness directive (AD) for Ballonbau Wörner GmbH Models NL–280/STU, NL–380/STU, NL–510/STU, NL–640/STU, NL–840/STU, and NL–1000/STU balloons. This proposed AD results from mandatory continuing airworthiness information (MCAI) originated by an aviation authority of another country to identify and correct an unsafe condition on an aviation product. The MCAI describes the unsafe condition as current inspection intervals are no longer adequate to ensure timely detection of deterioration or damage. We are issuing this proposed AD to require actions to address the unsafe condition on these products.

DATES: We must receive comments on this proposed AD by March 17, 2014.

ADDRESSES: You may send comments by any of the following methods:

- *Federal eRulemaking Portal:* Go to *http://www.regulations.gov.* Follow the instructions for submitting comments.
- *Fax:* (202) 493–2251.
- *Mail:* U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.
- *Hand Delivery:* U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

For service information identified in this proposed AD, contact Ballonbau Wörner GmbH, Zirbelstrasse 57c, D–86154 Augsburg, Germany; telephone: +49 821 4504060; fax: +49 821 419641; Internet: *www.ballonbau.de.* You may review this referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2014–0041; or in person at the Docket Management Facility between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this proposed AD, the regulatory evaluation, any comments received, and other information. The street address for the Docket Office (telephone (800) 647–5527) is in the **ADDRESSES** section. Comments will be available in the AD docket shortly after receipt.

FOR FURTHER INFORMATION CONTACT: Karl Schletzbaum, Aerospace Engineer, FAA, Small Airplane Directorate, 901 Locust, Room 301, Kansas City, Missouri 64106; telephone: (816) 329–4123; fax: (816) 329–4090; email: *karl.schletzbaum@faa.gov.*

SUPPLEMENTARY INFORMATION:

Comments Invited

We invite you to send any written relevant data, views, or arguments about this proposed AD. Send your comments to an address listed under the **ADDRESSES** section. Include ''Docket No. FAA–2014–0041; Directorate Identifier 2013–CE–053–AD'' at the beginning of your comments. We specifically invite comments on the overall regulatory, economic, environmental, and energy aspects of this proposed AD. We will consider all comments received by the closing date and may amend this proposed AD because of those comments.

We will post all comments we receive, without change, to *http://regulations.gov,* including any personal information you provide. We will also post a report summarizing each substantive verbal contact we receive about this proposed AD.

Discussion

The European Aviation Safety Agency (EASA), which is the Technical Agent for the Member States of the European Community, has issued AD No.: 2013–0293R1, dated December 17, 2013 (referred to after this as ''the MCAI''), to correct an unsafe condition for Ballonbau Wörner GmbH Models NL–280/STU, NL–380/STU, NL–510/STU, NL–640/STU, NL–840/STU, and NL–1000/STU balloons. The MCAI states:

> The results of an analysis of NL–STU maintenance data revealed that the current inspection intervals are no longer adequate to ensure timely detection of deterioration or damage, which could affected the structural integrity of the balloon.
>
> This condition, if not detected and corrected, could lead to failure of balloon components or envelope, possibly resulting in loss of the balloon.
>
> To address this potential unsafe condition, Ballonbau Wörner developed new, more detailed and descriptive Instructions for Continued Airworthiness (at the same time separated from the Flight Manual) and issued Technische Mitteilung/Technical Note EASA.BA.009–6 to inform all operators.
>
> For the reasons described above, EASA issued AD 2013–0293 to require compliance with the updated Instructions for Continued Airworthiness. This AD is revised to extend the compliance time for the initial porosity test, for balloons which have already exceeded the relevant threshold.

You may examine the MCAI on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2014–0041.

Relevant Service Information

Ballonbau Wörner GmbH has issued Technische Mitteilung (English translation: Technical Note) Ballonbau Wörner GmbH EASA.BA.009–6, dated November 7, 2013; and Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013. The actions described in this service information are intended to correct the unsafe condition identified in the MCAI.

FAA's Determination and Requirements of the Proposed AD

This product has been approved by the aviation authority of another country, and is approved for operation in the United States. Pursuant to our bilateral agreement with this State of Design Authority, they have notified us of the unsafe condition described in the MCAI and service information referenced above. We are proposing this AD because we evaluated all information and determined the unsafe condition exists and is likely to exist or develop on other products of the same type design.

Costs of Compliance

We estimate that this proposed AD will affect 6 products of U.S. registry.

The scope of the proposed inspections may vary depending on the condition of the balloon. We have no way of knowing how extensive an inspection may be necessary for each balloon. The scope of damage found in the proposed inspections could vary significantly from balloon to balloon. We have no way of determining how much damage may be found on each balloon or the cost to repair damaged parts on each balloon or the number of balloons that may require repair.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. ''Subtitle VII: Aviation Programs,'' describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in ''Subtitle VII, Part A, Subpart III, Section 44701: General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We determined that this proposed AD would not have federalism implications under Executive Order 13132. This proposed AD would not have a substantial direct effect on the States, on the relationship between the national Government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify this proposed regulation:

(1) Is not a ''significant regulatory action'' under Executive Order 12866,

(2) Is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979),

(3) Will not affect intrastate aviation in Alaska, and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new AD:

Ballonbau Worner GmbH: Docket No. FAA–2014–0041; Directorate Identifier 2013–CE–053–AD.

(a) Comments Due Date

We must receive comments by March 17, 2014.

(b) Affected ADs

None.

(c) Applicability

This AD applies to Ballonbau Wörner GmbH Model NL–280/STU, NL–380/STU, NL–510/STU, NL–640/STU, NL–840/STU, and NL–1000/STU balloons, all serial numbers, certificated in any category.

(d) Subject

Air Transport Association of America (ATA) Code 5: Time Limits.

(e) Reason

This AD was prompted by mandatory continuing airworthiness information (MCAI) originated by an aviation authority of another country to identify and correct an unsafe condition on an aviation product. The MCAI describes the unsafe condition as current inspection intervals are no longer adequate to ensure timely detection of deterioration or damage. If this condition is uncorrected, it could result in reduced structural integrity of the balloon.

(f) Actions and Compliance

Unless already done, do the actions in paragraphs (f)(1) through (f)(4) of this AD:

(1) Before further flight after the effective date of this AD, complete all inspections and maintenance tasks described in the Chapter 5, Annual Inspection, in the Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013.

(2) If any discrepancies are found during the inspection required in paragraph (f)(1) of this AD, before further flight, repair as applicable following Chapter 6, Standard Repair Procedures, in the Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013.

(3) If on the effective date of this AD, a balloon has already exceeded the threshold compliance time for the porosity test as defined in Sections 5.1.1.4, 5.1.2.4 and 5.1.3.4 of Chapter 5 in Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013, within 3 months after the effective date of this AD, conduct the porosity test following Sections 5.1.1.4, 5.1.2.4 and 5.1.3.4 of Chapter 5 in Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013.

(4) After the effective date of this AD, do all inspections and necessary repairs following Technische Mitteilung (English translation: Technical Note) Ballonbau Wörner GmbH EASA.BA.009–6, dated November 7, 2013; and Ballonbau Wörner GmbH Instructions for Continued Airworthiness, Gas Balloon Model NL–STU, Issue 1, dated November 2013.

Note 1 to paragraph (f) of this AD: Pilots may only accomplish preventative maintenance limited to those items identified in 14 CFR Part 43, Appendix A.

(g) Other FAA AD Provisions

The following provisions also apply to this AD:

(1) *Alternative Methods of Compliance (AMOCs):* The Manager, Standards Office, FAA, has the authority to approve AMOCs for this AD, if requested using the procedures found in 14 CFR 39.19. Send information to ATTN: Karl Schletzbaum, Aerospace Engineer, FAA, Small Airplane Directorate, 901 Locust, Room 301, Kansas City, Missouri 64106; telephone: (816) 329–4123; fax: (816) 329–4090; email: *karl.schletzbaum@faa.gov.* Before using any approved AMOC on any airplane to which the AMOC applies, notify your appropriate principal inspector (PI) in the FAA Flight Standards District Office (FSDO), or lacking a PI, your local FSDO.

(2) *Airworthy Product:* For any requirement in this AD to obtain corrective actions from a manufacturer or other source, use these actions if they are FAA-approved. Corrective actions are considered FAA-approved if they are approved by the State of Design Authority (or their delegated agent). You are required to assure the product is airworthy before it is returned to service.

(h) Related Information

Refer to MCAI European Aviation Safety Agency (EASA) AD No.: 2013–0293R1, dated December 17, 2013, for related information. You may examine the MCAI on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2014–0041. For service information related to this AD, contact Ballonbau Wörner GmbH, Zirbelstrasse 57c, D–86154 Augsburg, Germany; telephone: +49 821 4504060; fax: +49 821 419641; Internet: *www.ballonbau.de.* You may review this referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

Issued in Kansas City, Missouri, on January 23, 2014.

Earl Lawrence,

Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 2014–01950 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2014–0038; Directorate Identifier 2013–SW–023–AD]

RIN 2120–AA64

Airworthiness Directives; Airbus Helicopters (Type Certificate Previously Held by Eurocopter France)

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: We propose to adopt a new airworthiness directive (AD) for Airbus Model EC225LP helicopters. This proposed AD would require repetitive visual and tap test inspections of each main rotor blade (blade) leading edge stainless steel protective strip (strip) for a crack, cut, or blind or open debonding (debonding), and taking approved corrective measures. If there is a crack or if there is debonding that exceeds acceptable limits, this AD would require, before further flight, repairing or replacing the blade with an airworthy part. This proposed AD is prompted by suspected water seepage through a crack in the blade strip resulting in significant debonding. The proposed actions are intended to prevent loss of the blade strip, excessive vibrations induced by blade weight imbalance, and subsequent loss of control of the helicopter.

DATES: We must receive comments on this proposed AD by April 1, 2014.

ADDRESSES: You may send comments by any of the following methods:

- *Federal eRulemaking Docket:* Go to *http://www.regulations.gov.* Follow the online instructions for sending your comments electronically.
- *Fax:* 202–493–2251.
- *Mail:* Send comments to the U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590–0001.
- *Hand Delivery:* Deliver to the ''Mail'' address between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this proposed AD, the foreign authority's AD, the economic evaluation, any comments received, and other information. The street address for the Docket Operations Office (telephone 800–647–5527) is in the **ADDRESSES** section. Comments will be available in the AD docket shortly after receipt.

For service information identified in this proposed AD, contact Airbus Helicopters, Inc., 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.airbushelicopters.com/techpub.* You may review the referenced service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

FOR FURTHER INFORMATION CONTACT: Gary Roach, Aviation Safety Engineer, Regulations and Policy Group, Rotorcraft Directorate, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone (817) 222–5110; email *gary.b.roach@faa.gov.*

SUPPLEMENTARY INFORMATION:

Comments Invited

We invite you to participate in this rulemaking by submitting written comments, data, or views. We also invite comments relating to the economic, environmental, energy, or federalism impacts that might result from adopting the proposals in this document. The most helpful comments reference a specific portion of the proposal, explain the reason for any recommended change, and include supporting data. To ensure the docket does not contain duplicate comments, commenters should send only one copy of written comments, or if comments are filed electronically, commenters should submit only one time.

We will file in the docket all comments that we receive, as well as a report summarizing each substantive public contact with FAA personnel concerning this proposed rulemaking. Before acting on this proposal, we will consider all comments we receive on or before the closing date for comments. We will consider comments filed after the comment period has closed if it is possible to do so without incurring expense or delay. We may change this proposal in light of the comments we receive.

Discussion

The European Aviation Safety Agency (EASA), which is the Technical Agent for the Member States of the European Union, issued EASA AD No. 2013–0103, dated May 2, 2013, which supersedes EASA AD No. 2007–0180–E, dated June 29, 2007, to correct an unsafe condition for the Eurocopter Model EC225LP helicopters with certain blades installed. EASA advises that an investigation of significant debonding of a blade strip revealed rapidly progressing debonding caused by water seepage through a crack in the blade strip. EASA AD No. 2007–0180–E required repetitive inspections of the blade strip and accomplishing any corrective actions. After issuance of EASA AD No. 2007–0180–E, Eurocopter developed a modified strip and re-identified blade part numbers with the modified strip. Because these other blades with the modified strip are still susceptible to debonding, EASA issued superseding AD 2013–0103 to extend the applicability to the new part-numbered blades.

FAA's Determination

This helicopter has been approved by the aviation authority of France and is approved for operation in the United States. Pursuant to our bilateral agreement with France, EASA, its technical representative, has notified us of the unsafe condition described in the EASA AD. We are proposing this AD because we evaluated all known relevant information and determined that an unsafe condition is likely to exist or develop on other helicopters of the same type design.

Related Service Information

Eurocopter issued an Emergency Alert Service Bulletin (EASB) No. 05A010, Revision 2, dated April 22, 2013, for the Model EC225LP helicopter and for the non-FAA typed certificated Model EC725AP military helicopter. The EASB specifies a visual check and tapping test of the bonding of the strip on the leading edge of the blades for cracks, cuts, and debonding and taking corrective actions as applicable. Revision 1 to the EASB changed the visual check and the tapping test so that they can be performed without removing the blades. Revision 2 extended the applicability to additional part-numbered blades with a modified strip installed.

Proposed AD Requirements

This proposed AD would require:

- Within 15 hours time-in-service (TIS) and thereafter at intervals not to exceed 85 hours TIS, visually and tap

test inspecting each blade strip for a crack, a cut, or open or blind debonding. For purposes of this proposed AD, open debonding, also known as edge bond separation, occurs when a bonded part becomes unattached (debonded) leaving the surface under it exposed to open air around the periphery of the part. Blind debonding occurs when a bonded part becomes unattached internally yet remains bonded around its entire periphery.

- If there is debonding beyond acceptable limits or located outside a specific area, or if there is a crack, before further flight, repairing or replacing the blade.
- If there is a cut in the blade root polyurethane protective strip, tap test inspecting the area. If there is no debonding, tap test inspecting the blade strip every 15 hours TIS. If there is debonding beyond acceptable limits or located outside a specific area, before further flight, repairing or replacing the blade.

Differences Between This Proposed AD and the EASA AD

If there is a crack in the blade leading edge, this proposed AD would require repairing or replacing the blade before further flight, while the EASA AD permits a re-inspection within 15 hours TIS.

Costs of Compliance

We estimate that this proposed AD would affect 4 helicopters of U.S. Registry. We estimate that operators may incur the following costs in order to comply with this AD. Labor costs are estimated at $85 per work hour. We estimate 4 work hours to inspect the helicopter for a total of $340 per helicopter and $1,360 for the U.S. operator fleet per inspection cycle. If necessary, it would take 4 work hours to repair the blade and $600 for required parts for a total of $940 per helicopter. It would take about 5 work hours to replace a blade at a cost of $425 for labor. Parts would cost $315,495 to replace P/N 332A11–0050–01 and $403,650 to replace P/N 332A11–0055–00, for a total cost of $315,920 and $404,075, respectively.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. ''Subtitle VII: Aviation Programs,'' describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in ''Subtitle VII, Part A, Subpart III, Section 44701: General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We determined that this proposed AD would not have federalism implications under Executive Order 13132. This proposed AD would not have a substantial direct effect on the States, on the relationship between the national Government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed, I certify this proposed regulation:

1. Is not a ''significant regulatory action'' under Executive Order 12866;
2. Is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);
3. Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and
4. Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this proposed AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

Airbus Helicopters (Type Certificate previously held by Eurocopter France): Docket No. FAA–2014–0038; Directorate Identifier 2013–SW–023–AD.

(a) Applicability

This AD applies to Model EC225LP helicopters with a main rotor blade (blade), part number (P/N) 332A11.0050.00, 332A11.0055.00, 332A11.0050.02, or 332A11.0055.02, installed, certificated in any category.

(b) Unsafe Condition

This AD defines the unsafe condition as loss of a blade stainless steel protective strip (strip), which could result in excessive vibrations induced by blade weight imbalance and subsequent loss of control of the helicopter.

(c) Comments Due Date

We must receive comments by April 1, 2014.

(d) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(e) Required Actions

Within 15 hours time-in-service (TIS) and thereafter at intervals not to exceed 85 hours TIS, visually and tap test inspect each blade strip for a crack, a cut, or open and blind debonding. For purposes of this AD, open debonding, also known as edge bond separation, occurs when a bonded part becomes unattached (debonded) leaving the surface under it exposed to open air around the periphery of the part. Blind debonding occurs when a bonded part becomes unattached internally yet remains bonded around its entire periphery.

(1) If there is open or blind debonding within acceptable limits and the debonded area is located inside Area D of Figure 1 of Eurocopter Emergency Alert Service Bulletin No. 05A010, Revision 2, dated April 22, 2013 (EASB), no further action is required until the next inspection.

(2) If there is open or blind debonding and the debonded area is located outside Area D of Figure 1 of the EASB, before further flight, repair or replace the blade.

(3) If there is open or blind debonding beyond acceptable limits, before further flight, repair or replace the blade.

(4) If there is a cut in the blade root polyurethane protective strip as depicted in Area A of Figure 2 of the EASB, tap test inspect the area.

(i) If there is no open and blind debonding, at intervals not to exceed 15 hours TIS, tap test inspect the blade strip in the blade root area, in the stainless steel leading edge/neoprene junction area for open or blind debonding.

(ii) If there is open or blind debonding within acceptable limits and the debonded area is located inside Area D of Figure 1 of the EASB, no further action is required until the next inspection.

(iii) If there is open or blind and the debonded area is located outside Area D of Figure 1 of the EASB, before further flight, repair or replace the blade.

(iv) If there is open or blind debonding beyond acceptable limits, before further flight, repair or replace the blade.

(5) If there is a crack, before further flight, repair or replace the blade.

(f) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Gary Roach, Aviation Safety Engineer, Regulations and Policy Group, Rotorcraft Directorate, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone (817) 222–5110; email *gary.b.roach@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office, before operating any aircraft complying with this AD through an AMOC.

(g) Additional Information

The subject of this AD is addressed in European Aviation Safety Agency (EASA) AD No. 2013–0103, dated May 2, 2013. You may view the EASA AD on the Internet in the AD Docket at *www.regulations.gov.*

(h) Subject

Joint Aircraft Service Component (JASC) Code: 6210 Main Rotor Blades.

Issued in Fort Worth, Texas, on January 16, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01951 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2014–0042; Directorate Identifier 2013–CE–050–AD]

RIN 2120–AA64

Airworthiness Directives; British Aerospace Regional Aircraft Airplanes

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: We propose to adopt a new airworthiness directive (AD) for British Aerospace Regional Aircraft Jetstream Series 3101 and Jetstream Model 3201 airplanes. This proposed AD results from mandatory continuing airworthiness information (MCAI) originated by an aviation authority of another country to identify and correct an unsafe condition on an aviation product. The MCAI describes the unsafe condition as inadequate instructions for inspection for corrosion on the rudder upper hinge bracket and certain internal wing and drainage paths. We are issuing this proposed AD to require actions to address the unsafe condition on these products.

DATES: We must receive comments on this proposed AD by March 17, 2014.

ADDRESSES: You may send comments by any of the following methods:

- *Federal eRulemaking Portal:* Go to *http://www.regulations.gov.* Follow the instructions for submitting comments.
- *Fax:* (202) 493–2251.
- *Mail:* U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590.
- *Hand Delivery:* U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

For service information identified in this proposed AD, contact BAE Systems (Operations) Limited, Customer Information Department, Prestwick International Airport, Ayrshire, KA9 2RW, Scotland, United Kingdom; telephone: +44 1292 675207; fax: +44 1292 675704; email: *RApublications@baesystems.com*; Internet: *http://www.baesystems.com/Businesses/RegionalAircraft/*. You may review this referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* by searching for and locating Docket No. FAA–2014–0042; or in person at the Docket Management Facility between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this proposed AD, the regulatory evaluation, any comments received, and other information. The street address for the Docket Office (telephone (800) 647–5527) is in the **ADDRESSES** section. Comments will be available in the AD docket shortly after receipt.

FOR FURTHER INFORMATION CONTACT: Taylor Martin, Aerospace Engineer, FAA, Small Airplane Directorate, 901 Locust, Room 301, Kansas City, Missouri 64106; telephone: (816) 329–4138; fax: (816) 329–4090; email: *taylor.martin@faa.gov.*

SUPPLEMENTARY INFORMATION:

Comments Invited

We invite you to send any written relevant data, views, or arguments about this proposed AD. Send your comments to an address listed under the **ADDRESSES** section. Include ''Docket No. FAA–2014–0042; Directorate Identifier 2013–CE–050–AD'' at the beginning of your comments. We specifically invite comments on the overall regulatory, economic, environmental, and energy aspects of this proposed AD. We will consider all comments received by the closing date and may amend this proposed AD because of those comments.

We will post all comments we receive, without change, to *http://regulations.gov,* including any personal information you provide. We will also post a report summarizing each substantive verbal contact we receive about this proposed AD.

Discussion

The European Aviation Safety Agency (EASA), which is the Technical Agent for the Member States of the European Community, has issued AD No.: 2012–0036, dated March 12, 2012 (referred to after this as ''the MCAI''), to correct an unsafe condition for British Aerospace Regional Aircraft Jetstream Series 3101 and Jetstream Model 3201 airplanes. The MCAI states:

> Compliance with the inspections in the Corrosion Prevention and Control Programme (CPCP) has been identified as a mandatory action for continued airworthiness and UK CAA AD 003–04–94 was issued to require operators to comply with those inspection instructions.
>
> Since the issuance of that AD, reports have been received of finding extensive corrosion on the rudder upper hinge bracket. Although there is an existing zonal inspection of the area in the CPCP, it has been concluded that this is inadequate to identify the corrosion on this bracket and consequently, a new specific inspection of the rudder upper hinge bracket, task 200/EX/01 C2, has been added to the CPCP, currently at Revision 6. Failure of the rudder upper hinge bracket could lead to the onset of flutter and loss of control of the aeroplane.
>
> In addition, although the CPCP already included a wing internal inspection to check for corrosion and to verify that all drainage paths are clear, prompted by feedback from the fleet sampling programme, a new, more specific, inspection of wing stations 36, 51 and 83, together with a check of the drainage paths, has been introduced into the CPCP through task 3/400/IN/01 C2. Failure to comply with these instructions could result in an unsafe condition.

For the reasons described above, this AD retains the requirements of UK CAA AD 003–04–94, which is superseded, and requires the implementation of the new inspections.

You may examine the MCAI on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2014–0042.

Relevant Service Information

BAE Systems (Operations) Limited has issued British Aerospace Jetstream Series 3100 & 3200 Corrosion Prevention and Control Programme, Manual Ref: JS/CPCP/01, Revision 6, dated November 15, 2010. The actions described in this service information are intended to correct the unsafe condition identified in the MCAI.

FAA's Determination and Requirements of the Proposed AD

This product has been approved by the aviation authority of another country, and is approved for operation in the United States. Pursuant to our bilateral agreement with this State of Design Authority, they have notified us of the unsafe condition described in the MCAI and service information referenced above. We are proposing this AD because we evaluated all information and determined the unsafe condition exists and is likely to exist or develop on other products of the same type design.

Costs of Compliance

We estimate that this proposed AD will affect 66 products of U.S. registry. We also estimate that it would take about 100 work-hours per product to comply with the basic requirements of this proposed AD. The average labor rate is $85 per work-hour.

Based on these figures, we estimate the cost of the proposed AD on U.S. operators to be $561,000, or $ 8,500 per product.

The scope of damage found in the required inspection could vary significantly from airplane to airplane. We have no way of determining how much damage may be found on each airplane or the cost to repair damaged parts on each airplane or the number of airplanes that may require repair.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. ''Subtitle VII: Aviation Programs,'' describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in ''Subtitle VII, Part A, Subpart III, Section 44701: General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We determined that this proposed AD would not have federalism implications under Executive Order 13132. This proposed AD would not have a substantial direct effect on the States, on the relationship between the national Government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed above, I certify this proposed regulation:

(1) Is not a ''significant regulatory action'' under Executive Order 12866,

(2) Is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979),

(3) Will not affect intrastate aviation in Alaska, and

(4) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new AD:

British Aerospace Regional Aircraft: Docket No. FAA–2014–0042; Directorate Identifier 2013–CE–050–AD.

(a) Comments Due Date

We must receive comments by March 17, 2014.

(b) Affected ADs

None.

(c) Applicability

This AD applies to British Aerospace Regional Aircraft Jetstream Series 3101 and Model 3201 airplanes, all serial numbers, certificated in any category.

(d) Subject

Air Transport Association of America (ATA) Code 5: Time Limits.

(e) Reason

This AD was prompted by mandatory continuing airworthiness information (MCAI) originated by an aviation authority of another country to identify and correct an unsafe condition on an aviation product. The MCAI describes the unsafe condition as inadequate instructions for inspection for corrosion on the rudder upper hinge bracket and certain internal wing stations and drainage paths. We are issuing this AD to prevent, detect, and correct corrosion on the rudder upper hinge bracket and internal wing, which could lead to reduced structural integrity of the airplane with consequent loss of control.

(f) Actions and Compliance

Comply with this AD within the compliance times specified in paragraphs (f)(1) through (f)(4) of this AD, including all subparagraphs, unless already done:

(1) After the effective date of this AD, except as required by paragraph (f)(2) of this AD, within the thresholds and intervals specified, incorporate into the FAA-approved maintenance program BAE Systems (Operations) Limited Jetstream Series 3100 & 3200 Corrosion Prevention and Control Programme, Manual Ref. JS/CPCP/01, Revision 6, dated November 15, 2010, in its entirety.

(2) Within 2 years after the effective date of this AD, do the initial inspections specified in tasks 200/EX/01 C2 and 3/400/IN/01 C2 in BAE Systems (Operations) Limited Jetstream Series 3100 & 3200 Corrosion Prevention and Control Programme, Manual Ref. JS/CPCP/01, Revision 6, dated November 15, 2010.

(3) If any discrepancy, particularly corrosion, is found during any inspections or tasks required by paragraphs (f)(1) and (f)(2) of this AD, within the compliance time specified, repair or replace, as applicable, all damaged structural parts and components and do the maintenance procedures for corrective action following BAE Systems (Operations) Limited Jetstream Series 3100 & 3200 Corrosion Prevention and Control Programme, Manual Ref. JS/CPCP/01, Revision 6, dated November 15, 2010. If no compliance time is defined, do the applicable corrective action before further flight.

(4) You may comply with the requirements of paragraphs (f)(1) and (f)(2) of this AD by incorporating BAE Systems (Operations) Limited Jetstream Series 3100 & 3200 Corrosion Prevention and Control Programme, Manual Ref. JS/CPCP/01, Revision 6, dated November 15, 2010, into your maintenance program (instructions for continued airworthiness) and complying with that program.

(g) Other FAA AD Provisions

The following provisions also apply to this AD:

(1) *Alternative Methods of Compliance (AMOCs):* The Manager, Standards Office, FAA, has the authority to approve AMOCs for this AD, if requested using the procedures found in 14 CFR 39.19. Send information to ATTN: Taylor Martin, Aerospace Engineer, FAA, Small Airplane Directorate, 901 Locust, Room 301, Kansas City, Missouri 64106; telephone: (816) 329–4138; fax: (816) 329–4090; email: *taylor.martin@faa.gov.* Before using any approved AMOC on any airplane to which the AMOC applies, notify your appropriate principal inspector (PI) in the FAA Flight Standards District Office (FSDO), or lacking a PI, your local FSDO.

(2) *Airworthy Product:* For any requirement in this AD to obtain corrective actions from a manufacturer or other source, use these actions if they are FAA-approved. Corrective actions are considered FAA-approved if they are approved by the State of Design Authority (or their delegated agent). You are required to assure the product is airworthy before it is returned to service.

(3) *Reporting Requirements:* For any reporting requirement in this AD, a federal agency may not conduct or sponsor, and a person is not required to respond to, nor shall a person be subject to a penalty for failure to comply with a collection of information subject to the requirements of the Paperwork Reduction Act unless that collection of information displays a current valid OMB Control Number. The OMB Control Number for this information collection is 2120–0056. Public reporting for this collection of information is estimated to be approximately 5 minutes per response, including the time for reviewing instructions, completing and reviewing the collection of information. All responses to this collection of information are mandatory. Comments concerning the accuracy of this burden and suggestions for reducing the burden should be directed to the FAA at: 800 Independence Ave. SW., Washington, DC 20591, Attn: Information Collection Clearance Officer, AES–200.

(h) Related Information

MCAI European Aviation Safety Agency (EASA) AD No.: 2012–0036, dated March 12, 2012, for related information. You may examine the MCAI on the Internet at *http://www.regulations.gov* by searching for and locating it in Docket No. FAA–2014–0042. For service information related to this AD, contact BAE Systems (Operations) Limited, Customer Information Department, Prestwick International Airport, Ayrshire, KA9 2RW, Scotland, United Kingdom; telephone: +44 1292 675207; fax: +44 1292 675704; email: *RApublications@baesystems.com;* Internet: *http://www.baesystems.com/Businesses/RegionalAircraft/.* You may review this referenced service information at the FAA, Small Airplane Directorate, 901 Locust, Kansas City, Missouri 64106. For information on the availability of this material at the FAA, call (816) 329–4148.

Issued in Kansas City, Missouri, on January 23, 2014.

Earl Lawrence,

Manager, Small Airplane Directorate, Aircraft Certification Service.

[FR Doc. 2014–01949 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. FAA–2014–0034; Directorate Identifier 2013–SW–006–AD]

RIN 2120–AA64

Airworthiness Directives; Eurocopter Deutschland GmbH Helicopters

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: We propose to supersede Airworthiness Directive (AD) 2012–10–53 for Eurocopter Deutschland GmbH (ECD) Model EC135P1, EC135P2, EC135P2+, EC135T1, EC135T2, and EC135T2+ helicopters. AD 2012–10–53 currently requires, before further flight and at specified intervals, checking and inspecting the upper and lower main rotor hub (MRH) shaft flanges for a crack, and inspecting the lower hub-shaft flange bolt attachment areas for a crack. Since we issued AD 2012–10–53, it has been determined that it is safe to increase the visual inspection intervals of the MRH shaft flanges from 10 hours time-in-service (TIS) to 50 hours TIS and remove the inspection of the lower MRH shaft flange bolt attachment areas. This proposed AD would continue to require checking and inspecting the upper and lower MRH shaft flanges for a crack. The proposed actions are intended to detect a crack on the MRH shaft flange, which if not corrected, could result in failure of the MRH and subsequent loss of control of the helicopter.

DATES: We must receive comments on this proposed AD by April 1, 2014.

ADDRESSES: You may send comments by any of the following methods:

- *Federal eRulemaking Docket:* Go to *http://www.regulations.gov.* Follow the online instructions for sending your comments electronically.
- *Fax:* 202–493–2251.
- *Mail:* Send comments to the U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590–0001.
- *Hand Delivery:* Deliver to the ''Mail'' address between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays.

Examining the AD Docket

You may examine the AD docket on the Internet at *http://www.regulations.gov* or in person at the Docket Operations Office between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The AD docket contains this proposed AD, the European Aviation Safety Agency (EASA) AD, the economic evaluation, any comments received and other information. The street address for the Docket Operations Office (telephone 800–647–5527) is in the **ADDRESSES** section. Comments will be available in the AD docket shortly after receipt.

For service information identified in this proposed AD, contact American Eurocopter Corporation, 2701 N. Forum Drive, Grand Prairie, TX 75052; telephone (972) 641–0000 or (800) 232–0323; fax (972) 641–3775; or at *http://www.eurocopter.com/techpub.* You may review service information at the FAA, Office of the Regional Counsel, Southwest Region, 2601 Meacham Blvd., Room 663, Fort Worth, Texas 76137.

FOR FURTHER INFORMATION CONTACT: Gary Roach, Aviation Safety Engineer, Regulations and Policy Group, Rotorcraft Directorate, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone (817) 222–5110; email *gary.b.roach@faa.gov.*

SUPPLEMENTARY INFORMATION:

Comments Invited

We invite you to participate in this rulemaking by submitting written comments, data, or views. We also invite comments relating to the economic, environmental, energy, or federalism impacts that might result from adopting the proposals in this document. The most helpful comments reference a specific portion of the proposal, explain the reason for any recommended change, and include supporting data. To ensure the docket does not contain duplicate comments, commenters should send only one copy of written comments, or if comments are filed electronically, commenters should submit only one time.

We will file in the docket all comments that we receive, as well as a report summarizing each substantive public contact with FAA personnel concerning this proposed rulemaking. Before acting on this proposal, we will

consider all comments we receive on or before the closing date for comments. We will consider comments filed after the comment period has closed if it is possible to do so without incurring expense or delay. We may change this proposal in light of the comments we receive.

Discussion

On May 15, 2012, we issued Emergency AD (EAD) No. 2012–10–51 for ECD Model EC135 series helicopters to detect a crack on the MRH shaft flange. EAD No. 2012–10–51 required a pilot check of the lower MRH shaft flange for a crack or deformed blade attachment bolt safety pins before the first flight of each day, inspecting the upper and lower MRH shaft flanges for a crack within 5 hours TIS, and replacing the MRH shaft if there is a crack. EAD No. 2012–10–51 was prompted by AD No. 2012–0041–E, dated March 12, 2012, issued by EASA, which is the Technical Agent for the Member States of the European Union, to correct an unsafe condition for the ECD Model EC 135 series helicopters. EASA revised AD No. 2012–0041–E with EASA AD No. 2012–0041R1, dated March 15, 2012.

After we issued EAD No. 2012–10–51, EASA issued AD No. 2012–0085–E, dated May 17, 2012, which superseded EASA AD No. 2012–0041R1. EASA advised that since issuing EASA AD No. 2012–0041R1, further cracks had been detected on two other helicopters during the pre-flight checks. These are the same two cracks that prompted our EAD No. 2012–10–51. However, EASA also stated that identification of deformed safety pins may not be sufficient to detect a crack on the MRH shaft flange. ECD investigated the cause of the cracks and developed new inspection procedures with further corrective actions. Therefore, we issued EAD No. 2012–10–53 on May 18, 2012, which superseded EAD No. 2012–10–51. EAD No. 2012–10–53 was published in the **Federal Register** as a Final rule; request for comments on November 20, 2012, at 77 FR 69558.

In issuing AD No. 2012–10–53, we included additional part-numbered MRH shafts that should have been included in EAD No. 2012–10–51, changed the daily checks to recurring checks at intervals not to exceed 6 hours TIS, added a 10 hour-TIS recurring inspection on MRH shafts with 400 or more hours TIS, and removed the check of the blade attachment bolt safety pins for deformation.

Actions Since AD 2012–10–53 Was Issued

Since we issued EAD No. 2012–10–53 on May 18, 2012, which was published as a Final Rule; Request for Comments on November 20, 2012 at 77 FR 69558, Eurocopter revised Alert Service Bulletin (ASB) No. EC135–62A–029, now at Revision 7, dated October 22, 2012. The inspection interval for the visual inspection of the MRH shaft flanges was increased to 50 flight hours based on results from full scale component testing. The note regarding the preflight check states that the time between two preflight checks must not exceed 6 flight hours, and clarifies that one flight may comprise of multiple take-offs and landings and a flight starts when the helicopter takes off and ends when the helicopter is on the ground with the engines shut off. Eurocopter also removed the visual inspection of the blade bolt attachment areas from the ASB.

EASA also revised its AD, now at EASA AD No. 2012–0085R5, dated October 30, 2012, to correct the unsafe condition. EASA advised that based on results of the further full scale component testing, it has been determined that the interval for the repetitive visual inspections of the upper and lower hub shaft flanges can be extended to 50 flight hours. EASA AD No. 2012–0085R5 also references ECD ASB No. EC135–62A–029, Revision 7, dated October 22, 2012, for related information. EASA considers AD No. 2012–0085R5 to be interim AD action and further AD action may follow.

FAA's Determination

These helicopters have been approved by the aviation authority of Germany and are approved for operation in the United States. Pursuant to our bilateral agreement with Germany, EASA, its technical representative, has notified us of the unsafe condition described in its AD. We are proposing this AD because we evaluated all known relevant information and determined that an unsafe condition is likely to exist or develop on other products of the same type design.

Related Service Information

We reviewed Eurocopter ASB No. EC135–62A–029, Revision 7, dated October 22, 2012, which describes procedures for preflight checking the visible area of the upper and lower MRH shaft flanges and performing a repetitive visual inspection of the upper and lower MRH shaft for cracks. EASA classified this ASB as mandatory and issued AD No. 2012–0085R5 to ensure the continued airworthiness of these helicopters.

Proposed AD Requirements

This proposed AD would retain the repetitive visual check and inspection of the upper and lower MRH shaft flanges, as well as the replacement requirements of AD No. 2012–10–53 (77 FR 69558, November 20, 2012). An owner/operator (pilot) may perform the required visual check and must enter compliance with the applicable paragraph of the AD into the helicopter maintenance records in accordance with 14 CFR §§ 43.9(a)(1)-(4) and 91.417(a)(2)(v). A pilot may perform this check because it involves only looking at the visible area of the MRH shaft flanges and can be performed equally well by a pilot or a mechanic. That check is an exception to our standard maintenance regulations. Further, this proposed AD would increase the repetitive visual inspection interval for MRH shafts with 400 hours or more TIS from 10 hours TIS to 50 hours TIS.

Any alternative method of compliance (AMOC) previously approved in accordance with AD No. 2012–10–53 (77 FR 69558, November 20, 2012), would continue to be considered approved as an AMOC for the corresponding requirements in this proposed AD.

Differences Between This Proposed AD and the EASA AD

EASA considers its AD action to be an interim action; we do not consider this proposed AD to be interim AD action because the proposed requirements for the applicable part-numbered MRH shafts are not expected to change. The EASA AD requires you to report the findings and send the removed MRH to ECD, while this proposed AD would not. The EASA AD requires the initial visual check within 3 days, while this proposed AD would require the initial visual check before further flight. The EASA AD does not specify affected MRH shaft part numbers; this proposed AD would because the FAA anticipates that ECD will produce new part-numbered MRH shafts without the same unsafe condition.

Costs of Compliance

We estimate that this proposed AD would affect 244 helicopters of U.S. Registry. We estimate inspecting the MRH shaft flanges would require 2.5 work-hours at an average labor rate of $85 per work-hour, for a total cost per helicopter of $212 and a total cost to U.S. operators of $51,728 per inspection cycle. Replacing an MRH shaft would require about 8 work-hours at an

average labor rate of $85 per work-hour, and required parts would cost $55,715, for a total cost per helicopter of $56,395.

Authority for This Rulemaking

Title 49 of the United States Code specifies the FAA's authority to issue rules on aviation safety. Subtitle I, section 106, describes the authority of the FAA Administrator. ''Subtitle VII: Aviation Programs,'' describes in more detail the scope of the Agency's authority.

We are issuing this rulemaking under the authority described in ''Subtitle VII, Part A, Subpart III, Section 44701: General requirements.'' Under that section, Congress charges the FAA with promoting safe flight of civil aircraft in air commerce by prescribing regulations for practices, methods, and procedures the Administrator finds necessary for safety in air commerce. This regulation is within the scope of that authority because it addresses an unsafe condition that is likely to exist or develop on products identified in this rulemaking action.

Regulatory Findings

We determined that this proposed AD would not have federalism implications under Executive Order 13132. This proposed AD would not have a substantial direct effect on the States, on the relationship between the national Government and the States, or on the distribution of power and responsibilities among the various levels of government.

For the reasons discussed, I certify this proposed regulation:

1. Is not a ''significant regulatory action'' under Executive Order 12866;

2. Is not a ''significant rule'' under the DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979);

3. Will not affect intrastate aviation in Alaska to the extent that it justifies making a regulatory distinction; and

4. Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

We prepared an economic evaluation of the estimated costs to comply with this proposed AD and placed it in the AD docket.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by removing Airworthiness Directive (AD) 2012–10–53 (77 FR 69558, November 20, 2012), and adding the following new AD:

Eurocopter Deutschland GmbH (ECD): Docket No. FAA–2014–0034; Directorate Identifier 2013–SW–006–AD.

(a) Applicability

This AD applies to Model EC135P1, EC135P2, EC135P2+, EC135T1, EC135T2, and EC135T2+ helicopters, with a main rotor hub (MRH) shaft, part number (P/N) L623M1006101, L623M1206101, L623M1006102, L623M1206102, L623M1006103, or L623M1206103 installed, certificated in any category.

(b) Unsafe Condition

This AD defines the unsafe condition as a crack in the MRH shaft flange, which could result in failure of the MRH and subsequent loss of control of the helicopter.

(c) Affected ADs

This AD supersedes AD 2012–10–53, Amendment 39–17254 (77 FR 69558, November 20, 2012).

(d) Comments Due Date

We must receive comments by April 1, 2014.

(e) Compliance

You are responsible for performing each action required by this AD within the specified compliance time unless it has already been accomplished prior to that time.

(f) Required Actions

(1) Before further flight, and thereafter at intervals not to exceed 6 hours time-in-service (TIS), check the MRH shaft lower flange and the visible area of the MRH shaft upper flange for a crack. Figures 1 and 2 to Paragraph (f)(1) of this AD are examples of cracks that have been discovered in the MRH shaft lower flange. The actions required by this paragraph may be performed by the owner/operator (pilot) holding at least a private pilot certificate, and must be entered into the aircraft records showing compliance with this AD in accordance with 14 CFR 43.9 (a)(1)-(4) and 14 CFR 91.417(a)(2)(v). The record must be maintained as required by 14 CFR 91.417, 121.380, or 135.439.

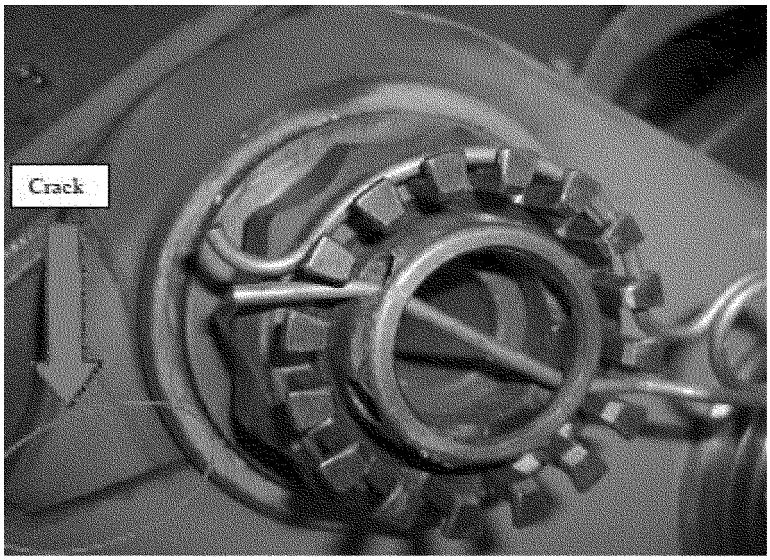

Figure 1 to Paragraph (f)(1)

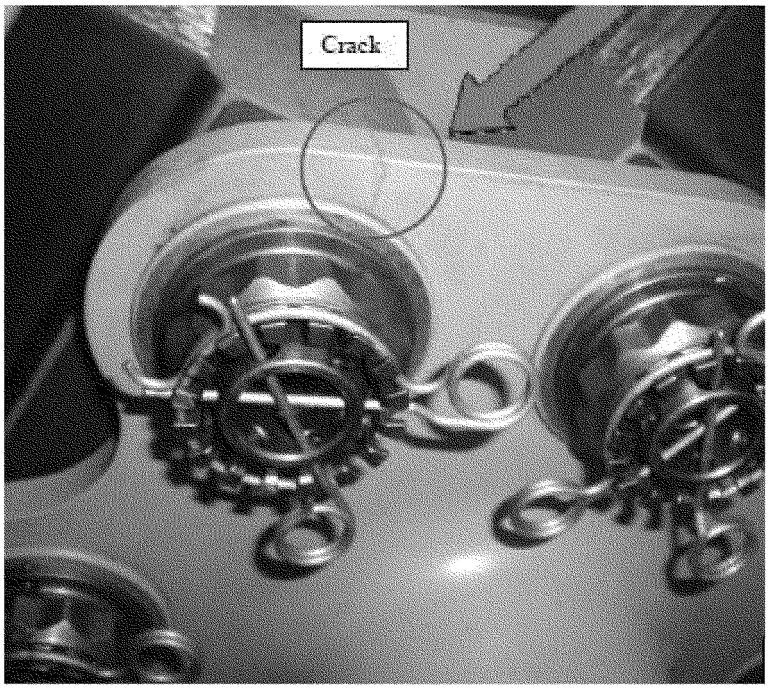

Figure 2 to Paragraph (f)(1)

(2) For MRH shafts with 400 or more hours TIS, within 50 hours TIS, and thereafter at intervals not to exceed 50 hours TIS:

(i) Remove the rotor-hub cap.

(ii) Clean the upper and lower MRH shaft flange as depicted in Figure 2 of Eurocopter Alert Service Bulletin No. EC135–62A–029, Revision 7, dated October 22, 2012, and visually inspect for a crack.

(3) If there is a crack in the upper or lower MRH shaft flange, before further flight, replace that MRH shaft with an airworthy MRH shaft. Replacing the MRH shaft with an MRH shaft having a P/N listed in the applicability of this AD does not constitute terminating action for the requirements of this AD.

(g) Alternative Methods of Compliance (AMOCs)

(1) The Manager, Safety Management Group, FAA, may approve AMOCs for this AD. Send your proposal to: Gary Roach,

Aviation Safety Engineer, Regulations and Policy Group, Rotorcraft Directorate, FAA, 2601 Meacham Blvd., Fort Worth, Texas 76137; telephone (817) 222–5110; email *gary.b.roach@faa.gov.*

(2) For operations conducted under a 14 CFR part 119 operating certificate or under 14 CFR part 91, subpart K, we suggest that you notify your principal inspector, or lacking a principal inspector, the manager of the local flight standards district office or certificate holding district office before operating any aircraft complying with this AD through an AMOC.

(3) Any AMOC approved previously in accordance with AD No. 2012–10–53, Amendment 39–17254 (77 FR 69558, November 20, 2012), is approved as an AMOC for the corresponding requirements in paragraph (f) of this AD.

(h) Additional Information

The subject of this AD is addressed in European Aviation Safety Agency (EASA) AD No. 2012–0085R5, dated October 30, 2012. You may view the EASA AD in Docket No. FAA–2014–0034 on the Internet at *http://www.regulations.gov.*

(i) Subject

Joint Aircraft Service Component (JASC) Code: 6220, Main Rotor Head.

Issued in Fort Worth, Texas, on January 16, 2014.

Lance T. Gant,

Acting Directorate Manager, Rotorcraft Directorate, Aircraft Certification Service.

[FR Doc. 2014–01954 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Docket No. FAA–2013–1008; Airspace Docket No. 13–AAL–8]

Proposed Revocation of Class E Airspace; Kwigillingok, AK

AGENCY: Federal Aviation Administration (FAA), Department of Transportation (DOT).

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This action proposes to remove Class E airspace at Kwigillingok Airport, Kwigillingok, AK, due to the cancellation of the approaches. The FAA is proposing this action to enhance the management of aircraft operations within the National Airspace System.

DATES: Comments must be received on or before March 17, 2014.

ADDRESSES: Send comments on this proposal to the U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590; telephone (202) 366–9826. You must identify FAA Docket No. FAA–2013–1008; Airspace Docket No. 13–AAL–8, at the beginning of your comments. You may also submit comments through the Internet at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Richard Roberts, Federal Aviation Administration, Operations Support Group, Western Service Center, 1601 Lind Avenue SW., Renton, WA 98057; telephone (425) 203–4517.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested parties are invited to participate in this proposed rulemaking by submitting such written data, views, or arguments, as they may desire. Comments that provide the factual basis supporting the views and suggestions presented are particularly helpful in developing reasoned regulatory decisions on the proposal. Comments are specifically invited on the overall regulatory, aeronautical, economic, environmental, and energy-related aspects of the proposal.

Communications should identify both docket numbers (FAA Docket No. FAA 2013–1008 and Airspace Docket No. 13–AAL–8) and be submitted in triplicate to the Docket Management System (see **ADDRESSES** section for address and phone number). You may also submit comments through the Internet at *http://www.regulations.gov.*

Commenters wishing the FAA to acknowledge receipt of their comments on this action must submit with those comments a self-addressed stamped postcard on which the following statement is made: ''Comments to FAA Docket No. FAA–2013–1008 and Airspace Docket No. 13–AAL–8''. The postcard will be date/time stamped and returned to the commenter.

All communications received on or before the specified closing date for comments will be considered before taking action on the proposed rule. The proposal contained in this action may be changed in light of comments received. All comments submitted will be available for examination in the public docket both before and after the closing date for comments. A report summarizing each substantive public contact with FAA personnel concerned with this rulemaking will be filed in the docket.

Availability of NPRM's

An electronic copy of this document may be downloaded through the Internet at *http://www.regulations.gov.* Recently published rulemaking documents can also be accessed through the FAA's Web page at *http://www.faa.gov/airports_airtraffic/air_traffic/publications/airspace_amendments/.*

You may review the public docket containing the proposal, any comments received, and any final disposition in person in the Dockets Office (see the **ADDRESSES** section for the address and phone number) between 9:00 a.m. and 5:00 p.m., Monday through Friday, except federal holidays. An informal docket may also be examined during normal business hours at the Northwest Mountain Regional Office of the Federal Aviation Administration, Air Traffic Organization, Western Service Center, Operations Support Group, 1601 Lind Avenue SW., Renton, WA 98057.

Persons interested in being placed on a mailing list for future NPRM's should contact the FAA's Office of Rulemaking, (202) 267–9677, for a copy of Advisory Circular No. 11–2A, Notice of Proposed Rulemaking Distribution System, which describes the application procedure.

The Proposal

The FAA is proposing an amendment to Title 14 Code of Federal Regulations (14 CFR) Part 71 by removing the Class E airspace extending upward from 700 and 1,200 feet above the surface at Kwigillingok Airport, Kwigillingok, AK. This action is necessary due to the cancellation of the Instrument Flight Rule approaches into the facility due to runway shortening.

Class E airspace designations are published in paragraph 6005, of FAA Order 7400.9X, dated August 7, 2013, and effective September 15, 2013, which is incorporated by reference in 14 CFR 71.1. The Class E airspace designation listed in this document will be published subsequently in this Order.

The FAA has determined this proposed regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. Therefore, this proposed regulation: (1) Is not a ''significant regulatory action'' under Executive Order 12866; (2) is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this proposed rule, when promulgated, would not have a significant economic impact on a substantial number of small entities

under the criteria of the Regulatory Flexibility Act.

The FAA's authority to issue rules regarding aviation safety is found in Title 49 of the U.S. Code. Subtitle 1, Section 106, describes the authority for the FAA Administrator. Subtitle VII, Aviation Programs, describes in more detail the scope of the agency's authority. This rulemaking is promulgated under the authority described in Subtitle VII, Part A, Subpart I, Section 40103. Under that section, the FAA is charged with prescribing regulations to assign the use of the airspace necessary to ensure the safety of aircraft and the efficient use of airspace. This regulation is within the scope of that authority as it would remove controlled airspace at Kwigillingok Airport, Kwigillingok, AK.

This proposal will be subject to an environmental analysis in accordance with FAA Order 1050.1E, ''Environmental Impacts: Policies and Procedures'' prior to any FAA final regulatory action.

List of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (air).

The Proposed Amendment

Accordingly, pursuant to the authority delegated to me, the Federal Aviation Administration proposes to amend 14 CFR Part 71 as follows:

PART 71—DESIGNATION OF CLASS A, B, C, D, AND E AIRSPACE AREAS; AIR TRAFFIC SERVICE ROUTES; AND REPORTING POINTS

■ 1. The authority citation for 14 CFR Part 71 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40103, 40113, 40120; E.O. 10854, 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389.

§ 71.1 [Amended]

■ 2. The incorporation by reference in 14 CFR 71.1 of the Federal Aviation Administration Order 7400.9X, Airspace Designations and Reporting Points, dated August 7, 2013, and effective September 15, 2013 is amended as follows:

Paragraph 6005 Class E airspace areas extending upward from 700 feet or more above the surface of the earth.

* * * * *

AAL AK E5 Kwigillingok, AK [Removed]

Issued in Seattle, Washington, on January 17, 2014.

Clark Desing,

Manager, Operations Support Group, Western Service Center.

[FR Doc. 2014–02040 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF COMMERCE

Bureau of the Census

15 CFR Part 30

[Docket Number: 131211999–3999–01]

Foreign Trade Regulations (FTR): Advanced Export Information (AEI) Pilot Program

AGENCY: Bureau of the Census, Commerce Department.

ACTION: Solicitation of Pilot Program Participants to Evaluate Potential Rulemaking Procedure.

SUMMARY: This document announces that the Bureau of the Census (U.S. Census Bureau), in cooperation with the U.S. Customs and Border Protection (CBP), is implementing a pilot program to evaluate a new filing option in the Automated Export System (AES). Specifically, the Advance Export Information (AEI) pilot is a voluntary program in which selected exporters agree to submit a limited set of Electronic Export Information (EEI) in accordance with existing filing deadlines followed by the full set of data elements submitted within five calendar days of the date of export. This notice provides a description of the AEI pilot, sets forth eligibility requirements for participation. If the AEI pilot is successful, we may discontinue the AES Post-Departure filing option and offer an AEI filing option.

DATES: Correspondence indicating interest in the AEI pilot will be accepted until April 1, 2014. The Census Bureau will notify applicants if they are accepted into the pilot. The notification will provide the date that the test environment will be available and further information about participation in the pilot. Approved pilot participants will then have 60 days after notification of acceptance to have their systems ready and able to transmit live AEI pilot data to the Automated Export System (AES).

FOR FURTHER INFORMATION CONTACT: Nick Orsini, Chief, Foreign Trade Division, U.S. Census Bureau, Room 6K032, Washington, DC 20233–6010, by phone (301) 763–6959, by fax (301) 763–8835, or by email *nick.orsini@census.gov.*

SUPPLEMENTARY INFORMATION:

Background

The Census Bureau is responsible for collecting, compiling, and publishing trade statistics for the United States under the provisions of Title 13, United States Code (U.S.C.), Chapter 9, Section 301. The Automated Export System (AES) is the primary instrument used for collecting export trade data. Through the AES, the Census Bureau collects Electronic Export Information (EEI), the electronic equivalent of the export data formerly collected on the Shipper's Export Declaration (SED), reported pursuant to Title 15, Code of Federal Regulations (CFR), Part 30. The EEI consists of data elements as set forth in 15 CFR 30.6 for an export shipment, and includes information, such as the exporter's identifying information, which includes name, address and identification number, and detailed information concerning the exported product. Other agencies use the EEI for the purpose of enforcing U.S. export laws and regulations.

Currently there are two AES filing options:

AES Predeparture Filing

All commodity information is filed electronically prior to departure as outlined in 15 CFR 30.4(b).

AES Postdeparture Filing

Postdeparture filing is available for approved United States Principal Party in Interest (USPPI) and provides for the electronic filing of the data elements for eligible shipments required by 15 CFR 30.6 no later than five calendar days from the date of exportation.

On August 15, 2003, the Census Bureau, in agreement with CBP, placed a moratorium on accepting new applications for Postdeparture filing due to an anticipated regulation change. The Census Bureau and CBP continued the moratorium on accepting new applications for the postdeparture program with the publication in the **Federal Register** of the revised regulations of March 14, 2013 (78 FR 16366). Though the moratorium continues, the Census Bureau and CBP have worked together to develop this pilot program to test the AEI approach, which is intended to replace the current postdeparture filing program. All exporters are eligible to apply for the AEI pilot program discussed in this notice.

Advanced export data are required in order for CBP and other agencies to

effectively target suspect export shipments as provided for in the Trade Act of 2002. Currently, the AES postdeparture filing program does not provide shipment information until after the shipment has left, which does not permit adequate screening of export shipments. Establishing an AEI program will provide the necessary information to permit CBP and other government agencies to conduct export enforcement and compliance activities, while permitting U.S. companies to export while some shipment details are unknown.

Authority for the program

5 U.S.C. 301; 13 U.S.C. 301–307; Reorganization Plan 5 of 1990 (3 CFR 1949–1953 Comp., p.1004); Department of Commerce Organization Order (DOO) No. 35–2A, July 22, 1987, as amended; DOO No. 35–2B, December 20, 1996, as amended; Public Law 107–228, 116 Stat. 1350; and Trade Act of 2002 (as amended by Public Law 107–295).

Description of the AEI Pilot Program

Submission of AEI Data

Participants in the AEI pilot will agree to provide a subset of the predeparture EEI data elements as defined in 15 CFR 30.6, while adhering to the timeframes outlined in 15 CFR 30.4(b). They will then submit the full EEI data set within five days of the date of export.

(a) Mandatory AEI data elements are:
(1) USPPI and USPPI identification.
(i) Name of the USPPI.
(ii) Address of the USPPI.
(iii) USPPI identification number.
(iv) Contact information.
(2) Ultimate consignee.
(3) Commodity classification number.
(4) Commodity description.
(5) Port of export.
(6) Date of export.
(7) Carrier identification.
(8) Conveyance name/carrier name.
(9) License code/license exemption code.
(10) Shipment reference number.
(b) Conditional AEI data elements are:
(1) Authorized agent's identification number (if an authorized agent is used to prepare and file the EEI).
(2) Export Control Classification Number (ECCN).

Note: Not all commodities are eligible for the AEI pilot, see the Conditions of Participation section, items J–L, of this notice.

These data elements were chosen because in meetings with members of the export trade community, they indicated that these data elements are commonly available prior to export. Additionally, the AEI data will be used by CBP to target export shipments, and enhance border security while minimizing disruption to U.S. commerce. Currently, the AES postdeparture filing program does not provide shipment information until after the shipment has left, which could represent a risk to national security.

The collection of the AEI data is subject to the requirements of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) and was approved under OMB Control Number 0607–0152. In the AEI pilot, participants agree to submit the AEI data directly to the AES.

Eligibility Requirements

The Census Bureau is seeking participation from a wide variety of stakeholders representing various industries who use different methods of transportation. Prospective AEI pilot participants will need to assess whether they can fulfill the following eligibility requirements:

1. The participant must be a USPPI as defined in 15 CFR 30.1. Authorized agents will not be approved for the AEI pilot.
2. The participant must have 12 months of export reporting history.
3. The participant must report a minimum of ten shipments per month. However, seasonal exporters will be considered on a case-by-case basis.
4. The participant must show an acceptable level of compliance for export reporting for the latest 12-month period.
5. The participant must be compliant with all other federal regulations related to trade import and export transactions.

AEI Pilot Application Process and Acceptance

All USPPIs interested in participating in the AEI pilot will have to apply, including USPPIs currently approved for postdeparture. An authorized agent may not apply on behalf of a USPPI; however, authorized agents may transmit AEI data, as well as the subsequent submission containing the full EEI, on behalf of a USPPI approved for AEI filing.

Interested parties who wish to be considered for participation in the AEI pilot should fax a letter on company letterhead to the Foreign Trade Division, Census Bureau, at 301–763–8835, stating their interest in participating and their qualifications based on the above eligibility requirements. The letter should also include a point of contact and the Employer Identification Numbers (EINs) of any of their establishments that they wish to be included in the pilot. Correspondence indicating interest in the AEI pilot will be accepted until April 1, 2014.

The Census Bureau will distribute letters received in response to this solicitation to CBP and the other federal government agencies participating in the AEI pilot filing review process. USPPIs that meet the eligibility requirements will be considered for selection in the AEI pilot.

Pilot participants will receive technical, operational, and policy guidance through all stages of pilot participation—from planning to implementation—on the necessary steps for the transmission of AEI and subsequent submission containing the full set of EEI.

The number of accepted applicants will depend on technical, fiscal, and personnel capacity of the reviewing government agencies. If more applications are received than can be supported, the applications will be processed in the order in which they are received. The Census Bureau will notify applicants if they are accepted into the pilot. The notification will provide the date that the test environment will be available and further information about participation in the pilot. Approved pilot participants will then have 60 days after notification of acceptance to have their systems ready and able to transmit live AEI pilot data to the AES.

Conditions of Participation

AEI pilot participants must agree to the following conditions of participation.

Participants must:

(A) Ensure the filing of the AEI data elements predeparture, adhering to the timeframes outlined in 15 CFR 30.4(b), as part of an initial data submission;

(B) Ensure the filing of the subsequent data submission, containing the full set of EEI data elements within five days of the date of export;

(C) Respond promptly with complete and accurate information when contacted by the Census Bureau, CBP or any other partnering agencies;

(D) Take part in teleconferences or meetings established by the Census Bureau or CBP, when necessary, to ensure any issues or challenges regarding the pilot are communicated and addressed;

(E) Respond to any and all AES response messages as outlined in 15 CFR 30.9;

(F) Report a minimum of 10 shipments within the scope of the AEI pilot per month. Special provisions may be made for seasonal exporters exporting less than 10 shipments per month. Not all shipments reported on behalf of a participant for a month must

be filed using AEI privileges. The remaining shipments may be filed using predeparture reporting or current postdeparture reporting (if the USPPI is an approved postdeparture filer);

(G) Promptly report any problems encountered during the duration of the pilot to the Census Bureau and/or CBP;

(H) Participate in the evaluation and debriefing of the pilot; and

(I) Have their systems ready and able to transmit live AEI pilot data to the AES 60 days after notification of acceptance in the pilot program.

Additional Conditions:

(J) Commodities controlled under Bureau of Industry and Security (BIS) Export Control Classification Numbers will not be permitted for AEI pilot reporting, with the exception of those specifically permitted to be filed postdeparture by the BIS;

(K) Any commodity under a general or specific license issued by any U.S. government agency will not be eligible for AEI pilot reporting; and

(L) All shipments required to be transmitted predeparture, pursuant to 15 CFR 30.4(a), will not be eligible for AEI pilot reporting.

Failure to maintain the conditions of participation outlined in this section or the eligibility requirements defined above, or any other reason determined by the Census Bureau, may result in removal from the AEI pilot program.

Filing Methods

AEI pilot participants or their authorized agent may submit AEI data directly to the AES mainframe. Further technical information related to filing AEI data to the AES will be provided to the AEI pilot participants following acceptance into the program.

Costs to AEI Pilot Participants

AEI pilot participants are responsible for all costs incurred as a result of their participation in the pilot and such costs will vary, depending on their pre-existing infrastructures. Costs may include, but are not limited to, programming and staff training. Costs incurred as a result of the AEI pilot may not be recouped if a resulting AEI program is not implemented, or is modified prior to implementation.

Benefits to AEI Pilot Participants

While the benefits to AEI pilot participants will vary, there are several advantages to participating. The benefits include but are not limited to:

- The opportunity to provide input into the Census Bureau's and CBP's efforts to establish, test, and refine the AEI program;
- The opportunity for your business model to be considered in the development and implementation of the AEI program;
- Facilitation of filing when not all information is known prior to export;
- Facilitation of corporate preparedness for future implementation of an AEI program and the discontinuation of the current postdeparture program; and
- If an AEI program is implemented based on this pilot, the participants that are in good standing, as determined by the Census Bureau, will not have to reapply for the AEI program.

Regulatory and Statutory Requirements

Participants in the AEI pilot are subject to the Conditions of Participation; however, this does not alter the participant's obligations to comply with applicable statutory and regulatory requirements, including but not limited to 15 CFR, Parts 30, 700–799; 19 CFR, Parts 1–199; and 22 CFR, Parts 120–130. Participants remain subject to all applicable penalties for non-compliance.

Evaluation of the AEI Pilot

The results of the AEI pilot will help determine whether the advanced export information permits CBP to effectively screen exports and will help identify and mitigate risks with the least impact practicable on trade operations. Additionally, the pilot will help determine whether any other related procedures and policies would be needed for any AEI program that may result.

While the pilot is in progress, the Census Bureau and CBP will evaluate the program and make a determination as to whether the pilot will be extended. If the pilot is extended, the Census Bureau will publish another notice in the **Federal Register**. When sufficient pilot analysis and evaluation has been conducted, the Census Bureau intends to begin rulemaking to address the future of postdeparture filing. If an AEI program is implemented based on this pilot, the participants that are in good standing, as determined by the Census Bureau, will not have to reapply for the AEI program.

Dated: January 22, 2014.

John H. Thompson,

Director, Bureau of the Census.

[FR Doc. 2014–01716 Filed 1–30–14; 8:45 am]

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DEPARTMENT OF COMMERCE

Bureau of Industry and Security

15 CFR Part 700

[Docket No. 0912311453–0016–01]

RIN 0694–AE81

Revisions to Defense Priorities and Allocations System Regulations

AGENCY: Bureau of Industry and Security, Department of Commerce.

ACTION: Proposed rule.

SUMMARY: This proposed rule would clarify existing standards and procedures by which the Bureau of Industry and Security (BIS) may require that certain contracts or orders that promote the national defense be given priority over other contracts or orders. It also proposes new standards and procedures for such prioritization with respect to contracts or orders for emergency preparedness activities. Finally, this rule proposes new standards and procedures by which BIS may allocate materials, services and facilities to promote the national defense. This rule implements provisions in the Defense Production Act Reauthorization of 2009 (123 Stat. 2006) (111 Pub. L. 67) (September 30, 2009) regarding publication of regulations providing standards and procedures for prioritization of contracts and orders and for allocation of materials, services, and facilities to promote the national defense under emergency and non-emergency conditions.

DATES: Comments must be received by April 1, 2014.

ADDRESSES: You may submit comments by any of the following methods:

- Federal eRulemaking Portal: *http://www.regulations.gov.* The ID number for this rulemaking is BIS–2010–0021.
- By email directly to *publiccomments@bis.doc.gov.* Include RIN 0694–AE81 in the subject line.
- By mail or delivery to Regulatory Policy Division, Bureau of Industry and Security, U.S. Department of Commerce, Room 2099B, 14th Street and Pennsylvania Avenue NW, Washington, DC 20230. Refer to RIN 0694–AE81.

FOR FURTHER INFORMATION CONTACT: Liam McMenanim at (202) 482–2233, *liam.mcmenamin@bis.doc.gov.*

SUPPLEMENTARY INFORMATION:

Executive Summary

Purpose of the Regulatory Action

This proposed rule would update the priorities and allocations provisions set

forth in the Defense Priorities and Allocations System regulations (15 CFR part 700) (DPAS) and implemented by the Bureau of Industry and Security (BIS) consistent with its authorities under Title I of the Defense Production Act of 1950 (as amended) (DPA). This rule also would establish certain new administrative procedures through which BIS will implement the allocations provisions of the DPA. In addition, this proposed rule would revise definitions found in § 700.8 of the DPAS regulations.

This rule implements the provisions in the Defense Production Act Reauthorization of 2009 (Pub. L. 111–67, 123 Stat. 2006, September 30, 2009) (Reauthorization Act), which require agencies with priorities and allocations authorities to issue rules establishing standards and procedures by which those authorities shall be used to promote the national defense, under both emergency and non-emergency conditions. This rule is part of a multi-agency effort that forms the Federal priorities and allocations system.

Background

The Reauthorization Act requires each Federal agency delegated priorities and allocations authority consistent with section 101 of the DPA to issue final rules establishing standards and procedures by which that authority is used to promote the national defense, during both emergency and non-emergency conditions. In the Reauthorization Act, Congress further directed that, to the extent practicable, the Federal agencies with priorities and allocations authoritiy should work together to develop a consistent and unified Federal priorities and allocations system.

In order to meet this mandate, BIS worked in conjunction with the Departments of Agriculture (USDA), Defense (DoD), Energy (DOE), Health and Human Services (HHS), Homeland Security (DHS), and Transportation (DOT) to develop common provisions based on the DPAS that can be used by each Department in its own regulation. The six regulations to be promulgated, one by each Department with delegated DPA Title I authority, comprise the Federal priorities and allocations system.

This proposed rule would update and expand the DPAS. BIS relies upon and uses the DPAS to implement priority and allocation actions involving industrial resources. BIS administers the DPAS pursuant to authority under Title I of the DPA (50 U.S.C. app. 2071, *et seq.*) as delegated by Executive Order 13603, March 16, 2012 (77 FR 16651, 3 CFR, 2012 Comp., p. 225). The DPAS has two principal components—priorities and allocations. Under the priorities component, certain contracts between the government and private parties or between private parties for the production or delivery of industrial resources are required to be given priority over other contracts to facilitate expedited delivery in promotion of the U.S. national defense. Under the allocations component, materials, services, and facilities may be allocated to promote the national defense. For both components, the term ''national defense'' means programs for military and energy production or construction, homeland security, stockpiling, space, emergency preparedness, and critical infrastructure protection and restoration. The term also includes foreign military and critical infrastructure assistance.

The Reauthorization Act required that within 270 days of its enactment, all agencies to which the President has delegated priorities and allocations authority under Title I of the DPA must publish final rules establishing standards and procedures by which that authority will be used to promote the national defense in both emergency and non-emergency situations. The act also required all such agencies to consult ''as appropriate and to the extent practicable to develop a consistent and unified Federal priorities and allocations system.'' (123 Stat. 2006, at 2009). This rule is one of several rules that have been or will be published to implement the provisions of the Reauthorization Act. The final rules of the agencies with Reauthorization Act authorities, which are the USDA, DOE, HHS, DOT, DoD, and DOC, will comprise the Federal priorities and allocations system.

June 2010 Proposed Rule, Comment and Response.

Proposed Rule and Comment

On June 7, 2010, BIS published a proposed rule to update and expand 15 CFR part 700 (75 FR 32122, June 7, 2010). BIS received one comment on that proposed rule. The commenter noted that Section 700.11 of the proposed rule discussed prioritization directives and referred to Section 700.12. The commenter noted that Section 700.12 stated that prioritization directives take precedence over all DX rated orders, DO rated orders, and unrated orders but that allocation orders take precedence over all. The commenter also noted the inference that prioritization directives may be different from DX rated orders. The commenter stated that he could find no provision that told how to mark an order as a prioritization directive so that the contractor could clearly tell that it was dealing with a prioritization directive.

Response

The June 7, 2010, proposed rule, the existing DPAS, and this proposed rule contemplate that directives will be issued by BIS to specific persons. BIS will provide the directive to the person to whom it applies. To the extent that directives modify or conflict with a DO or DX rated order or unrated order, the directive takes precedence. As will be further discussed below, this proposed rule does not draw a distinction between prioritization directives and allocation directives.

Due to the limited response to the June 2010 proposed rule and because BIS has reassessed some aspects of the June 2010 proposed rule, BIS has made several amendments and issued this second proposed rule for public consideration.

Summary of Principal Differences Between This Proposed Rule and the June 2010 Proposed Rule

Retention of Existing DPAS Format

The June 2010 proposed rule would have substantially reorganized the format of the DPAS. This proposed rule would largely retain the existing format. Upon reconsideration, BIS has concluded that the benefits of the revised format did not outweigh its drawbacks. Companies and government agencies that use the current DPAS are familiar with the current regulatory structure. They would have to incur the cost of learning any new structure that might be imposed. For example, the Department of Defense uses DPAS authority delegated to it by the Department of Commerce to place ratings on approximately 300,000 contracts annually. The Departments of Commerce and Defense estimate that, in addition, approximately 400,000 rated contracts are placed annually to satisfy national defense requirements. Parties who receive these rated contracts have not expressed to BIS any desire to reformat the regulations.

In addition to familiarity by current users, retaining the existing DPAS format simplifies identifying the substantive and procedural changes that this proposed rule would make and distinguishing those changes from the editorial changes that this proposed rule would also make.

Complementary Roles of Priorities and Allocations and Single Set of Deadlines

Although the June 2010 proposed rule did not explicitly state that priority

authority and allocations authority were mutually exclusive, it strongly implied that such was the case. For example, § 700.62 in the June 2010 proposed rule indicated that allocation orders would take precedent over priority ratings. BIS does not intend to issue conflicting orders or ratings. Currently, BIS issues only priority ratings. However, BIS can envision situations in which some combination of priorities and allocations would be needed. Accordingly, this proposed rule would not assign precedence between priorities and allocations by regulation. Instead, it would opt for flexibility when dealing with the situations that call for allocation orders. A description of the relationship between allocation orders and previously or subsequently received rated orders and unrated orders would be included in any allocation orders issued.

In connection with BIS' judgment that priorities authority and allocations authority might be used in a complementary manner, BIS has now concluded that shorter time limits than what the June 2010 proposed rule would have imposed with respect to filing requests for exception or adjustment of allocation orders, appeals of decisions denying those requests and BIS responses to those filings are not necessary. Therefore this proposed rule would apply, to both priorities and allocations, the time limits that the current DPAS applies to filing requests for exception or adjustment of priority rated orders, appeals of decisions denying those requests, and BIS responses to those filings. Although allocations would be used only in the circumstances described in the paragraph immediately below, BIS does not believe that such circumstances would necessarily require shorter time limits for the above-noted actions.

BIS does not intend or expect that allocations will be issued routinely or frequently. Under this proposed rule, allocations may be used to control the distribution of a material in the civilian market only upon approval by the President of a finding by the Secretary of Commerce or his or her designee that such material is a scarce and critical material essential to the national defense, and that the requirements of the national defense for such material cannot otherwise be met without creating a significant dislocation of the normal distribution of such material in the civilian market to such a degree as to create appreciable hardship. The June 2010 rule proposed that such findings be made by the Secretary of Commerce. This proposed rule adds language that would allow the Secretary or a designee of the Secretary to make such findings. This change recognizes that a Department Organization Order of the Department of Commerce delegates to the Under Secretary for Industry and Security those DPA authorities that have been delegated to the Secretary of Commerce. Even a narrower use of allocations authority under this proposed rule would also be subject to the policy set forth in § 700.30 which provides that allocations will be used only when there is insufficient supply of a material, service, or facility to satisfy national defense requirements through use of priorities authority or when the use of priorities authority would cause a severe and prolonged disruption in the supply of materials, services or facilities available to support normal U.S. economic activity. Given these requirements and its past practice, BIS anticipates that use of allocations will be a rare event.

Reduced Time for Written Follow-Up of Verbal Notice That a Party is Unable To Comply With An Order

Under the current DPAS, a party who gives verbal notice that performance of a priority rated order will be delayed must provide a written confirmation within five working days. The June 2010 proposed rule would have retained this provision and would have imposed the same time limit for written confirmation that a party is unable to comply with an allocation order. Upon further consideration, BIS has concluded that such written confirmation should be transmitted within one working day of the verbal notice. A party making such a notice would know at the time of the verbal notice the reasons that it cannot meet the specified delivery date or comply with the order. Rated orders are issued to satisfy requirements related to military and energy production or construction, military or critical infrastructure assistance to any foreign nation, homeland security, stockpiling, space, emergency preparedness, and critical infrastructure protection and restoration. Reducing the reason to writing should not take longer than one working day and the nature of these orders justifies requiring expeditious communication.

Issuance of Allocations Orders by an Authorized Employee or Official Other Than the Secretary

The June 2010 proposed rule stated that allocations orders would be signed by or include the name of the Secretary of Commerce and be addressed to the person to whom the order applies. This proposed rule would provide that an authorized official or employee sign allocations orders, consistent with existing practices. Both the June 2010 proposed rule and this proposed rule would require the President's approval of the finding before allocations could be used to control the general distribution of a material in the civilian market. BIS believes that, given this requirement, a requirement that the Secretary sign every order that may be issued to implement an allocation decision would serve no purpose.

Constructive Notice of Allocations Orders Through Federal Register Publication

The June 2010 proposed rule would have required that allocations orders (and modifications or cancellations of such orders) be issued directly to affected persons. This proposed rule would permit such orders to be issued directly to affected persons or by constructive notice through publication in the **Federal Register**. The **Federal Register** notice might apply to a specified class of persons rather than naming all affected persons. For example, an allocation order published in the **Federal Register** might apply to all manufacturers of a specified product but not name every manufacturer of that product in the order. BIS believes that situations might arise in which allocations are justified and that, although BIS would be able to identify the material to be allocated, it would not be able to identify all of the suppliers of that material. In such situations, constructive notice to the affected class of persons by publication in the **Federal Register** would be consistent with the procedure that the government uses generally when notice must be given to large numbers of persons or to persons not all of whom can be individually identified.

Use of Rated Orders for Emergency Preparedness Activities

This proposed rule would authorize use of rated orders for emergency preparedness activities and would authorize such orders to require acceptance or rejection within a shorter time than the 10 or 15 working days required for acceptance or rejection of other DX and DO rated orders. Emergency preparedness rated orders may require acceptance or rejection in as little as six hours after receipt of the order if the order is in response to a hazard that has occurred or 12 hours if the order is to prepare for an imminent hazard. This proposed rule would also require use of rated orders to obtain items needed to fill an emergency preparedness rated order and would require use of the reduced times for

acceptance or rejection noted above. The June 2010 proposed rule did not provide the option of imposing a shorter timeframe for acceptance or rejection of rated orders for emergency preparedness activities issued by the Department of Commerce, although it did note that rated orders issued by other agencies that are delegated authority by the Department of Commerce might have shorter timeframes for acceptance or rejection. This proposed rule provides for the option of shorter timeframes for all orders issued for emergency preparedness activities.

Removal of Limits on Use of do Rated Orders for the Metalworking Machine Industry

As discussed more fully in the description of the proposed changes to § 700.31 below, this proposed rule would remove completely the special treatment of the metalworking machine industry currently found in § 700.31. That section limits the amount of DO rated orders that metal working machine producers are required to accept. In recent years, there have been so few DO rated orders for metalworking machines that the maximum set by § 700.31 has never been met. Therefore, BIS believes that the maximum limitation is not needed. The June 2010 proposed rule made no changes to these limits.

Removal of Mandatory Criteria for Evaluating Whether Certain Materials, Equipment, and Services Used To Maximize Energy Supplies Are ''Scarce''

As discussed more fully in the description of the proposed changes to § 700.21 below, this proposed rule would clarify that the criteria listed for determining whether certain materials, equipment, and services related to energy production are ''scarce'' and whether priorities authority is needed are illustrative lists of criteria that the Department of Commerce may use. The June 2010 proposed rule would have retained the language currently in § 700.21.

Procedure for Requesting Assistance in Obtaining Rated Items or Priority Rating Authority for Homeland Security, Emergency Preparedness, and Critical Infrastructure Protection and Restoration Assistance Programs Within the United States

As discussed more fully in the description of proposed § 700.55 below, this proposed rule would provide a procedure for requesting assistance in obtaining rated items or priority rating authority for homeland security, emergency preparedness, and critical infrastructure protection and restoration assistance programs within the United States.

Revision to Schedule I

This proposed rule would revise Schedule I to part 700 to provide a program symbol for programs intended to provide critical infrastructure assistance to foreign nations. Additionally, this proposed rule would make format changes and a clarification, both of which are more fully described below.

Section-by-Section Analysis of the Changes That This Proposed Rule Would Make to the Existing DPAS

The following discussion explains the changes that this proposed rule would make to the existing DPAS.

Revisions to Subpart A—Purpose

Proposed § 700.1—Purpose of this part. The header of this section would be changed from ''Purpose'' to ''Purpose of this part'' to be more specific. This section would state the purpose of the DPAS in general terms and would largely restate information that appears at 15 CFR 700.1 in the existing regulations. However, extensive language about the source of BIS' legal authority would not be incorporated into the proposed § 700.1 on the grounds that such language is not regulatory in nature. BIS believes that the language regarding the DPAS's purpose would be clearer if it is not submerged in extensive discussions of legal authority.

Revisions to Subpart B—Overview

Section 700.2—Introduction. This rule would add references to homeland security and critical infrastructure protection and restoration activities to paragraph (a) to conform to the current definition of national defense in the DPA. Paragraph (b) would explicitly state that the Department of Commerce may exercise priorities and allocations authority. Paragraph (c) would state that recipients of rated orders have authority to place ratings on contracts with contractors, subcontractors, or suppliers. BIS is proposing to make these changes so that the introductory paragraph will give a more complete description of the DPAS and will reflect changes brought about by the 2009 amendments to the DPA under the Reauthorization Act. BIS believes that these changes would make this introduction more descriptive and useful.

Section 700.3—Priority ratings and rated orders. This section would be shortened to remove material that is covered elsewhere in 15 CFR part 700. References to ''these regulations'' would be changed to ''this part'' to make clear that the regulations referred to are 15 CFR part 700.

Sections 700.4, 700.5, 700.6 and 700.7 would be removed because the information that they contain is duplicated elsewhere the DPAS.

Revisions to Subpart C—Definitions

Section 700.8—Definitions. This rule would remove the reference to definitions in the DPA and Stafford Act. Definitions from those acts that also apply to the DPAS would be set forth separately in this section.

New definitions would be added for ''allocation,'' ''allocation order'' and ''allotment.'' These definitions relate to the expanded allocations provisions in Subpart F, which is needed to implement the amendments set forth in the Reauthorization Act.

A new definition for ''working day'' also would be added. This term currently is in the DPAS, but is not defined. The term would be defined as ''any day that the recipient of an order is open for business.''

As newly defined, this term would apply to time limits for acceptance or rejection of rated orders (other than orders placed for emergency preparedness activities), written confirmation of verbal notice that delivery or performance of a rated order will be delayed, and written confirmation of verbal notice of inability to comply with an allocation order.

The definitions of ''critical infrastructure,'' ''homeland security'' and ''national defense'' that appear in the DPA would be added so that readers would not need to refer to the statute for the definitions.

The definition of ''*Maintenance, repair and operating supplies (MRO)*'' would be amended by replacing the term ''*Maintenance, repair and operating supplies*'' with the term ''*Maintenance, repair and/or operating supplies.*'' For years, BIS has interpreted the term MRO to apply to maintenance, to repair, to operating supplies, to any combination of two of the three, or to all three. BIS is proposing to revise the language because it believes that the proposed language more clearly expresses the meaning that BIS has applied for years. In other respects, the definition is unchanged.

The new definitions of ''emergency preparedness'' and ''hazard'' relate primarily to the issuance of rated orders for emergency preparedness requirements, a topic addressed in §§ 700.13 and 700.15 of this proposed rule. The definitions of ''emergency

preparedness'' and ''hazard'' are taken from the Stafford Act.

The definition of ''official action'' would be changed to cover actions related to allocations as well as priorities. This change is needed to address the expanded material regarding allocations in §§ 700.30 through 700.34 and references to allocations in other sections of this proposed rule.

New definitions would be added for the terms ''priority rating'' and ''program identification symbols.'' These definitions are not substantively different than the descriptions of priority ratings and program identification symbols that currently appear in § 700.11 of the DPAS. BIS believes that priority ratings and program identification symbols are sufficiently central to the concept of priorities under the DPAS to warrant inclusion in the definitions section.

The definition of ''person'' would be expanded to include international organizations to conform to proposed new §§ 700.57 and 700.58, which address military and critical infrastructure assistance to international organizations as well as to foreign governments.

The definition of ''set-aside'' would be revised to match the text of the definition of this term in each agency's regulations (noted above) that together will comprise the Federal priorities and allocations system.

This proposed rule would remove the text currently at the beginning of the first sentence in § 700.8, which reads ''In addition to the definitions provided in Section 702 of the Defense Production Act (excepting the definition of ''industrial resources'' and Section 602(a) of the Stafford Act) . . .'' because the relevant definitions from those Acts would be added to § 700.8 of the DPAS under this proposed rule. This change would spare readers of the DPAS from the need to consult those two statutes to understand the meaning of terms used in 15 CFR part 700.

Revisions to Subpart D—Industrial Priorities

Section 700.10—Authority. Paragraph (a) would be revised to replace the reference to Executive Order 12919 with a reference Executive Order 13603, which revoked and superseded Executive Order 12919. Paragraph (b) would be revised to remove a reference to an internal delegation by the Department of Commerce, because that reference is unnecessary. The description of the priorities and allocations authority conveyed by statute or executive order to other government agencies currently found in § 700.18(b)(1) would be moved to a new paragraph (c) of Section 700.10. The language describing the authority of the Department of Agriculture would be revised to conform to the language in Executive Order 13603. The information currently in § 700.18(b)(2) would be removed because it merely describes an internal government procedure. The text regarding communications services would be revised to cite Executive Order 13618 of July 6, 2012. That executive order revoked Executive Order 12472, which currently is cited in § 700.18(b)(2). BIS believes that placing all of the statements of agency authority in a single section would aid understanding of the Defense Priorities and Allocations System Regulations.

700.11—Priority ratings. The phrase ''to this part'' would be added immediately following ''Schedule I'' in the second sentence of paragraph (b) to precisely identify the schedule. This is not a substantive change.

700.12—Elements of a rated order. Revised paragraph (a) of this section would be headed ''Elements required for all rated orders'' and would incorporate all of the elements of current paragraphs (a), (b) and (c) of § 700.12. In addition, in paragraph (a), this proposed rule would revise the parenthetical listing of rated order symbol examples by replacing ''DO–H1'', which is rarely used, with ''DO–N1'', which is more commonly used and which indicates a Federal emergency preparedness, mitigation, response and recovery action approved for DPAS support by the Department of Homeland Security.

Paragraph (b), headed ''Additional element required for certain emergency preparedness rated orders,'' would be added. This new paragraph would provide that if a rated order is placed for the purpose of emergency preparedness requirements, and if expedited action is necessary or appropriate to meet those requirements, the order must include a statement informing the recipient that the order is for the purpose of emergency preparedness and of the amount of time within which the recipient must accept or reject the order. The minimum amount of time that must be allowed for acceptance or rejection would be governed by proposed § 700.13(d)(2).

Section 700.13—Acceptance and rejection of rated orders. In paragraph (c), introductory text, the word ''Commerce'' would be replaced with the phrase ''the Department of Commerce.''

Paragraph (d)—Customer notification requirements. This paragraph would be changed in the following manner. Paragraph (d)(1) would continue to apply to most rated orders and would be substantively unchanged from existing paragraph (d)(1). The currently undefined term ''working days'' would be subject to the definition proposed in § 700.8 of this proposed rule. DO rated orders would have to be accepted or rejected within 15 working days after receipt, and DX rated orders would have to be accepted or rejected within 10 working days after receipt. Paragraph (d)(2) would be revised to address customer notification requirements for orders placed for emergency preparedness requirements where expedited action is necessary or appropriate to meet those requirements. Such orders would have to be accepted or rejected in the time frame noted in the order. That time frame could be as short as six hours if the order is issued by an authorized person in response to a hazard that has occurred, or 12 hours if the order is issued by an authorized person in response to an imminent hazard. Existing paragraph (d)(2), which requires persons who have accepted rated orders to give notice if performance will be delayed, would become paragraph (d)(3). The time limit in which to provide written confirmation of a verbal notice would be changed from five working days to one working day. BIS believes that the nature of rated orders, supporting national defense requirements, justifies expeditious communications and that once a verbal notice of delayed performance has been given, putting that notice into writing should not take more than one working day.

Section 700.14—Preferential scheduling. The proposed changes to this section are all non-substantive. To enhance clarity, an additional sentence emphasizing the priority of DX rated orders over DO rated orders would be added to the example at the end of paragraph (b). Paragraph (c) which addresses conflicting rated orders would be amended by changing references to ''§§ 700.50 through 700.54'' to ''Subpart H of this part'' to more completely state the provisions that deal with resolution of conflicting rated orders.

Section 700.15—Extension of priority ratings. This section requires persons who receive rated orders to use rated orders with suppliers to obtain items needed to fill a rated order. This proposed rule makes non-substantive changes to paragraphs (a) and (b). The term ''this regulation'' in paragraph (a) is replaced with ''this part'' to make clear that the regulation to which the sentence refers is 15 CFR part 700. The second sentence of paragraph (b) is revised to state expressly that the rating

continues throughout the entire supply chain.

Paragraph (c) would be added. The new paragraph would require use of rated orders to obtain items needed to fill an emergency preparedness rated order. It would require persons who have received emergency preparedness rated orders that have shortened timeframes for acceptance or rejection to impose shortened time frames for transmission of acceptance or rejection on rated orders placed with suppliers.

Section 700.16—Changes or cancellations of priority ratings and rated orders.

A substantive change would be made to paragraph (d), which lists amendments to a rated order that do not constitute a new rated order. The phrase ''prior to the start of production'' would be added immediately following the phrase ''a minor variation in size or design.'' Once production of an item is commenced, changes in design that would be minor prior to production can become significant. Therefore, BIS believes that the rule should allow for only changes in size or design that are specified before production starts to be considered merely an amendment to an existing rated order rather than a new rated order.

Paragraph (e), which imposes a duty to cancel rated orders that have been placed with suppliers, or to cancel the ratings on those orders if the items so ordered are no longer needed to fill a rated order, would be modified. This rule would amend this paragraph to make it clear that the person who placed the rated orders with the suppliers (or that person's successor in interest) has the duty to cancel them.

Paragraph (f), which imposes a duty to inform suppliers when a priority rating is placed on an order or when a priority rating is changed or cancelled, would be modified to make clear that the person who placed the rating on the order or who changed or cancelled the rating has the duty to inform the suppliers of the priority rating activity.

Section 700.17—Use of rated orders. Currently § 700.17(f) provides that a person is not required to place a priority rating on an order for items with a value of less than $50,000 or one half the Federal Acquisition Regulation (FAR) Simplified Acquisition Threshold, whichever is larger, if delivery can be obtained in a timely fashion without the priority rating. This proposed rule would raise the threshold from the current value of $50,000 to a new value of $75,000—which is one half the FAR Simplified Acquisition Threshold. None of the other changes to this section are substantive. Paragraph (d) describes combining rated and unrated orders. In paragraph (d)(1)(ii), which refers to the elements of a rated order as set forth in § 700.12, the word ''four'' would be removed because under this proposed rule, a rated order could have either four or five elements depending on whether or not the order is for certain emergency preparedness activities

Section 700.18—Limitations on placing rated orders. This proposed rule would make several clarifying and stylistic changes to this section. Paragraph (a)(1) would be revised to apply only to rated orders that are made pursuant to 15 CFR part 700 because some rated orders may be issued pursuant to regulations of other agencies. A more explicit description of the authorizations to place rated orders would be added.

The sentence in paragraph (a)(1)(ii), which begins: ''Separate rated orders . . .'' would be moved to a separate paragraph (a)(3) and revised to read: ''Separate rated orders may not be placed solely for obtaining minimum procurable quantities on each order if the minimum procurable quantity would be sufficient to cover more than one rated order.'' BIS believes that this change improves syntax and more clearly expresses the intent behind the sentence.

Existing paragraph (b)(1) would be moved to a new paragraph (c) in section 700.10 as discussed above.

Existing paragraph (b)(2) would be eliminated entirely because it refers to internal government documents and does not provide any useful information to the public.

Existing paragraph (b)(3) would become paragraph (b). The first clause in this new paragraph (b) would be revised to state more clearly the policy regarding the items listed in paragraph (b), which are: Copper raw materials, crushed stone, gravel, scrap, slag, central steam heat and waste paper. The new language would be: ''Notwithstanding language authorizing or requiring the placement of rated orders found elsewhere in this part, no person may place a rated order to obtain the following items unless such order is authorized by an official action of the Department of Commerce.'' BIS believes that the foregoing proposed language is clearer than the corresponding language currently in § 700.18(b)(3), which reads: ''The following items under the jurisdiction of Commerce are currently excluded from the rating provisions of this regulation; however, these items are subject to Commerce Directives.'' BIS does not regard this change as substantive.

Revisions to Subpart E—Industrial Priorities for Energy Programs

Section 700.21—Application for priority rating authority. This section sets forth the procedures to be used when applying for priority rating authority and provides information about the criteria considered by BIS in approving such applications. The proposed rule would make three changes. First, the rule would remove existing paragraph (b), which describes activities of the Department of Energy. BIS believes that this information is unnecessary.

Second, existing paragraph (c) would be the basis for new paragraph (b). The rule would rephrase proposed new paragraph (b) to emphasize that two Department of Commerce findings are needed to authorize priorities authority. Those findings are whether the items in question are scarce, and whether there is a need to use the priorities authority. The rule would add language emphasizing that the list of factors that the Department of Commerce may use in making those two findings is illustrative. This proposed rule also would add language to paragraph (b) making clear that if scarcity is not found, the Department of Commerce will not consider whether priority authority is needed. Applications for priority rating authority to maximize domestic energy supplies are rare. BIS has not received one in more than a decade. BIS recognizes that it must make fact-based decisions on these applications in a consistent manner. However, the rarity of these applications makes devising a list of all of the factors that could be relevant to every application impossible. Therefore, BIS believes that the list of factors in the rule must be illustrative and that the actual relevant factors must be determined on a case-by-case basis.

The proposed rule also would remove existing paragraph (d), which provides that if the Department of Commerce does not find the items to be scarce, it will not analyze the need for priorities and allocations authorities because the concept would addressed in paragraph (b).

Existing paragraph (e) would become paragraph (c) with minor changes to add clarity and precision. Existing paragraph (f) would become paragraph (d). The word ''Commerce'' would be replaced by ''the Department of Commerce'' throughout the section.

Revisions to Subpart F—National Emergency Preparedness and Critical Items. Subpart F Would Be Retitled Allocation Actions

Section 700.30—Policy. This section would be rewritten. The current heading, ''Priorities and allocations in a national emergency'' would be revised to ''Policy''.

The section would state that allocations authority would be used only when priority authority is unable to provide a sufficient supply of a material, service, or facility to meet the national defense, or when the use of priority authority would cause a severe and prolonged disruption in the supply of materials, services, or facilities available to support normal U.S. economic activities. This policy does not mean that priorities and allocations would, in all instances, be mutually exclusive. In some circumstances, the best course may be to use priority authority and allocations authority in a complementary manner. An example of such a situation is one in which national defense activities need less than the entire supply of a particular material, service or facility and priority authority could provide a sufficient supply to meet that need but only by causing a severe and prolonged disruption in the supply to support normal U.S. economic activities. If the national defense need were sufficiently critical, the best course overall might be to use priority authority to meet the national defense need and use allocation authority to distribute the remaining supply among other economic activities. Throughout this section, the definition of ''national defense'' in § 700.8 of this proposed rule would apply. Allocation authority would not be used to ration materials or services at the retail level.

Section 700.31—General procedures. This section also would be rewritten. The heading would be changed from ''Metalworking machines'' to ''General procedures.'' The proposed procedures set out in this section and in proposed § 700.32 are intended to provide a reasonable assurance that allocations authority would be used only in situations where use of such authority is justified. Section 700.31 would set a list of the elements that must be in a plan that the Department of Commerce would be required to develop before using its allocations authority to address a supply problem in all instances, whether or not the allocation would control the general distribution of a material in the civilian market. The section would not preclude the Department of Commerce from including additional elements in the plan; it would merely require that the following elements be included.

- A copy of the written determination made in accordance with section 202 of Executive Order 13603, that the program or programs that would be supported by the allocation action are necessary or appropriate to promote the national defense;
- A detailed description of the situation to include any unusual events or circumstances that have created the requirement for an allocation action;
- A statement of the specific objective(s) of the allocation action;
- A list of the materials, services, or facilities to be allocated;
- A list or description of the sources of the materials, services, or facilities that will be subject to the allocation action;
- A detailed description of the provisions that will be included in the allocation order, including the type(s) of allocation orders, the percentages or quantity of capacity or output to be allocated for each purpose, the relationship with previously or subsequently received priority rated and unrated contracts and orders, and the duration of the allocation action (e.g., anticipated start and end dates);
- An evaluation of the impact of the proposed allocation action on the civilian market; and
- Proposed actions, if any, to mitigate disruptions to civilian market operations.

The text of existing § 700.31—''Metalworking machines'' would be removed from the DPAS. Section 700.31 of the DPAS applies only when the metalworking machines that would be the subjects of a rated order have a list price in excess of $2,500. Section 700.13 currently allows any metalworking machine producer to reject any DO rated order that calls for delivery in any one month of more than 60 percent of that month's scheduled production of machines of the size called for in the order. Section 700.13 also currently allows any metalworking machine producer to reject any DO rated order that it receives less than three months prior to the beginning of the month for which delivery is requested.

BIS previously published a notice of inquiry seeking comments on the effects of eliminating this provision (73 FR 19666, April 17, 2006). BIS received no comments. Section 700.31, in effect, sets a limit on the amount of production capacity that a producer of metalworking machines could be required to set-aside in anticipation of rated orders. BIS has issued no directives or other official actions requiring such set-asides in many years. BIS believes that priority ratings affect an insignificant portion of the metalworking machine industry output. On that basis, BIS believes that a special provision that sets, by regulation, the maximum allocation that may be applied to this one industry, while allocations would be set for all other industries through fact-based, case-by-case basis determinations, is unwarranted.

Section 700.32—Controlling the general distribution of a material in the civilian market. This section would be new. It would set forth the findings that the Secretary of Commerce (or the Secretary's designee) must make and that the President must approve before the Department of Commerce may use allocations to control the distribution of a material in the civilian market. Those findings, which are required by § 101(b) of the DPA, are: Such material is a scarce and critical material essential to the national defense, and the requirements of the national defense for such material cannot otherwise be met without creating a significant dislocation of the normal distribution of such material in the civilian market to such a degree as to create appreciable hardship. Section 201(e) of Executive Order 13603 directs each agency with delegated authority under section 101 of the DPA to make the finding required by section 101(b) and submit the finding for the President's approval through the Assistant to the President and National Security Advisor and the Assistant to the President for Homeland Security and Counterterrorism.

Section 700.33—Types of allocation orders. This new section proposes to describe the three types of allocations orders the Department of Commerce might issue: A set-aside; a directive; or an allotment. A *set-aside* is an official action that would require a person to reserve a resource capacity in anticipation of receipt of rated orders. A *directive* is an official action that would require a person to take or refrain from taking certain actions in accordance with its provisions. For example, a directive could require a person to stop or reduce production of an item or service; prohibit the use of selected materials, services or facilities; divert supply of one type of material, service or facility to another; or to supply a specific quantity, size, shape, and type of an item or service within a specific time period. An *allotment* is an official action that would specify the maximum quantity of a material, service, or facility authorized for use in a specific program or application.

Section 700.34—Elements of an allocation order. This section sets forth certain elements that would be required in allocations orders issued by the Department of Commerce. Two elements would be required for all allocations orders: An explanation of the relationship between the allocation order and any previously or subsequently issued rated or unrated orders; and the specific start and end dates of each required allocation action. If an order is issued directly to the person to whom it applies, it must contain the written signature or name of an authorized official or employee of the Department of Commerce and a statement identifying the person to whom it applies by name. The order must state that it is for national defense and state the obligation to comply with the order and with the DPAS. If the order provides constructive notice through publication in the **Federal Register**, the order must be signed by an authorized official or employee of the Department of Commerce and the statement may either refer to the party(ies) to which the order applies by name or specify the class of persons to whom the order applies. The order must state the requirement to comply with the order itself and with the DPAS. Original signatures are not reproduced in the **Federal Register**.

Section 700.35—Mandatory acceptance of an allocation order. Paragraph (a) of this section would require a person to accept and comply with allocations orders. Paragraph (b) would state that a person may not discriminate against an allocation order in any manner, such as by charging higher prices or imposing terms and conditions on allocations orders that are different from what the person imposed on contracts or orders for the same resource prior to receiving the allocation order. Paragraph (c) would provide that a person who is unable to comply fully with the required actions specified in an allocation order must notify the Office of Strategic Industries and Economic Security immediately, explain the extent to which compliance is possible, and give reasons why full compliance is not possible. Such notice would not release the person from complying with the allocation order to the fullest extent possible until notified by the Department of Commerce that the order has been changed or cancelled. If the notice is given verbally, written or electronic confirmation must be provided within one working day.

Section 700.36—Changes or cancellations of allocation orders. This section would state that the Department of Commerce may change or cancel an allocation order through an official action. Notice of such changes or cancellations may be provided directly to persons to whom the order being cancelled or modified applies or constructive notice may be provided by publication in the **Federal Register**.

Revisions to Subpart H—Special Priorities Assistance

Section 700.50—General Provisions. No substantive changes would be made to this section. The first sentence of paragraph (a) would be revised from ''The DPAS is designed to be largely self-executing'' to ''Once a priority rating has been authorized pursuant to this part, further action by the Department of Commerce generally is not needed.'' BIS believes that the proposed revised sentence is a more precise introduction to paragraph (a) because § 700.50 applies to priority ratings and not to the DPAS as a whole, which would include allocations. In addition, the priority rating process is not truly self-executing. A person must place ratings on orders and respond to rated orders within the specified time limits. However, once the rating is authorized, in most instances no further action by the Department of Commerce or a Delegate Agency is needed.

Paragraph (b) would be revised to replace the phrase ''in support of this regulation'' with the phrase ''consistent with this part'' to more precisely state the purposes of special priorities assistance. In addition the phrase ''not automatically ratable under this regulation'' would be replaced with ''not otherwise ratable under this part'' because ratings do not occur automatically and to make clear that the regulation referred to is 15 CFR Part 700. A new sentence would be added to this paragraph to inform the public that if the Department of Commerce is unable to resolve the problem or to authorize the use of a priority rating and believes additional assistance is warranted, the Department of Commerce may forward the request for assistance to another resource agency, as appropriate, for action.

Section 700.51—Requests for priority rating authority. This proposed rule would remove one factor from the non-exclusive list of factors that the Department of Commerce will consider in evaluating requests for priority rating authority. The factor proposed for removal is ''the political sensitivity of the project.'' BIS believes that considering such a factor when evaluating a request for priority rating authority is an extremely unlikely possibility and should be removed from the list. This proposed rule also makes two non-substantive editorial changes to § 700.51. It changes ''Commerce'' to ''the Department of Commerce'' and changes the phrase ''this regulation'' to ''this part'' to make clear that the regulation being referred to is 15 CFR part 700.

Sections 700.53—Criteria for assistance, and 700.54 Instances where assistance will not be provided. This proposed rule would make only the non-substantive editorial revision of changing ''Commerce'' to read ''the Department of Commerce'' in these two sections.

Section 700.55—Homeland security, emergency preparedness, and critical infrastructure protection and restoration assistance programs within the United States. The text of this proposed section is entirely new. The topic covered by § 700.55 in the existing DPAS ''Assistance programs with Canada and other nations'' would be dealt with in the new §§ 700.56 and 700.57.

Proposed § 700.55 would direct persons seeking priority rating authority or assistance in obtaining rated items supporting homeland security, emergency preparedness and critical infrastructure protection and restoration related activities, to direct their requests to the Federal Emergency Management Agency. This section is in accordance with Section 202(c) of Executive Order 13603, which authorizes the Secretary of Homeland Security to determine whether ''all other defense programs, including civil defense and continuity of Government'' are ''necessary or appropriate to promote the national defense.'' A determination that a program is necessary or appropriate to promote the national defense must be made before the Department of Commerce may authorize issuance of priority ratings for contracts in support of that program.

Section 700.56—Military assistance programs with Canada. Proposed section 700.56 addresses situations in which a person in Canada, producing items for the Canadian government, seeks priorities assistance for items produced in the United States. BIS is proposing to create a new section that speaks only to military assistance with respect to Canada because the Canadian Government has been authorized to place priority ratings in the United States to support approved defense programs. Persons in other foreign countries may place priority ratings in the United States if their requests for military assistance are sponsored by their government and have DOD approval and endorsement. The existing DPAS address military assistance programs in Canada and other foreign nations in a single section. However,

BIS believes that the unique procedures that apply to requesting military assistance in Canada justify a separate section. Proposed § 700.56 also would update the contact information that applies to the government of Canada.

Section 700.57—Military assistance programs with other nations and international organizations. Proposed § 700.57 is little changed from § 700.55(c) and (d) of the existing DPAS. Contact information for the Department of Defense would be updated. Also, this section would expressly recognize that persons in international organizations may seek assistance in obtaining items in the United States or priority ratings for items to be purchased in the United States. BIS has provided assistance to international organizations in the past and believes that adding a reference to international organizations in proposed § 700.57 would merely codify existing agency practice and would not represent a change in policy. Proposed § 700.57(c) would add Australia and Finland to the listing of countries that have entered into bilateral security of supply arrangements with the United States Department of Defense and revise Department of Defense contact information to make both current.

Section 700.58—Critical infrastructure assistance programs to foreign nations and international organizations. This section directs persons in foreign nations and international organizations who are seeking assistance in obtaining items to be purchased in the United States for support of critical infrastructure protection or restoration to contact the Federal Emergency Management Agency. This section is included in accordance with Section 202(c) of Executive Order 13603, which authorizes the Secretary of Homeland Security to determine whether ''all other defense programs, including civil defense and continuity of Government'' are ''necessary or appropriate to promote the national defense.'' A determination that a program is necessary or appropriate to promote the national defense must be made before the Department of Commerce may authorize issuance of priority ratings for contracts in support of that program.

Revisions to Subpart I—Official Actions

Section 700.60—General provisions. Only non-substantive changes would be made to this section. References to ''Commerce'' would be changed to ''the Department of Commerce'' and references to ''this regulation'' would be changed to ''this part'' to make clear that the regulation referred to is 15 CFR part 700. This section of the proposed rule also would notify readers that directives are discussed in § 700.62.

Sections 700.61—Rating authorizations, 700.62 Directories, and 700.63 Letters of understanding. These sections would receive only non-substantive editorial changes. The rule would correct capitalizations and replace ''Commerce'' with ''the Department of Commerce.''

Revisions to Subpart J—Compliance

Section 700.70—General provisions. This proposed rule would remove paragraph (b) of the existing DPAS from this section. Paragraph (b) provides that persons who place rated orders ''should'' be familiar with the DPAS and must comply with its provisions. BIS believes that the former is aspirational rather than mandatory, and that the latter is redundant of specific language setting forth violations in section 700.74. This proposed rule would also make non-substantive editorial changes to section 700.70 by replacing reference to ''this regulation'' with references to ''this part'' to make clear that the regulation referred to is 15 CFR part 700.

Section 700.71—Investigations and audits. This section would be revised in several ways. The requirement for personal service of an administrative subpoena would be revised to allow leaving a copy of the document with someone at least 18 years old at the person's last known dwelling or place of business. Currently, section 700.70 allows leaving the document with a ''person of suitable age and discretion.'' BIS believes that setting a minimum age is more precise and will help to prevent misunderstandings about who is authorized to receive service. This proposed rule would remove the term ''official action'' from paragraphs (a), (c)(1), (c)(2) and (c)(3), because, as used in those paragraphs, compliance with an ''official action'' would be subsumed by a requirement to comply with the DPAS. References to ''this regulation'' would be replaced with references to ''this part'' to make clear that the regulation referred to is 15 CFR part 700.

Section 700.72—Compulsory process. This section would be revised to make clear that if a representative of the Department of Commerce is denied access to premises or sources of information necessary to the administration or for enforcement of the DPA or the DPAS, the Department of Commerce may seek compulsory process. The current language of § 700.72 could be read as stating that only the representative who was denied access may seek compulsory process. BIS believes that such a reading would be erroneous. However, in an effort to prevent confusion, the proposed rule would state that ''the Department of Commerce may seek compulsory process. . . .'' This proposed rule also would revise the word ''Commerce'' to read ''the Department of Commerce'' and would replace the reference to ''this regulation or official actions'' with ''this part.''

Section 700.73—Notification of failure to comply. The phrase ''this regulation'' would be changed to read ''this part'' to make clear that the regulation referred to is 15 CFR part 700.

Section 700.74—Violations, penalties, and remedies. Only minor changes would be made to this section. The phrase ''this regulation or an official action,'' would be replaced with the phrase ''of this part.'' In five additional places the word ''regulation'' would be replaced with the word ''part'' to make clear that the regulation referred to is 15 CFR part 700. The phrase ''this provision'' would be replaced with ''this section'' to make clear that the provision referred to is § 700.74.

Revisions to Subpart K—Adjustments, Exceptions, and Appeals

Section 700.80—Adjustments or exceptions. This proposed rule would add a requirement that the Office of Strategic Industries and Economic Security respond to requests for exceptions to or adjustments of the requirements of 15 CFR part 700, or of any official action taken by the Department of Commerce in connection with that part, within 25 days, not including Saturdays, Sundays, or government holidays. All other proposed changes to this section are non-substantive.

Section 700.81—Appeals. Non-substantive changes would be made to this section. The address to which appeals must be sent would be updated and moved from paragraph (b) to paragraph (a). The phrase ''for good cause shown'' currently at the end of last sentence of paragraph (b) would be removed. That sentence addresses when, at the discretion of the Assistant Secretary for Export Administration, appeals may be accepted after the 45 day deadline. BIS believes that the phrase adds nothing of substance to the rule. In paragraph (g) the phrase ''this regulation'' would be replaced by ''this part'' to clarify that the regulation referred to is 15 CFR part 700.

Revisions to Subpart L—Miscellaneous Provisions

Section 700.90—Protection against claims. One non-substantive change

would be made to this section. The phrase ''this regulation'' would be replaced with ''this part'' to make clear that the regulation referred to is 15 CFR part 700.

Section 700.91—Records and reports. Only non-substantive changes would be made to this section. The phrase ''this regulation'' would be replaced with the phrase ''this part'' in four places to make clear that the regulation referred to is 15 CFR part 700. The word ''Commerce'' would be replaced with ''the Department of Commerce.'' In paragraph (e), which quotes the confidentiality provision of the DPA, the references to Section 705(e) of the DPA would be corrected to read Section 705(d), which is the section quoted.

Section 700.92—Applicability of this part and official actions. Only non-substantive changes would be made to § 700.92. The phrase ''this regulation'' would be replaced with ''this part'' in the heading and in paragraphs (a), (b) and (c) to clarify that the regulation referred to is 15 CFR part 700. The phrase ''the Department of'' would be added immediately preceding the word ''Commerce'' at both places where the later appears in paragraph (c). The phrase ''the regulations'' would be replaced with the phrase ''any provision of this part'' in paragraph (d).

Section 700.93—Communications. This section would be revised to add an email address, delete the facsimile number, and clarify that the email address and telephone number listed in § 700.93 apply to requests for general information such as how to obtain copies of the DPAS, explanatory information, and requests for guidance or clarification. The section would expressly state that requests for special priorities assistance, adjustments, exceptions or appeals must be submitted in the matter specified in the sections governing those activities. The phrase ''this regulation'' would be replaced with the phrase ''this part'' to make clear that the regulation referred to is 15 CFR part 700.

Schedule I to Part 700—Approved Programs and Delegate Agencies

This proposed rule would revise the table in Schedule I to provide a new program symbol ''G4'' for a new topic heading ''Critical Infrastructure Assistance to Other Nations.'' To improve readability, the proposed rule would reformat the table by centering the topic headings and revising the headings for ''Military Assistance to Canada,'' ''Military Assistance to Other Foreign Nations'' and ''Co-production'' into full stand-alone topic headings rather than subheadings under the heading ''International Defense Programs.'' This rule would spell out the name of the approving agency on each line that identifies a program for which that agency has approval authority rather than use the abbreviation ''Do.,'' which stands for ''ditto,'' and would revise the term ''this regulation'' that appears in the footnote to read ''this part'' to make clear that the regulation referred to is 15 CFR part 700. Additionally, a footnote would be added to explain that program entries where the ''Department of Commerce'' appears in the third column require Department of Commerce authorization even though strictly speaking, the Department of Commerce is not a delegate agency.

Request for Comments

BIS seeks comments on all aspects of this proposed rule. BIS will consider all comments received on or before April 1, 2014. Comments received after that date will be considered if feasible, but consideration cannot be assured. All comments (including any personally identifying information that those comments or transmittal emails contain) will be made available for public inspection and copying. Parties who wish to comment anonymously may do so by submitting their comments via Regulations.gov, leaving the fields that would identify the commenter blank and including no identifying information in the comment itself.

Regulatory Requirements

1. Executive Orders 13563 and 12866 direct agencies to assess all costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits (including potential economic, environmental, public health and safety effects, distribute impacts, and equity). Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, of reducing costs, of harmonizing rules, and of promoting flexibility. This rule has been designated a ''significant regulatory action,'' although not economically significant, under section 3(f) of Executive Order 12866. Accordingly, the rule has been reviewed by the Office of Management and Budget (OMB).

2. Notwithstanding any other provision of law, no person is required to respond to, nor is subject to a penalty for failure to comply with, a collection of information, subject to the requirements of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*) (PRA), unless that collection of information displays a currently valid OMB control number. This regulation contains two collections previously approved by OMB. OMB control number 0694–0053 authorizes the requirement that recipients of rated orders notify the party placing the order whether or not they will fulfill the rated order. BIS believes that this rule will not materially change the burden imposed by this collection. OMB control number 0694–0057 authorizes the collection of information that parties must send to BIS when seeking special priorities assistance or priority rating authority. BIS believes that this rule will not materially change the burden imposed by this collection. Send comments regarding this burden estimate or any other aspect of these collections of information, including suggestions for reducing the burden, to Jasmeet K. Seehra, Office of Management and Budget, by email at *jseehra@omb.eop.gov* or by fax to (202) 395–7285 and to Liam McMenamin, *liam.mcmenamin@bis.doc.gov.*

3. This rule does not contain policies with Federalism implications as that term is defined under E.O. 13132.

4. The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA), 5 U.S.C. 601 *et seq.,* generally requires an agency to prepare a regulatory flexibility analysis of any rule subject to the notice and comment rulemaking requirements under the Administrative Procedure Act (5 U.S.C. 553) or any other statute. Under section 605(b) of the RFA, however, if the head of an agency certifies that a rule will not have a significant impact on a substantial number of small entities, the statute does not require the agency to prepare a regulatory flexibility analysis. Pursuant to section 605(b), the Chief Counsel for Regulations, Department of Commerce, certified to the Chief Counsel for Advocacy, Small Business Administration that this proposed rule, if promulgated, will not have a significant impact on a substantial number of small entities for the reasons explained below. Consequently, BIS has not prepared a regulatory flexibility analysis. The factual support for this certification is provided below.

Number of Small Entities

Small entities include small businesses, small organizations and small governmental jurisdictions. For purposes of assessing the impacts of this proposed rule on small entities, a small business, as described in the Small Business Administration's Table of Small Business Size Standards Matched to North American Industry

Classification System Codes (Effective March 26, 2012), has a maximum annual revenue of $35.5 million and a maximum of 1,500 employees (for some business categories, these numbers are lower). A small governmental jurisdiction is a government of a city, town, school district or special district with a population of less than 50,000. A small organization is any not-for-profit enterprise which is independently owned and operated and is not dominant in its field.

This rule sets criteria under which BIS (or agencies to which BIS delegates authority) will authorize prioritization of certain orders or contracts as well as criteria under which BIS would issue orders allocating resources or production facilities. This rule would affect organizations that enter into contracts to supply materials, services and facilities that are necessary for the national defense (broadly defined to include ''Programs for military and energy production or construction, military or critical infrastructure assistance to any foreign nation, homeland security, stockpiling, space, and any directly related activity''). BIS's experience in administering its priorities authority indicates that for-profit businesses are the organizations that provide such materials, services and facilities. If it becomes necessary to exercise allocations authority, the same types of materials, services and facilities and the same types of providers are the ones likely to be affected. Therefore, BIS believes that two of the categories of small entities identified by the RFA, small organizations and small government jurisdictions, are unlikely to experience any economic impact as a result of this rule. However, BIS has no basis on which to estimate the number of small businesses that are likely to be affected by this rule.

Impact

BIS believes that any impact that this rule might have on small businesses would be minor. The rule has two principle components: prioritization and allocation. Prioritization is the process that is, by far, more likely to be used. Under prioritization, BIS designates certain orders, which may be placed by Government or by private entities, and assigned under one of two possible priority levels. Once so designated, such orders are referred to as ''rated orders.'' The recipient of a rated order must give it priority over an unrated order. The recipient of a rated order with the higher priority rating must give that order priority over any rated orders with the lower priority rating and over unrated orders. A recipient of a rated order may place one or more orders at the same priority level with suppliers and subcontractors for supplies and services necessary to fulfill the recipient's rated order and the suppliers and subcontractors must treat the request from the rated order recipient as a rated order with the same priority level as the original rated order. The rule does not require recipients to fulfill rated orders if the price or terms of sale are not consistent with the price or terms of sale of similar non-rated orders. The rule provides a defense from liability for damages or penalties for actions or inactions made in compliance with the rule. BIS expects that this rule will not result in any increase in the use of rated orders. The changes to the provisions of 15 CFR part 700 that apply to rated orders are primarily simplifications and clarifications. The standards under which a rated order would be issued are not changed by this rule.

Although rated orders could require a firm to fill one order prior to filling another, they would not require a reduction in the total volume of orders nor would they require the recipient to reduce prices or provide rated orders with more favorable terms than a similar non-rated order. Under these circumstances, the economic effects on the rated order recipient of substituting one order for another are likely to be offsetting, resulting in no net loss.

Allocations could be used to control the general distribution of materials or services in the civilian market. Specific allocation actions that BIS might take are set-asides, directives and allotments. A set-aside is an official action that requires a person to reserve resource capacity in anticipation of receipt of rated orders. A directive is an official action that requires a person to take or refrain from taking certain actions in accordance with its provisions. A directive can require a person to stop or reduce production of an item, prohibit the use of selected items, or divert supply of one type of product to another, or to supply a specific quantity, size, shape, and type of an item within a specific time period. An allotment is an official action that specifies the maximum quantity of a material, service or facility authorized for use in a specific program or application.

According to available records, BIS has not taken any actions under its existing allocations authority in decades and any future allocations actions would be used only in extraordinary circumstances. As required by section 101(b) of the Defense Production Act of 1950, as amended, (50 U.S.C. app. 2071), hereinafter ''DPA,'' and by Section 201(e) of Executive Order 13603 of March 16, 2012, BIS may implement allocations to control the general distribution of a material in the civilian market only if the Department of Commerce made, and the President approved, a finding (1) that the material [or service] is a scarce and critical material [or service] essential to the national defense, and (2) that the requirements of the national defense for such material [or service] cannot otherwise be met without creating a significant dislocation of the normal distribution of such material [or service] in the civilian market to such a degree as to create appreciable hardship. The term ''national defense'' is defined to mean ''programs for military and energy production or construction, military or critical infrastructure assistance to any foreign nation, homeland security, stockpiling, space, and any related activity. Such term includes emergency preparedness activities conducted pursuant to title IV of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. 5195 *et seq.*) and critical infrastructure protection and restoration.''

Even a narrower use of allocations authority under this proposed rule would be subject to the policy set forth in § 700.30 which provides that allocations will be used only when there is insufficient supply of a material, service, or facility to satisfy national defense requirements through use of priorities authority or when the use of priorities authority would cause a severe and prolonged disruption in the supply of materials, services or facilities available to support normal U.S. economic activity.

Any allocation actions taken by BIS would also have to comply with Section 701(e) of the DPA (50 U.S.C. app. 2151(e)), which provides that ''small business concerns shall be accorded, to the extent practicable, a fair share of the such material [including services] in proportion to the share received by such business concerns under normal conditions, giving such special consideration as may be possible to emerging business concerns.''

Conclusion

Although BIS cannot determine precisely the number of small entities that would be affected by this rule, BIS believes that the overall impact on such entities would not be significant. With respect to priorities authority, this rule is not likely to increase the number of priority rated contracts compared to the number being issued currently. Therefore the priorities authorities' provisions of this rule are unlikely to

have any economic impact. BIS's lack of recent experience with allocations makes gauging the impact of an allocation, should one occur, difficult. However, because (1) all allocation actions require planning that includes evaluation of the impact on the civilian market, (2) allocations to control the general distribution of a material in the civilian market may be imposed only after a determination by the President, and (3) BIS has taken no allocation actions in decades, one can expect allocations will be a rare occurrence. BIS believes that the expected unchanged level of contract prioritizations, planning and review requirements and requirements of section 701 of the DPA, which are directed at protecting the interests of small businesses provide reasonable assurance that any impact on small business will not be significant. For the reasons set forth above, the Chief Counsel for Regulations at the Department of Commerce certified that this action would not have a significant impact on a substantial number of small entities.

List of Subjects in 15 CFR Part 700

Administrative practice and procedure, Business and industry, Government contracts, National defense, Reporting and recordkeeping requirements, Strategic and critical materials.

For the reasons stated in the preamble, 15 CFR part 700 is proposed to be amended as follows:

PART 700—[AMENDED]

■ 1. The authority citations paragraph for part 700 is revised to read as follows:

Authority: 50 U.S.C. App. 2061, *et seq.;* 42 U.S.C. 5195, *et seq.;* 50 U.S.C. App 468; 10 U.S.C. 2538; 50 U.S.C. 82; E.O. 12656, 53 FR 226, 3 CFR, 1988, Comp. 585; E.O. 12742, 56 FR 1079, 3 CFR, 1991 Comp. 309; E.O. 13603, 77 FR 16651, 3 CFR, 2012 Comp., p. 225.

■ 2. Section 700.1 is revised to read as follows:

§ 700.1 Purpose of this part.

This part implements the Defense Priorities and Allocations System (DPAS) that is administered by the Department of Commerce, Bureau of Industry and Security. The DPAS implements the priorities and allocations authority of the Defense Production Act, including use of that authority to support emergency preparedness activities pursuant to Title VI of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. 5195 *et seq.*), and the priorities authority of the Selective Service Act and related statutes, all with respect to industrial resources. The DPAS establishes procedures for the placement, acceptance, and performance of priority rated contracts and orders and for the allocation of materials, services, and facilities. The guidance and procedures in this part are generally consistent with the guidance and procedures provided in other regulations issued under Executive Order 13603 authority.

■ 3. Section 700.2 is revised to read as follows:

§ 700.2 Introduction.

(a) Certain national defense and energy programs (including military, emergency preparedness, homeland security, and critical infrastructure protection and restoration activities) are approved for priorities and allocations support. A complete list of currently approved programs is provided at Schedule I to this part.

(b) The Department of Commerce administers the DPAS and may exercise priorities and allocations authority to ensure the timely delivery of industrial items to meet approved program requirements.

(c) The Department of Commerce has delegated authority to place priority ratings on contracts or orders necessary or appropriate to promote the national defense to certain government agencies that issue such contracts or orders. Such delegations include authority to authorize recipients of rated orders to place ratings on contracts or orders to contractors, subcontractors, and suppliers. Schedule I to this part includes a list of agencies to which the Department of Commerce has delegated authority.

■ 4. In § 700.3, paragraphs (a), (b), and (e) are revised to read as follows:

§ 700.3 Priority ratings and rated orders.

(a) Rated orders are identified by a priority rating and a program identification symbol. Rated orders take precedence over all unrated orders as necessary to meet required delivery dates. Among rated orders, DX rated orders take precedence over DO rated orders. Program identification symbols indicate which approved program is attributed to the rated order.

(b) Persons receiving rated orders must give them preferential treatment as required by this part.

* * * * *

(e) Persons may place a priority rating on orders only when they are in receipt of a rated order, have been explicitly authorized to do so by the Department of Commerce or a Delegate Agency, or are otherwise permitted to do so by this part.

§ 700.4 [Removed and Reserved]

■ 5. Section 700.4 is removed and reserved.

§ 700.5 [Removed and Reserved]

■ 6. Section 700.5 is removed and reserved.

§ 700.6 [Removed and Reserved]

■ 7. Section 700.6 is removed and reserved.

§ 700.7 [Removed and Reserved]

■ 8. Section 700.7 is removed and reserved.

■ 9. Section 700.8 is revised to read as follows:

§ 700.8 Definitions.

The definitions in this section apply throughout this part:

Allocation. The control of the distribution of materials, services or facilities for a purpose deemed necessary or appropriate to promote the national defense.

Allocation order. An official action to control the distribution of materials, services, or facilities for a purpose deemed necessary or appropriate to promote the national defense.

Allotment. An official action that specifies the maximum quantity of a material, service, or facility authorized for a specific use to promote the national defense.

Approved program. A program determined as necessary or appropriate for priorities and allocations support to promote the national defense by the Secretary of Defense, the Secretary of Energy, or the Secretary of Homeland Security, under the authority of the Defense Production Act and Executive Order 13603, or the Selective Service Act and Executive Order 12742.

Construction. The erection, addition, extension, or alteration of any building, structure, or project, using materials or products which are to be an integral and permanent part of the building, structure, or project. Construction does not include maintenance and repair.

Critical infrastructure. Any systems and assets, whether physical or cyber-based, so vital to the United States that the degradation or destruction of such systems and assets would have a debilitating impact on national security, including, but not limited to, national economic security and national public health or safety.

Defense Production Act. The Defense Production Act of 1950, as amended (50 U.S.C. App. 2061, *et seq.)*

Delegate Agency. A government agency authorized by delegation from

the Department of Commerce to place priority ratings on contracts or orders needed to support approved programs.

Directive. An official action which requires a person to take or refrain from taking certain actions in accordance with its provisions.

Emergency preparedness. All activities and measures designed or undertaken to prepare for or minimize the effects of a hazard upon the civilian population, to deal with the immediate emergency conditions which would be created by the hazard, and to effectuate emergency repairs to, or the emergency restoration of, vital utilities and facilities destroyed or damaged by the hazard. Emergency preparedness includes the following:

(1) Measures to be undertaken in preparation for anticipated hazards (including the establishment of appropriate organizations, operational plans, and supporting agreements, the recruitment and training of personnel, the conduct of research, the procurement and stockpiling of necessary materials and supplies, the provision of suitable warning systems, the construction or preparation of shelters, shelter areas, and control centers, and, when appropriate, the nonmilitary evacuation of the civilian population);

(2) Measures to be undertaken during a hazard (including the enforcement of passive defense regulations prescribed by duly established military or civil authorities, the evacuation of personnel to shelter areas, the control of traffic and panic, and the control and use of lighting and civil communications); and

(3) Measures to be undertaken following a hazard (including activities for firefighting, rescue, emergency medical, health and sanitation services, monitoring for specific dangers of special weapons, unexploded bomb reconnaissance, essential debris clearance, emergency welfare measures, and immediately essential emergency repair or restoration of damaged vital facilities).

Hazard. An emergency or disaster resulting from:

(1) A natural disaster, or

(2) An accidental or man-caused event.

Homeland security. Includes efforts:

(1) To prevent terrorist attacks within the United States;

(2) To reduce the vulnerability of the United States to terrorism;

(3) To minimize damage from a terrorist attack in the United States; and

(4) To recover from a terrorist attack in the United States.

Industrial resources. All materials, services, and facilities, including construction materials, the authority for which has not been delegated to other agencies under Executive Order 13603. This term also includes the term ''item'' as defined and used in this part.

Item. Any raw, in process, or manufactured material, article, commodity, supply, equipment, component, accessory, part, assembly, or product of any kind, technical information, process, or service.

Maintenance and repair and/or operating supplies (MRO):

(1) *Maintenance* is the upkeep necessary to continue any plant, facility, or equipment in working condition.

(2) *Repair* is the restoration of any plant, facility, or equipment to working condition when it has been rendered unsafe or unfit for service by wear and tear, damage, or failure of parts.

(3) *Operating supplies* are any items carried as operating supplies according to a person's established accounting practice. Operating supplies may include hand tools and expendable tools, jigs, dies, fixtures used on production equipment, lubricants, cleaners, chemicals and other expendable items.

(4) MRO does not include items produced or obtained for sale to other persons or for installation upon or attachment to the property of another person, or items required for the production of such items; items needed for the replacement of any plant, facility, or equipment; or items for the improvement of any plant, facility, or equipment by replacing items which are still in working condition with items of a new or different kind, quality, or design.

National defense. Programs for military and energy production or construction, military or critical infrastructure assistance to any foreign nation, homeland security, stockpiling, space, and any directly related activity. Such term includes emergency preparedness activities conducted pursuant to Title VI of The Robert T. Stafford Disaster Relief and Emergency Assistance Act (42 U.S.C. 5195 *et seq.*) and critical infrastructure protection and restoration.

Official action. An action taken by the Department of Commerce under the authority of the Defense Production Act, the Selective Service Act and related statutes, and this part. Such actions include the issuance of rating authorizations, directives, letters of understanding, demands for information, inspection authorizations, administrative subpoenas and allocation orders.

Person. Any individual, corporation, partnership, association, or any other organized group of persons, or legal successor or representative thereof; or any authorized State or local government or agency thereof; and for purposes of administration of this part, includes the United States Government and any authorized foreign government or international organization or agency thereof, delegated authority as provided in this part.

Priorities authority. The authority of the Department of Commerce, pursuant to Section 101 of the Defense Production Act, to require priority performance of contracts and orders for industrial resource items for use in approved programs.

Priority rating. An identifying code assigned by a Delegate Agency or authorized person placed on all rated orders and consisting of the rating symbol and the program identification symbol.

Production equipment. Any item of capital equipment used in producing materials or furnishing services that has a unit acquisition cost of $2,500 or more, an anticipated service life in excess of one year, and the potential for maintaining its integrity as a capital item.

Program identification symbols. Abbreviations used to indicate which approved program is supported by a rated order.

Rated order. A prime contract, a subcontract, or a purchase order in support of an approved program issued in accordance with the provisions of this part.

Selective Service Act. Section 18 of the Selective Service Act of 1948 (50 U.S.C. app. 468).

Set-aside. An official action that requires a person to reserve materials, services, or facilities capacity in anticipation of the receipt of rated orders.

Stafford Act. Title VI (Emergency Preparedness) of the Robert T. Stafford Disaster Relief and Emergency Assistance Act, as amended (42 U.S.C. 5195, *et seq.*).

Working day. Any day that the recipient of an order is open for business.

■ 10. Section 700.10 is revised to read as follows:

§ 700.10 Authority.

(a) *Delegations to the Department of Commerce.* The priorities and allocations authorities of the President under Title I of the Defense Production Act with respect to industrial resources have been delegated to the Secretary of Commerce under Executive Order 13603 of March 16, 2012 (77 FR 16651, 3 CFR, 2012 Comp., p. 225). The priorities

authorities of the President under the Selective Service Act and related statutes with respect to industrial resources have also been delegated to the Secretary of Commerce under Executive Order 12742 of January 8, 1991 (56 FR 1079, 3 CFR, 1991 Comp. 309).

(b) *Delegations by the Department of Commerce.* The Department of Commerce has authorized the Delegate Agencies to assign priority ratings to orders for industrial resources needed for use in approved programs.

(c) *Jurisdiction limitations.* (1) The priorities and allocations authority for certain items have been delegated under Executive Order 13603, other executive orders, or Interagency Memoranda of Understanding between other agencies. Unless otherwise agreed to by the concerned agencies, the provisions of this part are not applicable to those other items which include:

(i) Food resources, food resource facilities, livestock resources, veterinary resources, plant health resources, and the domestic distribution of farm equipment and commercial fertilizer (delegated to the Department of Agriculture);

(ii) All forms of energy (delegated to the Department of Energy);

(iii) Health resources (delegated to the Department of Health and Human Services);

(iv) All forms of civil transportation (delegated to the Department of Transportation); and

(v) Water resources (delegated to the Department of Defense/U.S. Army Corps of Engineers).

(2) The priorities and allocations authority set forth in this part may not be applied to communications services subject to Executive Order 13618 of July 6, 2012—Assignment of National Security and Emergency Preparedness Communications Functions (77 FR 40779, 3 CFR, 2012 Comp., p. 273).

■ 11. Section 700.11 is amended by revising the second sentence of paragraph (b) to read as follows:

§ 700.11 Priority ratings.

* * * * *

(b) *Program identification symbols.* * * * The list of approved programs and their identification symbols is found in Schedule I to this part. * * *

* * * * *

■ 12. Section 700.12 is revised to read as follows:

§ 700.12 Elements of a rated order.

(a) *Elements required for all rated orders.* (1) The appropriate priority rating and program identification symbol (e.g., DO–A1, DX–A4, DO–N1).

(2) A required delivery date or dates. The words ''immediately'' or ''as soon as possible'' do not constitute a delivery date. When a ''requirements contract,'' ''basic ordering agreement,'' ''prime vendor contract,'' or similar procurement document bearing a priority rating contains no specific delivery date or dates, but provides for the furnishing of items from time-to-time or within a stated period against specific purchase orders, such as ''calls,'' ''requisitions,'' and ''delivery orders,'' the purchase orders supporting such contracts or agreements must specify a required delivery date or dates and are to be considered as rated as of the date of their receipt by the supplier and not as of the date of the original procurement document.

(3) The written signature on a manually placed order, or the digital signature or name on an electronically placed order, of an individual authorized to sign rated orders for the person placing the order. The signature, manual or digital, certifies that the rated order is authorized under this part and that the requirements of this part are being followed.

(4) A statement that reads in substance: This is a rated order certified for national defense use and you are required to follow all the provisions of the Defense Priorities and Allocations System regulations (15 CFR part 700).

(b) *Additional element required for certain emergency preparedness rated orders.* If a rated order is placed for the purpose of emergency preparedness requirements and expedited action is necessary or appropriate to meet these requirements, the following statement must be included in the order. ''This rated order is placed for the purpose of emergency preparedness. It must be accepted or rejected within [*Insert a time limit no less than the minimum applicable time limit specified in § 700.13(d)(2)t.*].''

■ 13. Section 700.13 is amended by revising paragraph (d) to read as follows:

§ 700.13 Acceptance and rejection of rated orders.

* * * * *

(d) *Customer notification requirements.* (1) Except as provided in paragraph (d)(2) of this section, a person must accept or reject a rated order in writing (hard copy), or in electronic format, within fifteen (15) working days after receipt of a DO rated order and within ten (10) working days after receipt of a DX rated order. If the order is rejected, the person must give reasons in writing or electronically for the rejection.

(2) If a rated order is placed for the purpose of emergency preparedness requirements and expedited action is necessary or appropriate to meet these requirements and the order includes the statement set forth in § 700.12(b), a person must accept or reject the rated order and transmit the acceptance or rejection in writing or in an electronic format within the time specified in the rated order. The minimum times for acceptance or rejection that such orders may specify are six (6) hours after receipt of the order if the order is issued by an authorized person in response to a hazard that has occurred, or twelve (12) hours after receipt if the order is issued by an authorized person to prepare for an imminent hazard.

(3) If a person has accepted a rated order and subsequently finds that shipment or performance will be delayed, the person must notify the customer immediately, give the reasons for the delay, and advise of a new shipment or performance date. If notification is given verbally, written (hard copy) or electronic confirmation must be provided within one working day of the verbal notice.

* * * * *

■ 14. Section 700.14 is amended by adding a sentence at the end of the examples paragraph in paragraph (b) and by revising paragraph (c)(2) to read as follows:

§ 700.14 Preferential scheduling.

* * * * *

(b) * * *

Examples: * * * However, if business operations cannot be altered to meet both the June 3 and July 15 delivery dates, then the DX rated order must be given priority over the DO rated order.

(c) * * *

(2) If a person is unable to resolve rated order delivery or performance conflicts under this section, the person should promptly seek special priorities assistance as provided in Subpart H of this part. If the person's customer objects to the rescheduling of delivery or performance of a rated order, the customer should promptly seek special priorities assistance as provided in Subpart H of this part. For any rated order against which delivery or performance will be delayed, the person must notify the customer as provided in § 700.13(d)(3).

* * * * *

■ 15. Section 700.15 is amended by revising the second sentence of paragraph (a), the undesignated paragraph following paragraph (a), revising the second sentence of

paragraph (b), and by adding paragraph (c) to read as follows:

§ 700.15 Extension of priority ratings.

(a) * * * The person must use the priority rating indicated on the customer's rated order, except as otherwise provided in this part or as directed by the Department of Commerce. * * *

Example: If a person is in receipt of a DO–A3 rated order for a navigation system and needs to purchase semiconductors for its manufacture, that person must use a DO–A3 rated order to obtain the needed semiconductors.

(b) * * * Therefore, the inclusion of the rating will continue from contractor to subcontractor to supplier throughout the entire supply chain.

(c) A person must use rated orders with suppliers to obtain items needed to fill an emergency preparedness rated order. That person must require acceptance or rejection, and transmission of that acceptance or rejection by the supplier within the time limit stated in the rated order that is being filled.

■ 16. Section 700.16 is amended by revising paragraphs (d), (e) and (f) to read as follows:

§ 700.16 Changes or cancellations of priority ratings and rated orders.

* * * * *

(d) The following amendments do not constitute a new rated order: a change in shipping destination; a reduction in the total amount of the order; an increase in the total amount of the order which has negligible impact upon deliveries; a minor variation in size or design (prior to the start of production); or a change which is agreed upon between the supplier and the customer.

(e) A person must cancel any rated orders that the person (or a predecessor in interest) has placed with suppliers or cancel the priority ratings on those orders if the person no longer needs the items in those orders to fill a rated order.

(f) A person adding a rating to an unrated order, or changing or cancelling a priority rating must promptly notify all suppliers to whom the order was sent of the addition, change or cancellation.

■ 17. Section 700.17 is amended by revising paragraphs (d)(1)(ii) and (f) to read as follows:

§ 700.17 Use of rated orders.

* * * * *

(d) * * *

(1) * * *

(ii) The elements of a rated order, as required by § 700.12, are included on the order with the statement required in § 700.12(a)(4) modified to read in substance: ''This purchase order contains rated order quantities certified for national defense use, and you are required to follow all the provisions of the Defense Priorities and Allocations System regulations (15 CFR part 700) as it pertains to the rated quantities.''

* * * * *

(f) A person is not required to place a priority rating on an order for less than $75,000, or one half of the Simplified Acquisition Threshold (as established in the Federal Acquisition Regulation (FAR) (see FAR section 2.101), whichever amount is greater, provided that delivery can be obtained in a timely fashion without the use of the priority rating.

■ 18. Section 700.18 is revised to read as follows:

§ 700.18 Limitations on placing rated orders.

(a) *General limitations.* (1) A person may not place a rated order pursuant to this part unless the person is in receipt of a rated order, has been explicitly authorized to do so by the Department of Commerce or a Delegate Agency or is otherwise permitted to do so by this part.

(2) Rated orders may not be used to obtain:

(i) Delivery on a date earlier than needed;

(ii) A greater quantity of the item than needed, except to obtain a minimum procurable quantity;

(iii) Items in advance of the receipt of a rated order, except as specifically authorized by the Department of Commerce (see § 700.41(c) for information on obtaining authorization for a priority rating in advance of a rated order); or

(iv) Any of the following items unless specific priority rating authority has been obtained from a Delegate Agency or the Department of Commerce:

(A) Items for plant improvement, expansion or construction, unless they will be physically incorporated into a construction project covered by a rated order; or

(B) Production or construction equipment or items to be used for the manufacture of production equipment (for information on requesting priority rating authority, see § 700.41).

(v) Any items related to the development of chemical or biological warfare capabilities or the production of chemical or biological weapons, unless such development or production has been authorized by the President or the Secretary of Defense.

(3) Separate rated orders may not be placed solely for obtaining minimum procurable quantities on each order if the minimum procurable quantity would be sufficient to cover more than one rated order.

(b) *Specific item limitations.* Notwithstanding any authorization or requirement to place a rated order stated elsewhere in this part, no person may place a rated order to obtain the following items unless such order is authorized by an official action of the Department of Commerce.

(1) Copper raw materials.
(2) Crushed stone.
(3) Gravel.
(4) Sand.
(5) Scrap.
(6) Slag.
(7) Steam heat, central.
(8) Waste paper.

■ 19. Section 700.21 is revised to read as follows:

§ 700.21 Application for priority rating authority.

(a) For projects believed to maximize domestic energy supplies, a person may request priority rating authority for scarce, critical, and essential supplies of materials, equipment, and services (related to the production of materials or equipment, or the installation, repair, or maintenance of equipment) by submitting a request to the Department of Energy. Further information may be obtained from the Department of Energy, Office of Electricity Delivery and Energy Reliability, 1000 Independence Avenue SW., Washington, DC 20585.

(b) If the Department of Energy notifies the Department of Commerce that the project maximizes domestic energy supplies and that the materials, equipment, or services are critical and essential, the Department of Commerce will determine whether the items in question are scarce, and, if they are scarce, whether there is a need to use the priorities authority.

(1) Scarcity implies an unusual difficulty in obtaining the materials, equipment, or services in a time frame consistent with the timely completion of the energy project. In determining scarcity, the Department of Commerce may consider factors such as the following:

(i) Value and volume of material or equipment shipments;

(ii) Consumption of material and equipment;

(iii) Volume and market trends of imports and exports;

(iv) Domestic and foreign sources of supply;

(v) Normal levels of inventories;

(vi) Rates of capacity utilization;
(vii) Volume of new orders; and
(viii) Lead times for new orders.

(2) In finding whether there is a need to use the priorities authority, the Department of Commerce may consider alternative supply solutions and other measures.

(c) After the Department of Commerce has conducted its analysis, it will advise the Department of Energy whether the two findings have been satisfied. If the findings are satisfied, the Department of Commerce will authorize the Department of Energy to grant the use of a priority rating to the applicant.

(d) Schedule I to this part includes a list of approved programs to support the maximization of domestic energy supplies. A Department of Energy regulation setting forth the procedures and criteria used by the Department of Energy in making its determination and findings is published in 10 CFR part 216.

Subpart F—Allocation Actions

■ 20. The heading of Subpart F is revised to read as set forth above.

■ 21. Section 700.30 is revised to read as follows:

§ 700.30 Policy.

(a) Allocation orders will:

(1) Be used only when there is insufficient supply of a material, service, or facility to satisfy national defense requirements through the use of the priorities authority or when the use of the priorities authority would cause a severe and prolonged disruption in the supply of materials, services, or facilities available to support normal U.S. economic activities; and

(2) Not be used to ration materials or services at the retail level.

(b) Allocation orders, when used, will be distributed equitably among the suppliers of the materials, services, or facilities being allocated and not require any person to relinquish a disproportionate share of the civilian market.

■ 22. Section 700.31 is revised to read as follows:

§ 700.31 General procedures.

Before the Department of Commerce uses its allocations authority to address a supply problem within its resource jurisdiction, it will develop a plan that includes:

(a) A copy of the written determination made in accordance with section 202 of Executive Order 13603, that the program or programs that would be supported by the allocation action are necessary or appropriate to promote the national defense;

(b) A detailed description of the situation to include any unusual events or circumstances that have created the requirement for an allocation action;

(c) A statement of the specific objective(s) of the allocation action;

(d) A list of the materials, services, or facilities to be allocated;

(e) A list or description of the sources of the materials, services, or facilities that will be subject to the allocation action;

(f) A detailed description of the provisions that will be included in the allocations orders, including the type(s) of allocations orders, the percentages or quantity of capacity or output to be allocated for each purpose, the relationship with previously or subsequently received priority rated and unrated contracts and orders, and the duration of the allocation action (*e.g.,* anticipated start and end dates);

(g) An evaluation of the impact of the proposed allocation action on the civilian market; and

(h) Proposed actions, if any, to mitigate disruptions to civilian market operations.

■ 23. In Subpart F, add § 700.32 to read as follows:

§ 700.32 Controlling the general distribution of a material in the civilian market.

No allocation action by the Department of Commerce may be used to control the general distribution of a material in the civilian market unless the conditions of paragraphs (a), (b) and (c) of this section are met.

(a) The Secretary has made a written finding that:

(1) Such material is a scarce and critical material essential to the national defense, and

(2) The requirements of the national defense for such material cannot otherwise be met without creating a significant dislocation of the normal distribution of such material in the civilian market to such a degree as to create appreciable hardship.

(b) The Secretary has submitted the finding for the President's approval through the Assistant to the President and National Security Advisor and the Assistant to the President for Homeland Security and Counterterrorism.

(c) The President has approved the finding.

(d) In this section, the term, ''Secretary'' means the Secretary of Commerce or his or her designee.

■ 24. In Subpart F, add § 700.33 to read as follows:

§ 700.33 Types of allocations orders.

There are three types of allocations orders available for communicating allocation actions.

(a) *Set-aside.* A set-aside is an official action that requires a person to reserve materials, services, or facilities capacity in anticipation of the receipt of rated orders.

(b) *Directive.* A directive is an official action that requires a person to take or refrain from taking certain actions in accordance with its provisions. For example, a directive can require a person to: Stop or reduce production of an item; prohibit the use of selected materials, services, or facilities; or divert the use of materials, services, or facilities from one purpose to another.

(c) *Allotment.* An allotment is an official action that specifies the maximum quantity of a material, service, or facility authorized for a specific use to promote the national defense.

■ 25. In Subpart F, add § 700.34 to read as follows:

§ 700.34 Elements of an allocation order.

Allocation orders may be issued directly to the affected persons or by constructive notice to the parties through publication in the **Federal Register**. This section describes the elements that each order must include.

(a) Elements to be included in all allocation orders.

(1) A detailed description of the required allocation action(s), including its relationship to previously or subsequently received DX rated orders, DO rated orders and unrated orders.

(2) Specific start and end calendar dates for each required allocation action.

(b) Elements to be included in orders issued directly to affected persons.

(1) A statement that reads in substance: ''This is an allocation order certified for national defense use. [Insert the name of the person receiving the order] is required to comply with this order, in accordance with the provisions of the Defense Priorities and Allocations System regulations (15 CFR part 700).''

(2) The written signature on a manually placed order, or the digital signature or name on an electronically placed order, of an authorized official or employee of the Department of Commerce.

(c) Elements to be included in an allocation order that gives constructive notice through publication in the **Federal Register**.

(1) A statement that reads in substance: ''This is an allocation order certified for national defense use. [Insert the name(s) of the person(s) to whom

the order applies or a description of the class of persons to whom the order applies] is (are) required to comply with this order, in accordance with the provisions of the Defense Priorities and Allocations System regulations (15 CFR part 700).''

(2) The order must be signed by an authorized official or employee of the Department of Commerce.

■ 26. In Subpart F, add § 700.35 to read as follows:

§ 700.35 Mandatory acceptance of an allocation order.

(a) Except as otherwise specified in this section, a person shall accept and comply with every allocation order received.

(b) A person shall not discriminate against an allocation order in any manner such as by charging higher prices for materials, services, or facilities covered by the order or by imposing terms and conditions for contracts and orders involving allocated materials, services, or facilities that differ from the person's terms and conditions for contracts and orders for the materials, services, or facilities prior to receiving the allocation order.

(c) If a person is unable to comply fully with the required action(s) specified in an allocation order, the person must notify the Office of Strategic Industries and Economic Security immediately, explain the extent to which compliance is possible, and give the reasons why full compliance is not possible. If notification is given verbally, written or electronic confirmation must be provided within one working day. Such notification does not release the person from complying with the order to the fullest extent possible, until the person is notified by the Department of Commerce that the order has been changed or cancelled.

■ 27. In Subpart F, add § 700.36 to read as follows:

§ 700.36 Changes or cancellations of allocation orders.

An allocation order may be changed or cancelled by an official action from the Department of Commerce. Notice of such changes or cancellations may be provided directly to persons to whom the order being cancelled or modified applies or constructive notice may be provided by publication in the **Federal Register**.

■ 28. Section 700.50 is amended by revising the first sentence of paragraph (a) and revising paragraph (b) to read as follows:

§ 700.50 General provisions.

(a) Once a priority rating has been authorized pursuant to this part, further action by the Department of Commerce generally is not needed. * * *

(b) Special priorities assistance can be provided for any reason consistent with this part, such as assisting in obtaining timely deliveries of items needed to satisfy rated orders or authorizing the use of priority ratings on orders to obtain items not otherwise ratable under this part. If the Department of Commerce is unable to resolve the problem or to authorize the use of a priority rating and believes additional assistance is warranted, the Department of Commerce may forward the request to another agency, identified in § 700.10(c), as appropriate, for action.

* * * * *

§ 700.51 [Amended]

■ 29. Section 700.51 is amended by:

■ a. Removing the word ''regulation'' and adding in its place the word ''part'' in paragraph (a), introductory text;

■ b. Adding the phrase ''the Department of'' immediately preceding the word ''Commerce'' in the first sentence of paragraph (c)(1);

■ c. Adding the word ''and'' at the end of paragraph (c)(3)(iv);

■ d. Removing paragraph (c)(3)(v); and

■ e. Redesignating paragraph (c)(3)(vi) as (c)(3)(v).

§ 700.53 [Amended]

■ 30. Section 700.53 is amneded by adding the words ''the Department of'' between the word ''or'' and the word ''Commerce'' in the introductory text.

§ 700.54 [Amended]

■ 31. Section 700.54 is amended by adding the words ''the Department of'' between the word ''or'' and the word ''Commerce'' in the introductory text.

■ 32. Section 700.55 is revised to read as follows:

§ 700.55 Homeland security, emergency preparedness, and critical infrastructure protection and restoration assistance programs within the United States.

Any person requesting priority rating authority or requiring assistance in obtaining rated items supporting homeland security, emergency preparedness, and critical infrastructure protection and restoration related activities should submit a request for such assistance or priority rating authority to the Office of Policy and Program Analysis, Federal Emergency Management Agency, Department of Homeland Security, 500 C Street SW., Washington, DC, 20472; telephone: (202) 646–3520; Fax: (202) 646–4060; Email: *fema-dpas@dhs.gov,* Web site: *http://www.fema.gov/defense-production-act-program-division.*

■ 33. In Subpart H, § 700.56 is added to read as follows:

§ 700.56 Military assistance programs with Canada.

(a) To promote military assistance to Canada, this section provides for authorizing priority ratings to persons in Canada to obtain items in the United States in support of approved programs. Although priority ratings have no legal authority outside of the United States, this section also provides information on how persons in the United States may obtain informal assistance in Canada in support of approved programs.

(b) The joint United States-Canadian military arrangements for the defense of North America and the integrated nature of the United States and Canadian defense industries require close coordination and the establishment of a means to provide mutual assistance to the defense industries located in both countries.

(c) The Department of Commerce coordinates with the Canadian Public Works and Government Services Canada on all matters of mutual concern relating to the administration of this part.

(d) Any person in the United States ordering defense items in Canada in support of an approved program should inform the Canadian supplier that the items being ordered are to be used to fill a rated order. The Canadian supplier should be informed that if production materials are needed from the United States by the supplier or the supplier's vendor to fill the order, the supplier or vendor should contact the Canadian Public Works and Government Services Canada for authority to place rated orders in the United States: Public Works and Government Services Canada, Acquisitions Branch, Business Management Directorate, Phase 3, Place du Portage, Level 0A1, 11 Laurier Street, Gatineau, Quebec, K1A 0S5, Canada; Telephone: (819) 956–6825; Fax: (819) 956–7827, or electronically at *DGA Prioritesdedefense.ACQBDefence Priorities@tpsgc-pwgsc.gc.ca.*

(e) Any person in Canada producing defense items for the Canadian government may also obtain priority rating authority for items to be purchased in the United States by applying to the Canadian Public Works and Government Services Canada, Acquisitions Branch, Business Management Directorate, in accordance with its procedures. (f) Persons in Canada needing special priorities

assistance in obtaining defense items in the United States may apply to the Canadian Public Works and Government Services Canada, Acquisitions Branch, Business Management Directorate, for such assistance. Public Works and Government Services Canada will forward appropriate requests to the Department of Commerce.

(g) Any person in the United States requiring assistance in obtaining items in Canada must submit a request through the Delegate Agency to the Office of Strategic Industries and Economic Security, U.S. Department of Commerce on Form BIS–999. The Department of Commerce will forward appropriate requests to the Canadian Public Works and Government Services Canada.

■ 34. In Subpart H, § 700.57 is added to read as follows:

§ 700.57 Military assistance programs with other nations and international organizations.

(a) *Scope.* To promote military assistance to foreign nations and international organizations (for example the North Atlantic Treaty Organization or the United Nations), this section provides for authorizing priority ratings to persons in foreign nations or international organizations to obtain items in the United States in support of approved programs. Although priority ratings have no legal authority outside of the United States, this section also provides information on how persons in the United States may obtain informal assistance in Australia, Finland, Italy, The Netherlands, Sweden, and the United Kingdom in support of approved programs. (b) *Foreign nations and international organizations.* (1) Any person in a foreign nation other than Canada, or any person in an international organization, requiring assistance in obtaining items in the United States or priority rating authority for items to be purchased in the United States, should submit a request for such assistance or priority rating authority to: The Department of Defense DPAS Lead in the Office of the Deputy Assistant Secretary of Defense for Manufacturing and Industrial Base Policy, 3330 Defense Pentagon, Washington, DC 20301; Telephone: (703) 697–0051; Fax: (703) 695–4885; Email: *MIBP@osd.mil,* Web site: *http://www.acq.osd.mil/mibp.*

(i) If the end product is being acquired by a U.S. Government agency, the request should be submitted to the Department of Defense DPAS Lead through the U.S. contract administration representative.

(ii) If the end product is being acquired by a foreign nation or international organization, the request must be sponsored prior to its submission to the Department of Defense DPAS Lead by the government of the foreign nation or the international organization that will use the end product.

(2) If the Department of Defense endorses the request, it will be forwarded to the Department of Commerce for appropriate action.

(c) *Requesting assistance in Australia, Finland, Italy, The Netherlands, Sweden, and the United Kingdom.*

(1) The Department of Defense has entered into bilateral security of supply arrangements with Australia, Finland, Italy, The Netherlands, Sweden, and the United Kingdom that allow the Department of Defense to request the priority delivery for Department of Defense contracts, subcontracts, and orders from companies in these countries.

(2) Any person in the United States requiring assistance in obtaining the priority delivery of a contract, subcontract, or order in Australia, Finland, Italy, The Netherlands, Sweden, or the United Kingdom to support an approved program should contact the Department of Defense DPAS Lead in the Office of the Deputy Assistant Secretary of Defense for Manufacturing and Industrial Base Policy for assistance. Persons in Australia, Finland, Italy, The Netherlands, Sweden, and the United Kingdom should request assistance in accordance with paragraph (b)(1) of this section.

■ 35. In Subpart H, § 700.58 is added to read as follows:

§ 700.58 Critical infrastructure assistance programs to foreign nations and international organizations.

(a) *Scope.* To promote critical infrastructure assistance to foreign nations, this section provides for authorizing priority ratings to persons in foreign nations or international organizations (for example the North Atlantic Treaty Organization or the United Nations) to obtain items in the United States in support of approved programs.

(b) *Foreign nations or international organizations.* Any person in a foreign nation or representing an international organization requiring assistance in obtaining items to be purchased in the United States for support of critical infrastructure protection and restoration should submit a request for such assistance or priority rating authority to the Office of Policy and Program Analysis, Federal Emergency Management Agency, Department of Homeland Security, 500 C Street SW., Washington, DC 20472; telephone: (202) 646–3520; Fax: (202) 646–4060; Email: *fema-dpas@dhs.gov*, Web site: *http://www.fema.gov/defense-production-act-program-division.*

■ 36. Section 700.60 is revised to read as follows:

§ 700.60 General provisions.

(a) The Department of Commerce may, from time-to-time, take specific official actions to implement or enforce the provisions of this part.

(b) Some of these official actions (rating authorizations and letters of understanding) are discussed in this subpart. Official actions that pertain to compliance (administrative subpoenas, demands for information, and inspection authorizations) are discussed in § 700.71(c). Directives are discussed in § 700.62.

■ 37. Section 700.61 is amended by revising the heading and paragraph (a) introductory text to read as follows:

§ 700.61 Rating authorizations.

(a) A rating authorization is an official action granting specific priority rating authority that:

* * * * *

§ 700.62 [Amended]

■ 38. Section 700.62 is amended by removing ''Directive'' wherever it appears and by adding in its place ''directive''.

§ 700.63 [Amended]

■ 39. Section 700.63 is amended by:

■ a. Removing ''Letter of Understanding'' wherever it appears and adding in its place ''letter of understanding''; and

■ b. Adding the words ''the Department of'' immediately preceding the word ''Commerce''.

§ 700.70 [Amended]

■ 40. Section 700.70 is amended by:

■ a. Removing paragraph (b);

■ b. Redesignating paragraph (c) as paragraph (b); and

■ c. Removing the word ''regulation'' wherever it appears and adding in its place the word ''part''.

■ 41. Section 700.71 is revised to read as follows:

§ 700.71 Audits and investigations.

(a) Audits and investigations are official actions involving the examination of books, records, documents, other writings and information to ensure that the provisions of the Defense Production Act, the Selective Service Act and

related statutes, and this part have been properly followed. An audit or investigation may also include interviews and a systems evaluation to detect problems or failures in the implementation of this part.

(b) When undertaking an audit, investigation, or other inquiry, the Department of Commerce shall:

(1) Define the scope and purpose in the official action given to the person under investigation, and

(2) Have ascertained that the information sought or other adequate and authoritative data are not available from any Federal or other responsible agency.

(c) In administering this part, the Department of Commerce may issue the following documents, which constitute official actions:

(1) *Administrative subpoenas.* An administrative subpoena requires a person to appear as a witness before an official designated by the Department of Commerce to testify under oath on matters of which that person has knowledge relating to the enforcement or the administration of the Defense Production Act, the Selective Service Act and related statutes, or this part. An administrative subpoena may also require the production of books, papers, records, documents and physical objects or property.

(2) *Demand for information.* A demand for information requires a person to furnish to a duly authorized representative of the Department of Commerce any information necessary or appropriate to the enforcement or the administration of the Defense Production Act, the Selective Service Act, or this part.

(3) *Inspection authorizations.* An inspection authorization requires a person to permit a duly authorized representative of the Department of Commerce to interview the person's employees or agents, to inspect books, records, documents, other writings and information in the person's possession or control at the place where that person usually keeps them, and to inspect a person's property when such interviews and inspections are necessary or appropriate to the enforcement or the administration of the Defense Production Act, the Selective Service Act, or this part.

(d) The production of books, records, documents, other writings and information will not be required at any place other than where they are usually kept if, prior to the return date specified in the administrative subpoena or demand for information, a duly authorized official of the Department of Commerce is furnished with copies of such material that are certified under oath to be true copies. As an alternative, a person may enter into a stipulation with a duly authorized official of the Department of Commerce as to the content of the material.

(e) An administrative subpoena, demand for information, or inspection authorization shall include the name, title or official position of the person to be served, the evidence sought to be adduced, and its general relevance to the scope and purpose of the audit, investigation, or other inquiry. If employees or agents are to be interviewed; if books, records, documents, other writings, or information are to be produced; or if property is to be inspected; the administrative subpoena, demand for information, or inspection authorization will describe them with particularity.

(f) Service of documents shall be made in the following manner:

(1) Service of a demand for information or inspection authorization shall be made personally, or by certified mail—return receipt requested at the person's last known address. Service of an administrative subpoena shall be made personally. Personal service may also be made by leaving a copy of the document with someone at least 18 years of age at the person's last known dwelling or place of business.

(2) Service upon other than an individual may be made by serving a partner, corporate officer, or a managing or general agent authorized by appointment or by law to accept service of process. If an agent is served, a copy of the document shall be mailed to the person named in the document.

(3) Any individual 18 years of age or older may serve an administrative subpoena, demand for information, or inspection authorization. When personal service is made, the individual making the service shall prepare an affidavit as to the manner in which service was made and the identity of the person served, and return the affidavit, and in the case of subpoenas, the original document, to the issuing officer. In case of failure to make service, the reasons for the failure shall be stated on the original document.

■ 42. Section 700.72 is amended by revising the first sentence of paragraph (a) to read as follows:

§ 700.72 Compulsory process.

(a) If a person refuses to permit a duly authorized representative of the Department of Commerce to have access to any premises or source of information necessary to the administration or enforcement of the Defense Production Act or this part, the Department of Commerce may seek compulsory process. * * *

* * * * *

■ 43. Section 700.73 is revised to read as follows:

§ 700.73 Notification of failure to comply.

(a) At the conclusion of an audit, investigation, or other inquiry, or at any other time, the Department of Commerce may inform the person in writing where compliance with the requirements of the Defense Production Act, the Selective Service Act and related statutes, or this part were not met.

(b) In cases where the Department of Commerce determines that failure to comply with the provisions of the Defense Production Act, the Selective Service Act and related statutes, or this part was inadvertent, the person may be informed in writing of the particulars involved and the corrective action to be taken. Failure to take corrective action may then be construed as a willful violation of the Defense Production Act, this part, or an official action.

■ 44. Section 700.74 is amended by revising paragraphs (a), (b), (c)(1), (c)(2) and (c)(3) to read as follows:

§ 700.74 Violations, penalties, and remedies.

(a) Willful violation of the provisions of Title I or Sections 705 or 707 of the Defense Production Act, the priorities provisions of the Selective Service Act and related statutes or this part is a crime and upon conviction, a person may be punished by fine or imprisonment, or both. The maximum penalty provided by the Defense Production Act is a $10,000 fine, or one year in prison, or both. The maximum penalty provided by the Selective Service Act is a $50,000 fine, or three years in prison, or both.

(b) The government may also seek an injunction from a court of appropriate jurisdiction to prohibit the continuance of any violation of, or to enforce compliance with, the Defense Production Act, this part, or an official action.

(c) * * *

(1) No person may solicit, influence or permit another person to perform any act prohibited by, or to omit any act required by, the Defense Production Act, this part, or an official action.

(2) No person may conspire or act in concert with any other person to perform any act prohibited by, or to omit any act required by, the Defense Production Act, this part, or an official action.

(3) No person shall deliver any item if the person knows or has reason to

believe that the item will be accepted, redelivered, held, or used in violation of the Defense Production Act, this part, or an official action. In such instances, the person must immediately notify the Department of Commerce that, in accordance with this section, delivery has not been made.

■ 45. Section 700.80 is amended by revising paragraphs (a)(1) and (2), (b), and (c), and by revising the parenthetical sentence at the end of paragraph (d) to read as follows:

§ 700.80 Adjustments or exceptions.

(a) * * *

(1) A provision of this part or an official action results in an undue or exceptional hardship on that person not suffered generally by others in similar situations and circumstances; or

(2) The consequence of following a provision of this part or an official action is contrary to the intent of the Defense Production Act, the Selective Service Act and related statutes, or this part.

(b) Each request for adjustment or exception must be in writing and contain a complete statement of all the facts and circumstances related to the provision of this part or official action from which adjustment is sought and a full and precise statement of the reasons why relief should be provided.

(c) The submission of a request for adjustment or exception shall not relieve any person from the obligation of complying with the provision of this part or official action in question while the request is being considered unless such interim relief is granted in writing by the Office of Strategic Industries and Economic Security. The Office of Strategic Industries and Economic Security shall respond to requests for adjustment of or exceptions to compliance with the provisions of this part or an official action within 25 (twenty-five) days, not including Saturdays, Sundays or Government holidays, of the date of receipt.

(d) * * * (For information on the appeal procedure, see § 700.81.)

■ 46. Section 700.81 is amended by revising paragraphs (a), (b), and (g), to read as follows:

§ 700.81 Appeals.

(a) Any person who has had a request for adjustment or exception denied by the Office of Strategic Industries and Economic Security under § 700.80, may appeal to the Assistant Secretary for Export Administration, Department of Commerce, who shall review and reconsider the denial. Such appeals should be submitted to the Office of the Assistant Secretary for Export Administration, Bureau of Industry and Security, Department of Commerce, Room 3886, Washington, DC 20230, Ref: DPAS Appeals.

(b) Appeals of denied requests for exceptions from or adjustments to compliance with the provisions of this part or an official action must be received by the Assistant Secretary for Export Administration no later than 45 days after receipt of a written notice of denial from the Office of Strategic Industries and Economic Security. After this 45-day period, an appeal may be accepted at the discretion of the Assistant Secretary for Export Administration.

* * * * *

(g) The submission of an appeal under this section shall not relieve any person from the obligation of complying with the provision of this part or official action in question while the appeal is being considered, unless such relief is granted in writing by the Assistant Secretary for Export Administration.

* * * * *

§ 700.90 [Amended]

■ 47. Section 700.90 is amended by removing the word ''regulation'' and adding in its place the word ''part''.

§ 700.91 [Amended]

■ 48. Section 700.91 is amended by:

■ a. Removing the word ''regulation'' wherever it appears and adding in its place the word ''part'';

■ b. Adding the phrase ''the Department of'' immediately preceding the word ''Commerce'' wherever it appears; and

■ c. Removing ''705(e)'' and adding in its place ''705(d)'' wherever it appears.

§ 700.92 [Amended]

■ 49. Section 700.92 is amended by:

■ a. Removing the word ''regulation'' wherever it appears in the heading and in paragraphs (a), (b) and (c) and adding in its place the word ''part'';

■ b. Adding the phrase ''the Department of'' immediately preceding the word ''Commerce'' wherever it appears; and

■ c. Removing the phrase ''the regulations'' and adding in its place ''any provision of this part'' in the first sentence of paragraph (d).

§ 700.93 [Amended]

■ 50. Section 700.93 is revised to read as follows:

§ 700.93 Communications.

General communications concerning this part, including how to obtain copies of this part and explanatory information, requests for guidance or clarification, may be addressed to the Office of Strategic Industries and Economic Security, Room 3876, Department of Commerce, Washington, DC 20230, Ref: DPAS; telephone (202) 482–3634, email *DPAS@bis.doc.gov.* Request for priorities assistance under § 700.50, adjustments or exceptions under § 700.80 of this part or appeals under § 700.81, must be submitted in the manner specified in those sections.

■ 51. Schedule I to part 700 is revised to read as follows:

Schedule I to Part 700—Approved Programs and Delegate Agencies

The programs listed in this schedule have been approved for priorities support under this part by the Department of Defense,[1] the Department of Energy or the Department of Homeland Security, in accordance with section 202 of Executive Order 13603. They have equal preferential status. The Department of Commerce has authorized the delegate agencies listed in the third column to use this part in support of those programs assigned to them, as indicated below.[2]

Program identification symbol	Approved program	Agency(ies)
	Defense Programs	
A1	Aircraft	Department of Defense.
A2	Missiles	Department of Defense.
A3	Ships	Department of Defense.

[1] Department of Defense includes: The Office of the Secretary of Defense, the Military Departments, the Joint Staff, the Combatant Commands, the Defense Agencies, the Defense Field Activities, all other organizational entities in the Department of Defense, and, for purposes of this part, the Central Intelligence Agency and the National Aeronautics and Space Administration as associated agencies.

[2] The Department of Commerce is also listed as an agency in the third column for programs where its authorization is necessary to place rated orders.

Program identification symbol	Approved program	Agency(ies)
A4	Tank—Automotive	Department of Defense.
A5	Weapons	Department of Defense.
A6	Ammunition	Department of Defense.
A7	Electronic and communications equipment	Department of Defense.
B1	Military building supplies	Department of Defense.
B8	Production equipment (for defense contractor's account)	Department of Defense.
B9	Production equipment (Government owned)	Department of Defense.
C1	Food resources (combat rations)	Department of Defense.
C2	Department of Defense construction	Department of Defense.
C3	Maintenance, repair, and operating supplies (MRO) for Department of Defense facilities.	Department of Defense.
C9	Miscellaneous	Department of Defense
	Military Assistance to Canada	
D1	Canadian military programs	Department of Commerce.
D2	Canadian production and construction	Department of Commerce.
D3	Canadian atomic energy program	Department of Commerce.
	Military Assistance to Other Foreign Nations	
G1	Certain munitions items purchased by foreign governments through domestic commercial channels for export.	Department of Commerce.
G2	Certain direct defense needs of foreign governments other than Canada	Department of Commerce.
G3	Foreign nations (other than Canada) production and construction	Department of Commerce.
	Critical Infrastructure Assistance to Foreign Nations	
G4	Foreign critical infrastructure programs	Department of Commerce.
	Co-Production	
J1	F–16 Co-Production Program	Departments of Commerce and Defense.
	Atomic Energy Programs	
E1	Construction	Department of Energy.
E2	Operations—including maintenance, repair, and operating supplies (MRO)	Department of Energy.
E3	Privately owned facilities	Department of Energy.
	Domestic Energy Programs	
F1	Exploration, production, refining, and transportation	Department of Energy.
F2	Conservation	Department of Energy.
F3	Construction, repair, and maintenance	Department of Energy.
	Other Defense, Energy, and Related Programs	
H1	Certain combined orders (see section 700.17(c))	Department of Commerce.
H5	Private domestic production	Department of Commerce.
H6	Private domestic construction	Department of Commerce.
H7	Maintenance, repair, and operating supplies (MRO)	Department of Commerce.
H8	Designated Programs	Department of Commerce.
K1	Federal supply items	General Services Administration.
	Homeland Security Programs	
N1	Federal emergency preparedness, mitigation, response, and recovery	Department of Homeland Security.
N2	State, local, tribal government emergency preparedness, mitigation, response, and recovery.	Department of Homeland Security.
N3	Intelligence and warning systems	Department of Homeland Security.
N4	Border and transportation security	Department of Homeland Security.
N5	Domestic counter-terrorism, including law enforcement	Department of Homeland Security.
N6	Chemical, biological, radiological, and nuclear countermeasures	Department of Homeland Security.
N7	Critical infrastructure protection and restoration	Department of Homeland Security.
N8	Miscellaneous	Department of Homeland Security.

Dated: January 21, 2014.

Kevin J. Wolf,

Assistant Secretary for Export Administration.

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

21 CFR Parts 16 and 121

[Docket No. FDA–2013–N–1425]

Focused Mitigation Strategies To Protect Food Against Intentional Adulteration; Public Meetings on Proposed Rule

AGENCY: Food and Drug Administration, HHS.

ACTION: Notification of public meetings.

SUMMARY: The Food and Drug Administration (FDA or we) is announcing two public meetings to discuss the proposed rule to require domestic and foreign food facilities that are required to register under the Federal Food, Drug, and Cosmetic Act (the FD&C Act) to address hazards that may be intentionally introduced by acts of terrorism. FDA proposed these requirements as part of our implementation of the FDA Food Safety Modernization Act (FSMA). The purpose of the public meetings is to inform the public of the provisions of the proposed rule and the rulemaking process (including how to submit comments, data, and other information to the rulemaking docket) as well as solicit oral stakeholder and public comments on the proposed rule and to respond to questions about the rule.

DATES: See section II, ''How to Participate in the Public Meeting'' in the **SUPPLEMENTARY INFORMATION** section for dates and times of the public meetings, closing dates for advance registration, and information on deadlines for submitting either electronic or written comments to FDA's Division of Dockets Management.

ADDRESSES: See section II, ''How to Participate in the Public Meeting'' in the **SUPPLEMENTARY INFORMATION** section.

FOR FURTHER INFORMATION CONTACT: *For questions about registering for the meeting, to register by phone, or to submit a notice of participation by mail, FAX, or email, contact:* Nick Cane, Nakamoto Group, Inc., 11820 Parklawn Dr., Suite 240, Rockville, MD 20852, 240–357–1176, FAX: 301–468–6536, email: *nick.cane@nakamotogroup.com. For general questions about the meeting; to request an opportunity to make an oral presentation at the public meeting; to submit the full text, comprehensive outline, or summary of an oral presentation; or for special accommodations due to a disability, contact:* Juanita Yates, Center for Food Safety and Applied Nutrition (HFS–009), Food and Drug Administration, 5100 Paint Branch Pkwy., College Park, MD 20740, 240–402–1731, email: *Juanita.yates@fda.hhs.gov.*

SUPPLEMENTARY INFORMATION:

I. Background

FSMA (Pub. L. 111–353) was signed into law by President Obama on January 4, 2011, to better protect public health by helping to ensure the safety and security of the food supply. FSMA amends the FD&C Act to establish the foundation of a modernized, prevention-based food safety system. Among other things, FSMA requires FDA to issue regulations requiring domestic and foreign food facilities that are required to register under the FD&C Act to address hazards that may be intentionally introduced by acts of terrorism. These food facilities would be required to identify and implement focused mitigation strategies to significantly minimize or prevent significant vulnerabilities identified at actionable process steps in a food operation. We expect the rulemaking would help to protect food from intentional adulteration caused by acts of terrorism.

FDA is announcing additional public meetings so that the food industry, consumers, foreign governments, and other stakeholders can better evaluate and comment on the proposals. These meetings, following the College Park, MD, public event on February 20, are the final two public meetings FDA plans to hold during the proposed rule comment period. All three public meetings are intended to facilitate and support the proposed rule's evaluation and commenting process.

II. How To Participate in the Public Meetings

FDA is holding the public meetings on ''Focused Mitigation Strategies to Protect Food Against Intentional Adulteration'' to: (1) Inform the public about the rulemaking process, including how to submit comments, data, and other information to the rulemaking docket; (2) respond to questions about the proposed rules; and (3) provide an opportunity for interested persons to make oral presentations. Due to limited space and time, FDA encourages all persons who wish to attend the meetings to register in advance. There is no fee to register for the public meetings, and registration will be on a first-come, first-served basis. Early registration is recommended because seating is limited. Onsite registration will be accepted, as space permits, after all preregistered attendees are seated.

Those requesting an opportunity to make an oral presentation during the time allotted for public comment at the meetings are asked to submit a request and to provide the specific topic or issue to be addressed. Due to the anticipated high level of interest in presenting public comment and limited time available, FDA is allocating 3 minutes to each speaker to make an oral presentation. Speakers will be limited to making oral remarks; there will not be an opportunity to display materials such as slide shows, videos, or other media during the meetings. If time permits, individuals or organizations that did not register in advance may be granted the opportunity to make an oral presentation. FDA would like to maximize the number of individuals who make a presentation at each meeting and will do our best to accommodate all persons who wish to make a presentation or express their opinions at a meeting.

FDA encourages persons and groups who have similar interests to consolidate their information for presentation by a single representative. After reviewing the presentation requests, FDA will notify each participant before the meeting of the approximate time their presentation is scheduled to begin, and remind them of the presentation format (i.e., 3-minute oral presentation without visual media).

While oral presentations from specific individuals and organizations will be necessarily limited due to time constraints during the public meetings, stakeholders may submit electronic or written comments discussing any issues of concern to the administrative record (the docket) for the rulemaking. All relevant data and documentation should be submitted with the comments to the relevant docket, i.e., Docket No. FDA–2013–N–1425.

Table 1 of this document provides information on participation in the public meetings:

TABLE 1—INFORMATION ON PARTICIPATION IN THE MEETINGS AND ON SUBMITTING COMMENTS TO THE RULEMAKING DOCKETS

	Date	Electronic address	Address	Other information
Chicago, IL, Public meeting.	February 27, 2014	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*	Hilton Chicago, 720 South Michigan Ave., Chicago, IL 60605.	Onsite registration from 8 a.m. to 8:30 a.m.
Chicago, IL, Advance registration.	Until February 18, 2014.	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*	We encourage you to use electronic registration if possible.[1]	There is no registration fee for the public meetings. Early registration is recommended because seating is limited.
Chicago, IL, Request to make a Public Comment.	February 10, 2014	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*[2]	.....	Requests made on the day of the meeting to make an oral presentation will be granted as time permits. Information on requests to make an oral presentation may be posted without change to *http://www.regulations.gov,* including any personal information provided.
Chicago, IL, Request special accommodations due to a disability.	February 10, 2014	Juanita Yates, email: *Juanita.yates@fda.hhs.gov.*	See **FOR FURTHER INFORMATION CONTACT**.	
Chicago, IL, Closing date for electronic or written comments.	March 31, 2014	Docket No. FDA–2013–N–1425.		
Anaheim, CA, Public meeting.	March 13, 2014	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*	Sheraton Park Hotel, 1855 South Harbor Blvd., Anaheim, CA 92802.	Onsite registration from 8 a.m. to 8:30 a.m.
Anaheim, CA, Advance registration.	Until March 4, 2014	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*	We encourage you to use electronic registration if possible.[1]	There is no registration fee for the public meetings. Early registration is recommended because seating is limited.
Anaheim, CA, Request to make a Public Comment.	February 18, 2014	*http://www.fda.gov/Food/GuidanceRegulation/FSMA/ucm247568.htm.*[2].	.....	Requests made on the day of the meeting to make an oral presentation will be granted as time permits. Information on requests to make an oral presentation may be posted without change to *http://www.regulations.gov,* including any personal information provided.
Anaheim, CA, Request special accommodations due to a disability.	February 18, 2014	Juanita Yates, email: *Juanita.yates@fda.hhs.gov.*	See **FOR FURTHER INFORMATION CONTACT**.	
Anaheim, CA, Closing date for electronic or written comments.	March 31, 2014	Docket No. FDA–2013–N–1425.		

[1] You may also register via email, mail, or FAX. Please include your name, title, firm name, address, and phone and FAX numbers in your registration information and send to: Nick Cane, Nakamoto Group, Inc., 11820 Parklawn Dr., Suite 240, Rockville, MD 20852, 240–357–1176, FAX: 301–468–6536, email: *nick.cane@nakamotogroup.com.* Onsite registration will also be available.

[2] You may also request to make an oral presentation at the public meetings via email. Please include your name, title, firm name, address, and phone and FAX numbers as well as the full text, comprehensive outline, or summary of your oral presentation and send to: Juanita Yates, Center for Food Safety and Applied Nutrition, Food and Drug Administration, 5100 Paint Branch Pkwy., College Park, MD 20740, 240–402–1731, email: *Juanita.yates@fda.hhs.gov.*

III. Comments, Transcripts, and Recorded Video

Information and data submitted voluntarily to FDA during the public meetings will become part of the administrative record for the rulemaking and will be accessible to the public at *http://www.regulations.gov.* The transcript of the proceedings from the public meetings will become part of the administrative record for the rulemaking. Please be advised that as soon as a transcript is available, it will be accessible at *http://www.regulations.gov* and at FDA's FSMA Web site at: *http://www.fda.gov/Food/GuidanceRegulation/FSMA/default.htm.* It may also be viewed at the Division of Dockets Management (HFA–305), Food and Drug Administration, 5630 Fishers Lane, Rm. 1061, Rockville, MD 20852. A transcript will also be available in either hardcopy or on CD–ROM, after submission of a Freedom of Information request. Written requests are to be sent to the Division of Freedom of Information (ELEM–1029), 12420 Parklawn Dr., Element Bldg., Rockville, MD 20857. Additionally, FDA will be video recording and live Web casting both of the public meetings. Once the recorded video is available, it will be accessible at FDA's FSMA Web site at *http://www.fda.gov/Food/GuidanceRegulation/FSMA/default.htm.*

Dated: January 28, 2014.

Leslie Kux,

Assistant Commissioner for Policy.

[FR Doc. 2014–01985 Filed 1–30–14; 8:45 am]

BILLING CODE 4160–01–P

POSTAL REGULATORY COMMISSION

39 CFR Part 3010

[Docket No. RM2014–3; Order No. 1879]

Price Cap Rules for Market Dominant Price Adjustments

AGENCY: Postal Regulatory Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Commission is proposing rules addressing the price cap for market dominant price adjustments as part of an ongoing review. This stage of the review concerns rate reductions, rate incentives, and de minimis rate increases. The Commission invites public comment on the proposals.

DATES: *Comments are due:* March 17, 2014. *Reply comments are due:* April 16, 2014.

FOR FURTHER INFORMATION CONTACT: Brian Corcoran, Acting General Counsel, 202–789–6820.

SUPPLEMENTARY INFORMATION:

Regulatory History

72 FR 5230, February 5, 2007
72 FR 29284, May 25, 2007
72 FR 33261, June 15, 2007
72 FR 63622, November 9, 2007
74 FR 49326, September 28, 2009
78 FR 22490, April 16, 2013
78 FR 52694, August 26, 2013
78 FR 67951, November 8, 2013

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I. Introduction

With this Notice of Proposed Rulemaking, the Commission is continuing a review of its rules in 39 CFR part 3010 and requesting comments and suggestions regarding the treatment of rate reductions, rate incentives, and de minimis rate increases under part 3010.

The purposes of this rulemaking are to clarify and standardize the Commission's previous treatment of rate reductions and rate incentives, to establish a type of de minimis rate adjustment that would allow the Postal Service to make extremely minor increases to rates without requiring the Postal Service to calculate the annual limitation or generate unused rate adjustment authority, and to improve other aspects of the process of adjusting rates for market dominant products. The proposed rules are intended to provide more certainty for the Postal Service and the mailing community as they make decisions that rely upon the Postal Service's authority to adjust rates for market dominant products under 39 U.S.C. 3622(d) and part 3010.

II. Background

In Docket No. RM2013–2, the Commission began the process of reviewing its rules in 39 CFR part 3010, with the intent of clarifying and improving those rules.[1] The Commission adopted final rules in that docket that, among other minor changes, reorganized part 3010; added definitions; clarified the information required to be submitted with proposed workshare discounts; clarified that the rules require that a 12-month period be used to calculate the annual limitation when notices of rate adjustment are more than 12 months apart; clarified that the Postal Service may not rely on anticipated changes in mailer behavior to make adjustments to billing determinants; and revised the rule establishing the maximum size of unused rate adjustment authority for rate changes to align with statutory language.[2]

Order No. 1786 noted that the Commission's proposed treatment of promotional rates and incentive programs generated significant disagreement among commenters. *Id.* at 28. The Commission stated its intent to establish a separate docket for the consideration of this issue. *Id.* at 29, 33.

III. Proposed Rules

The proposed rules included in this Notice of Proposed Rulemaking contain: (1) A separate process for rate adjustments that consist solely of rate decreases, designated as a ''Type 1–C rate adjustment''; (2) revisions to the rules for the treatment of rate incentives for rates of general applicability (Type 1–A and Type 1–B rate adjustments); (3) revisions to clarify the treatment of rate incentives that are not rates of general applicability; (4) revisions to clarify the treatment of deleted rate cells; and (5) a separate process for de minimis rate increases.

A. Type 1–C Rate Adjustments

The Commission proposes allowing the Postal Service to request certain rate reductions without the calculation of the annual limitation and allowing the Postal Service to recoup associated unused rate adjustment authority by using it in future rate adjustments. These proposed rules apply to notices that only contain rate decreases. If the Postal Service proposes a rate increase in a notice of rate adjustment, the adjustment must still be filed as a Type 1–A or Type 1–B rate adjustment. Proposed §§ 3010.3(b)(2), 3010.6, 3010.20(e), 3010.23(b)(2), and 3010.27 are designed to facilitate mid-year rate reductions by allowing the Postal Service to recoup unused rate adjustment authority from those rate reductions.

Under the Commission's existing rules, even for a rate decrease, the Postal Service must file a Type 1–A rate adjustment to create unused rate authority.[3] In the past, when the Postal Service has filed rate reductions that are not part of an omnibus rate adjustment, the Postal Service has elected to not utilize the existing rules to generate unused rate adjustment authority.

However, recently, the Postal Service has sought to use rate reductions that are not part of an omnibus rate adjustment to generate unused rate adjustment authority. In its Full-Service Intelligent Mail Barcode Technology Credit Promotion (Technology Credit Promotion) request, the Postal Service proposed to create unused rate adjustment authority that it could use in its next omnibus notice of rate adjustment.[4] Specifically, the Postal Service proposed to use the unused rate adjustment authority generated as a result of the Technology Credit Promotion before it used any of the unused rate adjustment authority generated during the previous 5 years. Technology Credit Notice at 5. The Commission rejected this proposal, on the basis that it violated the first-in, first-out rule established under 39 U.S.C. 3622(d)(2)(C)(iii)(III). Order No. 1743 at 12. The proposed rules would

[1] Docket No. RM2013–2, Notice of Proposed Rulemaking Requesting Comments on Proposed Commission Rules for Determining and Applying the Maximum Amount of Rate Adjustments, March 22, 2013, at 1–2 (Order No. 1678).

[2] Docket No. RM2013–2, Order Adopting Final Rules for Determining and Applying the Maximum Amount of Rate Adjustments, July 23, 2013 (Order No. 1786).

[3] For example, if the annual limitation was 2 percent, and the Postal Service requested a rate reduction that resulted in a 0.5 percent rate decrease, unused rate adjustment authority after that adjustment would equal 2.5 percent (2% − (− 0.5%)).

[4] Docket No. R2013–6, United States Postal Service Notice of Market-Dominant Price Adjustment (Technology Credit Promotion), April 16, 2013 (Technology Credit Notice); Docket No. R2013–6, Order Approving Technology Credit Promotion, June 10, 2013 (Order No. 1743).

allow the Postal Service to create unused rate adjustment authority in a manner consistent with 39 U.S.C. 3622(d). Under the proposed rules, the Postal Service will have the option to either forgo unused rate adjustment authority resulting from rate decreases, as it has chosen to do in the past, or create additional unused rate adjustment authority pursuant to proposed § 3010.23(b)(2).[5]

Rate reductions that occur outside annual omnibus rate adjustments can provide additional pricing flexibility for the Postal Service and lower rates for mailers. The Commission does not wish to unnecessarily limit that flexibility. In order to facilitate rate reductions that occur outside annual omnibus rate adjustments, the Commission believes the simplest path is to allow the Postal Service to amend its most recent omnibus rate adjustment to incorporate the effects of the rate reduction. This will allow the Postal Service to recoup unused rate adjustment authority without calculating the annual limitation or violating 39 U.S.C. 3622(d)(2)(C).

Proposed new rule 3010.27 promotes simplicity. It takes into consideration the fact that a proposed rate reduction would be in effect during the same period as the rates proposed in the most recent omnibus annual Type 1–A or Type 1–B rate adjustment. Instead of requiring new billing determinants, the Commission believes it is reasonable to require the Postal Service to amend the most recent percentage change in rates calculations to include the proposed rate reductions. However, if necessary, the Postal Service may still reasonably adjust its billing determinants pursuant to proposed §§ 3010.23(d) or (e), as applicable.

If the Postal Service chooses to file a Type 1–C rate adjustment and to generate unused rate adjustment authority as a result of that adjustment, it may add any associated unused rate adjustment authority to the unused rate adjustment authority for the most recent Type 1–A or 1–B rate adjustment. Below is an example.

Example:

DOCKET NO. R201X–1: TYPE 1—A RATE ADJUSTMENT

Date of Notice of Rate Adjustment.	January 1, 201X.
Annual Limitation	3.000 percent.
Percentage Change in Rates for the Class.	2.500 percent.
Generated Unused Rate Adjustment Authority.	0.500 percent.

DOCKET NO. R201X–2 TYPE 1–C RATE ADJUSTMENT

Date of Notice of Rate Adjustment.	July 1, 201X.
Annual Limitation	N/A.
Additional Generated Unused Rate Adjustment Authority.	2.250 percent.
Amended Percentage Change in Rates for the Class.	0.250 percent.
Amended Unused Rate Adjustment Authority Generated in Docket No. R201X–1.	0.750 percent.

In this example, the Postal Service files Docket No. R201X–2 6 months after a Type 1–A rate adjustment (Docket No. R201X–1). The Type 1–C rate adjustment only includes rate decreases, and results in a percentage change in rates for the class that is 0.250 percent lower than the preceding Type 1–A rate adjustment. This translates into an increase of the unused rate adjustment authority generated in R201X–1 from 0.500 percent to 0.750 percent.

Proposed § 3010.23(b)(2) establishes the procedures for calculating the percentage change in rates for Type 1–C rate adjustments. The procedures require the Postal Service to amend the most recent percentage change in rates calculations for a class by including the proposed rate reductions in those workpapers. For example, if in July 2013, the Postal Service were to request a decrease in the rate for Certified Mail from $3.10 to $3.00, the Docket No. R2013–1 Special Services rate cap calculations contained in PRC–LR–R2013–1/5 would be updated to reflect the ''new price'' of $3.00 for Certified Mail. When this change is made, it changes the overall percentage change in rates for all of Special Services as well as the unused rate adjustment authority generated.

In order to isolate the additional unused rate adjustment authority generated from the Type 1–C rate adjustment, proposed § 3010.27(a) requires two steps. First, the difference between the most recent Type 1–A or Type 1–B annual limitation and the percentage change in rates calculated pursuant to § 3010.23(b)(2) is calculated. Second, the unused rate adjustment authority generated in the most recent Type 1–A or Type 1–B rate adjustment is subtracted from that result.[6]

The unused rate adjustment authority generated pursuant to proposed § 3010.27(a) is then added to the unused rate adjustment authority generated in the most recent Type 1–A or Type 1–B rate adjustment as described in proposed § 3010.27(c). Proposed § 3010.27(b) and 3010.27(d) ensure that unused rate adjustment authority generated under Type 1–C procedures remains consistent with 39 U.S.C. 3622(d)(2)(C).

B. Treatment of Rate Incentives That Are Rates of General Applicability

In Docket No. RM2012–3, the Commission proposed rules regarding treatment of rate incentives in its percentage change in rates calculations. Order No. 1678, Attachment at 9, § 3010.23(e) and (f). Many interested parties filed comments expressing concern with the proposal as presented, and urged the exclusion of rate incentives from the calculation of percentage change in rates for rate adjustments.[7] Ultimately, the Commission chose to not include rules regarding rate incentives in its final rules. Order No. 1786 at 29, 33. The Commission now proposes to include the language proposed in Order No. 1678 for treatment of certain types of rate incentives in percentage change in rates calculations, and to specify the types of rate incentives that can be included and the types of rate incentives that must be excluded.

Proposed § 3010.23(a)(3) defines a ''rate incentive'' as a discount that is not a workshare discount and that is designed to increase or retain volume, improve the value of mail for mailers, or improve the operations of the Postal Service. Proposed § 3010.23(e) establishes the procedures associated with rate incentives of general applicability.[8] The proposed procedures first give the Postal Service the option to include rate incentives that satisfy certain criteria in its percentage change in rates calculations. If the Postal Service chooses not to include the rate incentives in its percentage change in rates calculations, it will not receive unused rate adjustment authority that it

[5] See, *e.g.,* Docket Nos. R2011–1 (Reply Rides Free and Saturation Volume Discount); R2011–5 (Mobile Barcode Promotion); and R2012–9 (Mobile Barcode Promotion).

[6] If the most recent rate adjustment was a Type 1–B rate adjustment, or no unused rate adjustment authority was generated in the Type 1–A rate adjustment, the unused rate adjustment authority for purposes of these calculations is zero.

[7] See Docket No. RM2013–2, Comments of the Association for Postal Commerce, May 16, 2013, at 2–4; Docket No. RM2013–2, Comments of the National Association of Presort Mailers, May 16, 2013, at 4; Docket No. RM2013–2, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Reply Comments on Notice of Proposed Rulemaking, May 31, 2013, at 2–3; Docket No. RM2013–2, Reply Comments of the National Postal Policy Council, May 31, 2013, at 6.

[8] The incentives discussed in this paragraph apply to discounts or rate reductions. If the Postal Service creates an incentive in the form of a surcharge, this would be a rate increase and thus be subject to the rules governing rate increases.

can use to increase other rates within the class.

The Postal Service also may choose not to receive unused rate adjustment authority for a rate incentive of general applicability when it is first offered, but rather to receive rate adjustment authority in a subsequent rate adjustment proceeding pursuant to proposed § 3010.23(a)(1)(iii). The proposed rule allows the Postal Service to recover rate adjustment authority from the previously excluded rate incentive over the most recent 12-month period.[9] This is accomplished by assuming the current rate [10] of the rate incentive is the undiscounted rate rather than the discounted rate in effect at the time of the Postal Service's notice of rate adjustment. For example, if a rate incentive provided a 5-cent discount on a rate that was normally 25 cents and the Postal Service elected to exclude the rate incentive from the calculation of the percentage change in rates in the most recent rate case, the Postal Service may choose in a subsequent rate case to begin including the discounted rate in its calculation of the percentage change in rates by using 25 cents (the full undiscounted rate) as the current rate and 20 cents (or the proposed discounted rate) as the planned rate.

Proposed § 3010.23(e)(2) provides criteria that must be met in order for rate incentives to be included in its percentage change in rates calculations. The first two criteria require that a rate incentive must be in the form of a discount or be easily translated into a discount and sufficient billing determinants [11] must be available. These criteria ensure that rate incentives can be incorporated into the percentage change in rates calculations.[12]

The third criterion requires that a rate incentive must be a rate of general applicability. The Commission proposes defining a ''rate of general applicability'' as ''a rate applicable to all mail meeting standards established by the Mail Classification Schedule and the Domestic Mail Manual.'' Proposed § 3010.1(g) goes on to explain that eligibility for a rate of general applicability cannot be dependent on factors other than the characteristics of the mail to which the rate applies and that a rate of general applicability cannot be available upon written agreement to only one mailer or a group of mailers. Limiting the inclusion of rate incentives to those that are rates of general applicability ensures that non-participating mailers are not harmed either by being excluded from the discount or by above-average rate increases levied to fund discounts for other mailers.

This proposed treatment of rate incentives is consistent with the treatment of rate incentives in Docket No. R2013–1. In Docket No. R2013–1, the Postal Service proposed including rate incentives in its percentage change in rate calculations. Those rate incentives were rates of general applicability.[13] Specifically, Mobile Coupon/Click-to-Call, Emerging Technologies, Mobile Buy-it-Now, and Earned Value Reply Mail Promotions were included in the percentage change in rates calculations for First-Class Mail and Standard Mail. These rate incentives were all in the form of discounts, used historical billing determinants, and met the proposed definition of rates of general applicability.

The current price cap rules accord the Postal Service the flexibility to apply rate changes in varying degrees to rates of general applicability. If a rate incentive is a rate of general applicability, then it follows that the Postal Service's pricing flexibility should extend to these rates.

C. Treatment of Rate Incentives That Are Not Rates of General Applicability

The Postal Service has, in the past, proposed rate incentives that would not be considered rates of general applicability under the proposed rules.[14] Notable among these is the Postal Service's proposed Technology Credit Promotion, which was the subject of several comments in Docket No. RM2013–2.[15]

Previously, when the Postal Service has proposed rate incentives that are not rates of general applicability, the Commission has provided the Postal Service with the option to treat the rate incentives like negotiated service agreements, pursuant to the procedures described in 39 CFR 3010.24.[16] In Docket No. RM2013–2, the Public Representative argued that certain rate incentives, like summer sales, were similar to negotiated service agreements in that they are designed to generate volume.[17] For that reason, the Public Representative argued that some rate incentives should be excluded from the calculation of the percentage change in rates under § 3010.23. *Id.* Other commenters in that docket focused on the effects of rate incentives like the Technology Credit Promotion on non-participating mailers, arguing that it would be inequitable or unjust to require non-participating mailers to pay higher rates to recover revenue lost to temporary promotional rates.[18]

Proposed § 3010.24 would formalize the Commission's past treatment of rate incentives that are not rates of general applicability by requiring that they be

[9] The proposed rule does not allow the Postal Service to recover rate adjustment authority from the rate incentive over multiple 12-month periods. For example, in Year 1, the Postal Service begins offering a rate incentive and chooses to exclude the rate incentive from its percentage change in rates calculations. In Year 3 of the rate incentive, the Postal Service decides to begin including the rate incentive in its percentage change in rates calculations. In the Year 3 percentage change in rates calculations the Postal Service may only use the billing determinants from the most recent 12-month period, not billing determinants spanning the previous 3 years. See rule 3010.23(d). In addition, if the rate incentive in Year 1 was a $0.10 discount and in Year 3 the rate incentive was a $0.05 discount, the Postal Service can only recover rate adjustment authority from the current rate incentive ($0.05) in the Year 3 percentage change in rates calculations. See proposed § 3010.23(a)(1).

[10] In Order No. 43, there was confusion regarding the ''current rate'' for seasonal and temporary rates. See Order No. 43, Docket No. RM2007–1, Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products, October 29, 2007, at 51. The proposed definition of current rate specifies that current rates are the rates in effect at the time of the Postal Service's notice of rate adjustment. For seasonal and temporary rates, the current rate for seasonal or temporary rates is the most recently available rate for the temporary or seasonal rate. This ensures that the seasonal or temporary rates are properly accounted for in the percentage change in rates calculations. The second exception is for rate incentives that were previously excluded from the percentage change in rates calculations.

[11] The proposed rule requires that ''sufficient billing determinants'' be available, which requires that adequate volume data are available for each rate cell of the rate incentive so the rate incentive can be accurately included in the percentage change in rates calculations for the class.

[12] Adjustments may be made to billing determinants if the adjustments are based on known mail characteristics or historical volume data (as opposed to forecasts of mailer behavior).

[13] See Docket No. R2013–1, United States Postal Service Notice of Market-Dominant Price Adjustment, October 11, 2012, at 9.

[14] See Docket No. R2011–5, Order Approving Market Dominant Price Adjustment, May 17, 2011 (Order No. 731); Docket No. R2012–6, Order Approving Market Dominant Price Adjustment, March 26, 2012 (Order No. 1296); Docket No. R2009–4, Order Approving Price Adjustment for Standard Mail High Density Flats, July 1, 2009, at 6–9 (Order No. 236); Order No. 1743 at 16–17.

[15] See, *e.g.,* Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Notice of Proposed Rulemaking, May 16, 2013, at 5; Comments of the Association for Postal Commerce, May 16, 2013, at 2; Comments of the National Association of Presort Mailers, May 16, 2013, at 4 n.1.

[16] See Order No. 731; Order No. 1296; Order No. 236; and Order No. 1743. See also Order No. 1807, Docket No. C2009–1R, Order on Reconsideration and Clarification, August 13, 2013, at 9–10.

[17] Docket No. RM2013–2, Public Representative Reply Comments, May 31, 2013, at 4.

[18] Docket No. RM2013–2, Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. Comments on Notice of Proposed Rulemaking, May 16, 2013, at 5; Docket No. RM2013–2, Comments of Pitney Bowes Inc., May 16, 2013, at 3; Docket No. RM2013–2, Reply Comments of the National Postal Policy Council, May 31, 2013, at 5.

treated like negotiated service agreements for purposes of calculating the percentage change in rates. Under the proposed rules, a rate incentive would not be considered a rate of general applicability if it did not fall within the definition of ''rate of general applicability'' in proposed § 3010.1(g). For example, a rate incentive that was only available to a single mailer would not be considered a rate of general applicability. Nor would a rate incentive that is dependent on a factor other than the characteristics of the mail to which the rate applies be considered a rate of general applicability.

Under the proposed rules, if the Postal Service files a notice of rate adjustment that contains rate incentives that are not rates of general applicability, the rate incentives that are not rates of general applicability will be subject to proposed § 3010.24. Volumes sent at the rate incentive rate will be included in the calculation of percentage change in rates as if those volumes had paid the rate of general applicability. This treatment will protect mailers who are ineligible to participate in the rate incentive from funding reduced rates which only benefit eligible mailers.

The proposed rules concerning rate incentives that are not rates of general applicability address many of the concerns about the Technology Credit Promotion raised in Docket No. RM2013–2. The Technology Credit Promotion would have been available to mailers from June 1, 2013 to May 31, 2014, but eligibility for the credit would have been based on the mailer's volume from the already concluded fiscal year 2012.[19] Proposed § 3010.1(g) provides that a ''rate is not a rate of general applicability if eligibility for the rate is dependent on factors other than the characteristics of the mail to which the rate applies.'' The volume of mail sent by a mailer in a previous year is not a characteristic of the mail that would be eligible for the Technology Credit Promotion. Therefore, the Technology Credit Promotion would not have qualified as a rate incentive that is a rate of general applicability. Under proposed § 3010.24, the Technology Credit Promotion would be treated in the same manner as a negotiated service agreement. As a result, the volumes sent under the Technology Credit Promotion would be included in the calculation of percentage change in rates as if they were sent at the undiscounted rate.

D. Adjustment for Deletion of Rate Cell

Proposed § 3010.23(d)(4) specifies the procedure for the deletion of rate cells. The proposed rule specifies that when the Postal Service deletes a rate cell, and there is not a reasonable substitute available, the Postal Service should adjust the billing determinants for that rate cell to zero. The proposed rule ensures that mailers within a class are not harmed by large increases when the Postal Service deletes a rate cell.

Docket No. R2013–1 was the first rate adjustment after the Commission approved the transfer of Parcel Post to the competitive product list.[20] In the Package Services workpapers, the Postal Service correctly removed the billing determinants associated with the transferred pieces. The Commission proposes to codify that treatment for future rate adjustments.

E. De Minimis Rate Increases

In 2009, the Commission amended §§ 3010.21(a) and 3010.22(b) to provide that the annual limitation would be ''rounded to three decimal places.''[21] Before that change, the Commission's calculations were limited by available data to one decimal place. Order No. 303 at 1; Order No. 246 at 2. The change to three decimal places was motivated by two considerations. First, the Commission expressed a desire to allow the Postal Service to exercise a greater degree of flexibility by making more precise rate adjustments. Order No. 246 at 2. Second, the Bureau of Labor Statistics began reporting the CPI–U index to three digits in 2007, allowing the Commission to calculate the percentage change in rates with a greater degree of precision. *Id.*

In Docket No. R2011–1, the Postal Service proposed a change to the Move Update Assessment threshold.[22] This change resulted in a percentage change in rates for First-Class Mail and Standard Mail of 0.0004 percent. *Id.* The Commission found that under its rules at that time, the Postal Service would have been required to calculate an annual limitation and generate unused rate adjustment authority. *Id.*

Upon re-evaluation, the Commission has found no sound basis for requiring the Postal Service to immediately calculate the annual limitation and bank unused rate adjustment authority when it makes a rate adjustment that results in a percentage increase in rates that is less than 0.001 percent. As the Commission recognized in Order No. 246, the Postal Service is entitled to exercise its pricing flexibility with a high degree of precision. *See* Order No. 246 at 2. Requiring the Postal Service to recalculate the annual limitation as a result of a rate increase that is so small that it would not impact the percentage change in rates for a class limits the Postal Service's ability to make minor, reasonable adjustments to its rates.

Allowing the Postal Service to exercise pricing flexibility is consistent with 39 U.S.C. 3622(b)(4). However, this flexibility should not become a means to circumvent the annual limitation. The proposed § 3010.30 would allow the Postal Service to make very small rate increases without immediately calculating the annual limitation and banking unused rate adjustment authority.[23] Under the proposed rules, if the Postal Service elects not to immediately bank unused rate adjustment authority as a result of a small rate increase, the effect of the rate increase will have to be accounted for in the next Type 1–A or Type 1–B notice of rate adjustment. Thus, the Postal Service will continue to be bound by the annual limitation on rate adjustments. Additionally, the proposed rules would prevent the Postal Service from filing a series of notices of de minimis rate increases if the sum of all rate increases resulting from those de minimis rate adjustments equals or exceeds 0.001 percent. This requirement would allow the Commission to ensure that the cumulative effect of small rate increases is less than 0.001 percent.

In order to ensure that the cumulative impact of de minimis rate increases does not exceed 0.001 percent, proposed § 3010.30(e) requires that the Postal Service file workpapers for the class that demonstrate that the total effect of every de minimis rate increase since the last Type 1–A or Type 1–B rate adjustment does not equal or exceed 0.001 percent. These workpapers should only include de minimis rate increases and should be updated versions of the workpapers for

[19] Docket No. R2013–6, United States Postal Service Notice of Market-Dominant Price Adjustment (Technology Credit Promotion), April 16, 2013, at 1.

[20] Docket No. R2013–1, United States Postal Service Notice of Market-Dominant Price Adjustment, October 11, 2012, at 29.

[21] Docket No. RM2009–8, Order Amending the Cap Calculation in the System of Ratemaking, September 22, 2009 (Order No. 303); Postal Rates, 74 FR 49326, September 28, 2009. See also Docket No. RM2009–8, Notice of Proposed Rulemaking to Amend the Cap Calculation in the System of Ratemaking, July 10, 2009 (Order No. 246); Postal Rates, 74 FR 36132, July 22, 2009.

[22] Docket No. R2011–1, Order Approving Market Dominant Classification and Price Changes, and Applying Price Cap Rules, December 10, 2010, at 9 (Order No. 606).

[23] De minimis rate adjustments are designed to only account for the effect of rate increases. Rate decreases must be filed as Type 1–A, Type 1–B, or Type 1–C rate adjustments. For the de minimis exemption to apply, the Postal Service may not offset rate increases with rate decreases.

the class from the most recent Type 1–A or Type 1–B rate adjustment.

IV. Comments Requested

Interested persons are invited to provide written comments concerning the proposed rules. Comments may include specific language amending the proposed rules.

Comments are due no later than 45 days after the date of publication of this notice in the **Federal Register**. All comments and suggestions received will be available for review on the Commission's Web site, *http://www.prc.gov.* Interested persons are further invited to review the submissions and provide follow-up comments and suggestions within 30 additional days (that is, within 75 days of the publication of this notice in the **Federal Register**).

Kenneth E. Richardson is designated the Public Representative to represent the interests of the general public in this docket.

V. Explanation of Proposed Rules

Following is a section-by-section analysis of the proposed rules.

Proposed § 3010.1 adds a definition of the term ''rate of general applicability.'' It also includes definitions and amendments to existing definitions relating to Type 1–C rate adjustments and de minimis rate adjustments. Finally, it specifies that the definitions apply to the entire part, not just subpart A.

Proposed § 3010.3(a) specifies that Type 1–C rate adjustments are consistent with 39 U.S.C. 3622.

Proposed § 3010.3(b)(2) specifies that a Type 1–C rate adjustment may not be combined with any other type of rate adjustment.

Proposed § 3010.4(a) eliminates a superfluous word.

Proposed § 3010.5 specifies that a Type 1–B rate adjustment is based on both the annual limitation and unused rate adjustment authority.

Proposed § 3010.6 contains a general description of a Type 1–C rate adjustment.

Proposed § 3010.10(a) includes a conforming change.

Proposed § 3010.11 contains conforming changes in the heading and in paragraphs (a) and (k).

Proposed § 3010.12(a) contains a conforming change.

Proposed § 3010.12(b) specifies the contents of notices that include rate incentives and of Type 1–C notices of rate adjustments.

Proposed § 3010.20(e) specifies that there is no limit on the amount of a rate decrease under a Type 1–C rate adjustment.

Proposed § 3010.21 contains conforming changes in the heading and in paragraph (b).

Proposed § 3010.22 contains conforming changes in the heading and in paragraph (b).

Proposed § 3010.23(a) includes definitions of the terms ''current rate,'' ''rate cell,'' and ''rate incentive.''

Proposed § 3010.23(b)(2) provides for the calculation of the percentage changes in rates for Type 1–C rate adjustments.

Proposed § 3010.23(c) contains conforming changes.

Proposed § 3010.23(d) changes the format, but not the content, of existing section 3010.23(d) and adds a provision specifying the treatment of deleted rate cells.

Proposed § 3010.23(e) provides for the treatment of rate incentives.

Proposed § 3010.24 specifies that rate incentives that are not rates of general applicability will be treated in the same manner as negotiated service agreements.

Proposed § 3010.26 contains conforming changes.

Proposed § 3010.27 describes how unused rate adjustment authority is calculated for Type 1–C rate adjustments.

Proposed § 3010.30 contains the requirements for de minimis rate increases.

VI. Ordering Paragraphs

It is ordered:

1. Docket No. RM2014–3 is established for the purpose of receiving comments with respect to the proposed rules attached to this order.

2. Interested persons may submit comments no later than 45 days after the date of publication of this notice in the **Federal Register**.

3. Reply comments may be filed no later than 75 days after the date of publication of this notice in the **Federal Register**.

4. Kenneth E. Richardson is designated the Public Representative to represent the interests of the general public in this docket.

5. The Secretary shall arrange for publication of this order in the **Federal Register** in conformance with official publication requirements.

List of Subjects in 39 CFR Part 3010

Administrative practice and procedure; Postal Service.

By the Commission.

Ruth Ann Abrams,

Acting Secretary.

For the reasons stated above, the Postal Regulatory Commission proposes to amend 39 CFR part 3010 to read as follows:

PART 3010—REGULATON OF RATES FOR MARKET DOMINANT PRODUCTS

■ 1. The authority citation for 39 CFR part 3010 continues to read as follows:

Authority: 39 U.S.C. 503; 3622.

■ 2. Revise § 3010.1 to read as follows:

§ 3010.1 Definitions.

(a) The definitions in paragraphs (b) through (m) of this section apply in this part.

(b) *Annual limitation* means:

(1) In the case of a notice of a Type 1–A or Type 1–B rate adjustment filed 12 or more months after the last Type 1–A or Type 1–B notice of rate adjustment, the full year limitation on the size of rate adjustments calculated pursuant to § 3010.21;

(2) In the case of a notice of a Type 1–A or Type 1–B rate adjustment filed less than 12 months after the last Type 1–A or Type 1–B notice of rate adjustment, the partial year limitation on the size of rate adjustments calculated pursuant to § 3010.22; and

(3) In the case of a notice of a Type 1–C rate adjustment, the annual limitation calculated pursuant to § 3010.21 or § 3010.22, as applicable, for the most recent notice of a Type 1–A or Type 1–B rate adjustment.

(c) *Class* means a class of market dominant postal products.

(d) *De minimis rate increase* means a rate adjustment described in § 3010.30.

(e) *Maximum rate adjustment* means the maximum rate adjustment that the Postal Service may make for a class pursuant to a notice of Type1–A or Type 1–B rate adjustment. The maximum rate adjustment is calculated in accordance with § 3010.20.

(f) *Most recent Type 1–A or Type 1–B notice of rate adjustment,* when used in reference to a notice of rate adjustment for a class, means the most recent Type 1–A or Type 1–B notice of rate adjustment for that class.

(g) *Rate of general applicability* means a rate applicable to all mail meeting standards established by the Mail Classification Schedule and the Domestic Mail Manual. A rate is not a rate of general applicability if eligibility for the rate is dependent on factors other than the characteristics of the mail to which the rate applies. A rate is not a rate of general applicability if it benefits a single mailer. A rate that is only available upon the written agreement of both the Postal Service and a mailer or group of mailers is not a rate of general applicability.

(h) *Type 1–A rate adjustment* means a rate adjustment described in § 3010.4.

(i) *Type 1–B rate adjustment* means a rate adjustment described in § 3010.5.

(j) *Type 1–C rate adjustment* means a rate adjustment described in § 3010.6.

(k) *Type 2 rate adjustment* means a rate adjustment described in § 3010.7.

(l) *Type 3 rate adjustment* means a rate adjustment described in § 3010.8.

(m) *Unused rate adjustment authority* means:

(1) In the case of a Type 1–A or Type 1–B rate adjustment, the percentage calculated pursuant to § 3010.26; and

(2) In the case of a Type 1–C rate adjustment, the percentage calculated pursuant to § 3010.27.

■ 3. In § 3010.2, revise the first sentence to read as follows:

§ 3010.2 Applicability.

The rules in this part implement provisions in 39 U.S.C. chapter 36, subchapter I, establishing rate setting policies and procedures for market dominant products. * * *

■ 4. Revise § 3010.3 to read as follows:

§ 3010.3 Types of rate adjustments for market dominant products.

(a) There are five types of rate adjustments for market dominant products. A Type 1–A rate adjustment is authorized under 39 U.S.C. 3622(d)(1)(D). A Type 1–B rate adjustment is authorized under 39 U.S.C. 3622(d)(2)(C). A Type 1–C rate adjustment is authorized under 39 U.S.C. 3622. A Type 2 rate adjustment is authorized under 39 U.S.C. 3622(c)(10). A Type 3 rate adjustment is authorized under 39 U.S.C. 3622(d)(1)(E).

(b)(1) The Postal Service may combine Type 1–A, Type 1–B, and Type 2 rate adjustments for purposes of filing with the Commission.

(2) The Postal Service may not combine a Type 1–C rate adjustment with any other type of rate adjustment. The Postal Service may file a Type 1–C rate adjustment and a de minimis rate increase contemporaneously, but the Type 1–C rate adjustment and the de minimis rate increase must be contained in separate notices of rate adjustment.

■ 5. In § 3010.4, revise paragraph (a) to read as follows:

§ 3010.4 Type 1–A rate adjustment—in general.

(a) A Type 1–A rate adjustment is an adjustment based on the annual limitation.

* * * * *

■ 6. Revise § 3010.5 to reads as follows:

§ 3010.5 Type 1–B rate adjustment—in general.

A Type 1–B rate adjustment is an adjustment that is based on the annual limitation and that uses unused rate adjustment authority in whole or in part.

§ 3010.6, 3010.7 and 3010.8 [Redesignated as §§ 3010.7, 3010.8 and 3010.9]

■ 7. Redesignate §§ 3010.6, 3010.7 and 3010.8 as §§ 3010.7, 3010.8 and 3010.9, respectively.

■ 8. Add new § 3010.6 to read as follows:

§ 3010.6 Type 1–C rate adjustment—in general.

(a) A Type 1–C rate adjustment is an adjustment to a rate of general applicability that contains only a decrease. A rate adjustment that includes both an increase and a decrease in rates of general applicability is a Type 1–A or Type 1–B rate adjustment; it is not a Type 1–C rate adjustment.

(b) A Type 1–C rate adjustment may generate unused rate adjustment authority, as described in § 3010.27. However, the Postal Service may elect not to generate unused rate adjustment authority in a Type 1–C rate adjustment.

■ 9. In § 3010.10, revise paragraph (a) to read as follows:

§ 3010.10 Notice.

(a) The Postal Service, in every instance in which it determines to exercise its statutory authority to make a Type 1–A, Type 1–B, or Type 1–C rate adjustment for a class shall:

(1) Provide public notice in a manner reasonably designed to inform the mailing community and the general public that it intends to adjust rates no later than 45 days prior to the intended implementation date of the rate adjustment; and

(2) Transmit a notice of rate adjustment to the Commission no later than 45 days prior to the intended implementation date of the rate adjustment.

* * * * *

■ 10. In Amend § 3010.11 revise the heading, the introductory text of paragraph (a), paragraph (b)(2), paragraph (d), and paragraph (k) to read as follows:

§ 3010.11 Proceedings for Type 1–A, Type 1–B, and Type 1–C rate adjustment filings.

(a) The Commission will establish a docket for each notice of Type 1–A, Type 1–B, or Type 1–C rate adjustment filing, promptly publish notice of the filing in the **Federal Register**, and post the filing on its Web site. The notice shall include:

* * * * *

(b) * * *

(2) Whether the planned rate adjustments measured using the formula established in § 3010.23(c) are at or below the limitation established in § 3010.29.

* * * * *

(d) Within 14 days of the conclusion of the public comment period the Commission will determine, at a minimum, whether the planned rate adjustments are consistent with the annual limitation calculated under § 3010.21 or § 3010.22, as applicable, the limitation set forth in § 3010.29, and 39 U.S.C. 3626, 3627, and 3629 and issue an order announcing its findings.

* * * * *

(k) A Commission finding that a planned Type 1–A, Type 1–B, or Type 1–C rate adjustment is in compliance with the annual limitation calculated under § 3010.21 or § 3010.22, as applicable; the limitation set forth in § 3010.29; and 39 U.S.C. 3626, 3627, and 3629 is decided on the merits. A Commission finding that a planned Type 1–A, Type 1–B, or Type 1–C rate adjustment does not contravene other policies of 39 U.S.C. chapter 36, subchapter I is provisional and subject to subsequent review.

■ 11. In § 3010.12, revise the introductory text of paragraph (a), paragraph (b)(4) and paragraph (e), redesignate existing paragraphs (b)(9) and (b)(10) as (b)(11) and (b)(12), respectively, and add new paragraphs (b)(9) and (b)(10) to read as follows:

§ 3010.12 Contents of notice of rate adjustment.

(a) A Type 1–A, Type 1–B, or Type 1–C notice of rate adjustment must include the following information:

* * * * *

(b) * * *

(4) The amount of new unused rate adjustment authority, if any, that will be generated by the rate adjustment calculated as required by § 3010.26 or § 3010.27, as applicable. All calculations are to be shown with citations to the original sources. If new unused rate adjustment authority will be generated for a class of mail that is not expected to cover its attributable costs, the Postal Service must provide the rationale underlying this rate adjustment.

* * * * *

(9) For a notice that includes a rate incentive:

(i) If the rate incentive is a rate of general applicability, sufficient information to demonstrate that the rate incentive is a rate of general applicability; and

(ii) Whether the Postal Service has excluded the rate incentive from the calculation of the percentage change in rates under § 3010.23(e) or § 3010.24.

(10) For a Type 1–C rate adjustment, whether the Postal Service elects to generate unused rate adjustment authority.

* * * * *

(e) The notice of rate adjustment shall identify for each affected class how much existing unused rate adjustment authority is used in the planned rates calculated as required by § 3010.28. All calculations are to be shown, including citations to the original sources.

* * * * *

■ 12. In § 3010.20, revise paragraphs (b) and (d) and add paragraph (e) to read as follows:

§ 3010.20 Calculation of maximum rate adjustment.

* * * * *

(b) Type 1–A and Type 1–B rate adjustments are subject to an inflation-based annual limitation computed using CPI–U values as detailed in §§ 3010.21(a) and 3010.22(a).

* * * * *

(d) In any 12-month period the maximum rate adjustment applicable to a class is:

(1) For a Type1–A notice of rate adjustment, the annual limitation for the class; and

(2) For a Type 1–B notice of rate adjustment, the annual limitation for the class plus the unused rate adjustment authority for the class that the Postal Service elects to use, subject to the limitation under § 3010.29.

(e) There is no limitation on the amount of a rate decrease contained in a notice of Type 1–C rate adjustment.

■ 13. In § 3010.21, revise the heading and paragraph (b) to read as follows:

§ 3010.21 Calculation of annual limitation when Type 1–A or Type 1–B notices of rate adjustment are 12 or more months apart.

* * * * *

(b) If a notice of a Type 1–A or Type 1–B rate adjustment is filed 12 or more months after the most recent Type 1–A or Type 1–B notice of rate adjustment, then the calculation of an annual limitation for the class (referred to as the *full year limitation*) involves three steps. First, a simple average CPI–U index is calculated by summing the most recently available 12 monthly CPI–U values from the date the Postal Service files its notice of rate adjustment and dividing the sum by 12 (Recent Average). Then, a second simple average CPI–U index is similarly calculated by summing the 12 monthly CPI–U values immediately preceding the Recent Average and dividing the sum by 12 (Base Average). Finally, the full year limitation is calculated by dividing the Recent Average by the Base Average and subtracting 1 from the quotient. The result is expressed as a percentage, rounded to three decimal places.

* * * * *

■ 14. In § 3010.22, revise the heading and paragraphs (a) and (b) to read as follows:

§ 3010.22 Calculation of annual limitation when Type 1–A or Type 1–B notices of rate adjustment are less than 12 months apart.

(a) The monthly CPI–U values needed for the calculation of the partial year limitation under this section shall be obtained from the Bureau of Labor Statistics (BLS) Consumer Price Index—All Urban Consumers, U.S. All Items, Not Seasonally Adjusted, Base Period 1982–84 = 100. The current Series ID for the index is ''CUUR0000SA0.''

(b) If a notice of a Type 1–A or Type 1–B rate adjustment is filed less than 12 months after the most recent Type 1–A or Type 1–B notice of rate adjustment, then the annual limitation for the class (referred to as the *partial year limitation*) will recognize the rate increases that have occurred during the preceding 12 months. When the effects of those increases are removed, the remaining partial year limitation is the applicable restriction on rate increases.

* * * * *

■ 15. Revise § 3010.23 to read as follows:

§ 3010.23 Calculation of percentage change in rates.

(a) *Definitions.* In this section:

(1) *Current rate.*

(i) *In general.* Except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of this section, the term *current rate* means the rate in effect when the Postal Service files the notice of rate adjustment.

(ii) *Seasonal and temporary rates.* When used with respect to a seasonal or temporary rate, as described in paragraph (a)(2) of this section, the term *current rate* means the most recent rate in effect for the rate cell, regardless of whether the seasonal or temporary rate is available at the time the Postal Service files the notice of rate adjustment.

(iii) *Exception.* When used with respect to a rate cell that corresponds to a rate incentive that was previously excluded from the calculation of the percentage change in rates under paragraph (e)(1) of this section, the term *current rate* means the full undiscounted rate in effect for the rate cell at the time of the filing of the notice of rate adjustment, not the discounted rate in effect for the rate cell at such time. For example, if a rate incentive provides a 5-cent discount on a 25-cent rate and the Postal Service previously elected to exclude the rate incentive from the calculation of the percentage change in rates, the Postal Service may choose to begin including the discounted rate in its calculation of the percentage change in rates. If the Postal Service makes that choice, the current rate for the discounted rate cell will be 25 cents (the full undiscounted rate).

(2) *Rate cell.* The term *rate cell* means each and every separate rate identified in any applicable notice of rate adjustment for rates of general applicability. A seasonal or temporary rate shall be identified and treated as a rate cell separate and distinct from the corresponding non-seasonal or permanent rate.

(3) *Rate incentive* means a discount that is not a workshare discount and that is designed to increase or retain volume, improve the value of mail for mailers, or improve the operations of the Postal Service.

(b) *Calculation.*

(1) *Type 1–A and Type 1–B rate adjustments.* For a Type 1–A or Type 1–B rate adjustment, for each class of mail and product within the class, the percentage change in rates is calculated in three steps. First, the volume of each rate cell in the class is multiplied by the planned rate for the respective cell and the resulting products are summed. Then, the same set of rate cell volumes are multiplied by the corresponding current rate for each cell and the resulting products are summed. Finally, the percentage change in rates is calculated by dividing the results of the first step by the results of the second step and subtracting 1 from the quotient. The result is expressed as a percentage.

(2) *Type 1–C rate adjustments.* For a Type 1–C rate adjustment, for each class of mail and product within the class, the percentage change in rates is calculated by amending the workpapers attached to the Commission's order relating to the most recent Type 1–A or Type 1–B notice of rate adjustment to replace the planned rates under the most recent Type 1–A or Type 1–B notice of rate adjustment with the corresponding planned rates applicable to the class from the Type 1–C notice of rate adjustment.

(c) *Formula.* The formula for calculating the percentage change in rates for a class described in paragraph (b) of this section is as follows:

Percentage change in rates =

$$\left(\frac{\sum_{i=1}^{N}(R_{i,n})(V_i)}{\sum_{i=1}^{N}(R_{i,c})(V_i)}\right) - 1$$

Where,

N = number of rate cells in the class

i = denotes a rate cell (i = 1, 2, . . ., N)

Ri,n = planned rate of rate cell i

Ri,c = current rate of rate cell i (for a Type 1–A or Type 1–B rate adjustment) or rate from most recent Type 1–A rate adjustment for rate cell i (for a Type 1–C rate adjustment)

Vi = volume of rate cell i

(d) *Volumes.*

(1) *Obtaining Volumes from billing determinants.* The volumes for each rate cell shall be obtained from the most recent available 12 months of Postal Service billing determinants.

(2) *Permissible adjustments.* The Postal Service shall make reasonable adjustments to the billing determinants to account for the effects of classification changes such as the introduction, deletion, or redefinition of rate cells. The Postal Service shall identify and explain all adjustments. All information and calculations relied upon to develop the adjustments shall be provided together with an explanation of why the adjustments are appropriate.

(3) *Basis for adjustments.* Whenever possible, adjustments shall be based on known mail characteristics or historical volume data, as opposed to forecasts of mailer behavior.

(4) *Adjustment for deletion of rate cell.* For an adjustment accounting for the effects of the deletion of a rate cell when an alternate rate cell is not available, the Postal Service should adjust the billing determinants associated with the rate cell to zero. If the Postal Service does not adjust the billing determinants for the rate cell to zero, the Postal Service shall include a rationale for its treatment of the rate cell with the information required under paragraph (d)(2) of this section.

(e) *Treatment of rate incentives.*

(1) Rate incentives may be excluded from a percentage change in rates calculation. If the Postal Service elects to exclude a rate incentive from a percentage change in rates calculation, the rate incentive shall be treated in the same manner as a rate under a negotiated service agreement (as described in § 3010.24).

(2) A rate incentive may be included in a percentage change in rates calculation if it meets the following criteria:

(i) The rate incentive is in the form of a discount or can be easily translated into a discount;

(ii) Sufficient billing determinants are available for the rate incentive to be included in the percentage change in rate calculation for the class, which may be adjusted based on known mail characteristics or historical volume data (as opposed to forecasts of mailer behavior); and

(iii) The rate incentive is a rate of general applicability.

■ 16. Revise § 3010.24 to read as follows:

§ 3010.24 Treatment of volume associated with negotiated service agreements and rate incentives that are not rates of general applicability.

(a) Mail volumes sent at rates under a negotiated service agreement or a rate incentive that is not a rate of general applicability are to be included in the calculation of percentage change in rates under § 3010.23 as though they paid the appropriate rates of general applicability. Where it is impractical to identify the rates of general applicability (*e.g.,* because unique rate categories are created for a mailer), the volumes associated with the mail sent under the terms of the negotiated service agreement or the rate incentive that is not a rate of general applicability shall be excluded from the calculation of percentage change in rates.

(b) The Postal Service shall identify and explain all assumptions it makes with respect to the treatment of negotiated service agreements and rate incentives that are not rates of general applicability in the calculation of the percentage change in rates and provide the rationale for its assumptions.

■ 17. In section 3010.26, revise the heading and paragraphs (b) and (e) to read as follows:

§ 3010.26 Calculation of unused rate adjustment authority for Type 1–A and Type 1–B rate adjustments.

* * * * *

(b) When notices of Type 1–A or Type1–B rate adjustments are filed 12 months apart or less, annual unused rate adjustment authority will be calculated. Annual unused rate adjustment authority for a class is equal to the difference between the annual limitation calculated pursuant to § 3010.21 or § 3010.22 and the percentage change in rates for the class calculated pursuant to § 3010.23(b)(1).

* * * * *

(e) Unused rate adjustment authority generated under this section lapses 5 years after the date of filing of the notice of rate adjustment leading to its calculation.

* * * * *

§ 3010.28 [Redesignated as § 3010.29 and amended.]

■ 18. Redesignate § 3010.28 as § 3010.29 and revise the heading to read as follows:

§ 3010.29 Maximum size of Type 1–B rate adjustments.

* * * * *

§ 3010.27 [Redesignated as § 3010.28.]

■ 19. Redesignate § 3010.27 as § 3010.28.

■ 20. Add new § 3010.27 to read as follows:

§ 3010.27 Calculation of unused rate adjustment authority for Type 1–C rate adjustments.

(a) For a notice of Type 1–C rate adjustment, unused rate adjustment authority for a class is calculated in two steps. First, the difference between the annual limitation calculated pursuant to § 3010.21 or § 3010.22 for the most recent notice of Type 1–A or Type 1–B rate adjustment and the percentage change in rates for the class calculated pursuant to § 3010.23(b)(2) is calculated. Second, the unused rate adjustment authority generated in the most recent Type 1–A or Type 1–B rate adjustment is subtracted from that result.

(b) Unused rate adjustment authority generated under paragraph (a) of this section lapses 5 years after the date of filing of the most recent notice of Type 1–A or Type 1–B rate adjustment.

(c) Unused rate adjustment authority generated under paragraph (a) of this section for a class shall be added to the unused rate adjustment authority generated in the most recent notice of Type 1–A rate adjustment on the schedule maintained under § 3010.26(f). For purposes of § 3010.28, the unused rate adjustment authority generated under paragraph (a) of this section for a class shall be deemed to have been added to the schedule maintained under § 3010.26(f) on the same date as the

most recent notice of Type 1–A or Type 1–B rate adjustment.

(d) Unused rate adjustment authority generated under paragraph (a) of this section shall be subject to the limitation under § 3010.29, regardless of whether it is used alone or in combination with other existing unused rate adjustment authority.

■ 21. Add new § 3010.30 to read as follows:

§ 3010.30 De minimis rate increases.

(a) The Postal Service may elect to file a Type 1–A notice of rate adjustment as a de minimis rate increase if:

(1) For each affected class, the rate increases contained within the notice of a Type 1–A rate adjustment do not result in the percentage change in rates for the class equaling or exceeding 0.001 percent; and

(2) For each affected class, the sum of all rate increases included in de minimis rate increases since the most recent Type 1–A or Type 1–B rate adjustment that was not a de minimis rate increase does not result in the percentage change in rates for the class equaling or exceeding 0.001 percent.

(b) No unused rate adjustment authority will be added to the schedule of unused rate adjustment authority maintained under § 3010.26(f) as a result of a de minimis rate increase.

(c) No rate decreases may be taken into account when determining whether rate increases comply with paragraphs (a)(1) and (a)(2) of this section.

(d) In the next notice of a Type 1–A or Type 1–B rate adjustment for a class that is not a de minimis rate increase:

(1) The annual limitation shall be calculated as if the de minimis rate increase had not been filed; and

(2) For purposes of calculating the percentage change in rates, the current rate shall be the current rate from the de minimis rate increase.

(e) The Postal Service shall file supporting workpapers with each notice of de minimis rate increase that demonstrate that the sum of all rate increases included in de minimis rate increases since the most recent Type 1–A or Type 1–B notice of rate adjustment that was not de minimis does not result in a percentage change in rates for the class equaling or exceeding 0.001 percent.

[FR Doc. 2014–01669 Filed 1–30–14; 8:45 am]

BILLING CODE 7710–FW–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[EPA–R05–OAR–2013–0502; FRL–9905–31–Region 5]

Approval and Promulgation of Air Quality Implementation Plans; Wisconsin; Total Suspended Particulate Matter SIP Revision

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: The Environmental Protection Agency (EPA) is proposing to approve a revision to the Wisconsin State Implementation Plan (SIP). The SIP revision repeals an obsolete Total Suspended Particulate Matter rule to align the State's air quality standards with the current National Ambient Air Quality Standards. This action makes no substantive changes to the SIP and imposes no new requirements.

DATES: Comments must be received on or before March 3, 2014.

ADDRESSES: Submit your comments, identified by Docket ID No. EPA–R05–OAR–2013–0502, by one of the following methods:

1. *www.regulations.gov:* Follow the on-line instructions for submitting comments.
2. *Email: aburano.douglas@epa.gov.*
3. *Fax:* (312) 408–2279.
4. *Mail:* Douglas Aburano, Chief, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), U.S. Environmental Protection Agency, 77 West Jackson Boulevard, Chicago, Illinois 60604.
5. *Hand Delivery:* Douglas Aburano, Chief, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), U.S. Environmental Protection Agency, 77 West Jackson Boulevard, Chicago, Illinois 60604. Such deliveries are only accepted during the Regional Office normal hours of operation, and special arrangements should be made for deliveries of boxed information. The Regional Office official hours of business are Monday through Friday, 8:30 a.m. to 4:30 p.m., excluding Federal holidays.

Please see the direct final rule which is located in the Rules section of this **Federal Register** for detailed instructions on how to submit comments.

FOR FURTHER INFORMATION CONTACT: Gilberto Alvarez, Environmental Scientist, Attainment Planning and Maintenance Section, Air Programs Branch (AR–18J), Environmental Protection Agency, Region 5, 77 West Jackson Boulevard, Chicago, Illinois 60604, (312) 886–6143, *alvarez.gilberto@epa.gov.*

SUPPLEMENTARY INFORMATION: In the Final Rules section of this **Federal Register**, EPA is approving the State's SIP submittal as a direct final rule without prior proposal because the Agency views this as a noncontroversial submittal and anticipates no adverse comments. A detailed rationale for the approval is set forth in the direct final rule. If no adverse comments are received in response to this rule, no further activity is contemplated. If EPA receives adverse comments, the direct final rule will be withdrawn and all public comments received will be addressed in a subsequent final rule based on this proposed rule. EPA will not institute a second comment period. Any parties interested in commenting on this action should do so at this time. Please note that if EPA receives adverse comment on an amendment, paragraph, or section of this rule and if that provision may be severed from the remainder of the rule, EPA may adopt as final those provisions of the rule that are not the subject of an adverse comment. For additional information, see the direct final rule which is located in the Rules section of this **Federal Register**.

Dated: December 23, 2013.

Susan Hedman,

Regional Administrator, Region 5.

[FR Doc. 2014–01899 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[EPA–R06–OAR–2006–0885; FRL–9906–02–Region 6]

Approval and Promulgation of Air Quality Implementation Plans; Texas; Approval of Texas Motor Vehicle Rule Revisions

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: The Environmental Protection Agency (EPA) is proposing approval of revisions submitted by the State of Texas that affect the Texas State Implementation Plan (SIP) concerning Texas' motor vehicle air pollution rules. Based upon the State's submitted Texas clean fuel fleet (TCFF) program equivalency demonstration that the new Tier 2 and 2007 heavy-duty diesel

vehicles and engines meet or exceed the LEV requirement, we are proposing to approve the removal of the TCFF program's repealed low emission vehicle (LEV) rules and mobile emission reduction credit (MERC) rules from the Texas SIP. We also are proposing to approve the removal of the Transportation Control Measures (TCM) substitution repealed rules from the Texas SIP. We are proposing to approve as part of the SIP, a new Texas Clean Fleet (TCF) program, with submitted revisions, to incentivize replacement of diesel vehicles and engines with alternatively fueled vehicles and engines, including hybrids.

DATES: Written comments must be received on or before March 3, 2014.

ADDRESSES: Comments may be mailed to Mr. Guy Donaldson, Chief, Air Planning Section (6PD–L), Environmental Protection Agency, 1445 Ross Avenue, Suite 1200, Dallas, Texas 75202–2733. Comments may also be submitted electronically or through hand delivery/courier by following the detailed instructions in the Addresses section of the direct final rule located in the rules section of this **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Mr. John Walser, Air Planning Section (6PD–L), Environmental Protection Agency, Region 6, 1445 Ross Avenue, Suite 700, Dallas, Texas 75202–2733, telephone (214) 665–7128; email address *walser.john@epa.gov*.

SUPPLEMENTARY INFORMATION: In the final rules section of this **Federal Register**, EPA is approving the State's SIP submittal without prior proposal because the Agency views this as a noncontroversial submittal and anticipates no adverse comments. A detailed rationale for the approval is set forth in the direct final rule. If no adverse comments are received in response to this action, no further activity is contemplated. If EPA receives adverse comments, the direct final rule will be withdrawn and all public comments received will be addressed in a subsequent final rule based on this proposed rule. EPA will not institute a second comment period. Any parties interested in commenting on this action should do so at this time. Please note that if EPA receives adverse comment on an amendment, paragraph, or section of this rule and if that provision may be severed from the remainder of the rule, EPA may adopt as final those provisions of the rule that are not the subject of an adverse comment.

For additional information, see the direct final rule which is located in the rules section of this **Federal Register**.

Dated: January 15, 2014.

Ron Curry,

Regional Administrator, Region 6.

[FR Doc. 2014–01902 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

FEDERAL COMMUNICATIONS COMMISSION

47 CFR Part 79

[MB Docket Nos. 12–108, 12–107; Report No. 2996]

Petition for Reconsideration of Action in Rulemaking Proceeding

AGENCY: Federal Communications Commission.

ACTION: Petition for reconsideration.

SUMMARY: In this document, a Petition for Reconsideration (Petition) has been filed in the Commission's Rulemaking proceeding by the National Association of the Deaf, *et al.*

DATES: Oppositions to the Petition must be filed by February 18, 2014. Replies to an opposition must be filed by February 25, 2014.

ADDRESSES: Federal Communications Commission, 445 12th Street SW., Washington, DC 20554.

FOR FURTHER INFORMATION CONTACT: For additional information on this proceeding, contact Adam Copeland, *Adam.Copeland@fcc.gov <mailto: Adam.Copeland@fcc.gov.>*, Media Bureau, Policy Division, (202) 418–2120.

SUPPLEMENTARY INFORMATION: This is a summary of Commission's document, Report No. 2996, released January 24, 2014. The full text of this document is available for viewing and copying in Room CY–B402, 445 12th Street SW., Washington, DC 20554, or may be purchased from the Commission's copy contractor, Best Copy and Printing, Inc. (BCPI) (1–800–378–3160). The Commission will not send a copy of this *Notice* pursuant to the Congressional Review Act, 5 U.S.C. 801(a)(1)(A), because this *Notice* does not have an impact on any rules of particular applicability.

Subject: Accessibility of User Interfaces, and Video Programming Guides and Menus; Accessible Emergency Information, and Apparatus Requirements for Emergency Information and Video Description: Implementation of the Twenty-First Century Communications and Video Accessibility Act of 2010, published at 78 FR 77209, December 20, 2013, and published pursuant to 47 CFR 1.429(e). *See* § 1.4(b)(1) of the Commission's rules.

Number of Petitions Filed: 1.

Federal Communications Commission.

Gloria J. Miles,

Federal Register Liaison, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–02000 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

50 CFR Part 648

[Docket No. 130716623–4062–01]

RIN 0648–BD50

Fisheries of the Northeastern United States; Atlantic Mackerel, Squid, and Butterfish Fisheries; Framework Adjustment 8

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Proposed rule, request for comments.

SUMMARY: Framework Adjustment 8 (Framework 8) proposes several changes to facilitate operation of the butterfish discard cap in the longfin squid fishery and the directed butterfish fishery. Framework 8 would allocate the butterfish discard cap among trimesters in the same percentages used for the trimester allocations for longfin squid: 43 percent to Trimester I (January to April); 17 percent to Trimester II (May to August), and 40 percent to Trimester III (September to December). Each trimester would close when it is estimated that 95 percent of the butterfish discard cap has been taken. In addition, Framework 8 would allow NMFS to transfer, in either direction, up to 50 percent of unused quota between the butterfish landing allocation and the discard cap on the longfin squid fishery. This would occur near the end of the year in order to optimally utilize the butterfish that is available for fishing each year.

DATES: Public comments must be received by March 3, 2014.

ADDRESSES: Copies of supporting documents used by the Mid-Atlantic Fishery Management Council (Council), including the Environmental Assessment (EA) and Regulatory Impact Review (RIR)/Initial Regulatory Flexibility Analysis (IRFA), are available from: Dr. Christopher M.

Moore, Executive Director, Mid-Atlantic Fishery Management Council, 800 North State Street, Suite 201, Dover, DE 19901, telephone (302) 674–2331. The EA/RIR/IRFA is also accessible via the Internet at *http://www.nero.noaa.gov.*

You may submit comments, identified by NOAA–NMFS–2014–0010, by any one of the following methods:

_ *Electronic Submission:* Submit all electronic public comments via the Federal e-Rulemaking Portal. Go to *www.regulations.gov/#!docketDetail;D=NOAA-NMFS-2014-0010,* click the ''Comment Now!'' icon, complete the required fields, and enter or attach your comments;

_ *Mail:* Submit written comments to NMFS, Northeast Regional Office, 55 Great Republic Drive, Gloucester, MA 01930. Mark the outside of the envelope ''Comments on Framework 8;''

Instructions: Comments sent by any other method, to any other address or individual, or received after the end of the comment period, may not be considered by NMFS. All comments received are a part of the public record and will generally be posted for public viewing on *www.regulations.gov* without change. All personal identifying information (e.g., name, address, etc.), confidential business information, or otherwise sensitive information submitted voluntarily by the sender will be publicly accessible. NMFS will accept anonymous comments (enter ''N/A'' in the required fields if you wish to remain anonymous). Attachments to electronic comments will be accepted in Microsoft Word, Excel, or Adobe PDF file formats only.

FOR FURTHER INFORMATION CONTACT: Aja Szumylo, Fishery Policy Analyst, 978-281–9195, fax 978–281–9135.

SUPPLEMENTARY INFORMATION:

Background

NMFS implemented the butterfish mortality cap on the longfin squid fishery on January 1, 2011, as part of Amendment 10 to the Atlantic Mackerel, Squid, and Butterfish (MSB) Fishery Management Plan (FMP) (75 FR 11441, March 11, 2010) as a means of reducing fishing mortality on the butterfish stock. Framework Adjustment 7 to the MSB FMP (78 FR 14230, March 5, 2013) changed the butterfish mortality cap on the longfin squid fishery from a catch cap to a discard cap to accommodate a potential directed fishery for butterfish. Butterfish discards in the longfin squid fishery account for the largest source of butterfish fishing mortality. If management measures do not control butterfish discards in the longfin squid fishery in real time, substantial overages of the butterfish annual catch limit (ACL), which includes both butterfish landings and discards, could occur. Since NMFS must deduct catch in excess of the ACL from the following fishing year's ACL, overages in one year could substantially disrupt the directed butterfish and longfin squid fisheries the next year. In order to minimize the likelihood of a butterfish ACL overage, NMFS tracks directed butterfish landings (allocated as the butterfish domestic annual harvest or domestic annual harvest (DAH)) in real-time, and NMFS reduces the directed trip limit to ensure that the landings quota is not exceeded. Similarly, NMFS tracks butterfish discards in the longfin squid fishery in real time, and NMFS issues a closure of the longfin squid fishery once NMFS projects that the fishery has harvested the applicable amount of the butterfish discard cap.

The butterfish discard cap is currently allocated by trimesters, with 65 percent of the cap allocated to Trimester I (January to April); 3.3 percent to Trimester II (May to August); and 31.7 percent to Trimester III (September to December). NMFS can close the directed longfin squid fishery when the fishery has harvested: 80 percent of the Trimester I cap; 75 percent of the annual cap in Trimester II; or 95 percent of the annual cap in Trimester III. Butterfish discard cap underages and overages from Trimesters I and II currently roll over into Trimester III.

Amendment 10 to the MSB FMP initially allocated a very low amount of the cap to Trimester II because, historically, butterfish bycatch in the longfin squid fishery during that period was very low. In recent years, longfin squid catches in Trimester II have been substantial, and if butterfish discards on longfin squid trips are substantial, the potential exists for 75 percent of the entire annual cap to be harvested in Trimester II alone. This could lead to a variety of negative outcomes, including premature closure of the Trimester III longfin squid fishery, and/or deductions from future years if the fishery exceeds the butterfish ACL.

In order to address this issue, Framework 8 measures would adjust the trimester allocations for the butterfish discard cap and create distinct closure thresholds for each trimester. The proposed action would set the following initial allocations for the trimesters beginning in January 2014: 43 percent to Trimester I; 17 percent to Trimester II; and 40 percent to Trimester III. The proposed trimester allocation percentages for the butterfish discard cap match the trimester allocations for the directed longfin squid fishery. Framework 8 proposes that each trimester would close when the fishery has harvested an estimated 95 percent of the butterfish discard cap.

Framework 8 would also allow NMFS to transfer unused butterfish quota in either direction, between the butterfish DAH and the butterfish discard cap on the longfin squid fishery. Prior to November each year, NMFS would make a projection regarding the likely trajectories of butterfish landings and the butterfish discard cap. If the butterfish DAH appears likely to constrain the directed butterfish fishery or the butterfish discard cap appears likely to constrain the longfin squid fishery, and the other fishery appears unlikely to be impacted by a shift in quota, NMFS could transfer up to 50 percent of the total butterfish DAH or total butterfish discard cap to optimize the use of the overall butterfish quota. NMFS would make this transfer on or about November 15 each fishing year, in accordance with the Administrative Procedure Act, in order to optimally utilize the butterfish that is available for fishing each year.

Classification

Pursuant to section 304(b)(1)(A) of the Magnuson-Stevens Fishery Conservation and Management Act (Magnuson-Stevens Act), the NMFS Assistant Administrator has determined that this proposed rule is consistent with the MSB FMP, other provisions of the Magnuson-Stevens Act, and other applicable law, subject to further consideration after public comment.

This proposed rule has been determined to be not significant for purposes of Executive Order 12866.

An initial regulatory flexibility analysis (IRFA) was prepared, as required by section 603 of the Regulatory Flexibility Act (RFA). The IRFA describes the economic impact this proposed rule, if adopted, would have on small entities. A summary of the analysis follows.

Statement of Objective and Need

This action proposes management measures for the longfin squid and butterfish fisheries. A complete description of the reasons why the Council and NMFS are considering this action, and the objectives of and legal basis for this action, are contained elsewhere in the preamble to this proposed rule and are not repeated here.

Description and Estimate of Number of Small Entities to Which the Rule Will Apply

Subsequent to Council action related to this proposed rule, the Small Business Administration revised its small business size standards for several industries in a final rule effective July 22, 2013. The rule increased the size standard for Finfish Fishing from $4.0 to 19.0 million, Shellfish Fishing from $4.0 to 5.0 million, and Other Marine Fishing from $4.0 to 7.0 million. NMFS has reviewed the analyses prepared for this action in light of the new size standards. While longfin squid is technically a shellfish, and would fall under the lower shellfish fishing standard of $5.0 million, all entities subject to this action were considered small entities under the former, lower size standards, thus they all would continue to be considered small under the new standards. Thus, all of the approximately 375 vessels with limited access butterfish/longfin squid permits would qualify as small businesses.

Having different size standards for different types of marine fishing activities creates difficulties in categorizing businesses that participate in more than one of these activities. For now, the short-term approach is to classify a business entity into the SBA defined categories based on which activity produced the most gross revenue. In this case, it is very likely the revenue from finfishing was greater than revenue (if any) from shellfishing and greater than the revenue from charter boat fishing. Based on these assumptions, the finfish size standard would apply and the business is considered large, only if revenues are greater than $19 million. Section 5.6 in the Framework 8 EA describes the vessels, key ports, and revenue information for the longfin squid and butterfish fisheries; therefore, that information is not repeated here.

Although it is possible that some entities, based on rules of affiliation, would qualify as large business entities, due to lack of reliable ownership affiliation data NMFS cannot apply the business size standard at this time. NMFS is currently compiling data on vessel ownership that should permit a more refined assessment and determination of the number of large and small entities for future actions. For this action, since available data are not adequate to identify affiliated vessels, each operating unit is considered a small entity for purposes of the RFA, and, therefore, there is no differential impact between small and large entities. Therefore, there are no disproportionate economic impacts on small entities.

The measures in this action could have some impact on the approximately 375 vessels with limited access butterfish/longfin squid permits, all of which qualify as small businesses because their gross revenues are less than $19 million annually. With a longfin squid price of approximately $1,600/mt, the fishery's FY 2012 landings totaled 671 mt and generated $1.1 million in ex-vessel revenues.

Description of Projected Reporting, Recordkeeping, and Other Compliance Requirements Minimizing Significant Economic Impacts on Small Entities

This action does not contain any new collection-of-information, reporting, recordkeeping, or other compliance requirements. It does not duplicate, overlap, or conflict with any other Federal rules.

Economic Impact of the Proposed Action Compared to Significant Non-Selected Alternatives

The Council conducted a comprehensive evaluation of the potential socioeconomic impacts of Framework 8 in the EA (see **ADDRESSES**), and a discussion of this evaluation follows.

Framework 8 proposes adjusting the trimester allocations for the butterfish cap (Trimester I: 43 percent; Trimester II: 17 percent; Trimester III: 40 percent), and proposes closing each trimester when it is projected that 95 percent of the trimester allocation has been harvested (Alternative 2). In addition to the no action alternative (Alternative 1), Framework 8 also considered allocating 54 percent of the butterfish cap to Trimester I, 10.15 percent to Trimester II, and 35.85 percent to Trimester III, with 95 percent closure thresholds for each trimester (Alternative 3). Similar to the status quo alternative, both of the adjusted allocations proposed in the action alternatives would allow rollovers of quota not used during trimesters early in the year, and would deduct overages from later trimesters when the trimester allocations have been exceeded early in the year.

The alternatives to amend in-season Trimester II closure authority would result in positive long-term socioeconomic impacts compared to the status quo because they would: (1) Reduce the chance of acceptable biological catch (ABC) overages that could reduce long-term butterfish productivity; (2) avoid distributional issues in the longfin squid fishery that would occur if Trimester II harvested most (75 percent) of the butterfish cap; and (3) avoid future disruptions of the fishery if the status quo led to an ABC overage that had to be repaid.

Compared to the status quo, it is possible that either of the action alternatives could result in vessel owners losing some squid revenues in the short term if NMFS were to close Trimester II earlier than it would under the status quo, especially if those revenues are not recouped later in the year because squid are unavailable. The amount of potential relative losses is not clear because there have been no closures at current cap levels on which to base potential economic impacts. The longer-term benefits of reducing the likelihood of exceeding ABC each year would offset any occasional short-term losses of revenue.

There are distributional issues in the longfin squid fishery that would occur if most (75 percent) of the butterfish cap was harvested in Trimester II. The disparity of allocation percentages between the current butterfish cap and the longfin squid allocation could cause unnecessary closures that would be avoided if the allocation percentages were the same. Under the status quo, Trimester I receives a large percentage of the cap (65 percent), but Trimester II is not limited by the cap until 75 percent of the entire annual cap is reached. This means that no catch might be available in Trimester III if the combined Trimester I and Trimester II usage of the cap nears 75 percent. The preferred alternative, Alternative 2, would provide vessels with the opportunity to maximize their longfin squid catch while avoiding closures due to the butterfish cap. Maximized catch with no closures would allow for increased and steady revenues for vessels and the fishery as a whole.

To ensure that Trimester III has a reasonable amount of quota, some quota must be reallocated from Trimesters I and II. At the same time, Trimester II needs to retain a reasonable quota allocation. At current cap quota levels, none of the proposed allocations would be expected to cause a closure as long as the longfin squid fleet maintains relatively low butterfish discard rates. The preferred alternative, Alternative 2, was chosen because it aligns the cap allocation with the squid allocation. Thus, each longfin squid Trimester is responsible for its butterfish cap, and each trimester starts with a butterfish cap that matches its longfin squid allocation. This provides good incentive for vessels to avoid discarding butterfish each trimester and does not penalize vessels fishing in a trimester that had low historical butterfish discards by giving it a very low quota. By avoiding

closures and discouraging discards, Alternative 2 would maximize potential revenues for the fishery.

Among the alternatives, Trimester I has the most cap allocation under the status quo, less under Alternative 3, and least under the preferred Alternative 2. However, since the offshore fleet fishes in Trimesters I and III, and the overall purpose is to ensure that a reasonable amount of cap remains for Trimester III, any disadvantage from losing cap quota in Trimester I for the offshore fleet may be made up by improved access to Trimester III.

Framework 8 considered two alternatives to shift quota between the butterfish cap and butterfish landings: Status quo (Alternative 4) and the proposed alternative, which would allow for transfers between these two allocations late in the year in order to optimally utilize the available butterfish allocation (Alternative 5). The alternative to shift quota at the end of the year could facilitate some additional butterfish fishing or additional longfin squid fishing compared to the status quo, which would have positive economic effects for the fisheries. The maximum transfer amount is 50 percent of the original quota, i.e., 50 percent of one could be transferred to the other (50 percent of the landings quota to the cap quota or 50 percent of the cap quota to landings). As there has been no directed butterfish fishery in the past, it is not possible to predict the exact amount of landings this could result in over time, but because the transfer would occur near the end of the FY, they would probably be limited. Since the transfer would only be in place after November 15, (approximately 12 percent of the FY) a substantial amount of effort would have already taken place earlier in the year, but a transfer could still offer additional fishing opportunity compared to the status quo.

Since the 2013 butterfish landings quota is 2,570 mt, this provides a starting point for examining the range of benefits that could accrue from a transfer from butterfish landings to the cap. At most, one half of the landings quota (1,285 mt) could be transferred. It is possible that such a transfer could result in reopening of the longfin fishery for the last 6 weeks of the year, or the longfin squid fishery staying open when it would have otherwise closed. While the last 6 weeks of the year have seen relatively low longfin squid landings recently, late season catches in 2004–2007 demonstrate that catches of 1–2 million lb (453.6 to 907.1 mt) per week of longfin squid are possible in the last six weeks of the year, which could theoretically result in additional revenues of approximately $6-$12 million, given recent longfin squid prices, though this would likely be the high end of the range.

With the butterfish cap in 2013 set at 3,884 mt, half of that amount would be 1,942 mt which would be the most that could be transferred to butterfish landings. It is possible that 1,942 mt of butterfish could be landed in 6 weeks, but the price of such landings is difficult to determine. In recent years, prices have ranged from $1,400—$1,800 per metric ton, which could theoretically mean additional revenues of around $3 million dollars, though it is not clear that recent prices would be maintained at higher landings levels, which would mean that $3 million should be considered the high end of possible additional revenues.

In both of the transfer scenarios, since a transfer would only be made if it appears the quota would not be used during the FY, there are no opportunity costs associated with the transfer in terms of other fishery operations.

List of Subjects in 50 CFR Part 648

Fisheries, Fishing, Recordkeeping and reporting requirements.

Dated: January 24, 2014.

Alan D. Risenhoover,

Director, Office of Sustainable Fisheries, performing the functions and duties of the Deputy Assistant Administrator for Regulatory Programs, National Marine Fisheries Service.

For the reasons set out in the preamble, 50 CFR part 648 is proposed to be amended as follows:

PART 648—FISHERIES OF THE NORTHEASTERN UNITED STATES

■ 1. The authority citation for part 648 continues to read as follows:

Authority: 16 U.S.C. 1801 *et seq.*

■ 2. In § 648.22, paragraphs (b)(3)(vi) and (vii) are revised to read as follows:

§ 648.22 Atlantic mackerel, squid, and butterfish specifications.

* * * * *

(b) * * *

(3) * * *

(vi) The butterfish mortality cap will be based on a portion of the ACT (set annually during specifications) and the specified cap amount will be allocated to the longfin squid fishery as follows: Trimester I—43 percent; Trimester II—17 percent; and Trimester III—40 percent.

(vii) Any underages of the cap for Trimester I that are greater than 25 percent of the Trimester I cap will be reallocated to Trimester II and III (split equally between both trimesters) of the same year. The reallocation of the cap from Trimester I to Trimester II is limited, such that the Trimester II cap may only be increased by 50 percent; the remaining portion of the underage will be reallocated to Trimester III. Any underages of the cap for Trimester I that are less than 25 percent of the Trimester I quota will be applied to Trimester III of the same year. Any overages of the cap for Trimesters I and II will be subtracted from Trimester III of the same year.

* * * * *

■ 3. In § 648.24, paragraph (c)(3) is revised and paragraph (c)(5) is added to read as follows:

§ 648.24 Fishery closures and accountability measures.

* * * * *

(c) * * *

(3) *Butterfish mortality cap on the longfin squid fishery.* NMFS shall close the directed fishery in the EEZ for longfin squid when the Regional Administrator projects that 95 percent of each Trimester's butterfish mortality cap allocation has been harvested.

* * * * *

(5) *Butterfish allocation transfer.* NMFS may transfer up to 50 percent of any unused butterfish allocation from the butterfish DAH to the butterfish mortality cap on the longfin squid fishery if the butterfish catch in the longfin squid fishery is likely to result in a closure of the longfin squid fishery, and provided the transfer does not increase the likelihood of closing the directed butterfish fishery. NMFS may instead transfer up to 50 percent of the unused butterfish catch from the butterfish mortality cap allocation to the butterfish DAH if harvest of butterfish in the directed butterfish fishery is likely to exceed the butterfish DAH, and provided the transfer of butterfish allocation from the butterfish mortality cap allocation does not increase the likelihood of closing the longfin squid fishery due to harvest of the butterfish mortality cap. NMFS would make this transfer on or about November 15 each fishing year, in accordance with the Administrative Procedure Act.

* * * * *

[FR Doc. 2014–01896 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–22–P

Notices

Federal Register

Vol. 79, No. 21

Friday, January 31, 2014

This section of the FEDERAL REGISTER contains documents other than rules or proposed rules that are applicable to the public. Notices of hearings and investigations, committee meetings, agency decisions and rulings, delegations of authority, filing of petitions and applications and agency statements of organization and functions are examples of documents appearing in this section.

DEPARTMENT OF AGRICULTURE

Submission for OMB Review; Comment Request

The Department of Agriculture has submitted the following information collection requirement(s) to OMB for review and clearance under the Paperwork Reduction Act of 1995, Public Law 104–13. Comments regarding (a) whether the collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (b) the accuracy of the agency's estimate of burden including the validity of the methodology and assumptions used; (c) ways to enhance the quality, utility and clarity of the information to be collected; (d) ways to minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology should be addressed to: Desk Officer for Agriculture, Office of Information and Regulatory Affairs, Office of Management and Budget (OMB), New Executive Office Building, 725—17th Street NW., Washington, DC 20502. Commenters are encouraged to submit their comments to OMB via email to: *OIRA_Submission@omb.eop.gov* or fax (202) 395–5806 and to Departmental Clearance Office, USDA, OCIO, Mail Stop 7602, Washington, DC 20250–7602. Comments regarding these information collections are best assured of having their full effect if received by March 3, 2014. Copies of the submission(s) may be obtained by calling (202) 720–8681.

An agency may not conduct or sponsor a collection of information unless the collection of information displays a currently valid OMB control number and the agency informs potential persons who are to respond to the collection of information that such persons are not required to respond to the collection of information unless it displays a currently valid OMB control number.

Rural Housing Service

Title: Fire and Rescue Loans—7 CFR 1942, Subpart C.

OMB Control Number: 0575–0120.

Summary of Collection: The Rural Housing Service (RHS) is authorized by Section 306 of the Consolidated Farm and Rural Development Act (7 U.S.C. 1926) to make loans to public agencies, nonprofit corporations, and Indian tribes for the development of essential community facilities primarily servicing rural residents. The primary regulation for administering this Community Facility program is 7 CFR part 1942–A. The Community Facilities program has been used to finance about 100 different types of facilities varying in size and complexity from fire trucks to hospitals. A significant portion of the loans made have been used for public safety to finance fire stations, fire trucks, ambulances, and rescue facilities and other small Community Facilities projects. The information must be collected to determine eligibility, analyze financial feasibility, take security, monitor the use of loan funds, and monitor the financial condition of borrowers, and otherwise assisting borrowers.

Need and Use of the Information: The Rural Development requires that an application form SF–424 be completed by applicant/borrowers with each application package in addition to other necessary information. This form gives basic information regarding the applicant, including the type of loan/grant assistance they are seeking. This information will be used to determine applicant/borrower eligibility, project feasibility, and ensure borrowers operate on a sound basis and use loan funds for authorized purposes.

Description of Respondents: Business or other for-profit; Not-for-profit institutions; State, Local or Tribal Government.

Number of Respondents: 3,752.

Frequency of Responses: Reporting: On occasion; Quarterly; Annually.

Total Burden Hours: 28,471.

Charlene Parker,

Departmental Information Collection Clearance Officer.

[FR Doc. 2014–01948 Filed 1–30–14; 8:45 am]

BILLING CODE 3410–XV–P

DEPARTMENT OF AGRICULTURE

Food and Nutrition Service

Agency Information Collection Activities: Proposed Collection; Comment Request—WIC Farmers' Market Nutrition Program (FMNP) Form and Regulations

AGENCY: Food and Nutrition Service (FNS), USDA.

ACTION: Notice.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995, this notice invites the general public and other public agencies to comment on the consolidation of forms FNS–683 (WIC Farmers' Market Nutrition Annual Financial and Program Report) and FNS–203 (WIC Farmers' Market Nutrition Program Report). The proposed consolidation with this renewal will be used to collected information related to WIC Farmers' Market Nutrition Program Financial and Program Data per WIC Farmers' Market Nutrition Program Regulations (7 CFR part 248).

DATES: Written comments must be received by April 1, 2014.

ADDRESSES: Written comments are invited on: (a) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (b) the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (c) ways to enhance the quality, utility and clarity of the information to be collected; and (d) ways to minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology.

Comments may be sent to: Donna Hines, Chief, Policy Branch, Supplemental Food Programs Division, Food and Nutrition Service, U.S. Department of Agriculture, 3101 Park Center Drive, Room 528, Alexandria, VA 22302. Comments may also be submitted via fax to the attention of Donna Hines at 703–305–2196 or via email to *wichq-web@fns.usda.gov.* Comments will also be accepted through the Federal eRulemaking Portal. Go to *http://www.regulations.gov,* and follow the online instructions for submitting comments electronically. In all cases, please label your comments as ''Proposed Collection of Information: WIC Farmers' Market Nutrition Program.''

All written comments will be open for public inspection at the office of the Food and Nutrition Service during regular business hours (8:30 a.m., to 5 p.m. Monday through Friday) at 3101 Park Center Drive, Room 520, Alexandria, Virginia 22302.

All responses to this notice will be summarized and included in the request for Office of Management and Budget approval, and will become a matter of public record.

FOR FURTHER INFORMATION CONTACT: Requests for additional information or copies of the information collection forms and instructions should be directed to Donna Hines, Chief, Policy Branch, Supplemental Food Programs Division at 703–305–3746 or *Donna.Hines@fns.usda.gov.*

SUPPLEMENTARY INFORMATION:

Title: WIC Farmers' Market Nutrition Program (FMNP) Form and Regulations

OMB Number: 0584–0447.

Form Number: Form FNS–683.

Expiration Date: September 30, 2014.

Type of Request: Approval of the newly consolidated FNS 683 Information Collection.

Abstract: Section 17(m)(8) of the Child Nutrition Act of 1966, 42 U.S.C. 1786(m)(8), and the WIC Farmers' Market Nutrition Program (FMNP) regulations at 7 CFR part 248 require that certain Program-related information and financial data be compiled and submitted to FNS and that full and complete records concerning the FMNP operations are maintained. With this renewal, FNS proposes to consolidate forms FNS–683 (WIC Farmers' Market Nutrition Annual Financial and Program Report) and FNS–203 (WIC Farmers' Market Nutrition Program Report). Each State agency administering the FMNP will be required to use the newly consolidated FNS–683 to report financial and participation data. The information gathered is used for funding and program management decisions.

The currently approved reporting and recordkeeping requirements for the FMNP are based on 45 State agencies administering the program. The most recent annual report shows that 46 State agencies administer the FMNP, including the authorization of 3,392 farmers' markets, 18,246 farmers, and 2,969 roadside stands authorized to accept FMNP coupons (for a total of 24,607 authorized entities). However, FNS estimates that one third of authorized farmers or farmers' markets complete an agreement every year, thereby estimating the number of agreements submitted per year at 8,120. This represents an increase in the number of authorized entities from the currently approved reporting and recordkeeping requirements for the FMNP. The increase is due to the addition of one new FMNP State Agency. Therefore, FNS is requesting a revision and the approval of the newly consolidated FNS–683 information collection burden due to an increase in the number of authorized entities submitting farmer's market agreements and authorizations. The total burden is being increased from 23,917 to 24,460 hours.

Affected Public: 46 State Agencies; 8,120 Farmers (Farmers' Market and Roadside Stand).

Estimated Number of Respondents: 8,166.

Estimated Number of Responses per Respondent: 2.34.

Estimated Number of Total Annual Responses: 19,091.

Estimated Time (burden hours) per Respondent: 1.28.

Estimated Total Reporting Burden Hours: 24,138.

Estimated Total Recordkeeping Burden Hours: 322.

Estimated Total Burden for Reporting and Recordkeeping: 24,460.

INFORMATION COLLECTION BURDEN

[WIC Farmer's Market Nutrition Program (FMNP) OMB No. 0584–0447]

Regulation section	Requirement	Estimated No. respondents	Avg. No. responses per respondent	Total annual responses	Hours per response	Annual burden hours	Previously approved burden hours	Reason to adjustment to burden hours
Reporting								
Affected Public: STATE & LOCAL AGENCIES (Including Indian Tribal Organizations and US Territories)								
248.4	State Plan	46	1.00	46.00	40.00	1,840.00	1,800.00	Increase in State Agencies from 45 to 46
248.10(a)(2) &(3)	Authorization	46	176.53	8,120.31	1.00	8,120.31	7,947.00	
248.10(e)	Monitoring/Review	46	53.49	2,460.70	2.00	4,921.40	4,768.00	Increase due to authorization of more farmers/markets/farm stands
248.10(f)	Coupon Management System.	46	1.00	46.00	5.00	230.00	225.00	Increase in State Agencies from 45 to 46
248.11	Financial Management System.	46	1.00	46.00	10.00	460.00	450.00	Increase in State Agencies from 45 to 46
248.17(b)(2)(ii)	State Agency Corrective Action Plan.	9	1.00	9.00	10.00	90.00	90.00	
248.18(b)	Audit Responses	13	1.00	13.00	15.00	195.00	195.00	
248.23(b)	Annual Financial Report FNS–683.	46	1.00	46.00	3.50	161.00	135.00	Increase in State Agencies from 45 to 46 and consolidation of FNS–683 and FNS–203
	Annual Report on Recipients, Farmers, Farmer's Markets, Roadside Stands FNS 203.	0	0.00	0.00	0.00	0.00	46.00	Decrease due to consolidation of FNS–683 and FNS 203
Subtotal (Reporting Requirement).	46	236.02	10,787.01		16,017.71	15,656.00		
Affected Public: Farms (Farmers/Markets/Roadside stands)								
248.10(a)(2)(3)&(b)	Farmer's Market Agreement and Authorization (1/3 of 24,607 authorized entities per year for 3 year periods).	8,120	1	8,120.31	1	8,120.31	7,947.00	
Subtotal (Reporting Requirement).		8,120		8,120.31		8,120.31		
Total Reporting Requirement.	8,166		18,907.32		24,138.02			
Affected Public: STATE & LOCAL AGENCIES (Including Indian Tribal Organizations and US Territories)								
Recordkeeping:								

248.9	Nutrition Education	46	1.00	46.00	1.00	46.00	45.00	Increase in State Agencies from 45 to 46
248.10(b)	Farmer/Farmers Market/Roadside Stand Agreement & Authorization.	46	1.00	46.00	2.00	92.00	90.00	Increase in State Agencies from 45 to 46
248.10(e)	Summary of Farmer/Farmers' Market/Roadside Stand Monitoring.	46	1.00	46.00	2.00	92.00	90.00	Increase in State Agencies from 45 to 46
248.11(c)	Record of Financial Expenditures.	46	1.00	46.00	2.00	92.00	90.00	Increase in State Agencies from 45 to 46
Subtotal (Recordkeeping Requirement).	46	4.00	184.00	1.75	322.00	315.00	Increase in State Agencies from 45 to 46	
TOTAL BURDEN	8,166	2.33	19,091.32	1.28	24,460.02			

Dated: January 24, 2014.

Audrey Rowe,

Administrator, Food and Nutrition Service.

[FR Doc. 2014–02094 Filed 1–30–14; 8:45 am]

BILLING CODE 3410–30–P

DEPARTMENT OF AGRICULTURE

Forest Service

Newspapers Used for Publication of Legal Notices in the Southwestern Region, which includes Arizona, New Mexico, and parts of Oklahoma and Texas

AGENCY: Forest Service, USDA.

ACTION: Notice

SUMMARY: This notice lists the newspapers that will be used by all Ranger Districts, Grasslands, Forests, and the Regional Office of the Southwestern Region to publish legal notices required under 36 CFR parts 215, 218, and 219. The intended effect of this action is to inform interested members of the public which newspapers the Forest Service will use to publish notices of proposed actions, notices of decision, and notices of opportunity to file an objection. This will provide the public with constructive notice of Forest Service proposals and decisions, provide information on the procedures to comment, appeal, or object, and establish the date that the Forest Service will use to determine if comments, appeals, or objections were timely.

DATES: Publication of legal notices in the listed newspapers will begin on the date of this publication and continue until further notice.

ADDRESSES: Margaret Van Gilder, Regional Administrative Review Coordinator, Forest Service, Southwestern Region; 333 Broadway SE., Albuquerque, NM 87102–3498.

FOR FURTHER INFORMATION CONTACT: Margaret Van Gilder, Regional Administrative Review Coordinator; (505)842–3223.

SUPPLEMENTARY INFORMATION: The administrative procedures at 36 CFR parts 215, 218, and 219 require the Forest Service to publish notices in a newspaper of general circulation. The content of the notices is specified in 36 CFR parts 215, 218, and 219. In general, the notices will identify: the decision or project, by title or subject matter; the name and title of the official making the decision; how to obtain additional information; and where and how to file comments, appeals, or objections. The date the notice is published will be used to establish the official date for the beginning of the comment, appeal, or objection period. Where more than one newspaper is listed for any unit, the first newspaper listed is the primary newspaper of record of which publication date shall be used for calculating the time period to file comment, appeal, or an objection.

Southwestern Regional Office

Regional Forester

Notices of Availability for Comment and Decisions and Objections affecting New Mexico Forests:—''*Albuquerque Journal'',* Albuquerque, New Mexico, for National Forest System Lands in the State of New Mexico for any projects of Region-wide impact, or for any projects affecting more than one National Forest or National Grassland in New Mexico.

Regional Forester Notices of Availability for Comment and Decisions and Objections affecting Arizona Forests:—''*The Arizona Republic'',* Phoenix, Arizona, for National Forest System lands in the State of Arizona for any projects of Region-wide impact, or for any projects affecting more than one National Forest in Arizona.

Regional Forester Notices of Availability for Comment and Decisions and Objections affecting National Grasslands in New Mexico, Oklahoma, and Texas are listed by Grassland and location as follows: Kiowa National Grassland notices published in: —''*Union County Leader'',* Clayton New Mexico. Rita Blanca National Grassland in Cimarron County, Oklahoma notices published in:—''*Boise City News'',* Boise City, Oklahoma. Rita Blanca National Grassland in Dallam County, Texas notices published in:—''*The Dalhart Texan'',* Dalhart, Texas. Black Kettle National Grassland in Roger Mills County, Oklahoma notices published in:—''*Cheyenne Star'',* Cheyenne, Oklahoma. Black Kettle National Grassland in Hemphill County, Texas notices published in:—''*The Canadian Record'',* Canadian, Texas. McClellan Creek National Grassland in Gray County, Texas notices published in:—''*The Pampa News'',* Pampa, Texas.

Regional Forester Notices of Availability for Comment and Decisions and Objections affecting only one National Forest or National Grassland unit will appear in the newspaper of record elected by each National Forest or National Grassland as listed below.

Arizona National Forests

Apache-Sitgreaves National Forests

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Alpine Ranger District, Black Mesa Ranger District, Lakeside Ranger District, and Springerville Ranger District are published in: —''*The White Mountain Independent'',* Show Low and Navajo County, Arizona.

Clifton Ranger District Notices are published in:—''*Copper Era'',* Clifton, Arizona.

Coconino National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Mogollon Rim Ranger District, and Flagstaff Ranger District are published in: —''*Arizona Daily Sun'',* Flagstaff, Arizona.

Red Rock Ranger District Notices are published in: —''*Red Rock News'',* Sedona, Arizona.

Coronado National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor and Santa Catalina Ranger District are published in: —''*The Arizona Daily Star'',* Tucson, Arizona.

Douglas Ranger District Notices are published in:—''*Daily Dispatch'',* Douglas, Arizona.

Nogales Ranger District Notices are published in: —''*Nogales International'',* Nogales, Arizona.

Sierra Vista Ranger District Notices are published in:—''*Sierra Vista Herald'',* Sierra Vista, Arizona.

Safford Ranger District Notices are published in:—''*Eastern Arizona Courier'',* Safford, Arizona.

Kaibab National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, North Kaibab Ranger District, Tusayan Ranger District, and Williams Ranger District Notices are published in: —''*Arizona Daily Sun'',* Flagstaff, Arizona.

Prescott National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Bradshaw Ranger District, Chino Valley Ranger District are published in: —''*Daily Courier'',* Prescott, Arizona. Notices for Availability for Comments, Decisions and Objections by the Verde Ranger District are published in: ''*Verde Independent'',* Cottonwood, Arizona.

Tonto National Forest

Notices for Availability for Comments, Decisions, and Objections by Forest Supervisor, Cave Creek Ranger District, and Mesa Ranger District are published in:—''*Arizona Capitol Times'',* in Phoenix, Arizona.

Globe Ranger District Notices are published in:—''*Arizona Silver Belt'',*

Globe, Arizona. Payson Ranger District, Pleasant Valley Ranger District and Tonto Basin Ranger District Notices are published in: —''*Payson Roundup'',* Payson, Arizona.

New Mexico National Forests

Carson National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Camino Real Ranger District, Tres Piedras Ranger District and Questa Ranger District are published in: —*''The Taos News'',* Taos, New Mexico.

Canjilon Ranger District and El Rito Ranger District Notices are published in: —*''Rio Grande Sun'',* Espanola, New Mexico.

Jicarilla Ranger District Notices are published in:—*''Farmington Daily Times'',* Farmington, New Mexico.

Cibola National Forest and National Grasslands

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor affecting lands in New Mexico, except the National Grasslands are published in:—*''Albuquerque Journal'',* Albuquerque, New Mexico.

Forest Supervisor Notices affecting National Grasslands in New Mexico, Oklahoma and Texas are published by grassland and location as follows: Kiowa National Grassland in Colfax, Harding, Mora and Union Counties, New Mexico published in: —*''Union County Leader'',* Clayton, New Mexico. Rita Blanca National Grassland in Cimarron County, Oklahoma published in:—*''Boise City News'',* Boise City, Oklahoma. Rita Blanca National Grassland in Dallam County, Texas published in: —*''The Dalhart Texan'',* Dalhart, Texas. Black Kettle National Grassland, in Roger Mills County, Oklahoma published in:—*''Cheyenne Star'',* Cheyenne, Oklahoma. Black Kettle National Grassland, in Hemphill County, Texas published in:—*''The Canadian Record'',* Canadian, Texas. McClellan Creek National Grassland published in:—*''The Pampa News'',* Pampa, Texas.

Mt. Taylor Ranger District Notices are published in:—*''Cibola County Beacon'',* Grants, New Mexico.

Magdalena Ranger District Notices are published in:—*''Defensor-Chieftain'',* Socorro, New Mexico.

Mountainair Ranger District Notices are published in:—*''Mountain View Telegraph'',* Moriarity, New Mexico.

Sandia Ranger District Notices are published in:—*''Albuquerque Journal'',* Albuquerque, New Mexico.

Kiowa National Grassland Notices are published in: —*''Union County Leader'',* Clayton, New Mexico.

Rita Blanca National Grassland Notices in Cimarron County, Oklahoma are published in:—*''Boise City News'',* Boise City, Oklahoma while Rita Blanca National Grassland Notices in Dallam County, Texas are published in:—*''Dalhart Texan'',* Dalhart, Texas.

Black Kettle National Grassland Notices in Roger Mills County, Oklahoma are published in:—*''Cheyenne Star'',* Cheyenne, Oklahoma, while Black Kettle National Grassland Notices in Hemphill County, Texas are published in:—*''The Canadian Record'',* Canadian, Texas. McClellan Creek National Grassland Notices are published in:—*''The Pampa News'',* Pampa, Texas.

Gila National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Quemado Ranger District, Reserve Ranger District, Glenwood Ranger District, Silver City Ranger District and Wilderness Ranger District are published in: —*''Silver City Daily Press'',* Silver City, New Mexico.

Black Range Ranger District Notices are published in: —*''The Herald'',* Truth or Consequences, New Mexico.

Lincoln National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor and the Sacramento Ranger District are published in:—*''Alamogordo Daily News'',* Alamogordo, New Mexico.

Guadalupe Ranger District Notices are published in: —*''Carlsbad Current Argus'',* Carlsbad, New Mexico.

Smokey Bear Ranger District Notices are published in: —*''Ruidoso News'',* Ruidoso, New Mexico.

Santa Fe National Forest

Notices for Availability for Comments, Decisions and Objections by Forest Supervisor, Coyote Ranger District, Cuba Ranger District, Espanola Ranger District, Jemez Ranger District and Pecos-Las Vegas Ranger District are published in: —*''Albuquerque Journal'',* Albuquerque, New Mexico.

Dated: January 17, 2014.

Gilbert Zepeda,

Deputy Regional Forester, Southwestern Region.

[FR Doc. 2014–01976 Filed 1–30–14; 8:45 am]

BILLING CODE 3410–11–P

COMMISSION ON CIVIL RIGHTS

Agenda and Notice of Public Meeting of the South Dakota Advisory Committee

Date and Time: Wednesday, February 19, 2014, 12:00 p.m. [CST].

Place: Via Teleconference. Public Dial-in 1–877–446–3914; Listen Line Code: 8358320.

TDD: Dial Federal Relay Service 1–800–977–8339 give operator the following number: 303–866–1040—or by email at *ebohor@usccr.gov.*

Notice is hereby given, pursuant to the provisions of the rules and regulations of the U.S. Commission on Civil Rights (Commission), and the Federal Advisory Committee Act (FACA), that a planning meeting of the South Dakota Advisory Committee to the Commission will convene via conference call. The purpose of the meeting is to discuss civil rights issues in the state and plan future activities which will include discussing the South Dakota Department of Motor Vehicle Tax Exemption for Native Americans who live on reservation land.

Members of the public are entitled to submit written comments. The comments must be received in the regional office by Wednesday, March 19, 2014. Comments may be mailed to the Rocky Mountain Regional Office, U.S. Commission on Civil Rights, 999 18th Street, Suite 1380 South, Denver, CO 80202, faxed to (303) 866–1050, or emailed to *Evelyn Bohor at ebohor@usccr.gov.* Persons who desire additional information may contact the Rocky Mountain Regional Office at 303–866–1040.

Records generated from this meeting may be inspected and reproduced at the Rocky Mountain Regional Office, as they become available, both before and after the meeting. Persons interested in the work of this advisory committee are advised to go to the Commission's Web site, *www.usccr.gov,* or to contact the Rocky Mountain Regional Office at the above phone number, email or street address.

The meetings will be conducted pursuant to the provisions of the rules and regulations of the Commission and FACA.

Dated: January 27, 2014.

David Mussatt,

Acting Chief, Regional Programs Coordination Unit.

[FR Doc. 2014–01971 Filed 1–30–14; 8:45 am]

BILLING CODE 6335–01–P

DEPARTMENT OF COMMERCE

Foreign-Trade Zones Board

[B–06–2014]

Foreign-Trade Zone 197—Doña Ana County, New Mexico;

Application for Reorganization under Alternative Site Framework

An application has been submitted to the Foreign-Trade Zones (FTZ) Board by the Board of County Commissioners of Doña Ana County, New Mexico, grantee of FTZ 197, requesting authority to reorganize the zone under the alternative site framework (ASF) adopted by the FTZ Board (15 CFR Sec. 400.2(c)). The ASF is an option for grantees for the establishment or reorganization of zones and can permit significantly greater flexibility in the designation of new subzones or ''usage-driven'' FTZ sites for operators/users located within a grantee's ''service area'' in the context of the FTZ Board's standard 2,000-acre activation limit for a zone. The application was submitted pursuant to the Foreign-Trade Zones Act, as amended (19 U.S.C. 81a-81u), and the regulations of the Board (15 CFR part 400). It was formally docketed on January 28, 2014.

FTZ 197 was approved by the FTZ Board on November 26, 1993 (Board Order 665, 58 FR 64546, 12/08/1993) and expanded on November 27, 2007, (Board Order 1536, 72 FR 69649, 12/10/2007).

The current zone includes the following sites: *Site 1* (897 acres)—3 parcels as follows: Santa Teresa Airport Industrial Park (200 acres), 8016 Airport Road, Santa Teresa; Santa Teresa Business Center (489 acres), 2700 Airport Road, Santa Teresa; and, the Santa Teresa Logistics Park (208 acres), 4751 Avenida Creel, Santa Teresa; *Site 2* (206 acres)—West Mesa Industrial Park, 350 Alliance Drive, Las Cruces; *Site 3* (304 acres)—Santa Teresa Bi-National Park, 401 Avenida Ascension, Las Cruces.

The grantee's proposed service area under the ASF would be Doña Ana County, New Mexico, as described in the application. If approved, the grantee would be able to serve sites throughout the service area based on companies' needs for FTZ designation. The proposed service area is within and adjacent to the Santa Teresa U.S. Customs and Border Protection port of entry.

As part of the reorganization request, the grantee is requesting that two of the parcels which are currently part of Site 1 be renumbered to create Site 4 and Site 5. The applicant is requesting authority to reorganize its existing zone project to include both the existing and renumbered sites as ''magnet'' sites. The ASF allows for the possible exemption of one magnet site from the ''sunset'' time limits that generally apply to sites under the ASF, and the applicant proposes that Site 4 be so exempted. No subzones/usage-driven sites are being requested at this time.

In accordance with the FTZ Board's regulations, Christopher Kemp of the FTZ Staff is designated examiner to evaluate and analyze the facts and information presented in the application and case record and to report findings and recommendations to the FTZ Board.

Public comment is invited from interested parties. Submissions shall be addressed to the FTZ Board's Executive Secretary at the address below. The closing period for their receipt is April 1, 2014. Rebuttal comments in response to material submitted during the foregoing period may be submitted during the subsequent 15-day period to April 16, 2014.

A copy of the application will be available for public inspection at the Office of the Executive Secretary, Foreign-Trade Zones Board, Room 21013, U.S. Department of Commerce, 1401 Constitution Avenue NW., Washington, DC 20230–0002, and in the ''Reading Room'' section of the FTZ Board's Web site, which is accessible via *www.trade.gov/ftz.* For further information, contact Christopher Kemp at *Christopher.Kemp@trade.gov* or (202) 482–0862.

Dated: January 28, 2014.

Andrew McGilvray,

Executive Secretary.

[FR Doc. 2014–02078 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–DS–P

DEPARTMENT OF COMMERCE

International Trade Administration

[A–570–970]

Multilayered Wood Flooring from the People's Republic of China: Initiation of Antidumping Duty New Shipper Review

AGENCY: Enforcement & Compliance, formerly Import Administration, International Trade Administration, Department of Commerce

DATES: *Effective Date:* January 31, 2014.

SUMMARY: The Department of Commerce (''Department'') has determined that a request for a new shipper review of the antidumping duty order on multilayered wood flooring from the People's Republic of China (''PRC'') meets the statutory and regulatory requirements for initiation. The period of review (''POR'') for the new shipper review is December 1, 2012, through November 30, 2013.

FOR FURTHER INFORMATION CONTACT: Maisha Cryor, AD/CVD Operations, Office IV, Enforcement & Compliance, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue NW., Washington, DC 20230; telephone: (202) 482–5831.

SUPPLEMENTARY INFORMATION:

Background

The Department published the antidumping duty order on multilayered wood flooring from the PRC on December 8, 2011.[1] On December 20, 2013, pursuant to section 751(a)(2)(B)(i) of the Tariff Act of 1930, as amended (the ''Act''), and 19 CFR 351.214(c), the Department received a timely request for a new shipper review from Linyi Anying Wood Co., Ltd., (''Anying'').[2] In order to confirm certain information in Anying's request, we requested entry documents from U.S. Customs and Border Protection (''CBP'').[3] The continuation of the new shipper review will be contingent upon confirmation of the information received in response to that request. Additionally, on January 15, 2014, the Department received entry data from CBP.[4]

Anying stated that it is both the producer and the exporter of the subject merchandise upon which its request for a new shipper review is based.[5] Pursuant to section 751(a)(2)(B)(i)(I) of the Act and 19 CFR 351.214(b)(2)(i), Anying certified that it did not export multilayered wood flooring to the United States during the period of investigation (''POI'').[6] In addition, pursuant to section 751(a)(2)(B)(i)(II) of the Act and 19 CFR 351.214(b)(2)(iii)(A),

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[1] *See Multilayered Wood Flooring from the People's Republic of China: Amended Final Determination of Sales at Less Than Fair Value and Antidumping Duty Order,* 76 FR 76690 (December 8, 2011) (''*Order*'').

[2] *See* Letter from Anying to the Secretary of Commerce ''Multilayered Wood Flooring from China,'' dated December 20, 2013 (''Initiation Request'').

[3] *See* Memorandum to Michael Walsh, Director, AD/CVD/Revenue Policy & Programs, Office of International Trade, U.S. Customs and Border Protection, from Abdelali Elouaradia, Director Office IV, AD/CVD Operations, Enforcement and Compliance, ''Multilayered Wood Flooring from the People's Republic of China (A–570–970),'' dated January 7, 2014.

[4] *See* Letter from Robert Bolling, Program Manager, AD/CVD Operations, Office IV to All Interested Parties ''Multilayered Wood Flooring from the People's Republic of China 12/01/2012–11/30/2013,'' dated concurrently with this notice.

[5] *See* Initiation Request at Exhibit 1.

[6] *Id.*

Anying certified that, since the initiation of the investigation, it has never been affiliated with any exporter or producer that exported multilayered wood flooring to the United States during the POI, including those not individually examined during the investigation.[7] As required by 19 CFR 351.214(b)(2)(iii)(B), Anying also certified that its export activities were not controlled by the central government of the PRC.[8]

In addition to the certifications described above, pursuant to 19 CFR 351.214(b)(2)(iv), Anying submitted documentation establishing the following: (1) The date on which it first shipped multilayered wood flooring for export to the United States and the date on which the multilayered wood flooring was first entered, or withdrawn from warehouse, for consumption; (2) the volume of its first shipment; and (3) the date of its first sale to an unaffiliated customer in the United States.[9]

The Department conducted a CBP database query and confirmed that Anying's shipment of subject merchandise entered the United States for consumption and that liquidation of such entries has been properly suspended for antidumping duties. Pursuant to 19 CFR 351.221(c)(1)(i), the Department will publish the notice of initiation of a new shipper review no later than the last day of the month following the anniversary month or semiannual anniversary month of the order.

Initiation of New Shipper Review

Pursuant to section 751(a)(2)(B) of the Act, 19 CFR 351.214(b), and based on the information on the record, the Department finds that Anying meets the threshold requirements for initiation of a new shipper review of its shipment of multilayered wood flooring from the PRC.[10] However, if the information supplied by Anying is later found to be incorrect or insufficient during the course of this proceeding, the Department may rescind the review or apply adverse facts available pursuant to section 776 of the Act, depending upon the facts on record. The POR for the new shipper review of Anying is December 1, 2012, through November 30, 2013.[11] The Department intends to issue the preliminary results of this review no later than 180 days from the date of initiation, and the final results of this review no later than 90 days after the date the preliminary results are issued.[12]

It is the Department's usual practice, in cases involving non-market economies, to require that a company seeking to establish eligibility for an antidumping duty rate separate from the country-wide rate provide evidence of *de jure* and *de facto* absence of government control over the company's export activities. Accordingly, the Department will issue a questionnaire to Anying which will include a section requesting information with regard to its export activities for separate rates purposes. The review of Anying will proceed if the response provides sufficient indication that Anying is not subject to either *de jure* or *de facto* government control with respect to its exports of subject merchandise.

The Department will instruct CBP to allow, at the option of the importer, the posting, until the completion of the review, of a bond or security in lieu of a cash deposit for entries of subject merchandise from Anying in accordance with section 751(a)(2)(B)(iii) of the Act and 19 CFR 351.214(e). Because Anying certified that it produced and exported the subject merchandise, the Department will apply the bonding privilege only for subject merchandise that the respondent both produced and exported.

Interested parties requiring access to proprietary information in this new shipper review should submit applications for disclosure under administrative protective order in accordance with 19 CFR 351.305 and 351.306.

This initiation and notice are published in accordance with section 751(a)(2)(B) of the Act and 19 CFR 351.214 and 351.221(c)(1)(i).

Dated: January 24, 2014.

Christian Marsh,

Deputy Assistant Secretary for Antidumping and Countervailing Duty Operations.

[FR Doc. 2014–02066 Filed 1–30–14; 8:45 am]

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[7] *Id.*

[8] *Id.*

[9] *Id.* at 2.

[10] *See,* generally, Memorandum to the File through Abdelali Elouaradia, Director, AD/CVD Operations, Office IV ''Initiation of Antidumping New Shipper Review of Multilayered Wood Flooring from the People's Republic of China: Linyi Anying Wood Co., Ltd., Initiation Checklist,'' dated concurrently with this notice (''Initiation Checklist'').

[11] *See* 19 CFR 351.214(g)(1)(i)(A).

[12] *See* section 751(a)(2)(B)(iv) of the Act.

DEPARTMENT OF COMMERCE

International Trade Administration

[A–201–836]

Light-Walled Rectangular Pipe and Tube from Mexico: Final Results of Antidumping Duty Administrative Review; 2011–2012

AGENCY: Enforcement and Compliance, formerly Import Administration, International Trade Administration, Department of Commerce.

SUMMARY: On September 6, 2013, the Department of Commerce (the Department) published the preliminary results of the administrative review of the antidumping duty (AD) order on light-walled rectangular pipe and tube (LWR pipe and tube) from Mexico.[1] The period of review (POR) is August 1, 2011, through July 31, 2012. This review covers two producers or exporters of subject merchandise: Regiomontana de Perfiles y Tubos S.A. de C.V. (Regiopytsa) and Maquilacero S.A. de C.V. (Maquilacero). For the final results, we continue to find that Regiopytsa sold subject merchandise at less than normal value during the POR and that Maquilacero did not. For the final weighted-average dumping margins, see the ''Final Results of Review'' section below.

DATES: *Effective Date:* January 31, 2014.

FOR FURTHER INFORMATION CONTACT: Brian Davis or Ericka Ukrow, AD/CVD Operations, Office VI, Enforcement and Compliance, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue NW., Washington, DC 20230; telephone: (202) 482–7924 or (202) 482–0405, respectively.

SUPPLEMENTARY INFORMATION:

Background

On September 6, 2013, the Department published in the **Federal Register** the *Preliminary Results.* We invited interested parties to comment on the *Preliminary Results.* On October 22 and 23, 2013, respectively, the Department received case briefs from Regiopytsa and Maquilacero. No party submitted rebuttal briefs or requested a hearing.

Scope of the Order

The merchandise subject to the order is certain welded carbon-quality light-

[1] *See Light-Walled Rectangular Pipe and Tube from Mexico: Preliminary Results and Partial Rescission of Antidumping Duty Administrative Review; 2011–2012,* 78 FR 54864 (September 6, 2013) (*Preliminary Results*), and the accompanying Decision Memorandum (Preliminary Decision Memorandum).

walled steel pipe and tube, of rectangular (including square) cross section, having a wall thickness of less than 4 mm.[2] The welded carbon-quality rectangular pipe and tube subject to the order is currently classified under the Harmonized Tariff Schedule of the United States (HTSUS) subheadings 7306.61.50.00 and 7306.61.70.60. While HTSUS subheadings are provided for convenience and customs purposes, our written description of the scope of the order is dispositive.[3]

Tolling of Deadlines

As explained in the memorandum from the Assistant Secretary for Enforcement and Compliance, the Department exercised its discretion to toll deadlines for the duration of the closure of the Federal Government from October 1, through October 16, 2013.[4] Therefore, all deadlines in this segment of the proceeding were extended by 16 days. If the new deadline falls on a non-business day, in accordance with the Department's practice, the deadline will become the next business day. Accordingly, the revised deadline for the final results of this review is now January 22, 2014.

Analysis of Comments Received

All issues raised in the case briefs by parties to this administrative review are addressed in the Issues and Decision Memorandum.

The Issues and Decision Memorandum is a public document and is on file in the Central Records Unit (CRU), room 7046 of the main Department of Commerce building, as well as electronically via Enforcement and Compliance's Antidumping and Countervailing Duty Centralized Electronic Service System (IA ACCESS). IA ACCESS is available to registered users at *http://iaaccess.trade.gov,* and it is available to all parties in the CRU. In addition, a complete version of the Issues and Decision Memorandum can be accessed directly on the internet at *http://enforcement.trade.gov/frn/.* The signed Issues and Decision Memorandum and the electronic versions of the Issues and Decision Memorandum are identical in content.

Final Results of Review

We have made no changes to our calculations announced in the *Preliminary Results.* Therefore, as a result of our review, we continue to determine that the following weighted-average dumping margin exists for the period August 1, 2011, through July 31, 2012:

Producer or exporter	Weighted-average dumping margin (percent)
Regiomontana de Perfiles y Tubos S.A. de C.V.	1.45
Maquilacero S.A. de C.V.	0.00

Assessment Rates

The Department shall determine and U.S. Customs and Border Protection (CBP) shall assess antidumping duties on all appropriate entries.[5] Since the weighted-average dumping margin is not zero or *de minimis* (*i.e.,* less than 0.50 percent) for Regiopytsa, we calculated importer-specific *ad valorem* duty assessment rates based on the ratio of the total amount of dumping calculated for an importer's examined sales to the total entered value of those same sales in accordance with 19 CFR 351.212(b)(1). Where either a respondent's weighted-average dumping margin is zero or *de minimis,* or an importer-specific assessment rate is zero or *de minimis,* we instruct CBP to liquidate the appropriate entries without regard to antidumping duties.

The Department clarified its ''automatic assessment'' regulation on May 6, 2003.[6] This clarification will apply to entries of subject merchandise during the POR produced by Maquilacero and Regiopytsa for which they did not know that their merchandise was destined for the United States. In such instances, we will instruct CBP to liquidate unreviewed entries at the all-others rate of 3.76 percent, as established in the less-than-fair-value investigation of this proceeding,[7] if there is no rate for the intermediate company(ies) involved in the transaction.

In accordance with 19 CFR 356.8(a), the Department intends to issue assessment instructions to CBP on or after 41 days following the publication of the final results of this review.

Cash Deposit Requirements

The following cash deposit requirements will be effective upon publication of the final results of this administrative review for all shipments of the subject merchandise entered or withdrawn from warehouse for consumption on or after the publication date of these final results, consistent with section 751(a)(2)(C) of the Act: (1) For subject merchandise manufactured and exported by Maquilacero and Regiopytsa, the cash deposit rate will be equal to the weighted-average dumping margins established in the final results of this review; (2) for previously reviewed or investigated companies, the cash deposit rate will continue to be the company-specific rate published from the completed segment for the most recent period; (3) if the exporter is not a firm covered in this review, the prior review, or the investigation but the manufacturer is, then the cash-deposit rate will be the rate established from the completed segment for the most recent period for the manufacturer of the merchandise; and (4) if neither the exporter nor the manufacturer is a firm covered in this review, a previous review or the less-than-fair-value investigation conducted by the Department, then the cash deposit rate will be the all-others rate of 3.76 percent. These deposit requirements, when imposed, shall remain in effect until further notice.

Reimbursement of Duties

This notice also serves as a final reminder to importers of their responsibility under 19 CFR 351.402(f)(2) to file a certificate regarding the reimbursement of antidumping duties prior to liquidation of the relevant entries during this review period. Failure to comply with this requirement could result in the Secretary's presumption that reimbursement of antidumping duties

[2] *See* Memorandum to Paul Piquado, Assistant Secretary for Enforcement and Compliance, through Christian Marsh, Deputy Assistant Secretary for Antidumping and Countervailing Duty Operations, ''Issues and Decision Memorandum for the Final Results of the Administrative Review of the Antidumping Duty Order on Light-Walled Rectangular Pipe and Tube from Mexico; 2011–2012,'' dated concurrently with these results and hereby adopted by this notice, for a complete description of the scope of the order (Issues and Decision Memorandum).

[3] *See Light-Walled Rectangular Pipe and Tube from Mexico, the People's Republic of China, and the Republic of Korea: Antidumping Duty Orders; Light-Walled Rectangular Pipe and Tube from the Republic of Korea: Notice of Amended Final Determination of Sales at Less Than Fair Value,* 73 FR 45403, 45405 (August 5, 2008) (*Orders*).

[4] *See* Memorandum for the Record from Paul Piquado, Assistant Secretary for Enforcement and Compliance, ''Deadlines Affected by the Shutdown of the Federal Government,'' dated October 18, 2013.

[5] In these final results, the Department applied the assessment rate calculation method adopted in *Antidumping Proceedings: Calculation of the Weighted-Average Dumping Margin and Assessment Rate in Certain Antidumping Proceedings: Final Modification,* 77 FR 8101 (February 14, 2012).

[6] *See Antidumping and Countervailing Duty Proceedings: Assessment of Antidumping Duties,* 68 FR 23954 (May 6, 2003) (*Assessment Policy Notice*).

[7] *See Light-Walled Rectangular Pipe and Tube from Mexico, the People's Republic of China, and the Republic of Korea: Antidumping Duty Orders; Light-Walled Rectangular Pipe and Tube from the Republic of Korea: Notice of Amended Final Determination of Sales at Less Than Fair Value,* 73 FR 45403, 45405 (August 5, 2008).

occurred and the subsequent assessment of double antidumping duties.

Return or Destruction of Proprietary Information

This notice serves as a reminder to parties subject to the administrative protective order (APO) of their responsibility concerning the disposition of proprietary information disclosed under the APO in accordance with 19 CFR 351.305(a)(3). Timely written notification of return or destruction of APO materials or conversion to judicial protective order is hereby requested. Failure to comply with the regulations and the terms of an APO is a sanctionable violation.

These final results of review are issued and published in accordance with sections 751(a)(1) and 777(i)(1) of the Act and 19 CFR 351.213(h).

Dated: January 22, 2014.

Paul Piquado,

Assistant Secretary for Enforcement and Compliance.

Appendix I—List of Topics Discussed in the Issues and Decision Memorandum

1. Authority to Consider an Alternative Comparison Methodology Absent an Allegation of Targeted Dumping
2. Differential Pricing Analysis
3. Arm's-Length Analysis of Certain of Maquilacero's Sales

[FR Doc. 2014–02068 Filed 1–30–14; 8:45 am]

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DEPARTMENT OF COMMERCE

International Trade Administration

[C–570–911]

Circular Welded Carbon Quality Steel Pipe From the People's Republic of China: Rescission of Countervailing Duty Administrative Review; 2012

AGENCY: Enforcement and Compliance, formerly Import Administration, International Trade Administration, Department of Commerce.

SUMMARY: The Department of Commerce (Department) is rescinding the administrative review of the countervailing duty (CVD) order on circular welded carbon quality steel pipe (circular welded pipe) from the People's Republic of China (PRC) for the period January 1, 2012, through December 31, 2012.

DATES: *Effective Date:* January 31, 2014.

FOR FURTHER INFORMATION CONTACT: Mary Kolberg; AD/CVD Operations, Office I, Enforcement and Compliance, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue NW., Washington, DC 20230; telephone: (202) 482–1785.

Background

On August 28, 2013, the Department initiated an administrative review of the CVD order on circular welded pipe from the PRC with respect to 19 companies for the period January 1, 2012, through December 31, 2012, based on a request from Wheatland Tube Company (Wheatland).[1] On December 9, 2013, Wheatland withdrew its request for an administrative review. No other party requested a review.

Rescission of Administrative Review

Pursuant to 19 CFR 351.213(d)(l), the Department will rescind an administrative review, in whole or in part, if the party that requested a review withdraws the request within 90 days of the publication of the notice of initiation of the requested review. In this case, Wheatland withdrew its request within the 90-day deadline as extended,[2] and no other parties requested an administrative review of the CVD order. Therefore, in accordance with 19 CFR 351.213(d)(1), we are rescinding the administrative review of circular welded pipe from the PRC covering the period January 1, 2012, through December 31, 2012.

Assessment

The Department will instruct U.S. Customs and Border Protection (CBP) to assess CVDs on all appropriate entries of circular welded pipe from the PRC during the period of review at rates equal to the cash deposit of estimated CVDs required at the time of entry, or withdrawal from warehouse, for consumption, in accordance with 19 CFR 351.212(c)(1)(i). The Department intends to issue appropriate assessment instructions to CBP 15 days after the date of publication of this notice of rescission of administrative review.

Notifications

This notice serves as a final reminder to importers of their responsibility under 19 CFR 351.402(f)(2) to file a certificate regarding the reimbursement of CVDs prior to liquidation of the relevant entries during this review period.

This notice also serves as a final reminder to parties subject to administrative protective order (APO) of their responsibility concerning the return or destruction of proprietary information disclosed under APO in accordance with 19 CFR 351.305(a)(3). Timely written notification of the return or destruction of APO materials or conversion to judicial protective order is hereby requested. Failure to comply with the regulations and terms of an APO is a violation that is subject to sanction.

This notice is issued and published in accordance with sections 751(a)(1) and 777(i)(1) of the Tariff Act of 1930, as amended, and 19 CFR 351.213(d)(4).

Dated: January 27, 2014.

Christian Marsh,

Deputy Assistant Secretary for Antidumping and Countervailing Duty Operations.

[FR Doc. 2014–02081 Filed 1–30–14; 8:45 am]

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[1] *See Initiation of Antidumping and Countervailing Duty Administrative Reviews and Requests for Revocation in Part,* 78 FR 53128 (August 28, 2013).

[2] The 90-day deadline for withdrawal would have been November 26, 2013. However, as explained in the memorandum from the Assistant Secretary for Enforcement and Compliance, the Department exercised its discretion to toll deadlines for the duration of the closure of the Federal Government from October 1, through October 16, 2013. *See* Memorandum for the Record from Paul Piquado, Assistant Secretary for Enforcement and Compliance, ''Deadlines Affected by the Shutdown of the Federal Government'' (October 18, 2013). Therefore, the revised deadline for withdrawal was December 12, 2013.

DEPARTMENT OF COMMERCE

International Trade Administration

[C–533–844]

Certain Lined Paper Products from India: Notice of Partial Rescission of Countervailing Duty Administrative Review: 2012

AGENCY: Enforcement and Compliance, formerly Import Administration, International Trade Administration, Department of Commerce.

DATES: *Effective Date:* January 31, 2014.

FOR FURTHER INFORMATION CONTACT: John Conniff, Office III, AD/CVD Operations, Enforcement and Compliance, International Trade Administration, U.S. Department of Commerce, 14th Street and Constitution Avenue NW., Washington, DC 20230; telephone: (202) 482–1009.

SUPPLEMENTARY INFORMATION:

Background

On September 3, 2013, the Department of Commerce (the Department) published a notice of opportunity to request an administrative review of the countervailing duty order on certain lined paper products from India.[1] On September 30, 2013, Navneet

[1] *See Initiation of Antidumping or Countervailing Duty Order, Finding or Suspended Investigation;*

Continued

Education Ltd. (Navneet) filed a timely request for review. No other interested party submitted a review request for Navneet. The Department published in the **Federal Register** the notice of initiation of this countervailing duty administrative review, which included Navneet, for the period January 1, 2012, through December 31, 2012.[2]

On January 6, 2014, Navneet submitted a timely withdrawal of its review request.[3] Therefore, we are rescinding the review with regard to Navneet.

Partial Rescission of the 2012 Administrative Review

Pursuant to 19 CFR 351.213(d)(1), the Secretary will rescind an administrative review, in whole or in part, if the parties that requested a review withdraw the request within 90 days of the date of publication of the notice of initiation of the requested review. The Department published the *Initiation* on November 8, 2013. Navneet's withdrawal request was submitted within the 90-day period following the publication of the *Initiation* and, thus, is timely. Therefore, in accordance with 19 CFR 351.213(d)(1) we are rescinding this review of the countervailing duty order on certain lined paper products from India with respect to Navneet. We will continue this administrative review with regard to the remaining company, A.R. Printing & Packaging (India) Pvt. Ltd., for which a review was requested and not subsequently withdrawn.

Assessment

The Department will instruct U.S. Customs and Border Protection (CBP) to assess countervailing duties on all appropriate entries at a rate equal to the cash deposit of estimated countervailing duties required at the time of entry, or withdrawal from warehouse, for consumption, during the period January 1, 2012, through December 31, 2012, in accordance with 19 CFR 351.212(c)(1)(i).

The Department intends to issue appropriate assessment instructions directly to CBP 15 days after publication of this notice.

Notification Regarding Administrative Protective Order

This notice serves as a final reminder to parties subject to administrative protective orders (APOs) of their responsibility concerning the disposition of proprietary information disclosed under an APO in accordance with 19 CFR 351.305(a)(3), which continues to govern business proprietary information in this segment of the proceeding. Timely written notification of the return/destruction of APO materials or conversion to judicial protective order is hereby requested. Failure to comply with the regulations and terms of an APO is a violation which is subject to sanction.

This notice is issued and published in accordance with sections 751(a)(1) and 777(i)(1) of the Tariff Act of 1930, as amended, and 19 CFR 351.213(d)(4).

Dated: January 27, 2014.

Christian Marsh,

Deputy Assistant Secretary for Antidumping and Countervailing Duty Operations.

[FR Doc. 2014–02076 Filed 1–30–14; 8:45 am]

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Opportunity to Request Administrative Review, 78 FR 54235, 78 FR 54236 (September 3, 2013).

[2] *See Initiation of Antidumping and Countervailing Duty Administrative Reviews and Request for Revocation in Part* 78 FR 67104, 67105 (November 8, 2013) (*Initiation*).

[3] *See* Navneet's January 6, 2014, Withdrawal of Request for Countervailing Duty Administrative Review.

DEPARTMENT OF COMMERCE

International Trade Administration

[C–580–818]

Corrosion-Resistant Carbon Steel Flat Products from the Republic of Korea: Final Results of Countervailing Duty Administrative Review; 2011

AGENCY: Enforcement and Compliance, formerly Import Administration, International Trade Administration, Department of Commerce.

SUMMARY: The Department of Commerce (''Department'') has completed its administrative review of the countervailing duty (''CVD'') order on corrosion-resistant carbon steel flat products from the Republic of Korea (''Korea'') for the period January 1, 2011, through December 31, 2011. On September 10, 2013, we published the *Preliminary Results* of this review.[1] In these final results we continue to find that the respondents, Dongbu Steel Co., Ltd. (''Dongbu''), Hyundai HYSCO Ltd. (''HYSCO''), and Pohang Iron & Steel Co. Ltd. (''POSCO''), received subsidies that result in *de minimis* net subsidy rates.

DATES: *Effective Date:* January 31, 2014.

FOR FURTHER INFORMATION CONTACT: Robert Copyak, Andrew Medley, or Christopher Hargett, Office III, AD/CVD Operations, Enforcement and Compliance, U.S. Department of Commerce, 14th Street and Constitution Avenue NW., Washington, DC 20230; telephone (202) 482–2209, (202) 482–4987, and (202) 482–4161, respectively.

SUPPLEMENTARY INFORMATION:

Background

On September 10, 2013, we published the *Preliminary Results* in the **Federal Register**. We received case briefs from POSCO and HYSCO on October 28, 2013.[2] No parties submitted rebuttal briefs. We conducted no hearing in this review, as none was requested.

As explained in the memorandum from the Assistant Secretary for Enforcement and Compliance, the Department exercised its discretion to toll deadlines for the duration of the closure of the Federal Government from October 1, through October 16, 2013.[3] Therefore, all deadlines in this segment of the proceeding were extended by 16 days. Accordingly, the deadline for the final results of this review was revised forward to January 24, 2014.

Scope of the Order

The merchandise covered by this *Order*[4] is certain corrosion-resistant carbon steel flat products from Korea. These products include flat-rolled carbon steel products, of rectangular shape, either clad, plated, or coated with corrosion-resistant metals such as zinc, aluminum, or zinc-, aluminum-, nickel- or iron-based alloys, whether or not corrugated or painted, varnished or coated with plastics or other nonmetallic substances in addition to the metallic coating.[5] The merchandise subject to this *Order* is currently classifiable in the Harmonized Tariff Schedule of the United States (''HTSUS'') at subheadings: 7210.30.0000, 7210.31.0000, 7210.39.0000, 7210.41.0000, 7210.49.0030, 7210.49.0090, 7210.49.0091, 7210.49.0095,

[1] *See Corrosion-Resistant Carbon Steel Flat Products From the Republic of Korea: Preliminary Results of Countervailing Duty Administrative Review; 2011,* 78 FR 55241 (September 10, 2013) (''*Preliminary Results*'').

[2] At the Department's request, POSCO and HYSCO removed certain new factual information from their case briefs and resubmitted revised case briefs on November 1, 2013.

[3] *See* Memorandum for the Record from Paul Piquado, Assistant Secretary for Enforcement and Compliance, titled ''Deadlines Affected by the Shutdown of the Federal Government,'' dated October 18, 2013.

[4] *See Countervailing Duty Orders and Amendments to Final Affirmative Countervailing Duty Determinations: Certain Steel Products From Korea,* 58 FR 43752 (August 17, 1993) (''*Order*'').

[5] For a complete description of the scope of the *Order, see* the Memorandum to Paul Piquado, Assistant Secretary for Enforcement and Compliance, titled ''Issues and Decision Memorandum for the Final Results of the Countervailing Duty Administrative Review of Corrosion-Resistant Carbon Steel Flat Products from Korea; 2011,'' dated concurrent with and adopted by this notice (''Issues and Decision Memorandum'').

7210.60.0000, 7210.61.0000, 7210.69.0000, 7210.70.6030, 7210.70.6060, 7210.70.6090, 7210.90.1000, 7210.90.6000, 7210.90.9000, 7212.20.0000, 7212.21.0000, 7212.29.0000, 7212.30.1030, 7212.30.1090, 7212.30.3000, 7212.30.5000, 7212.40.1000, 7212.40.5000, 7212.50.0000, 7212.60.0000, 7215.90.1000, 7215.9030, 7215.90.5000, 7217.12.1000, 7217.13.1000, 7217.19.1000, 7217.19.5000, 7217.20.1500, 7217.22.5000, 7217.23.5000, 7217.29.1000, 7217.29.5000, 7217.30.15.0000, 7217.32.5000, 7217.33.5000, 7217.39.1000, 7217.39.5000, 7217.90.1000 and 7217.90.5000. Although the HTSUS numbers are provided for convenience and customs purposes, the written product description, available in the *Preliminary Results,* remains dispositive.

Analysis of Comments Received

All issues raised in the case briefs are addressed in the Issues and Decision Memorandum.[6] A list of the issues raised is attached to this notice as an Appendix. The Issues and Decision Memorandum is a public document and is available on file electronically via Enforcement and Compliance's Antidumping and Countervailing Duty Centralized Electronic Service System (''IA ACCESS''). IA ACCESS is available to registered users at *http://iaaccess.trade.gov* and in the Central Records Unit, Room 7046 of the main Department of Commerce building. In addition, a complete version of the Issues and Decision Memorandum can be accessed directly on the internet at *http://enforcement.trade.gov/frn/.* The signed Issues and Decision Memorandum and the electronic versions of the Issues and Decision Memorandum are identical in content.

Final Results of Review

In accordance with 19 CFR 351.221(b)(5), we calculated net subsidy rates for Dongbu, POSCO, and HYSCO of 0.10, 0.20, and 0.26 percent *ad valorem,* respectively, which are *de minimis* rates.[7]

Assessment Rates

In accordance with 19 CFR 351.212(b)(2), the Department intends to issue appropriate assessment instructions directly to U.S. Customs and Border Protection (''CBP'') 15 days after the date of publication of these final results, to liquidate shipments of subject merchandise by Dongbu, POSCO, and HYSCO entered, or withdrawn from warehouse, for consumption on or after January 1, 2011, through December 31, 2011, without regard to countervailing duties because a *de minimis* subsidy rate was calculated for each company.

Cash Deposit Instructions

On March 19, 2013, the Department published the *Revocation Notice* in the **Federal Register** in which it explained that 15 days after the publication date of the *Revocation Notice,* the Department would instruct CBP to terminate the suspension of liquidation and to discontinue the collection of cash deposits on entries of the subject merchandise, entered or withdrawn from warehouse, on or after February 14, 2012.[8] Pursuant to the *Revocation Notice* the Department will further instruct CBP to refund with interest all cash deposits on entries made on or after February 14, 2012. Further, as explained in the *Revocation Notice,* entries of subject merchandise prior to the effective date of revocation will continue to be subject to suspension of liquidation and antidumping and/or countervailing duty deposit requirements and assessments. Lastly, in the *Revocation Notice,* the Department explained that it will complete any pending or requested administrative reviews of these orders covering entries prior to February 14, 2012.[9]

Thus, as a result of the revocation of the order, the Department will not issue cash deposit instructions in connection with this administrative review.

Administrative Protective Order

This notice serves as a reminder to parties subject to administrative protective order (''APO'') of their responsibility concerning the return or destruction of proprietary information disclosed under APO in accordance with 19 CFR 351.305(a)(3). Timely written notification of return or destruction of APO materials or conversion to judicial protective order is hereby requested. Failure to comply with the regulations and the terms of an APO is a sanctionable violation.

Disclosure

We will disclose the calculations performed within five days of the date of publication of this notice to parties in this proceeding, in accordance with 19 CFR 351.224(b).

We are issuing and publishing these results in accordance with sections 751(a)(1) and 777(i)(1) of the Tariff Act of 1930, as amended, and 19 CFR 351.213(h)(1).

Dated: January 24, 2014.

Paul Piquado,

Assistant Secretary for Enforcement and Compliance.

Appendix—Issues and Decision Memorandum

Comment 1: HYSCO's and POSCO's Tax Credits under the Restriction of Special Taxation Act (''RSTA'')

Comment 2: Calculation of HYSCO's Benefit from Document Acceptance (''D/A'') Financing

[FR Doc. 2014–02071 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–DS–P

[6] No rebuttal briefs were submitted by parties.

[7] *See* 19 CFR 351.106(c)(1).

[8] *See Corrosion-Resistant Carbon Steel Flat Products from Germany and the Republic of Korea: Revocation of Antidumping and Countervailing Duty Orders,* 78 FR 16832 (March 19, 2013) (''*Revocation Notice*'').

[9] *Id.*

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

RIN 0648–XD047

Fisheries of the Caribbean, Gulf of Mexico, and South Atlantic; Generic Accountability Measure and Dolphin Allocation Amendment

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice of Intent (NOI) to prepare a draft environmental impact statement (DEIS); request for comments.

SUMMARY: NMFS, Southeast Region, in collaboration with the South Atlantic Fishery Management Council (Council), intends to prepare a DEIS to describe and analyze a range of alternatives for management actions to be included in the Generic Accountability Measure (AM) and Dolphin Allocation Amendment. The Generic AM and Dolphin Allocation Amendment would amend the Fishery Management Plans (FMPs) for: the Dolphin and Wahoo Fishery of the Atlantic; the Snapper-Grouper Fishery of the South Atlantic Region; and the Golden Crab Fishery of the South Atlantic Region. The Generic AM and Dolphin Allocation Amendment will consider alternative AMs for snapper-grouper species and golden crab, as well as alternatives to modify existing commercial and recreational sector allocations for dolphin. The purpose of this NOI is to solicit public comments on the scope of issues to be addressed in the DEIS.

DATES: Written comments on the scope of issues to be addressed in the DEIS will be accepted until March 3, 2014.

ADDRESSES: You may submit comments on the NOI identified by ''NOAA–NMFS–2013–0181'' by any of the following methods:

• Electronic submissions: Submit electronic comments via the Federal e-Rulemaking Portal: *http://www.regulations.gov.* Go to *www.regulations.gov/#!docketDetail;D=NOAA–NMFS–2013–0181,* click the ''Comment Now!'' icon, complete the required fields, and enter or attach your comments.

• Mail: Submit written comments to Jack McGovern, Southeast Regional Office, NMFS, 263 13th Avenue South, St. Petersburg, FL 33701.

Instructions: Comments sent by any other method, to any other address or individual, or received after the end of the comment period, may not be considered by NMFS. All comments received are a part of the public record and will generally be posted for public viewing on *www.regulations.gov* without change. All personal identifying information (*e.g.,* name, address, etc.), confidential business information, or otherwise sensitive information submitted voluntarily by the sender will be publicly accessible. NMFS will accept anonymous comments (enter ''N/A'' in the required fields if you wish to remain anonymous). Attachments to electronic comments will be accepted in Microsoft Word, Excel, or Adobe PDF file formats only.

FOR FURTHER INFORMATION CONTACT: Jack McGovern, Southeast Regional Office, telephone: 727–824–5305, or email: *john.mcgovern@noaa.gov*. Kim Iverson, Public Information Officer, South Atlantic Fisheries Management Council, 4055 Faber Place Drive, Suite 201, North Charleston, SC 29405; telephone: 843–571–4366, or email: *kim.iverson@safmc.net*.

SUPPLEMENTARY INFORMATION: The Council and NMFS have implemented AMs for snapper-grouper species, AMs for golden crab, and sector allocations for dolphin.

AMs for snapper-grouper species were established in 2010 through Amendments 17A and 17B to the Snapper-Grouper Fishery of the South Atlantic Region (75 FR 76874, December 9, 2010, and 75 FR 82280, December 30, 2010, respectively) and in 2012 through the Comprehensive ACL Amendment (77 FR 15916, March 16, 2012) and Amendment 24 to the Snapper-Grouper Fishery of the South Atlantic Region (77 FR 34254, June 11, 2012). AMs for golden crab were established in 2012 through the Comprehensive ACL Amendment (77 FR 15916, March 16, 2012). The DEIS for the Generic AM and Dolphin Allocation Amendment would consider alternatives to modify existing AMs for these species to provide consistency of AMs among species, and ensure overfishing does not occur.

Sector allocations for dolphin were established in 2012 through the Comprehensive ACL Amendment (77 FR 15916, March 16, 2012), using a formula which provided equal weighting to long-term and short-term trends in landings. The long-term landings trend was from 1986 through 2008, and the short-term trend used landings from 2006 through 2008. The DEIS for the Generic AM and Dolphin Allocation Amendment would consider alternatives to modify existing sector allocations for dolphin.

NMFS, in collaboration with the Council, will develop a DEIS to describe and analyze alternatives to address the management needs described above including the ''no action'' alternative. In accordance with NOAA's Administrative Order 216–6, Section 5.02(c), Scoping Process, NMFS, in collaboration with the Council, has identified preliminary environmental issues as a means to initiate discussion for scoping purposes only. The public is invited to provide written comments on the preliminary issues, which are identified as actions and alternatives in the Generic AM and Dolphin Allocation Amendment scoping document. These preliminary issues may not represent the full range of issues that eventually will be evaluated in the DEIS.

After the DEIS associated with Generic AM and Dolphin Allocation Amendment is completed, it will be filed with the Environmental Protection Agency (EPA). After filing, the EPA will publish a notice of availability of the DEIS for public comment in the **Federal Register**. The DEIS will have a 45-day comment period. This procedure is pursuant to regulations issued by the Council on Environmental Quality (CEQ) for implementing the procedural provisions of the National Environmental Policy Act (NEPA; 40 CFR parts 1500–1508) and to NOAA's Administrative Order 216–6 regarding NOAA's compliance with NEPA and the CEQ regulations.

The Council and NMFS will consider public comments received on the DEIS in developing the final environmental impact statement (FEIS), and before voting to submit the final amendment to NMFS for Secretarial review, approval, and implementation. NMFS will announce in the **Federal Register** the availability of the final amendment and FEIS for public review during the Secretarial review period, and will consider all public comments prior to final agency action to approve, disapprove, or partially approve the final amendment.

NMFS will announce, through a document published in the **Federal Register**, all public comment periods on the final amendment, its proposed implementing regulations, and the availability of its associated FEIS. NMFS will consider all public comments received during the Secretarial review period, whether they are on the final amendment, the proposed regulations, or the FEIS, prior to final agency action.

Authority: 16 U.S.C. 1801 *et seq.*

Dated: January 28, 2014.

Sean F. Corson,

Acting Deputy Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 2014–02011 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–22–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

RIN 0648–XD102

Council Coordination Committee Meeting

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice of a public meeting.

SUMMARY: NMFS will host a meeting of the Council Coordination Committee (CCC), consisting of the Regional Fishery Management Council chairs, vice chairs, and executive directors in February 2014. The intent of this meeting is to discuss issues of relevance to the Councils, including budget allocations for FY 2014 and budget planning for FY 2015 and beyond, FY 2014 Priorities, update from the Marine Fisheries Advisory Committee Endangered Species Act work group report and the seafood certification process, fisheries allocation, national science program review, electronic monitoring workshop report, Magnuson-Stevens Fishery Conservation and Management Act (MSA) reauthoization, National Fish Habitat Partnership Board's consideration of habitat in the fishery management process, and other topics related to implementation of the MSA.

DATES: The meeting will begin at 9 a.m. on Wednesday, February 19, 2014, recess at 5:30 p.m. or when business is

complete; and reconvene at 9 a.m. on Thursday, February 20, 2014, and adjourn by 4:30 p.m. or when business is complete.

ADDRESSES: The meeting will be held at the Holiday Inn Capitol Hill, 550 C Street SW., Washington, DC 20024, telephone 202–479–4000, fax 202–288–4627.

FOR FURTHER INFORMATION CONTACT: William D. Chappell: telephone 301–427–8505 or email at *William.Chappell@noaa.gov;* or Tara Scott: telephone 301–427–8505 or email at *Tara.Scott@noaa.gov.*

SUPPLEMENTARY INFORMATION: The Magnuson-Stevens Fishery Conservation and Management Reauthorization Act (MSRA) of 2006 established the Council Coordination Committee (CCC) by amending Section 302 (16 U.S.C. 1852) of the MSA. The committee consists of the chairs, vice chairs, and executive directors of each of the eight Regional Fishery Management Councils authorized by the MSA or other Council members or staff. NMFS will host this meeting and provide reports to the CCC for its information and discussion. All sessions are open to the public.

Proposed Agenda

Wednesday, February 19, 2014

9 a.m.—Morning Session Begins

9:00– 9:35 Welcome and Introductions
9:35–10:05 NMFS Updates
- NMFS FY14 Priorities
- National Standard One
- National Environmental Protection Act
- Inspector General Report

10:05–10:20 Break
10:20–11:00 Council Report Round Robin
11:00–12:00 Management and Budget Update
- FY 2014: Status, Council Funding
- FY 2015: Update
- Budget Outlook
- FY 2015 and Beyond—Management and Administration Cost

12 p.m.—Lunch

1:30 p.m.—Afternoon Session Begins

1:30–2:15 Councils/Marine Fisheries Advisory Committee Endangered Species Act (ESA) Working Group update
2:15–3:15 Councils/Marine Fisheries Advisory Committee Seafood Certification Process
3:15–3:30 Break
3:30–4:30 Fisheries Allocation
- National SSC Tasking
- Next Steps

4:30–5:30 National Science Programs Review
5:30—Adjourn for the day

Thursday, February 20, 2014

9 a.m.—Morning Session Begins

9:00–10:00 Electronic Monitoring Workshop Report
10:00 –10:15 Break
10:15–11:00 Revision of Operational Guidelines
11:00–12:00 Revisions to CCC Terms of Reference
- Creating a National SSC

12 p.m.—Lunch

1:30 p.m.—Afternoon Session Begins

1:30–2:30 MSA Reauthorization
- Hill Activity
- HNR Committee Discussion Draft Bill
- Follow up from October CCC Webinar/Next Steps

2:30–2:45 Break
2:45–3:45 National Fish Habitat Partnership Board Considering Habitat in the Fishery Management Process
3:45–4: 30 Other Business
4:30 p.m.—Adjourn.

The order in which the agenda items are addressed may change. The CCC will meet as late as necessary to complete scheduled business.

Special Accommodations

This meeting is physically accessible to people with disabilities. Requests for sign language interpretation or other auxiliary aids should be directed to Tara Scott at 301–427–8505 at least five working days prior to the meeting.

Dated: January 27, 2014.

Alan Risenhoover,

Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 2014–02074 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–22–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

RIN 0648–XD108

New England Fishery Management Council; Public Meeting

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice; public meeting.

SUMMARY: The New England Fishery Management Council (Council) is re-scheduling a public meeting of its Recreational Advisory Panel to consider actions affecting New England fisheries in the exclusive economic zone (EEZ). Recommendations from this group will be brought to the full Council for formal consideration and action, if appropriate.

DATES: This meeting will be held on Wednesday, February 19, 2014 at 9 a.m. This meeting has been re-scheduled from January 22, 2014.

ADDRESSES:

Meeting address: The meeting will be held at the DoubleTree by Hilton Hotel, 50 Ferncroft Road, Danvers, MA 01923; telephone: (978) 777–2500; fax: (978) 750–7959.

Council address: New England Fishery Management Council, 50 Water Street, Mill 2, Newburyport, MA 01950.

FOR FURTHER INFORMATION CONTACT: Thomas A. Nies, Executive Director, New England Fishery Management Council; telephone: (978) 465–0492.

SUPPLEMENTARY INFORMATION: The Recreational Advisory Panel (RAP) will meet to have a discussion of Habitat Omnibus Amendment 2 management alternatives related to the recreational groundfish fishery. Also, on the agenda will be a discussion of recreational accountability measures for Gulf of Maine cod and haddock. Other business may be discussed.

Although non-emergency issues not contained in this agenda may come before this group for discussion, those issues may not be the subject of formal action during this meeting. Action will be restricted to those issues specifically listed in this notice and any issues arising after publication of this notice that require emergency action under section 305(c) of the Magnuson-Stevens Act, provided the public has been notified of the Council's intent to take final action to address the emergency.

Special Accommodations

This meeting is physically accessible to people with disabilities. Requests for sign language interpretation or other auxiliary aids should be directed to Thomas A. Nies, Executive Director, at (978) 465–0492, at least 5 days prior to the meeting date.

Authority: 16 U.S.C. 1801 *et seq.*

Dated: January 28, 2014.

Tracey L. Thompson,

Acting Deputy Director, Office of Sustainable Fisheries, National Marine Fisheries Service.

[FR Doc. 2014–02020 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–22–P

DEPARTMENT OF COMMERCE

National Oceanic and Atmospheric Administration

RIN 0648- XC599

Marine Mammals; File No. 17845

AGENCY: National Marine Fisheries Service (NMFS), National Oceanic and Atmospheric Administration (NOAA), Commerce.

ACTION: Notice; issuance of permit.

SUMMARY: Notice is hereby given that a permit has been issued to Rachel Cartwright, Keiki Kohola Project, 761 Coronado Place, Oxnard, CA 93035 to conduct research on humpback whales (*Megaptera novaeangliae*).

ADDRESSES: The permit and related documents are available for review upon written request or by appointment in the following offices: See **SUPPLEMENTARY INFORMATION**.

FOR FURTHER INFORMATION CONTACT: Kristy Beard or Carrie Hubard, (301)427–8401.

SUPPLEMENTARY INFORMATION: On April 9, 2013, notice was published in the **Federal Register** (78 FR 21113) that a request for a permit to conduct research on the species identified above had been submitted by the above-named applicant. The requested permit has been issued under the authority of the Marine Mammal Protection Act of 1972, as amended (16 U.S.C. 1361 *et seq.*), the regulations governing the taking and importing of marine mammals (50 CFR part 216), the Endangered Species Act of 1973, as amended (ESA; 16 U.S.C. 1531 *et seq.*), and the regulations governing the taking, importing, and exporting of endangered and threatened species (50 CFR parts 222–226).

The permit authorizes the level A and B harassment of humpback whales during photo-identification, behavioral follows, and surface and underwater observations in Hawaii, Alaska, and California. The applicant will approach up to 1,047 humpback whales in Hawaii, 630 in Alaska and 480 in California each year. Short-term, non-invasive, suction cup tagging of maternal females will be conducted within Hawaiian waters to document nocturnal behaviors and fine-scale movements and in Californian waters to better understand use of waters around the Santa Barbara Channel and Channel Islands (Anacapa, Santa Cruz and Santa Rosa Islands). Twelve tags would be deployed annually in both Hawaii and California. The purpose of the proposed research is to identify and define critical habitat used by maternal female humpback whales and their calves, across the period from infancy to maturity and independence. Opportunistic research on Pacific white-sided dolphins (*Lagenorhynchus obliquidens*), Risso's dolphins (*Grampus griseus*), Dall's porpoise (*Phocoenoides dalli*), blue whales (*Balaenoptera musculus*), killer whales (*Orcinus orca*), minke whales (*B. acutorostrata*), spinner dolphins (*Stenella longirostris*), bottlenose dolphins (*Tursiops truncatus*), and false killer whales (*Pseudorca crassidens*) may also be conducted. Incidental harassment of Steller (*Eumetopias jubatus*) and California sea lions (*Zalophus californianus*) would also occur. The permit is valid for five years from the date of issuance.

In compliance with the National Environmental Policy Act of 1969 (42 U.S.C. 4321 *et seq.*), a final determination has been made that the activity proposed is categorically excluded from the requirement to prepare an environmental assessment or environmental impact statement.

As required by the ESA, issuance of this permit was based on a finding that such permit: (1) Was applied for in good faith; (2) will not operate to the disadvantage of such endangered species; and (3) is consistent with the purposes and policies set forth in section 2 of the ESA.

Documents may be reviewed in the following locations:

Permits and Conservation Division, Office of Protected Resources, NMFS, 1315 East-West Highway, Room 13705, Silver Spring, MD 20910; phone (301)427–8401; fax (301)713–0376;

Alaska Region, NMFS, P.O. Box 21668, Juneau, AK 99802–1668; phone (907)586–7221; fax (907)586–7249;

West Coast Region, NMFS, 501 West Ocean Blvd., Suite 4200, Long Beach, CA 90802–4213; phone (562)980–4005; fax (562)980–4027; and

Pacific Islands Region, NMFS, 1601 Kapiolani Blvd., Rm 1110, Honolulu, HI 96814–4700; phone (808)944–2200; fax (808)973–2941.

Dated: January 27, 2014.

P. Michael Payne,

Chief, Permits and Conservation Division, Office of Protected Resources, National Marine Fisheries Service.

[FR Doc. 2014–01906 Filed 1–30–14; 8:45 am]

BILLING CODE 3510–22–P

COMMITTEE FOR PURCHASE FROM PEOPLE WHO ARE BLIND OR SEVERELY DISABLED

Procurement List Additions

AGENCY: Committee for Purchase From People Who Are Blind or Severely Disabled.

ACTION: Additions to the Procurement List.

SUMMARY: This action adds products and services to the Procurement List that will be furnished by nonprofit agencies employing persons who are blind or have other severe disabilities.

DATES: *Effective Date:* March 3, 2014.

ADDRESSES: Committee for Purchase From People Who Are Blind or Severely Disabled, 1401 S. Clark Street, Suite 10800, Arlington, Virginia, 22202–4149.

FOR FURTHER INFORMATION CONTACT: Patricia Briscoe, Telephone: (703) 603–7740, Fax: (703) 603–0655, or email *CMTEFedReg@AbilityOne.gov.*

SUPPLEMENTARY INFORMATION:

Additions

On 11/29/2013 (78 FR 71582–71583) and 12/6/2013 (78 FR 73504), the Committee for Purchase From People Who Are Blind or Severely Disabled published notices of proposed additions to the Procurement List.

After consideration of the material presented to it concerning capability of qualified nonprofit agencies to provide the products and services and impact of the additions on the current or most recent contractors, the Committee has determined that the products and services listed below are suitable for procurement by the Federal Government under 41 U.S.C. 8501–8506 and 41 CFR 51–2.4.

Regulatory Flexibility Act Certification

I certify that the following action will not have a significant impact on a substantial number of small entities. The major factors considered for this certification were:

1. The action will not result in any additional reporting, recordkeeping or other compliance requirements for small entities other than the small organizations that will furnish the products and services to the Government.

2. The action will result in authorizing small entities to furnish the products and services to the Government.

3. There are no known regulatory alternatives which would accomplish the objectives of the Javits-Wagner-O'Day Act (41 U.S.C. 8501–8506) in connection with the products and

services proposed for addition to the Procurement List.

End of Certification

Accordingly, the following products and services are added to the Procurement List:

Products:

NSN: 8950–01–E62–3516—Allspice, Ground, 6/16 oz. Bottles

NSN: 8950–01–E62–3528—Cloves, Ground, 6/16 oz. Bottles

NSN: 8950–01–E62–3532—Poppy Seed, Whole, 6/20 oz. Bottles

NSN: 8950–01–E62–3508—Rosemary Leaves, Ground, 6/11 oz. Bottles

NSN: 8950–01–E62–3524—Caribbean Jerk Seasoning Blend, 6/18 oz. Bottles

NSN: 8950–01–E62–3520—Chives, Dehydrated, Chopped, 6/1.35 oz. Bottles

NSN: 8950–01–E62–3526—Chinese 5 Spice, 6/16 oz. Bottles

NSN: 8950–01–E62–3510—Cilantro, Freeze Dried, 6/3.75 oz. Bottles

NSN: 8950–01–E62–3530—Tarragon, Whole, 6/3.5 oz. Bottles

NSN: 8950–01–E62–3512—Sage, Rubbed, 6/6 oz. Bottles

NSN: 8950–01–E62–3514—Rosemary Leaves, Whole, 6/6 oz. Bottles

NSN: 8950–01–E62–3518—Marjoram, Ground, 6/11 oz. Bottles

NSN: 8950–01–E62–3522—Garlic and Herb Seasoning, 6/18 oz. Bottles

NSN: 8950–01–E62–3506—Fennel Seed, Whole, 6/14 oz. Bottles

NPA: CDS Monarch, Webster, NY.

Contracting Activity: Defense Logistics Agency Troop Support, Philadelphia, PA.

COVERAGE: C-List for 100% of the requirement of the Department of Defense, as aggregated by the Defense Logistics Agency Troop Support, Philadelphia, PA.

NSN: 7045–00–NIB–0386—Blank media discs, CD–R, White, Thermal Printable, 52x Speed, 80Min/700MB, 50 pack spindle

NPA: North Central Sight Services, Inc., Williamsport, PA.

Contracting Activity: Defense Logistics Agency Troop Support, Philadelphia, PA.

COVERAGE: A-List for the Total Government Requirement as aggregated by the Defense Logistics Agency, Philadelphia, PA.

Services:

Service Type/Location: Custodial Service, U.S. Geological Survey, Patuxent Wildlife Research Center, 12100 Beech Forest Rd., Laurel, MD.

NPA: MVLE, Inc., Springfield, VA.

Contracting Activity: DEPT OF THE INTERIOR, GEOLOGICAL SURVEY, OFFICE OF PROCUREMENT AND CONTRACTS, RESTON, VA.

Service Type/Location: Custodial Service, Directorate of Contracting Procurement Logistics Support Detachment, Undisclosed Location, Ft. Belvoir, VA

NPA: MVLE, Inc., Springfield, VA.

Contracting Activity: Directorate of Contracting Procurement Logistics Support Detachment, Fort Belvoir, VA.

Patricia Briscoe,

Deputy Director, Business Operations, (Pricing and Information Management).

[FR Doc. 2014–02013 Filed 1–30–14; 8:45 am]

BILLING CODE 6353–01–P

COMMITTEE FOR PURCHASE FROM PEOPLE WHO ARE BLIND OR SEVERELY DISABLED

Procurement List; Proposed Additions And Deletions

AGENCY: Committee for Purchase From People Who Are Blind or Severely Disabled.

ACTION: Proposed Additions to and Deletions From the Procurement List.

SUMMARY: The Committee is proposing to add products to the Procurement List that will be furnished by the nonprofit agency employing persons who are blind or have other severe disabilities, and delete products previously furnished by such agency.

Comments Must Be Received On Or Before: March 3, 2014.

ADDRESSES: Committee for Purchase From People Who Are Blind or Severely Disabled, 1401 S. Clark Street, Suite 10800, Arlington, Virginia, 22202–4149.

For Further Information or to Submit Comments Contact: Patricia Briscoe, Telephone: (703) 603–7740, Fax: (703) 603–0655, or email *CMTEFedReg@AbilityOne.gov*.

SUPPLEMENTARY INFORMATION:

This notice is published pursuant to 41 USC 8503 (a)(2) and 41 CFR 51–2.3. Its purpose is to provide interested persons an opportunity to submit comments on the proposed actions.

Additions

If the Committee approves the proposed additions, the entities of the Federal Government identified in this notice will be required to procure the products listed below from the nonprofit agency employing persons who are blind or have other severe disabilities.

The following products are proposed for addition to the Procurement List for production by the nonprofit agency listed:

Products:

Screwdriver

NSN: 5120–00–NIB–0072—3/16w Slotted Tip, Premium Grade, 3''

NSN: 5120–00–NIB–0073—1/4w Slotted Tip, Premium Grade, 4''

NSN: 5120–00–NIB–0074—5/16w Slotted Tip, Premium Grade, 6''

NSN: 5120–00–NIB–0075—3/8w Slotted Tip, Premium Grade, 8''

NSN: 5120–00–NIB–0076—7/16w Slotted Tip, Premium Grade, 10''

NSN: 5120–00–NIB–0077—1/4w Slotted Tip, Premium Grade, 1–7/8''

NSN: 5120–00–NIB–0078—#1 Phillips, Premium Grade, 3''

NSN: 5120–00–NIB–0079—#2 Phillips, Premium Grade, 4''

NSN: 5120–00–NIB–0080—#2 Phillips, Premium Grade, 8''

NSN: 5120–00–NIB–0081—#3 Phillips, Premium Grade, 6''

NSN: 5120–00–NIB–0082—#4 Phillips, Premium Grade, 6''

NSN: 5120–00–NIB–0083—#2 Phillips, Premium Grade, 1–1/2

NSN: 5120–00–NIB–0084—Set, 3/16—3/8w Slotted Tip, Premium Grade, 6PC

NSN: 5120–00–NIB–0085—Set, Phillips, Premium Grade, 6PC

NSN: 5120–00–NIB–0086—Set, Assorted, Premium Grade, 7PC

NPA: Industries for the Blind, Inc., West Allis, WI.

Contracting Activity: General Services Administration, Tools Acquisition Division I, Kansas City, MO.

Coverage: B-List for the Broad Government Requirement as aggregated by the General Services Administration.

Deletions

The following products are proposed for deletion from the Procurement List:

Products:

Kit, Pre-Inked Stamps

NSN: 7520–00–NIB–1090

NSN: 7520–00–NIB–1099

NSN: 7520–00–NIB–1105

NSN: 7520–00–NIB–1107

NPA: The Lighthouse for the Blind, Inc. (Seattle Lighthouse), Seattle, WA.

Contracting Activity: U.S. Postal Service, Washington, DC.

Patricia Briscoe,

Deputy Director, Business Operations, (Pricing and Information Management).

[FR Doc. 2014–02014 Filed 1–30–14; 8:45 am]

BILLING CODE 6353–01–P

DEPARTMENT OF DEFENSE

Office of the Secretary

[Transmittal Nos. 13–74]

36(b)(1) Arms Sales Notification

AGENCY: Department of Defense, Defense Security Cooperation Agency.

ACTION: Notice.

SUMMARY: The Department of Defense is publishing the unclassified text of a section 36(b)(1) arms sales notification. This is published to fulfill the requirements of section 155 of Public Law 104–164 dated July 21, 1996.

FOR FURTHER INFORMATION CONTACT: Ms. B. English, DSCA/DBO/CFM, (703) 601–3740.

The following is a copy of a letter to the Speaker of the House of Representatives, Transmittals 13–74 with attached transmittal and policy justification.

Dated: January 28, 2014.

Aaron Siegel,

Alternate OSD Federal Register Liaison Officer, Department of Defense.

DEFENSE SECURITY COOPERATION AGENCY
201 12TH STREET SOUTH, STE 203
ARLINGTON, VA 22202-5408

JAN 22 2014

The Honorable John A. Boehner
Speaker of the House
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Speaker:

Pursuant to the reporting requirements of Section 36(b)(1) of the Arms Export Control Act, as amended, we are forwarding herewith Transmittal No. 13-74, concerning the Department of the Army's proposed Letter(s) of Offer and Acceptance to Libya for defense articles and services estimated to cost $600 million. After this letter is delivered to your office, we plan to issue a press statement to notify the public of this proposed sale.

Sincerely,

For J. W. Rixey
Vice Admiral, USN
Director

Enclosures:
1. Transmittal
2. Policy Justification
3. Regional Balance (Classified Document Provided Under Separate Cover)

Transmittal No. 13–74

Notice of Proposed Issuance of Letter of Offer Pursuant to Section 36(b)(1) of the Arms Export Control Act, as amended

(i) *Prospective Purchaser:* Libya

(ii) *Total Estimated Value:*

Major Defense Equipment* ..	$ 0 million
Other	$600 million
Total	$600 million

(iii) *Description and Quantity or Quantities of Articles or Services under Consideration for Purchase:* training for a 6,000 to 8,000 person General Purpose Force for Libya. The training includes services for up to 8 years for training, facilities sustainment and improvements, personnel training and training equipment, 637 M4A4 carbines and small arms ammunition, U.S. Government and contractor technical and logistics support services, Organizational Clothing and Individual Equipment (OCIE), and other related elements of logistical and program support.

(iv) *Military Department:* Army (DAC)

(v) *Prior Related Cases, if any:* None

(vi) *Sales Commission, Fee, etc., Paid, Offered, or Agreed to be Paid:*

(vii) *Sensitivity of Technology Contained in the Defense Article or Defense Services Proposed to be Sold:* None

(viii) *Date Report Delivered to Congress:* 22 Jan 2014

* As defined in Section 47(6) of the Arms Export Control Act.

POLICY JUSTIFICATION

Libya—General Purpose Force Training

The Government of Libya has requested a sale of training for a 6,000 to 8,000 person General Purpose Force. The training includes services for up to 8 years for training, facilities sustainment and improvements, personnel training and training equipment, 637 M4A4 carbines and small arms ammunition, U.S. Government and contractor technical and logistics support services, Organizational Clothing and Individual Equipment (OCIE), and other related elements of logistical and program support. The estimated cost is $600 million.

This proposed sale will contribute to the foreign policy and national security of the United States by helping to improve the security of Libya.

The proposed sale will enable Libya to develop, and train a General Purpose Force. The basic, collective and advanced training will be critical for establishing a professional and disciplined General Purpose Force used in protecting Libya's institutions, facilities, and personnel as well as keeping peace and security within Libya.

The proposed sale of this equipment and support will not alter the basic military balance in the region.

The principal contractors are unknown at this time but will be determined during the competitive bid process. There are no known offset agreements in connection with this potential sale.

Implementation of this proposed sale will require the assignment of 350 U.S. Government and contractor personnel for up to 8 years to conduct training at the Novo Selo training site in Bulgaria.

There will be no adverse impact on U.S. defense readiness as a result of this proposed sale.

[FR Doc. 2014–01988 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–06–P

DEPARTMENT OF DEFENSE

Office of the Secretary

Meeting of the Department of Defense Military Family Readiness Council (MFRC)

AGENCY: Department of Defense.

ACTION: Notice.

SUMMARY: The Department of Defense is publishing this notice to announce a Federal advisory committee meeting of the Department of Defense Military Family Readiness Council. This meeting will be open to the public.

DATES: Friday, February 28, 2014, from 1:00 p.m. to 3:30 p.m.

ADDRESSES: Pentagon Conference Center B6 (escorts will be provided from the Pentagon Metro entrance).

FOR FURTHER INFORMATION CONTACT: Ms. Melody McDonald or Ms. Betsy Graham, Office of the Deputy Assistant Secretary of Defense (Military Community & Family Policy), 4800 Mark Center Drive Alexandria, VA 22350–2300, Room 3G15. Telephones (571) 372–0880; (571) 372–0881 and/or email: OSD Pentagon OUSD P–R Mailbox Family Readiness Council, *osd.pentagon.ousd-p-r.mbx.family-readiness-council@mail.mil*.

SUPPLEMENTARY INFORMATION:

This meeting is being held under the provisions of the Federal Advisory Committee Act of 1972 (5 U.S.C. Appendix, as amended), the Government in the Sunshine Act of 1976 (5 U.S.C. 552b, as amended), and 41 CFR 102–3.150.

The purpose of this meeting is to introduce and discuss Military Family Readiness Council focus items for 2014.

Friday, February 28, 2014 Meeting agenda

Welcome & Administrative Remarks

Introduction and discussion of 2014 Military Family Readiness Council focus items.

Closing Remarks

Note: Exact order may vary.

Pursuant to 5 U.S.C. 552b and 41 CFR 102–3.140 through 102–3.165, this meeting is open to the public, subject to the availability of space. Persons desiring to attend may contact Ms. Melody McDonald at 571–372–0880 or email OSD Pentagon OUSD P–R Mailbox Family Readiness Council, *osd.pentagon.ousd-p-r.mbx.family-readiness-council@mail.mil* no later than 5:00 p.m., on Friday, February 14, 2014 to arrange for escort inside the Pentagon to the Conference Room area.

Pursuant to 41 CFR 102–3.105(j) and 102–3.140, and section 10(a)(3) of the Federal Advisory Committee Act of 1972, interested persons may submit a written statement for consideration by the Council. Persons desiring to submit a written statement to the Council must notify the point of contact listed in **FOR FURTHER INFORMATION CONTACT** no later than 5:00 p.m., Friday February 7, 2014.

Dated: January 28, 2014.

Aaron Siegel,

Alternate OSD Federal Register Liaison Officer, Department of Defense.

[FR Doc. 2014–02057 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–06–P

DEPARTMENT OF DEFENSE

Department of the Air Force

Record of Decision for the First Air National Guard F–35A Operational Base Final Environmental Impact Statement

ACTION: Notice of Availability (NOA) of a Record of Decision (ROD).

SUMMARY: On December 2, 2013, the United States Air Force signed the ROD for the F–35A Operational Basing Final Environmental Impact Statement (FEIS). The ROD states the Air Force decision to implement the Preffered Alternative to beddown 18 F–35A Primary aircraft authorized (PAA), at Burlington Air Guard Station, VT.

The decision was based on matters discussed in the FEIS, inputs from the public and regulatory agencies, and other relevant factors. The FEIS was made available to the public on October 4, 2013 through a NOA in the **Federal Register** (Volume 78, Number 193, Page 61845) with a wait period that ended on

November 4 2013. The ROD documents only the decision of the Air Force with respect to the proposed Air Force actions analyzed in the FEIS. Authority: This NOA is published pursuant to the regulations (40 CFR Part 1506.6) implementing the provisions of the NEPA of 1969 (42 USC. 4321, *et seq.*) and the Air Force's Environmental Impact Analysis Process (EIAP) (32 CFR Parts 989.21(b) and 989.24(b)(7)).

FOR FURTHER INFORMATION CONTACT: Mr. Nicholas Germanos, ACC/A7NS, 129 Andrews St., Suite 332, Langley AFB, VA 23665, ph: 757–764–9334.

Bao-Anh Trinh,

Air Force Federal Register Liaison Officer.

[FR Doc. 2014–01973 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–10–P

DEPARTMENT OF DEFENSE

Department of the Air Force

Record of Decision for the First Active Duty F–35A Operational Base Final Environmental Impact Statement

ACTION: Notice of Availability (NOA) of a Record of Decision (ROD).

SUMMARY: On December 2, 2013, the United States Air Force signed the ROD for the F–35A Operational Basing Final Environmental Impact Statement (FEIS). The ROD states the Air Force decision to implement the Preffered Alternative to beddown 72 F–35A Primary aircraft authorized (PAA), support personnel and facilities at Hill Air Force Base, Utah.

The decision was based on matters discussed in the FEIS, inputs from the public and regulatory agencies, and other relevant factors. The FEIS was made available to the public on October 4, 2013 through a NOA in the **Federal Register** (Volume 78, Number 193, Page 61845) with a wait period that ended on November 4 2013. The ROD documents only the decision of the Air Force with respect to the proposed Air Force actions analyzed in the FEIS. Authority: This NOA is published pursuant to the regulations (40 CFR 1506.6) implementing the provisions of the NEPA of 1969 (42 U.S.C. 4321, *et seq.*) and the Air Force's Environmental Impact Analysis Process (EIAP) (32 CFR 989.21(b) and 989.24(b)(7))

FOR FURTHER INFORMATION CONTACT: Mr. Nicholas Germanos, ACC/A7NS, 129 Andrews St., Suite 332, Langley AFB, VA 23665, ph: 757–764–9334.

Bao-Anh Trinh,

Air Force Federal Register Liaison Officer.

[FR Doc. 2014–01972 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–10–P

DEPARTMENT OF DEFENSE

Department of the Air Force

[Docket ID USAF–2014–0003]

Privacy Act of 1974; System of Records

AGENCY: Department of the Air Force, DoD.

ACTION: Notice to delete a system of records.

SUMMARY: The Department of the Air Force is deleting a system of records notice in its existing inventory of record systems subject to the Privacy Act of 1974 (5 U.S.C. 552a), as amended. The system of records notice being deleted is F036 AF DP F, Employee Assistance Program (EAP) Case Record Systems.

DATES: This proposed action will be effective on March 3, 2014 unless comments are received which result in a contrary determination. Comments will be accepted on or before March 3, 2014.

ADDRESSES: You may submit comments, identified by docket number and title, by any of the following methods:

* Federal Rulemaking Portal: *http://www.regulations.gov.*

Follow the instructions for submitting comments.

* Mail: Federal Docket Management System Office, 4800 Mark Center Drive, East Tower, 2nd Floor, Suite 02G09, Alexandria, VA 22350–3100.

Instructions: All submissions received must include the agency name and docket number for this **Federal Register** document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at *http://www.regulations.gov* as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Mr. Charles J. Shedrick, Department of the Air Force Privacy Office, Air Force Privacy Act Office, Office of Warfighting Integration and Chief Information officer, ATTN: SAF/CIO A6, 1800 Air Force Pentagon, Washington, DC 20330–1800, or by phone at (571) 256–2515.

SUPPLEMENTARY INFORMATION: The Department of the Air Force systems of records notices subject to the Privacy Act of 1974 (5 U.S.C. 552a), as amended, have been published in the **Federal Register** and are available from the address in **FOR FURTHER INFORMATION CONTACT**.

The Department of the Air Force proposes to delete one system of records notice from its inventory of record systems subject to the Privacy Act of 1974 (5 U.S.C. 552a), as amended. The proposed deletion is not within the purview of subsection (r) of the Privacy Act of 1974 (5 U.S.C. 552a), as amended, which requires the submission of a new or altered system report.

Dated: January 28, 2014.

Aaron Siegel,

Alternate OSD Federal Register Liaison Officer, Department of Defense.

Deletion:

F036 AF DP F.

Employee Assistance Program (EAP) Case Record Systems (June 11, 1997, 62 FR 31793).

REASON:

The Air Force does not mandate Employee Assistance Programs (EAP). Air Force civilian personnel sections do not collect/maintain data on employees utilizing EAP.

Federal Occupational Health (FOH)/Department of Health and Human Services (HHS) is the custodian of records for Federal EAP customers and has a published HHS System of Records Notice, 09–90–0010, EAP Records, which covers Federal employees and their family members using EAP through contractual agreement between HSS and their organizations.

This system does not have an OMB control number.

[FR Doc. 2014–01993 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–05–P

DEPARTMENT OF DEFENSE

Department of the Air Force

[Docket ID: USAF–2014–0004]

Privacy Act of 1974; System of Records

AGENCY: Department of the Air Force, DoD.

ACTION: Notice to amend a System of Records.

SUMMARY: The Department of the Air Force proposes to amend a system of records notice, F036 AFPC P, Separation Case Files (Officer and Airman), in its existing inventory of records systems subject to the Privacy Act of 1974, as amended. This system will operate an

Air Force centralized personnel management system in a geographically and dispersed environment and a population diverse in terms of qualifications, experience, military status and requirements.

DATES: This proposed action will be effective on March 4, 2014 unless comments are received which result in a contrary determination. Comments will be accepted on or before March 3, 2014.

ADDRESSES: You may submit comments, identified by docket number and title, by any of the following methods:

* *Federal Rulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

* *Mail:* Federal Docket Management System Office, 4800 Mark Center Drive East Tower, 2nd Floor, Suite 02G09, Alexandria, VA 22350–3100.

Instructions: All submissions received must include the agency name and docket number for this **Federal Register** document. The general policy for comments and other submissions from members of the public is to make these submissions available for public viewing on the Internet at *http://www.regulations.gov* as they are received without change, including any personal identifiers or contact information.

FOR FURTHER INFORMATION CONTACT: Mr. Charles J. Shedrick, Department of the Air Force Privacy Office, Air Force Privacy Act Office, Office of Warfighting Integration and Chief Information Officer, ATTN: SAF/CIO A6, 1800 Air Force Pentagon, Washington, DC 20330–1800, or by phone at (571) 256–2515.

SUPPLEMENTARY INFORMATION: The Department of the Air Force systems of records notices subject to the Privacy Act of 1974 (5 U.S.C. 552a), as amended, have been published in the **Federal Register** and are available from the address in **FOR FURTHER INFORMATION CONTACT** or at the Defense Privacy and Civil Liberties Office Web site at *http://dpclo.defense.gov/privacy/SORNs/component/airforce/index.html.*

The proposed changes to the record system being amended are set forth below. The proposed amendment is not within the purview of subsection (r) of the Privacy Act of 1974 (5 U.S.C. 552a), as amended, which requires the submission of a new or altered system report.

Dated: January 28, 2014.

Aaron Siegel,

Alternate OSD Federal Register Liaison Officer, Department of Defense.

F036 AFPC P

SYSTEM NAME:

Separation Case Files (Officer and Airman) (September 19, 2012, 77 FR 58107).

CHANGES:

* * * * *

SYSTEM LOCATION:

Delete entry and replace with ''National Personnel Records Center, Military Personnel Records Center, 9700 Page Avenue, St. Louis, MO 63132–5100. Air Reserve Personnel Center, 6760 East Irvington Place, Records Branch, Denver, CO 80280–4450. Air Force Personnel Center, 550 C. Street West, Suite 21, (Records Branch), Randolph AFB, TX 78150–4723, and The Judge Advocate General, Headquarters United States Air Force, 1420 Air Force Pentagon, Washington, DC 20330.''

CATEGORIES OF INDIVIDUALS COVERED BY THE SYSTEM:

Delete entry and replace with ''Air Force Active Duty Officer and enlisted personnel.''

* * * * *

[FR Doc. 2014–02003 Filed 1–30–14; 8:45 am]

BILLING CODE 5001–06–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for the Final Environmental Impact Statement for the Disposition of Hangars 2 and 3, Fort Wainwright, AK

AGENCY: Department of the Army, DoD.

ACTION: Notice of availability.

SUMMARY: The Department of the Army announces the availability of the Final Environmental Impact Statement (EIS) for the Disposition of Hangars 2 and 3 at Fort Wainwright, Alaska. The Final EIS analyzes and evaluates the potential environmental impacts associated with proposed disposition options for two historic World War II-era hangars and supporting infrastructure located on the Main Post of Fort Wainwright. Cultural resources would experience significant impacts under both alternatives; however, both the Ladd Field National Historic Landmark and Cold War Historic District will retain their historic integrity despite the loss of the hangars as contributing resources to these districts.

The Army considered several reuse alternatives for the hangars. All but one of these reuse alternatives were incompatible with the current or future military mission at Fort Wainwright. The one reuse alternative that was compatible (using one of the hangars as an unmanned aerial system maintenance hangar) was determined to be prohibitively expensive. As a result, only one action alternative was considered to be reasonable and was analyzed in detail in the Final EIS: demolition of Hangars 2 and 3 (Alternative 1). This alternative is the Army's preferred alternative. The No Action Alternative was also considered and carried through for detailed analysis in the Final EIS. Under the No Action Alternative, demolition of Hangars 2 and 3 would not occur, the hangars would remain vacant, and they would be maintained at minimal levels. The No Action Alternative provides the environmental baseline conditions for comparing the impacts associated with the other alternative.

DATES: The waiting period for the Final EIS will end 30 days after the publication of a Notice of Availability in the **Federal Register** by the United States Environmental Protection Agency.

ADDRESSES: Please send questions or requests for a copy of the Final EIS to Mr. Matthew Sprau, Directorate of Public Works, Attention: IMFW–PWE (Sprau), 1060 Gaffney Road #4500, Fort Wainwright, AK 99703–4500 or by email to: *matthew.h.sprau.civ@mail.mil.*

FOR FURTHER INFORMATION CONTACT: Ms. Linda Douglass, Public Affairs Office (PAO), IMFW–PAO (Douglass), 1060 Gaffney Road #5900, Fort Wainwright, AK 99703–5900; telephone (907) 353–6701, email: *linda.douglass@us.army.mil*

SUPPLEMENTARY INFORMATION: Hangars 2 and 3 are contributing resources to the Ladd Field National Historic Landmark (Ladd Field NHL) and the Ladd Air Force Base Cold War Historic District (Cold War Historic District) at Fort Wainwright. The Ladd Field NHL was listed in the National Register of Historic Places in 1984, and the Cold War Historic District was determined to be eligible for the National Register of Historic Places in 2010. Constructed between 1943 and 1944 as semi-permanent structures, these hangars have received varying degrees of operational maintenance over the years, but no large-scale rehabilitation has occurred. To accommodate changing

missions, the Army completed numerous interior modifications, including creating doorways and windows and altering the interior lateral cross-bracing. The lack of rehabilitation, interior modifications, the age of the structures, a fire in Hangar 2, and the harsh Alaskan environment all have contributed to the compromised structural integrity of both buildings. The United States Army Garrison Fort Wainwright, Alaska (USAG FWA) has condemned the buildings, and they are no longer used because they present a safety hazard.

The Final EIS has been prepared in accordance with the National Environmental Policy Act of 1969 (NEPA), as amended (42 United States Code § 4321 *et seq.*); NEPA-implementing regulations issued by the President's Council on Environmental Quality (40 Code of Federal Regulations [CFR] §§ 1500–1508); and the Army's NEPA-implementing regulation (32 CFR § 651, Environmental Analysis of Army Actions). The purpose of the Final EIS is to inform the decision makers, agencies, interested parties, Alaska Native tribes, and the public of possible environmental consequences associated with the reasonable disposition alternatives for Hangars 2 and 3.

The USAG FWA entered into consultation concerning the proposed disposition of Hangars 2 and 3 as required by Section 106 of the National Historic Preservation Act and its implementing regulations (36 CFR § 800). The USAG FWA concludes that the disposition would result in historic properties being adversely affected. The disposition of the hangars would adversely affect the hangars as contributing resources to the Ladd Field NHL and the Cold War Historic District and, in so doing, would adversely affect both districts. The Army entered into a Memorandum of Agreement (MOA) with the Alaska State Historic Preservation Office and the Advisory Council on Historic Preservation pursuant to 36 CFR § 800.6(2)(c) to mitigate adverse effects.

Mitigation measures provided in the MOA require public outreach in the pursuit of more visibility and appreciation for the Ladd Field NHL, re-evaluation of the Ladd Field NHL, and stewardship of the Ladd Field NHL. Mitigation under the No Action Alternative would be the same as under Alternative 1, except the time frame for completing the stipulations would be based on the date of execution of the MOA rather than on the demolition of the hangars.

Public and agency comments received on the Draft EIS did not result in modification of the alternatives or the environmental analysis; therefore, the full text of the EIS has not been reprinted. Instead, an erratum was prepared to supplement the Draft EIS, and these two documents together constitute the Final EIS for the Disposition of Hangars 2 and 3 at Fort Wainwright, Alaska. Public and agency comments received on the Draft EIS and government responses can be found in Appendix E of the Final EIS. Comments received resulted in the inclusion of two additional mitigation measures in the final National Historic Preservation Act (NHPA) Section 106 Memorandum of Agreement. These additional mitigation measures are also appropriately reflected in the Final EIS, Section 3.*0 Errata Sheet Revisions to be Made to the Draft Environmental Impact Statement.*

An electronic version of the Final EIS can be viewed or downloaded from the following Web site: *http://www.wainwright.army.mil/env/NEPA/Current.html* Copies of the Final EIS will also be available for review at the Noel Wien Public Library in Fairbanks, Alaska.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01851 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for Exclusive, Non-Exclusive, or Partially-Exclusive Licensing of an Invention Concerning Health Outcome Prediction and Management System and Method

AGENCY: Department of the Army, DoD.

ACTION: Notice.

SUMMARY: Announcement is made of the availability for licensing of the invention set forth in U.S. Patent Application Serial No. 13/910,254, entitled ''Health Outcome Prediction and Management System and Method,'' filed on June 5, 2013. The United States Government, as represented by the Secretary of the Army, has rights to this invention.

ADDRESSES: Commander, U.S. Army Medical Research and Materiel Command, ATTN: Command Judge Advocate, MCMR–JA, 504 Scott Street, Fort Detrick, Frederick, MD 21702–5012.

FOR FURTHER INFORMATION CONTACT: For patent issues, Ms. Elizabeth Arwine, Patent Attorney, (301) 619–7808. For licensing issues, Dr. Paul Mele, Office of Research and Technology Applications (ORTA), (301) 619–6664, both at telefax (301) 619–5034.

SUPPLEMENTARY INFORMATION: The invention relates to systems, methods and apparatus for providing statistical estimates useful for decision support, including computer networks and software configured to provide such support.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01932 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for Exclusive, Non-Exclusive, or Partially-Exclusive Licensing of an Invention Concerning Filovirus Fusion Proteins and Their Uses

AGENCY: Department of the Army, DoD.

ACTION: Notice.

SUMMARY: Announcement is made of the availability for licensing of the invention set forth in U.S. Patent Application Serial No. 13/882,041, entitled ''Filovirus Fusion Proteins and Their Uses,'' filed on April 26, 2013. The United States Government, as represented by the Secretary of the Army, has rights to this invention.

ADDRESSES: Commander, U.S. Army Medical Research and Materiel Command, ATTN: Command Judge Advocate, MCMR–JA, 504 Scott Street, Fort Detrick, Frederick, MD 21702–5012.

FOR FURTHER INFORMATION CONTACT: For patent issues, Ms. Elizabeth Arwine, Patent Attorney, (301) 619–7808. For licensing issues, Dr. Paul Mele, Office of Research and Technology Applications (ORTA), (301) 619–6664, both at telefax (301) 619–5034.

SUPPLEMENTARY INFORMATION: The invention relates to the use of the Filovirus glycoprotein fusion proteins for the prevention and diagnosis of Filovirus infection.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01936 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for Exclusive, Non-Exclusive, or Partially-Exclusive Licensing of an Invention Concerning Graft Copolymer Polyelectrolyte Complexes for Drug Delivery

AGENCY: Department of the Army, DoD.

ACTION: Notice.

SUMMARY: Announcement is made of the availability for licensing of the invention set forth in U.S. Provisional Patent Application Serial No. 13/828,105, entitled ''Graft Copolymer Polyelectrolyte Complexes for Drug Delivery,'' filed on March 14, 2013. The United States Government, as represented by the Secretary of the Army, has rights to this invention.

ADDRESSES: Commander, U.S. Army Medical Research and Materiel Command, ATTN: Command Judge Advocate, MCMR–JA, 504 Scott Street, Fort Detrick, Frederick, MD 21702–5012.

FOR FURTHER INFORMATION CONTACT: For patent issues, Ms. Elizabeth Arwine, Patent Attorney, (301) 619–7808. For licensing issues, Dr. Paul Mele, Office of Research and Technology Applications (ORTA), (301) 619–6664, both at telefax (301) 619–5034.

SUPPLEMENTARY INFORMATION: The invention relates to efficient delivery of anionic, cationic or polyelectrolyte therapeutic agents into biological cells, and for maintaining the biological activity of these molecules while in serum and other aqueous environments.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01934 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for Exclusive, Non-Exclusive, or Partially-Exclusive Licensing of an Invention Concerning Methods, Manufactures, and Compositions Related to Leishmania

AGENCY: Department of the Army, DoD.

ACTION: Notice.

SUMMARY: Announcement is made of the availability for licensing of the invention set forth in U.S. Patent Application Serial No. 13/832,152, entitled ''Methods, Manufactures, and Compositions Related to Leishmania,'' filed on March 15, 2013. The United States Government, as represented by the Secretary of the Army, has rights to this invention.

ADDRESSES: Commander, U.S. Army Medical Research and Materiel Command, ATTN: Command Judge Advocate, MCMR–JA, 504 Scott Street, Fort Detrick, Frederick, MD 21702–5012.

FOR FURTHER INFORMATION CONTACT: For patent issues, Ms. Elizabeth Arwine, Patent Attorney, (301) 619–7808. For licensing issues, Dr. Paul Mele, Office of Research and Technology Applications (ORTA), (301) 619–6664, both at telefax (301) 619–5034.

SUPPLEMENTARY INFORMATION: The invention relates to assays and more particularly to screening biological samples.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01924 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Army

Notice of Availability for Exclusive, Non-Exclusive, or Partially-Exclusive Licensing of an Invention Concerning Life Sign Detection and Health State Assessment System

AGENCY: Department of the Army, DoD.

ACTION: Notice.

SUMMARY: Announcement is made of the availability for licensing of the invention set forth in U.S. Provisional Patent Application Serial No. 13/744,865, entitled ''Life Sign Detection and Health State Assessment System,'' filed on January 18, 2013. The United States Government, as represented by the Secretary of the Army, has rights to this invention.

ADDRESSES: Commander, U.S. Army Medical Research and Materiel Command, ATTN: Command Judge Advocate, MCMR–JA, 504 Scott Street, Fort Detrick, Frederick, MD 21702–5012.

FOR FURTHER INFORMATION CONTACT: For patent issues, Ms. Elizabeth Arwine, Patent Attorney, (301) 619–7808. For licensing issues, Dr. Paul Mele, Office of Research and Technology Applications (ORTA), (301) 619–6664, both at telefax (301) 619–5034.

SUPPLEMENTARY INFORMATION: The invention relates to compact wearable systems for measuring a subject's vital signs, such as heart rate, respiration rate, temperature, position and motion. It also relates to processing algorithms for generating electrical signals indicating vital signs, and more generally for developing diagnostic information from groups of sensor readings.

Brenda S. Bowen,

Army Federal Register Liaison Officer.

[FR Doc. 2014–01928 Filed 1–30–14; 8:45 am]

BILLING CODE 3710–08–P

DEPARTMENT OF DEFENSE

Department of the Navy

Notice of Public Meetings of the Draft Environmental Impact Statement/Overseas Environmental Impact Statement for Military Readiness Activities in the Northwest Training and Testing Study Area

AGENCY: Department of the Navy, DoD.

ACTION: Notice.

SUMMARY: Pursuant to section 102(2)(c) of the National Environmental Policy Act of 1969, regulations implemented by the Council on Environmental Quality (40 Code of Federal Regulations Parts 1500–1508), and Presidential Executive Order 12114, the Department of the Navy (DoN) has prepared and filed with the U.S. Environmental Protection Agency a Draft Environmental Impact Statement/Overseas Environmental Impact Statement (EIS/OEIS). The Draft EIS/OEIS includes the evaluation of the potential environmental effects associated with military readiness training and research, development, test, and evaluation activities (training and testing) conducted within the Northwest Training and Testing (NWTT) Study Area. The National Marine Fisheries Service (NMFS) and the U.S. Coast Guard are cooperating agencies for this EIS/OEIS.

The NWTT Study Area is composed of established maritime operating areas and warning areas in the eastern North Pacific Ocean, including the Strait of Juan de Fuca, Puget Sound, and Western Behm Canal in southeastern Alaska. The NWTT Study Area includes: air and water space within and outside Washington state waters, and outside state waters of Oregon and Northern California; four existing range complexes and facilities (Northwest Training Range Complex [NWTRC], Naval Undersea Warfare Center [NUWC] Division Keyport Range Complex, Carr Inlet Operations Area, and Southeast Alaska Acoustic Measurement Facility [SEAFAC]); and Navy pierside locations where sonar maintenance and testing

occur (Naval Base Kitsap Bremerton, Naval Base Kitsap Bangor and Naval Station Everett). The land-based portions of the range complexes and facilities are not a part of the Study Area and will be or already have been addressed under separate DoN environmental planning documentation.

With the filing of the Draft EIS/OEIS, the DoN is initiating a 60-day public comment period and has scheduled eight public meetings to receive comments on the Draft EIS/OEIS. This notice announces the dates and locations of the public meetings and provides supplementary information about the environmental planning effort.

Dates and Addresses: The 60-day Draft EIS/OEIS public review period will begin on January 24, 2014, and end on March 25, 2014. The DoN will hold eight public meetings that will include an open house information session, followed by a short presentation by the DoN. DoN representatives will be available during the open house information sessions to clarify information related to the Draft EIS/OEIS. Federal, state, and local agencies and officials, and interested organizations and individuals are encouraged to provide comments in writing during the public review period or in person at one of the scheduled public meetings.

The public meetings will be held from 5:00 p.m. to 8:00 p.m., with a DoN presentation at 6:30 p.m., on the following dates and at the following locations:

1. Wednesday, February 26, 2014, at the Oak Harbor High School Student Union Building, 1 Wildcat Way, Oak Harbor, WA, 98277.

2. Thursday, February 27, 2014, at the Cascade High School Student Commons, 801 E. Casino Road, Everett, WA, 98203.

3. Friday, February 28, 2014, at the North Kitsap High School Commons, 1780 NE Hostmark St., Poulsbo, WA, 98370.

4. Monday, March 3, 2014, at the Astoria High School Student Commons, 1001 W. Marine Drive, Astoria, OR, 97103.

5. Tuesday, March 4, 2014, at the Isaac Newton Magnet School Gym, 825 NE 7th St., Newport, OR, 97365.

6. Thursday, March 6, 2014, at the Red Lion Hotel Redwood Ballroom, 1929 4th St., Eureka, CA, 95501.

7. Friday, March 7, 2014, at the Redwood Coast Senior Center West Room, 490 N. Harold St., Fort Bragg, CA, 95437.

8. Tuesday, March 11, 2014, at the Southeast Alaska Discovery Center Lobby, 50 Main St., Ketchikan, AK, 99901.

Attendees will be able to submit oral and written comments during the public meetings. Oral comments from the public will be recorded by a court reporter. In the interest of available time, and to ensure all who wish to provide an oral statement to the court reporter have the opportunity to do so, each speaker's comments will be limited to three (3) minutes, which may be extended if meeting attendance permits. Equal weight will be given to oral and written statements. Comments may also be submitted via the U.S. Postal Service to Naval Facilities Engineering Command Northwest, Attention: Ms. Kimberly Kler—NWTT EIS/OEIS Project Manager, 1101 Tautog Circle, Suite 203, Silverdale, WA 98315–1101, or electronically via the project Web site (*www.NWTTEIS.com*). All comments, oral or written, submitted during the public review period will become part of the public record. All comments will be reviewed and acknowledged or responded to in the Final EIS/OEIS. Comments must be postmarked or received online by March 25, 2014, for consideration in the Final EIS/OEIS.

FOR FURTHER INFORMATION CONTACT: Naval Facilities Engineering Command Northwest, Attention: Ms. Kimberly Kler—NWTT EIS/OEIS Project Manager, 1101 Tautog Circle, Suite 203, Silverdale, WA 98315–1101.

SUPPLEMENTARY INFORMATION: A Notice of Intent to prepare this Draft EIS/OEIS was published in the **Federal Register** on February 27, 2012 (77 FR 11497).

The DoN's Proposed Action is to conduct military readiness training and testing activities, to include the use of active Sound Navigation and Ranging (sonar) and explosives, primarily within existing range complexes, operating areas, and testing ranges of the NWTT Study Area. The Proposed Action also includes pierside sonar maintenance and testing within the Study Area.

The purpose of the Proposed Action is to achieve and maintain military readiness to meet the requirements of Title 10 of the U.S. Code, thereby ensuring that the DoN accomplishes its mission to maintain, train, and equip combat-ready naval forces capable of winning wars, deterring aggression, and maintaining freedom of the seas. This Draft EIS/OEIS will also support the renewal of federal regulatory permits and authorizations for current training and testing activities and to propose future activities requiring environmental analysis.

The Draft EIS/OEIS includes analysis of the potential environmental impacts of three alternatives, including the No Action Alternative. The No Action Alternative would continue baseline training and testing activities, as defined by existing environmental planning documents, including the NWTRC EIS/OEIS, the NUWC Division Keyport Range Complex Extension EIS/OEIS, and the SEAFAC EIS. Alternative 1 (Preferred Alternative) consists of the No Action Alternative, plus adjustments to the types and levels of training and testing activities conducted within the Study Area as necessary to support current and planned requirements. This alternative includes activities associated with force structure changes, such as those resulting from the development, testing, and ultimate introduction of new vessels, aircraft, and weapons systems into the fleet; training exercises in support of Civilian Port Defense; and testing activities. Alternative 2 consists of all activities that would occur under Alternative 1, plus additional adjustments to the levels of training and testing activities.

In this EIS/OEIS, the DoN analyzes potential impacts on environmental resources resulting from activities under the alternatives. Resources evaluated include sediments and water quality, air quality, marine habitats, marine mammals, sea turtles, birds, marine vegetation, marine invertebrates, fish, cultural resources, Native American and Alaska Native Traditional Resources, socioeconomic resources, and public health and safety.

The DoN is requesting Marine Mammal Protection Act incidental take authorizations from NMFS, as well as governing regulations for the incidental take of marine mammals that may result from the implementation of the activities analyzed in the Draft EIS/OEIS. In accordance with Section 7 of the Endangered Species Act, the DoN is consulting with NMFS and the U.S. Fish and Wildlife Service on the potential impacts of training and testing activities on federally listed species. In accordance with the Magnuson-Stevens Fishery Conservation and Management Act, the DoN is consulting with NMFS on federally managed species and their essential fish habitat.

The cumulative impacts of past, present, and other reasonably foreseeable future actions are expected to result in impacts on marine mammals and sea turtles, including Endangered Species Act-listed marine mammal species, in the Study Area. The Draft EIS/OEIS indicates that the incremental contribution of the No Action Alternative, Alternative 1, or Alternative 2 to all other resource areas analyzed would be negligible.

The Draft EIS/OEIS was distributed to federal, state, and local agencies, elected officials, and other interested organizations and individuals.

Copies of the Draft EIS/OEIS are available for public review at the following public libraries:

1. Everett Main Library, 2702 Hoyt Ave., Everett, WA 98201.
2. Gig Harbor Library, 4424 Point Fosdick Drive NW., Gig Harbor, WA 98335.
3. Jefferson County Library—Port Hadlock, 620 Cedar Ave., Port Hadlock, WA 98339.
4. Kitsap Regional Library—Poulsbo, 700 NE Lincoln Road, Poulsbo, WA 98370.
5. Kitsap Regional Library—Sylvan Way (Bremerton), 1301 Sylvan Way, Bremerton, WA 98310.
6. Oak Harbor Public Library, 1000 SE Regatta Drive, Oak Harbor, WA 98277.
7. Port Angeles Main Library, 2210 S. Peabody St., Port Angeles, WA 98362.
8. Port Townsend Public Library, 1925 Blaine St., Port Townsend, WA 98368.
9. Timberland Regional Library—Aberdeen, 121 E. Market St., Aberdeen, WA 98520.
10. Timberland Regional Library—Hoquiam, 420 7th St., Hoquiam, WA 98550.
11. Astoria Public Library, 450 10th St., Astoria, OR 97103.
12. Driftwood Public Library, 801 SW Highway 101, Lincoln City, OR 97367.
13. Newport Public Library, 35 NW Nye St., Newport, OR 97365.
14. Tillamook Main Library, 1716 Third St., Tillamook, OR 97141.
15. Fort Bragg Branch Library, 499 Laurel St., Fort Bragg, CA 95437.
16. Humboldt County Public Library, Arcata Branch Library, 500 7th St., Arcata, CA 95521.
17. Humboldt County Public Library, Eureka Main Library, 1313 3rd St., Eureka, CA 95501.
18. Juneau Public Library, Downtown Branch, 292 Marine Way, Juneau, AK 99801.
19. Ketchikan Public Library, 1110 Copper Ridge Lane, Ketchikan, AK 99901.

The Draft EIS/OEIS is also available for electronic viewing at *www.NWTTEIS.com*. A compact disc of the Draft EIS/OEIS will be made available upon written request by contacting: Naval Facilities Engineering Command Northwest, Attention: Ms. Kimberly Kler—NWTT EIS/OEIS Project Manager, 1101 Tautog Circle, Suite 203, Silverdale, WA 98315–1101.

Dated: January 23, 2014.

N. A. Hagerty-Ford,

Commander, Office of the Judge Advocate General, U. S. Navy. Federal Register Liaison Officer.

[FR Doc. 2014–01910 Filed 1–30–14; 8:45 am]

BILLING CODE 3810–FF–P

DEPARTMENT OF DEFENSE

Department of the Navy

Notice of Intent to Grant Exclusive Patent License; LumaCyte, LLC

AGENCY: Department of the Navy, DoD.

ACTION: Notice.

SUMMARY: The Department of the Navy hereby gives notice of its intent to grant to LumaCyte, LLC a revocable, nonassignable, exclusive license to practice in the field of use of biomedical research and medical diagnostics in the United States, the Government-owned inventions described in U.S. Patent No. 8,529,760: Optical Separator and Method for Separating Particles Suspended in a Fluid, Navy Case No. 084,517.//U.S. Patent Application No. 13/954,654: Device and Method for Laser Analysis and Separation (LAS) of Particles, Navy Case No. 101,970.//U.S. Patent Application No. 13/961,968: Separation of Colloidal Suspensions Using Laser Optical Pressure Fluidic Devices, Navy Case No. 084,517.//U.S. Patent Application No. 14/043,384: Paired Laser and Electrokinetic Separation, Manipulation, and Analysis Device, Navy Case No. 102,097 and any continuations, divisionals or re-issues thereof.

DATES: Anyone wishing to object to the grant of this license must file written objections along with supporting evidence, if any, not later than February 18, 2014.

ADDRESSES: Written objections are to be filed with the Naval Research Laboratory, Code 1004, 4555 Overlook Avenue SW, Washington, DC 20375–5320.

FOR FURTHER INFORMATION CONTACT: Rita Manak, Head, Technology Transfer Office, NRL Code 1004, 4555 Overlook Avenue SW, Washington, DC 20375–5320, telephone 202–767–3083. Due to U.S. Postal delays, please fax 202–404–7920, email: *rita.manak@nrl.navy.mil* or use courier delivery to expedite response.

Authority: 35 U.S.C. 207, 37 CFR Part 404.

Dated: January 24, 2014.

N. A. Hagerty-Ford,

Commander, Office of the Judge Advocate General, U.S. Navy, Federal Register Liaison Officer.

[FR Doc. 2014–01918 Filed 1–30–14; 8:45 am]

BILLING CODE 3810–FF–P

DEPARTMENT OF DEFENSE

Department of the Navy

Meeting of the Board of Advisors to the Presidents of the Naval Postgraduate School and the Naval War College; Correction

AGENCY: Department of the Navy, DoD.

ACTION: Notice; correction.

SUMMARY: The Department of the Navy published a document in the **Federal Register** (79 FR 3785) on January 23, 2014, concerning the open meeting of the Board of Advisors to the Presidents of the Naval Postgraduate School and the Naval War College. Due to changing requirements the location, starting and ending times of the meeting have changed.

DATES: The meeting will be held on Wednesday, February 19, 2014, from 11 a.m. to 5 p.m. and on Thursday, February 20, from 9 a.m. to 3 p.m. Eastern Time Zone.

ADDRESSES: The meeting will be held at 4825 Mark Center Drive, Alexandria, VA.

FOR FURTHER INFORMATION CONTACT: Ms. Jaye Panza, Naval Postgraduate School, Monterey, CA, 93943–5001, telephone number 831–656–2514.

Dated: January 23, 2014.

N. A. Hagerty-Ford,

Commander, Office of the Judge Advocate General, U.S. Navy, Federal Register Liaison Officer.

[FR Doc. 2014–01912 Filed 1–30–14; 8:45 am]

BILLING CODE 3810–FF–P

DEPARTMENT OF DEFENSE

Department of the Navy

Meeting of the U.S. Naval Academy Board of Visitors

AGENCY: Department of the Navy, DoD.

ACTION: Notice of partially closed meeting.

SUMMARY: The U.S. Naval Academy Board of Visitors will meet to make such inquiry, as the Board shall deem necessary, into the state of morale and discipline, the curriculum, instruction, physical equipment, fiscal affairs, and

academic methods of the Naval Academy. The executive session of this meeting from 11:00 a.m. to 12:00 p.m. on March 3, 2014, will include discussions of new and pending administrative/minor disciplinary infractions and non-judicial punishment proceedings involving Midshipmen attending the U.S. Naval Academy, to include, but not limited to, individual honor/conduct violations within the Brigade. For this reason, the executive session of this meeting will be closed to the public.

DATES: The open session of the meeting will be held on March 3, 2014, from 8:30 a.m. to 11:00 a.m. The closed session of this meeting will be the executive session held from 11:00 a.m. to 12:00 p.m.

ADDRESSES: The meeting will be held in Alumni Hall at the United States Naval Academy in Annapolis Maryland. The meeting will be handicap accessible.

FOR FURTHER INFORMATION CONTACT: Lieutenant Commander Matt Cady, USN, Executive Secretary to the Board of Visitors, Office of the Superintendent, U.S. Naval Academy, Annapolis, MD 21402–5000, 410–293–1503.

SUPPLEMENTARY INFORMATION: This notice of meeting is provided per the Federal Advisory Committee Act, as amended (5 U.S.C. App.). The executive session of the meeting from 11:00 a.m. to 12:00 p.m. on March 3, 2014, will consist of discussions of new and pending administrative/minor disciplinary infractions and non-judicial punishment proceedings involving Midshipmen attending the U.S. Naval Academy, to include, but not limited to, individual honor/conduct violations within the Brigade. The discussion of such information cannot be adequately segregated from other topics, which precludes opening the executive session of this meeting to the public. Accordingly, the Secretary of the Navy has determined in writing that the meeting shall be partially closed to the public because the discussions during the executive session from 11:00 a.m. to 12:00 p.m. will be concerned with matters coming under sections 552b(c)(5), (6), and (7) of Title 5, United States Code.

Dated: January 27, 2014.

N. A. Hagerty-Ford,

Commander, Office of the Judge Advocate General, U.S. Navy, Federal Register Liaison Officer.

[FR Doc. 2014–01908 Filed 1–30–14; 8:45 am]

BILLING CODE 3810–FF–P

DEPARTMENT OF DEFENSE

Department of the Navy

Record of Decision for the Proposed Modernization and Expansion of Townsend Bombing Range, Georgia

AGENCY: Department of the Navy, DoD.

ACTION: Notice of Record of Decision.

SUMMARY: Pursuant to Section (102)(2)(c) of the National Environmental Policy Act (NEPA) of 1969 (42 United States Code [U.S.C.] 4321–4370h); the Council on Environmental Quality regulations for implementing the procedural provisions of NEPA (40 CFR parts 1500–1508); Department of the Navy (DoN) Procedures for Implementing NEPA (32 CFR part 775); and United States Marine Corps (USMC) NEPA directives (Marine Corps Order P5090.2A), the DoN announces its decision to modernize and expand Townsend Bombing Range (TBR) in Long and McIntosh Counties, Georgia. The DoN has decided to implement Alternative 4, the Preferred Alternative, to include acquisition of Acquisition Areas 1B and 3.

To support this decision, DoN will implement the following four actions: (1) Acquire Acquisition Areas 1B and 3 (28,630 acres); (2) terminate a 3,007-acre timber easement held by McIntosh County on DoN-owned land within the current TBR boundary; (3) modify Restricted Area R–3007 airspace by extending the current 100-foot floor to ground level over the land to be acquired (Acquisition Areas 1B and 3) to match the existing restricted airspace over the current range; and (4) construct infrastructure to support precision-guided munitions (PGM) training, including Target Areas 1, 2, 3, 4, 5, and 8. This modernization and expansion of TBR to accommodate inert PGM training will significantly enhance USMC east coast aviation unit training efficiency. Presently, TBR can accommodate only 47% of the required F/A–18 Hornet individual fixed-wing air crew air-to-ground training syllabus. The Proposed Action will allow air crews to meet up to 85% of their air-to-ground proficiency requirements at TBR. All practical means to avoid or minimize environmental impacts resulting from implementation of the Preferred Alternative that were identified in the EIS have been adopted.

SUPPLEMENTARY INFORMATION: The complete text of the Record of Decision is available for public viewing on the project Web site at *http://www.townsendbombingrangeeis.com* along with the EIS. For further information, contact Marine Corps Air Station Beaufort Public Affairs Officer, Captain Jordan Cochran, 596 Geiger Blvd. MCAS Beaufort, SC 29904 at 843–228–6123.

Dated: January 27, 2014.

N. A. Hagerty-Ford,

Commander, Office of the Judge Advocate General, U.S. Navy, Federal Register Liaison Officer.

[FR Doc. 2014–01947 Filed 1–30–14; 8:45 am]

BILLING CODE 3810–FF–P

DEPARTMENT OF EDUCATION

[Docket No. ED–2014–ICCD–0009]

Agency Information Collection Activities; Comment Request; Financial Status and Program Performance Final Report for State and Partnership for the Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP)

AGENCY: Office of Postsecondary Education (OPE), Department of Education (ED).

ACTION: Notice.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 3501 *et seq.*), ED is proposing a revision of an existing information collection

DATES: Interested persons are invited to submit comments on or before April 1, 2014.

ADDRESSES: Comments submitted in response to this notice should be submitted electronically through the Federal eRulemaking Portal at *http://www.regulations.gov* by selecting Docket ID number ED–2014–ICCD–0009 or via postal mail, commercial delivery, or hand delivery. *Please note that comments submitted by fax or email and those submitted after the comment period will not be accepted.* Written requests for information or comments submitted by postal mail or delivery should be addressed to the Director of the Information Collection Clearance Division, U.S. Department of Education, 400 Maryland Avenue SW., LBJ, Mailstop L–OM–2–2E319, Room 2E103,Washington, DC 20202.

FOR FURTHER INFORMATION CONTACT: For questions related to collection activities or burden, please call Kate Mullan, 202–401–0563 or electronically mail *ICDocketMgr@ed.gov*. Please do not send comments here. We will ONLY accept comments in this mailbox when the regulations.gov site is not available to the public for any reason.

SUPPLEMENTARY INFORMATION: The Department of Education (ED), in

accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)(A)), provides the general public and Federal agencies with an opportunity to comment on proposed, revised, and continuing collections of information. This helps the Department assess the impact of its information collection requirements and minimize the public's reporting burden. It also helps the public understand the Department's information collection requirements and provide the requested data in the desired format. ED is soliciting comments on the proposed information collection request (ICR) that is described below. The Department of Education is especially interested in public comment addressing the following issues: (1) Is this collection necessary to the proper functions of the Department; (2) will this information be processed and used in a timely manner; (3) is the estimate of burden accurate; (4) how might the Department enhance the quality, utility, and clarity of the information to be collected; and (5) how might the Department minimize the burden of this collection on the respondents, including through the use of information technology. Please note that written comments received in response to this notice will be considered public records.

Title of Collection: Financial Status and Program Performance Final Report for State and Partnership for the Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP).

OMB Control Number: 1840–0782.

Type of Review: A revision of an existing information collection.

Respondents/Affected Public: State, Local, or Tribal Governments.

Total Estimated Number of Annual Responses: 125.

Total Estimated Number of Annual Burden Hours: 5,625.

Abstract: The purpose of this information collection is to determine whether recipients of Gaining Early Awareness and Readiness for Undergraduate Programs (GEAR UP) have made substantial progress towards meeting the objectives of their respective projects, as outlined in their grant applications and/or subsequent work plans. In addition, the final report will enable the Department to evaluate each grant project's fiscal operations for the entire grant performance period, and compare total expenditures relative to federal funds awarded, and actual cost-share/matching relative to the total amount in the approved grant application. This report is a means for grantees to share the overall experience of their projects and document achievements and concerns, and describe effects of their projects on participants being served; project barriers and major accomplishments; and evidence of sustainability. The report will be GEAR UP's primary method to collect/analyze data on students' high school graduation and immediate college enrollment rates.

Summary of Changes

If grantees choose to serve students for 7 years, they must report on the 7th year of activities which include following GEAR UP students into the first year of postsecondary education and any students still in high school. The 5 hour burden increase is due to the additional time required to collect data on GEAR UP students enrolled in postsecondary education.

Dated: January 27, 2014.

Kate Mullan,

Acting Director, Information Collection Clearance Division, Privacy, Information and Records Management Services, Office of Management.

[FR Doc. 2014–01890 Filed 1–30–14; 8:45 am]

BILLING CODE 4000–01–P

DEPARTMENT OF EDUCATION

[Docket No.: ED–2014–ICCD–0008]

Agency Information Collection Activities; Comment Request; Charter School Authorizer Annual Update

AGENCY: Office of Innovation and Improvement (OII), Department of Education (ED).

ACTION: Notice.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 3501 *et seq.*), ED is proposing an extension of an existing information collection.

DATES: Interested persons are invited to submit comments on or before April 1, 2014.

ADDRESSES: Comments submitted in response to this notice should be submitted electronically through the Federal eRulemaking Portal at *http://www.regulations.gov* by selecting Docket ID number ED–2014–ICCD–0008 or via postal mail, commercial delivery, or hand delivery. Please note that comments submitted by fax or email and those submitted after the comment period will not be accepted. Written requests for information or comments submitted by postal mail or delivery should be addressed to the Director of the Information Collection Clearance Division, U.S. Department of Education, 400 Maryland Avenue SW., LBJ, Mailstop L–OM–2–2E319, Room 2E115, Washington, DC 20202.

FOR FURTHER INFORMATION CONTACT: For questions related to collection activities or burden, please call Tomakie Washington, 202–401–1097 or electronically mail *ICDocketMgr@ed.gov*. Please do not send comments here. We will ONLY accept comments in this mailbox when the regulations.gov site is not available to the public for any reason.

SUPPLEMENTARY INFORMATION: The Department of Education (ED), in accordance with the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3506(c)(2)(A)), provides the general public and Federal agencies with an opportunity to comment on proposed, revised, and continuing collections of information. This helps the Department assess the impact of its information collection requirements and minimize the public's reporting burden. It also helps the public understand the Department's information collection requirements and provide the requested data in the desired format. ED is soliciting comments on the proposed information collection request (ICR) that is described below. The Department of Education is especially interested in public comment addressing the following issues: (1) Is this collection necessary to the proper functions of the Department; (2) will this information be processed and used in a timely manner; (3) is the estimate of burden accurate; (4) how might the Department enhance the quality, utility, and clarity of the information to be collected; and (5) how might the Department minimize the burden of this collection on the respondents, including through the use of information technology. Please note that written comments received in response to this notice will be considered public records.

Title of Collection: Charter School Authorizer Annual Update.

OMB Control Number: 1855–0023.

Type of Review: An extension of an existing information collection.

Respondents/Affected Public: State, Local, or Tribal Governments.

Total Estimated Number of Annual Responses: 90.

Total Estimated Number of Annual Burden Hours: 2,025.

Abstract: The U.S. Department of Education (ED) has as one of its important policy goals expanding the number of high-quality public school choice options. Specifically, according to Part B section 5201 of the Elementary and Secondary Education Act, two of the established purposes of the

Charter School Program office are: evaluating the effects of charter schools, including the effects on students,

student academic achievement, staff and parents, and expanding the number of high-quality charter schools available to students across the nation.

Charter school authorization is at the very crux of any efforts to expand and ensure high-quality public school choice options through public charter schools because charter school authorizers are the public entities primarily responsible for: initial charter authorizations, on-going monitoring and oversight, and charter renewal and closure decisions.

Currently, there is no other comprehensive national database of the roughly 900 charter school authorizers complete with the schools under their authority; some of these data elements are available from public documents, but they are not made available to the public consistently across all authorizers. There is also no other comprehensive, fully-populated tool for tracking the activities of and evaluating the quality of authorizers nationwide based on their authorizing decisions in light of schools performance. This data collection will be administered to the all charter school authorizers.

Dated: January 27, 2014.

Tomakie Washington,

Acting Director, Information Collection Clearance Division, Privacy, Information and Records Management Services, Office of Management.

[FR Doc. 2014–01943 Filed 1–30–14; 8:45 am]

BILLING CODE 4000–01–P

DEPARTMENT OF ENERGY

Environmental Management Advisory Board

AGENCY: Office of Environmental Management, Department of Energy.

ACTION: Notice of Renewal.

SUMMARY: Pursuant to Section 14(a)(2)(A) of the Federal Advisory Committee Act (Pub. L. 92–463), and in accordance with Title 41 of the Code of Federal Regulations, section 102–3.65(a), and following consultation with the Committee Management Secretariat, General Services Administration, notice is hereby given that the Environmental Management Advisory Board (Board) will be renewed for a two-year period beginning January 23, 2014.

The Board provides the Assistant Secretary for Environmental Management (EM) with information and strategic advice on a broad range of corporate issues affecting the EM program. These corporate issues include, but are not limited to, project management and oversight activities, cost/benefit analyses, program performance, human capital development, and contracts and acquisition strategies.

Additionally, the renewal of the Environmental Management Advisory Board has been determined to be essential to conduct DOE's business and to be in the public interest in connection with the performance of duties imposed on DOE by law and agreement. The Board will operate in accordance with the provisions of the Federal Advisory Committee Act, and rules and regulations issued in implementation of that Act.

FOR FURTHER INFORMATION CONTACT: Ms. Kristen G. Ellis, Designated Federal Officer, at (202) 586–5810 or *kristen.ellis@em.doe.gov*.

Issued in Washington, DC on January 23, 2014.

Carol A. Matthews,

Committee Management Officer.

[FR Doc. 2014–02021 Filed 1–30–14; 8:45 am]

BILLING CODE 6450–01–P

DEPARTMENT OF ENERGY

Environmental Management Site-Specific Advisory Board, Hanford

AGENCY: Department of Energy.

ACTION: Notice of Open Meeting.

SUMMARY: This notice announces a meeting of the Environmental Management Site-Specific Advisory Board (EM SSAB), Hanford. The Federal Advisory Committee Act (Pub. L. 92–463, 86 Stat. 770) requires that public notice of this meeting be announced in the **Federal Register**.

DATES: Thursday, March 6, 2014, 8:30 a.m.—5:00 p.m.; Friday, March 7, 2014, 8:30 a.m.—3:30 p.m.

ADDRESSES: Red Lion Columbia Center, 1101 North Columbia Center Blvd., Kennewick, WA 99336.

FOR FURTHER INFORMATION CONTACT: Kimberly Ballinger, Federal Coordinator, Department of Energy Richland Operations Office, 825 Jadwin Avenue, P.O. Box 550, A7–75, Richland, WA, 99352; Phone: (509) 376–6332; or Email: kimberly.ballinger@rl.doe.gov.

SUPPLEMENTARY INFORMATION:

Purpose of the Board: The purpose of the Board is to make recommendations to DOE–EM and site management in the areas of environmental restoration, waste management, and related activities.

Tentative Agenda:

- Potential Draft Advice
  - 100 N Proposed Plan Draft A
  - Office of River Protection Framework Document
- Discussion Topics
  - Tri-Party Agreement Agencies' Program Updates
  - Hanford Advisory Board Committee Reports
  - Emergency Preparedness
  - Potential technical issues at Waste Treatment and Immobilization Plant
  - Board Business

Public Participation: The meeting is open to the public. The EM SSAB, Hanford, welcomes the attendance of the public at its advisory committee meetings and will make every effort to accommodate persons with physical disabilities or special needs. If you require special accommodations due to a disability, please contact Kimberly Ballinger at least seven days in advance of the meeting at the phone number listed above. Written statements may be filed with the Board either before or after the meeting. Individuals who wish to make oral statements pertaining to agenda items should contact Kimberly Ballinger at the address or telephone number listed above. Requests must be received five days prior to the meeting and reasonable provision will be made to include the presentation in the agenda. The Deputy Designated Federal Officer is empowered to conduct the meeting in a fashion that will facilitate the orderly conduct of business. Individuals wishing to make public comments will be provided a maximum of five minutes to present their comments.

Minutes: Minutes will be available by writing or calling Kimberly Ballinger's office at the address or phone number listed above. Minutes will also be available at the following Web site: *http://www.hanford.gov/page.cfm/hab*.

Issued at Washington, DC on January 28, 2014.

LaTanya R. Butler,

Deputy Committee Management Officer.

[FR Doc. 2014–02017 Filed 1–30–14; 8:45 am]

BILLING CODE 6450–01–P

DEPARTMENT OF ENERGY

Environmental Management Site-Specific Advisory Board, Nevada

AGENCY: Department of Energy.

ACTION: Notice of Open Meeting.

SUMMARY: This notice announces a meeting of the Environmental Management Site-Specific Advisory Board (EM SSAB), Nevada. The Federal Advisory Committee Act (Pub. L. 92–463, 86 Stat. 770) requires that public

notice of this meeting be announced in the **Federal Register**.

DATES: Wednesday, February 19, 2014, 5:00 p.m.

ADDRESSES: Beatty Community Center, 100 A Avenue South, Beatty, Nevada 89003.

FOR FURTHER INFORMATION CONTACT: Barbara Ulmer, Board Administrator, 232 Energy Way, M/S 505, North Las Vegas, Nevada 89030. Phone: (702) 630–0522; Fax (702) 295–5300 or Email: *NSSAB@nnsa.doe.gov*.

SUPPLEMENTARY INFORMATION: Purpose of the Board: The purpose of the Board is to make recommendations to DOE–EM and site management in the areas of environmental restoration, waste management, and related activities.

Tentative Agenda

1. Nevada National Security Site Communication Plan for Groundwater Sampling Results—Work Plan Item #5.
2. Recommendation Development for Radionuclide Decay at Use-Restricted Soil Sites—Work Plan Item #3.
3. Recommendation Development for Groundwater Open House—Work Plan Item #4.

Public Participation: The EM SSAB, Nevada, welcomes the attendance of the public at its advisory committee meetings and will make every effort to accommodate persons with physical disabilities or special needs. If you require special accommodations due to a disability, please contact Barbara Ulmer at least seven days in advance of the meeting at the phone number listed above. Written statements may be filed with the Board either before or after the meeting. Individuals who wish to make oral presentations pertaining to agenda items should contact Barbara Ulmer at the telephone number listed above. The request must be received five days prior to the meeting and reasonable provision will be made to include the presentation in the agenda. The Deputy Designated Federal Officer is empowered to conduct the meeting in a fashion that will facilitate the orderly conduct of business. Individuals wishing to make public comments can do so during the 15 minutes allotted for public comments.

Minutes: Minutes will be available by writing to Barbara Ulmer at the address listed above or at the following Web site: *http://nv.energy.gov/nssab/MeetingMinutes.aspx*

Issued at Washington, DC on January 28, 2014.

LaTanya R. Butler,

Deputy Committee Management Officer.

[FR Doc. 2014–02009 Filed 1–30–14; 8:45 am]

BILLING CODE 6450–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

Combined Notice of Filings #1

Take notice that the Commission received the following electric rate filings:

Docket Numbers: ER10–1569–008; ER10–2791–008; ER10–2792–008; ER10–1575–006; ER11–2062–009; ER12–2413–006; ER10–1291–010; ER11–2508–008; ER11–4307–009; ER12–261–008; ER10–2876–008; ER10–2888–009; ER10–2914–009; ER10–2931–008; ER13–1965–003; ER11–4308–009; ER11–2805–008; ER10–3143–010

Applicants: NRG Power Marketing LLC, Bayou Cove Peaking Power LLC, Big Cajun I Peaking Power LLC, CottonWood Energy Company LP, Energy Plus Holdings LLC, Energy Alternatives Wholesale, LLC, GenConn Energy LLC, GenOn Energy Management, LLC, Green Mountain Energy Company, Independence Energy Group LLC, Louisiana Generating LLC, Norwalk Power LLC, NRG New Jersey Energy Sales LLC, NRG Sterlington Power LLC, NRG Wholesale Generation LP, Reliant Energy Northeast LLC, RRI Energy Services, LLC, Sabine Cogen, LP

Description: Notice of Non-Material Change in Status of NRG MBR Entities.

Filed Date: 1/22/14.

Accession Number: 20140122–5241.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER10–3125–007; ER10–3243–002; ER10–3102–007; ER10–3245–001; ER10–3249–001; ER10–3250–001; ER10–3169–005; ER10–3100–007; ER12–2570–003; ER11–2639–001; ER10–3143–009; ER13–821–003; ER10–3107–007; ER10–3109–007; ER13–618–002; ER12–1301–002

Applicants: AL Sandersville, LLC, Chandler Wind Partners, LLC, Effingham County Power, LLC, Foote Creek II, LLC, Foote Creek III, LLC, Foote Creek IV, LLC, Michigan Power Limited Partnership, MPC Generating, LLC, Panther Creek Power Operating, LLC, Ridge Crest Wind Partners, LLC, Sabine Cogen, LP, Scrubgrass Generating Company, L.P., Walton County Power, LLC, Washington County Power, LLC, Westwood Generation, LLC, Zone J Tolling Co., LLC.

Description: Notice of Non-Material Change in Status of AL Sandersville, LLC, et al.

Filed Date: 1/22/14.

Accession Number: 20140122–5225.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER10–3145–004; ER10–3147–004; ER13–442–001; ER10–3116–004; ER10–3120–004; ER11–2036–004; ER13–1544–001; ER10–3128–004; ER13–1139–003; ER10–1800–004; ER10–3136–004; ER11–2701–006; ER10–1728–004; ER10–2491–004; ER97–2904–012; ER97–4222–003; ER11–3131–001.

Applicants: AES Alamitos, LLC, AES Armenia Mountain Wind, LLC, AES Beaver Valley, LLC, AES Energy Storage, LLC, AES Huntington Beach, L.L.C., AES Laurel Mountain LLC, AES ES Tait, LLC, AES Redondo Beach, L.L.C., Condon Wind Power, LLC, Imperial Valley Solar 1, LLC, Indianapolis Power & Light Company, Mountain View Power Partners, LLC, The Dayton Power and Light Company, DPL Energy, LLC,LAKE BENTON POWER PARTNERS LLC, Storm Lake Power Partners II, LLC, Mountain View Power Partners IV, LLC.

Description: Supplement to July 1, 2013 Triennial Market Power Update for the Southwest Region of AES MBR Affiliates.

Filed Date: 1/22/14.

Accession Number: 20140122–5220.

Comments Due: 5 p.m. ET 2/5/14.

Docket Numbers: ER10–3168–008; ER13–445–002; ER11–4063–002; ER11–4060–002; ER11–4061–002.

Applicants: ArcLight Energy Marketing, LLC, Badger Creek Limited, Double ''C'' Limited, High Sierra Limited, Kern Front Limited.

Description: Notice of Non-Material Change in Status of ArcLight Energy Marketing, LLC, et al.

Filed Date: 1/22/14.

Accession Number: 20140122–5224.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER12–1179–016.

Applicants: Southwest Power Pool, Inc.

Description: Implementation of Order No. 745 in the Integrated Marketplace to be effective 3/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5174.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER12–1589–002.

Applicants: Public Service Company of Colorado.

Description: 2014–01–22_Att-O_PSCo_Formula_Rate_Filing to be effective 11/17/2012.

Filed Date: 1/22/14.

Accession Number: 20140122–5211.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–238–002.

Applicants: Appalachian Power Company.

Description: Sporn Operating Agreement Compliance Filing to be effective 1/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5179.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–239–002.

Applicants: Kentucky Power Company.

Description: Mitchell Operating Agreement Compliance Filing to be effective 1/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5180.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–2452–001.

Applicants: California Independent System Operator Corporation.

Description: 2014–01–22_RIMPR1_BCR_Compliance to be effective 4/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5204.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–2468–001.

Applicants: Midcontinent Independent System Operator, Inc.

Description: 2014–01–22_Docket No. ER13–2468–000_CMMPA Compliance Filing to be effective 1/1/2014 .

Filed Date: 1/22/14.

Accession Number: 20140122–5154.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–2490–004.

Applicants: Simon Solar Farm, LLC.

Description: Notice of Non-Material Change in Status of Simon Solar Farm, LLC.

Filed Date: 1/22/14.

Accession Number: 20140122–5226.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–663–001.

Applicants: Energy Discounters, LLC.

Description: Amendment to 1 to be effective 12/18/2013.

Filed Date: 1/22/14.

Accession Number: 20140122–5138.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–1134–000.

Applicants: Sabine Cogen, LP.

Description: Sabine Filing in Compliance with Order No. 784 to be effective 1/23/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5177.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–1135–000.

Applicants: Renewable Power Direct, LLC.

Description: Original Volume No. 1 to be effective 4/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5193.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–1136–000.

Applicants: PJM Interconnection, L.L.C.

Description: Original Service Agreement No. 3741—Queue Position Y3–012 to be effective 12/23/2013.

Filed Date: 1/22/14.

Accession Number: 20140122–5194.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–1137–000.

Applicants: Pheasant Run Wind, LLC.

Description: Pheasant Run Wind, LLC Common Facilities Agreement to be effective 1/23/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5212.

Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER14–1138–000.

Applicants: New York Independent System Operator, Inc.

Description: Request for Waiver, Shortened Comment Period and Expedited Commission Action of New York Independent System Operator, Inc.

Filed Date: 1/22/14

Accession Number: 20140122–5219.

Comments Due: 5 p.m. ET 1/29/14.

The filings are accessible in the Commission's eLibrary system by clicking on the links or querying the docket number.

Any person desiring to intervene or protest in any of the above proceedings must file in accordance with Rules 211 and 214 of the Commission's Regulations (18 CFR 385.211 and 385.214) on or before 5:00 p.m. Eastern time on the specified comment date. Protests may be considered, but intervention is necessary to become a party to the proceeding.

eFiling is encouraged. More detailed information relating to filing requirements, interventions, protests, service, and qualifying facilities filings can be found at: *http://www.ferc.gov/docs-filing/efiling/filing-req.pdf.* For other information, call (866) 208–3676 (toll free). For TTY, call (202) 502–8659.

Dated: January 23, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–02051 Filed 1–30–14; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

Combined Notice Of Filings

Take notice that the Commission has received the following Natural Gas Pipeline Rate and Refund Report filings:

Filings Instituting Proceedings

Docket Numbers: RP14–374–000.

Applicants: East Cheyenne Gas Storage, LLC.

Description: ECGS Compliance Filing GT&C Section 34 (Non-Conforming Agreements) to be effective 1/5/2014.

Filed Date: 1/17/14.

Accession Number: 20140117–5265.

Comments Due: 5 p.m. ET 1/29/14.

Docket Numbers: RP14–375–000.

Applicants: Cheyenne Plains Gas Pipeline Company, L.

Description: Negotiated Rate Non-Conforming TSA Updates to be effective 1/18/2014.

Filed Date: 1/17/14.

Accession Number: 20140117–5308.

Comments Due: 5 p.m. ET 1/29/14.

Docket Numbers: RP14–376–000.

Applicants: Natural Gas Pipeline Company of America.

Description: Removal of Expired/Expiring Agreements to be effective 2/21/2014.

Filed Date: 1/21/14.

Accession Number: 20140121–5019.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–377–000.

Applicants: Iroquois Gas Transmission System, L.P.

Description: 01/21/14 Negotiated Rates—Sequent Energy Management (HUB) 3075–89 to be effective 1/18/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5003.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–378–000.

Applicants: Texas Eastern Transmission, LP.

Description: Negotiated Rate for NJNG Contract 910230 to be effective 11/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5012.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–379–000.

Applicants: Texas Eastern Transmission, LP.

Description: Modifications to Pro Forma Exhibits A and C to be effective 4/1/2014.

Filed Date: 1/22/14.

Accession Number: 20140122–5029.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–380–000.

Applicants: National Fuel Gas Supply Corporation,Empire Pipeline, Inc.

Description: Petition of National Fuel Gas Supply Corporation and Empire Pipeline, Inc. for Limited Waiver of Order No. 787.

Filed Date: 1/21/14.

Accession Number: 20140121–5241.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–381–000.

Applicants: Transcontinental Gas Pipe Line Company.

Description: DPEs-NESL to be effective 2/22/20140.

Filed Date: 1/22/14.

Accession Number: 20140122–5064.

Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–382–000.

Applicants: Iroquois Gas Transmission System, L.P.

Description: 01/22/14 Negotiated Rates—Trafigura AG (HUB) 7445–89 to be effective 1/18/2014.
Filed Date: 1/22/14.
Accession Number: 20140122–5143.
Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–383–000.
Applicants: Iroquois Gas Transmission System, L.P.
Description: 01/22/14 Negotiated Rates—JP Morgan Ventures Energy Corp (HUB) 6025–89 to be effective 1/18/2014.
Filed Date: 1/22/14.
Accession Number: 20140122–5153.
Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: RP14–384–000.
Applicants: Iroquois Gas Transmission System, L.P.
Description: 01/22/14 Negotiated Rates—United Energy Trading, LLC (RTS) 5095–22 to be effective 1/18/2014.
Filed Date: 1/22/14.
Accession Number: 20140122–5183.
Comments Due: 5 p.m. ET 2/3/14.

Any person desiring to intervene or protest in any of the above proceedings must file in accordance with Rules 211 and 214 of the Commission's Regulations (18 CFR § 385.211 and § 385.214) on or before 5:00 p.m. Eastern time on the specified comment date. Protests may be considered, but intervention is necessary to become a party to the proceeding.

Filings in Existing Proceedings

Docket Numbers: RP13–1041–001.
Applicants: Iroquois Gas Transmission System, L.P.
Description: 01/22/14 Reservation Charge Credit to be effective 1/1/2014.
Filed Date: 1/22/14.
Accession Number: 20140122–5169.
Comments Due: 5 p.m. ET 2/3/14.

Any person desiring to protest in any of the above proceedings must file in accordance with Rule 211 of the Commission's Regulations (18 CFR § 385.211) on or before 5:00 p.m. Eastern time on the specified comment date.

The filings are accessible in the Commission's eLibrary system by clicking on the links or querying the docket number.

eFiling is encouraged. More detailed information relating to filing requirements, interventions, protests, service, and qualifying facilities filings can be found at: *http://www.ferc.gov/docs-filing/efiling/filing-req.pdf.* For other information, call (866) 208–3676 (toll free). For TTY, call (202) 502–8659.

Dated: January 23, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–02055 Filed 1–30–14; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

Combined Notice Of Filings

Take notice that the Commission has received the following Natural Gas Pipeline Rate and Refund Report filings:

Filings Instituting Proceedings

Docket Numbers: RP14–371–000.
Applicants: Colorado Interstate Gas Company, L.L.C.
Description: High Plains Expansion Non-Conforming Agreement Filing to be effective 2/15/2014.
Filed Date: 1/15/14.
Accession Number: 20140115–5170.
Comments Due: 5 p.m. ET 1/27/14.

Docket Numbers: RP14–372–000.
Applicants: Transcontinental Gas Pipe Line Company.
Description: Negotiated Rates—Cherokee—AGL and MGAG to be effective 2/16/2014.
Filed Date: 1/16/14.
Accession Number: 20140116–5110.
Comments Due: 5 p.m. ET 1/28/14.

Docket Numbers: RP14–373–000.
Applicants: Equitrans, L.P.
Description: Market Lateral Service to be effective 3/1/2014.
Filed Date: 1/17/14.
Accession Number: 20140117–5033.
Comments Due: 5 p.m. ET 1/29/14.

The filings are accessible in the Commission's eLibrary system by clicking on the links or querying the docket number.

Any person desiring to intervene or protest in any of the above proceedings must file in accordance with Rules 211 and 214 of the Commission's Regulations (18 CFR § 385.211 and § 385.214) on or before 5:00 p.m. Eastern time on the specified comment date. Protests may be considered, but intervention is necessary to become a party to the proceeding.

eFiling is encouraged. More detailed information relating to filing requirements, interventions, protests, service, and qualifying facilities filings can be found at: *http://www.ferc.gov/docs-filing/efiling/filing-req.pdf.* For other information, call (866) 208–3676 (toll free). For TTY, call (202) 502–8659.

Dated: January 17, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–02054 Filed 1–30–14; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

Combined Notice Of Filings #2

Take notice that the Commission received the following electric rate filings:

Docket Numbers: ER13–342–003.
Applicants: CPV Shore, LLC.
Description: Notice of Non-Material Change in Status of CPV Shore, LLC.
Filed Date: 1/23/14.
Accession Number: 20140123–5198.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–793–001.
Applicants: The Empire District Electric Company.
Description: Supplement to MBR to be effective 3/1/2014.
Filed Date: 1/24/14.
Accession Number: 20140124–5079.
Comments Due: 5 p.m. ET 2/14/14.

Docket Numbers: ER14–1145–000.
Applicants: PJM Interconnection, L.L.C.
Description: Request for Waiver, Shortened Comment Period and Expedited Commission Action of PJM Interconnection, L.L.C.
Filed Date: 1/23/14.
Accession Number: 20140123–5174.
Comments Due: 5 p.m. ET 1/30/14.

Docket Numbers: ER14–1149–000.
Applicants: Midcontinent Independent System Operator, Inc.
Description: 2014–01–24_SA 865 Entergy Big Cajun 2 Succession Filing to be effective 12/19/2013.
Filed Date: 1/24/14.
Accession Number: 20140124–5134.
Comments Due: 5 p.m. ET 2/14/14.

Docket Numbers: ER14–1149–001.
Applicants: Midcontinent Independent System Operator, Inc.
Description: Midcontinent Independent System Operator, Inc. submits tariff filing per 35.17(b): 2014–01–24_SA 865 Entergy Big Cajun 2 v32 Succession Amendment to be effective 12/19/2013.
Filed Date: 1/24/14.
Accession Number: 20140124–5144.
Comments Due: 5 p.m. ET 2/14/14.

Docket Numbers: ER14–1150–000.
Applicants: Powerex Corp.
Description: Powerex Corp. submits tariff filing per 35.13(a)(2)(iii: Amendment to Powerex Corp. Rate Schedule No. 5 to be effective 6/1/2013.
Filed Date: 1/24/14.
Accession Number: 20140124–5142.
Comments Due: 5 p.m. ET 2/14/14.

Take notice that the Commission received the following electric securities filings:

Docket Numbers: ES14–23–000.
Applicants: Ameren Services Company.
Description: Application for Authorization under Federal Power Act Section 204 of Ameren Services Company on behalf of Union Electric Company.
Filed Date: 1/23/14.
Accession Number: 20140123–5201.
Comments Due: 5 p.m. ET 2/13/14.

The filings are accessible in the Commission's eLibrary system by clicking on the links or querying the docket number.

Any person desiring to intervene or protest in any of the above proceedings must file in accordance with Rules 211 and 214 of the Commission's Regulations (18 CFR 385.211 and 385.214) on or before 5:00 p.m. Eastern time on the specified comment date. Protests may be considered, but intervention is necessary to become a party to the proceeding.

eFiling is encouraged. More detailed information relating to filing requirements, interventions, protests, service, and qualifying facilities filings can be found at: *http://www.ferc.gov/docs-filing/efiling/filing-req.pdf.* For other information, call (866) 208–3676 (toll free). For TTY, call (202) 502–8659.

Dated: January 24, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–02053 Filed 1–30–14; 8:45 am]

BILLING CODE 6717–01–P

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

Combined Notice Of Filings #1

Take notice that the Commission received the following electric rate filings:

Docket Numbers: ER10–3301–002, ER10–2757–003, ER10–2756–003.
Applicants: Arlington Valley, LLC, Griffith Energy LLC, GWF Energy LLC.
Description: Notice of Change in Status under Market Based Authority, et. al. of the Star West Companies.
Filed Date: 1/22/14.
Accession Number: 20140122–5228.
Comments Due: 5 p.m. ET 2/12/14.

Docket Numbers: ER13–2164–001.
Applicants: Southwest Power Pool, Inc.
Description: AG Study Backlog Clearing Process Tariff Revisions Compliance Filing to be effective 10/12/2013.
Filed Date: 11/8/13.
Accession Number: 20131108–5121.
Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: ER14–8–001.
Applicants: Public Service Company of Oklahoma.
Description: Operating Agreement Compliance to be effective 3/1/2014.
Filed Date: 1/24/14.
Accession Number: 20140124–5042.
Comments Due: 5 p.m. ET 2/14/14.

Docket Numbers: ER14–581–001.
Applicants: ISO New England Inc.
Description: Tariff Revisions Related to Demand Response Comm. Op. Auditing to be effective 6/1/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5057.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–724–001.
Applicants: Westar Energy, Inc.
Description: Amendment, Market-Based Rate Tariff to be effective 3/1/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5143.
Comments Due: 5 p.m. ET 2/3/14.

Docket Numbers: ER14–772–001.
Applicants: Fortistar North Tonawanda Inc.
Description: Supplemental Filing to be effective 1/23/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5063.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1106–001.
Applicants: Duke Energy Carolinas, LLC.
Description: OATT 2nd Revised Attachment F–2 NITSA to be effective 1/1/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5000.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1139–000.
Applicants: PacifiCorp.
Description: Termination of Logan City Construction Agreement to be effective 4/10/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5074.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1140–000.
Applicants: Inspire Energy Holdings, LLC.
Description: Inspire Energy Holdings, LLC FERC Tariff Filing to be effective 1/24/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5092.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1141–000.
Applicants: PJM Interconnection, L.L.C.
Description: 4th Quarter 2013 Updates to PJM Operating Agreement and RAA Membership Lists to be effective 12/31/2013.
Filed Date: 1/23/14.
Accession Number: 20140123–5125.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1142–000.
Applicants: NorthWestern Corporation.
Description: SA 703—Yellowstone Valley Electric Coop Telemetry Construction Agreement to be effective 1/24/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5127.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1143–000.
Applicants: ONEOK Energy Services Company, L.P.
Description: ONEOK Energy Services Notice of MBR Tariff Cancellation and Request for Waiver to be effective 1/23/2014.
Filed Date: 1/23/14.
Accession Number: 20140123–5144.
Comments Due: 5 p.m. ET 2/13/14.

Docket Numbers: ER14–1147–000.
Applicants: ISO New England Inc., New England Power Pool Participants Committee.
Description: Revisions to the NCPC Credit Rules to be effective 12/3/2014.
Filed Date: 1/24/14
Accession Number: 20140124–5050.
Comments Due: 5 p.m. ET 2/14/14.

Docket Numbers: ER14–1148–000.
Applicants: Public Service Company of Colorado.
Description: 2014–1–24_PSC–RDCWD-Rev-ISA–116–0.0.0-Filing to be effective 3/25/2014.
Filed Date: 1/24/14.
Accession Number: 20140124–5075.
Comments Due: 5 p.m. ET 2/14/14.

The filings are accessible in the Commission's eLibrary system by clicking on the links or querying the docket number.

Any person desiring to intervene or protest in any of the above proceedings must file in accordance with Rules 211 and 214 of the Commission's Regulations (18 CFR 385.211 and 385.214) on or before 5:00 p.m. Eastern time on the specified comment date. Protests may be considered, but intervention is necessary to become a party to the proceeding.

eFiling is encouraged. More detailed information relating to filing requirements, interventions, protests, service, and qualifying facilities filings can be found at: *http://www.ferc.gov/docs-filing/efiling/filing-req.pdf.* For other information, call (866) 208–3676 (toll free). For TTY, call (202) 502–8659.

Dated: January 24, 2014.

Nathaniel J. Davis, Sr.,

Deputy Secretary.

[FR Doc. 2014–02052 Filed 1–30–14; 8:45 am]

BILLING CODE 6717–01–P

ENVIRONMENTAL PROTECTION AGENCY

[EPA–HQ–OPPT–2012–0915; FRL–9906–11–OEI]

Information Collection Request Submitted to OMB for Review and Approval; Comment Request; Reporting and Recordkeeping for Asbestos Abatement Worker Protection

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: The Environmental Protection Agency has submitted a new information collection request (ICR), ''Reporting and Recordkeeping for Asbestos Abatement Worker Protection'' (EPA ICR No. 1246.12, OMB Control No. 2070–0072) to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act (44 U.S.C. 3501 *et seq.*). Public comments were previously requested via the **Federal Register** (78 FR 48431) on August 8, 2013, during a 60-day comment period. This notice allows for an additional 30 days for public comments. A fuller description of the ICR is given below, including its estimated burden and cost to the public. An Agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number.

DATES: Additional comments may be submitted on or before March 3, 2014.

ADDRESSES: Submit your comments, referencing Docket ID Number EPA–HQ–OPPT–2012–0915, to (1) EPA online using *www.regulations.gov* (our preferred method), by email to *oppt.ncic@epa.gov* or by mail to: EPA Docket Center, Environmental Protection Agency, Mail Code 28221T, 1200 Pennsylvania Ave. NW., Washington, DC 20460, and (2) OMB via email to *oira_submission@omb.eop.gov.* Address comments to OMB Desk Officer for EPA.

EPA's policy is that all comments received will be included in the public docket without change including any personal information provided, unless the comment includes profanity, threats, information claimed to be Confidential Business Information (CBI) or other information whose disclosure is restricted by statute.

FOR FURTHER INFORMATION CONTACT: Pamela Myrick, Deputy Director, Environmental Assistance Division, Office of Pollution Prevention and Toxics, Mail code: 7408–M, Environmental Protection Agency, 1200 Pennsylvania Ave. NW., Washington, DC 20460; telephone number: 202–554–1404; fax number: 202–564–8251; email address: *TSCA-Hotline@epa.gov.*

SUPPLEMENTARY INFORMATION: Supporting documents which explain in detail the information that the EPA will be collecting are available in the public docket for this ICR. The docket can be viewed online at *www.regulations.gov* or in person at the EPA Docket Center, EPA West, Room 3334, 1301 Constitution Ave. NW., Washington, DC. The telephone number for the Docket Center is 202–566–1744. For additional information about EPA's public docket, visit *http://www.epa.gov/dockets.*

Abstract: EPA's asbestos worker protection rule is designed to provide occupational exposure protection to state and local government employees who are engaged in asbestos abatement activities in states that do not have state plans approved by the Occupational Safety and Health Administration (OSHA). The rule provides protection for public employees not covered by the OSHA standard from the adverse health effects associated with occupational exposure to asbestos. Specifically the rule requires state and local governments to monitor employee exposure to asbestos, take action to reduce exposure to asbestos, monitor employee health and train employees about asbestos hazards.

The rule includes a number of information reporting and recordkeeping requirements. State and local government agencies are required to provide employees with information about exposures to asbestos and the associated health effects. The rule also requires state and local governments to notify EPA before commencing any asbestos abatement project. State and local governments must maintain medical surveillance and monitoring records and training records on their employees, must establish a set of written procedures for respirator programs and must maintain procedures and records of respirator fit tests. EPA will use the information to monitor compliance with the asbestos worker protection rule. This request addresses these reporting and recordkeeping requirements.

Responses to the collection of information are mandatory (see 40 CFR 763 Subpart G). EPA will disclose information that is covered by a claim of confidentiality only to the extent permitted by, and in accordance with, the procedures in TSCA and 40 CFR Part 2.

Form Numbers: None.

Respondents/affected entities: Entities potentially affected by this action are state and local government employers in 25 states, the District of Columbia, and certain U.S. Territories that have employees engaged in asbestos-related construction, custodial and brake and clutch repair activities without OSHA-approved state plans.

Respondent's obligation to respond: Mandatory.

Estimated number of respondents: 22,488 (total).

Frequency of response: On occasion.

Total estimated burden: 363,517 hours per year. Burden is defined at 5 CFR 1320.03(b).

Total estimated cost: $14,548,910 per year, includes $0 annualized capital or operation and maintenance costs.

Changes in the estimates: There is a very minor decrease of 6 burden hours per year compared with that identified in the ICR currently approved by OMB (from 363,523 hours to 363,517 hours). This change is an adjustment and is explained in the supporting statement.

John Moses,

Director, Collection Strategies Division.

[FR Doc. 2014–02039 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[EPA–HQ–OECA–2013–0319; FRL—9906–12–OEI]

Information Collection Request Submitted to OMB for Review and Approval; Comment Request; NSPS for VOC Emissions from Petroleum Refinery Wastewater Systems (Renewal)

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: The Environmental Protection Agency has submitted an information collection request (ICR), ''NSPS for VOC Emissions from Petroleum Refinery Wastewater Systems (40 CFR Part 60, Subpart QQQ) (Renewal)'' (EPA ICR No. 1136.11, OMB Control No. 2060–0172), to the Office of Management and Budget (OMB) for review and approval in accordance with the Paperwork Reduction Act (44 U.S.C. 3501 *et seq*). This is a proposed extension of the ICR, which is currently approved through April 30, 2014. Public comments were previously requested via the **Federal Register** (78 FR 35023) on June 11, 2013 during a 60-day comment period. This notice allows for an additional 30 days

for public comments. A fuller description of the ICR is given below, including its estimated burden and cost to the public. An Agency may not conduct or sponsor and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number.

DATES: Additional comments may be submitted on or before March 3, 2014.

ADDRESSES: Submit your comments, referencing Docket ID Number EPA–HQ–OECA–2013–0319, to: (1) EPA online, using *www.regulations.gov* (our preferred method), or by email to: *docket.oeca@epa.gov,* or by mail to: EPA Docket Center, Environmental Protection Agency, Mail Code 28221T, 1200 Pennsylvania Ave. NW., Washington, DC 20460; and (2) OMB via email to *oira_submission@omb.eop.gov.* Address comments to OMB Desk Officer for EPA.

EPA's policy is that all comments received will be included in the public docket without change including any personal information provided, unless the comment includes profanity, threats, information claimed to be Confidential Business Information (CBI) or other information whose disclosure is restricted by statute.

FOR FURTHER INFORMATION CONTACT: Learia Williams, Monitoring, Assistance, and Media Programs Division, Office of Compliance, Mail Code 2227A, Environmental Protection Agency, 1200 Pennsylvania Ave. NW., Washington, DC 20460; telephone number: (202) 564–4113; fax number: (202) 564–0050; email address: *williams.learia@epa.gov.*

SUPPLEMENTARY INFORMATION: Supporting documents which explain in detail the information that the EPA will be collecting are available in the public docket for this ICR. The docket can be viewed online at *www.regulations.gov* or in person at the EPA Docket Center, WJC West, Room 3334, 1301 Constitution Ave. NW., Washington, DC. The telephone number for the Docket Center is 202–566–1744. For additional information about EPA's public docket, visit: *http://www.epa.gov/dockets.*

Abstract: Owners and operators of petroleum refinery wastewater systems are required to keep records of design and operating specifications of all equipment installed to comply with such standards such as water seals, roof seals, control devices, and other equipment. This information is necessary to ensure that equipment design and operation specifications are met, and the source is in compliance with NSPS subpart QQQ.

Form Numbers: None.

Respondents/affected entities: Petroleum refinery wastewater systems.

Respondent's obligation to respond: Mandatory (40 CFR part 60, subpart QQQ)

Estimated number of respondents: 135 (total).

Frequency of response: Initially, occasionally, and semiannually

Total estimated burden: 9,237 hours (per year). ''Burden'' is defined at 5 CFR 1320.3(b).

Total estimated cost: $921,126 (per year), includes $17,550 annualized capital or operation & maintenance costs.

Changes in the Estimates: There is no change in the labor hours in this ICR compared to the previous ICR. This is due to two considerations: (1) The regulations have not changed over the past three years and are not anticipated to change over the next three years; and (2) the growth rate for the industry is very low, negative or non-existent, so there is no significant change in the overall burden. The increase in respondent and Agency costs from the most recently approved ICR is due to an adjustment in labor rates. This ICR uses updated labor rates from the Bureau of Labor Statistics to calculate burden costs.

John Moses,

Director, Collection Strategies Division.

[FR Doc. 2014–02038 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[ER–FRL–9013–3]

Environmental Impact Statements; ≤ Notice of Availability

Responsible Agency: Office of Federal Activities, General Information (202) 564–7146 or *http://www.epa.gov/compliance/nepa/*

Weekly receipt of Environmental Impact Statements Filed 01/21/2014 Through 01/24/2014 Pursuant to 40 CFR 1506.9.

Notice: Section 309(a) of the Clean Air Act requires that EPA make public its comments on EISs issued by other Federal agencies. EPA's comment letters on EISs are available at: *http://www.epa.gov/compliance/nepa/eisdata.html.*

EIS No. 20140019, Draft EIS, FRA, NY, High Speed Rail Empire Corridor Tier 1, Comment Period Ends: 03/24/2014, Contact: Michelle W. Fishburne 202–493–0398

EIS No. 20140020, Final EIS, USA, AK, Fort Wainwright Hangars 2 and 3 Disposition, Review Period Ends: 03/03/2014, Contact: Matthew Sprau 907–361–9688

EIS No. 20140021, Draft EIS, USFS, CA, BEH Rangeland Allotments, Comment Period Ends: 03/17/2014, Contact: Crispin Holland 209–532–3671 ext. 274

EIS No. 20140022, Final EIS, BIA, NY, Stockbridge-Munsee Community, Proposed Fee to Trust Conveyance of Property and Casino Project, Review Period Ends: 03/03/2014, Contact: Chester McGhee 615–564–6830

EIS No. 20140023, Draft EIS, USFS, OR, Wolf Fuels and Vegetation Management Project, Comment Period Ends: 03/17/2014, Contact: Jeff Marszal 541–416–6436

EIS No. 20140024, Draft Supplement, USFS, MT, Miller West Fisher Project, Comment Period Ends: 03/17/2014, Contact: Denise Beck 406–293–7773

Amended Notices

EIS No. 20130376, Draft EIS, BLM, WY, Wyoming Greater Sage-Grouse Draft Land Use Plan Amendment, Comment Period Ends: 03/26/2014, Contact: Lisa Solberg Schwab 307–367–5340 Revision to FR Notice Published 12/27/2013; Correction to Comment Period End Date from 2/10/2014 to 3/26/2014

Dated: January 28, 2014.

Aimee S. Hessert,

Deputy Director, NEPA Compliance Division, Office of Federal Activities.

[FR Doc. 2014–02098 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

ENVIRONMENTAL PROTECTION AGENCY

[FRL- 9906–07–OA]

Notification of Three Public Meetings of the Chemical Assessment Advisory Committee (CAAC), the CAAC Augmented for the Review of Ammonia and the CAAC Augmented for the Review of Trimethylbenzenes

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice.

SUMMARY: The Environmental Protection Agency (EPA or agency) Science Advisory Board (SAB) Staff Office announces three public meetings. The SAB Chemical Assessment Advisory Committee (CAAC) and additional experts will meet in a plenary session to learn about new enhancements to the EPA's process for developing Integrated Risk Information System (IRIS) health assessments for chemicals. After the

plenary session, there will be two concurrent panel meetings to conduct chemical-specific peer reviews. A panel composed of a subset of CAAC members augmented with subject matter experts will conduct a peer review of the EPA's IRIS *Toxicological Review of Ammonia* (August 2013 Draft). A panel composed of the remaining subset of CAAC members augmented with other subject matter experts will conduct a peer review of the EPA's *Toxicological Review of Trimethylbenzenes* (August 2013 Draft).

DATES: The plenary session will be held on Tuesday February 18, 2014 from 8:30 a.m. to 11:30 a.m. (Eastern Time). The meetings to review the two draft IRIS assessments, *Toxicological Review of Ammonia* (August 2013 Draft) and *Toxicological Review of Trimethylbenzenes* (August 2013 Draft) will be held concurrently on Tuesday February 18, 2014 from 11:30 a.m. to 5:30 p.m. (Eastern Time), Wednesday February 19, 2014 from 8:30 a.m. to 5:30 p.m. (Eastern Time) and Thursday February 20, 2014 from 8:30 a.m. to 5:30 p.m. (Eastern Time).

ADDRESSES: The meetings will be held at the Crowne Plaza Washington National Airport, 1480 Crystal Drive, Arlington, VA, 22202.

FOR FURTHER INFORMATION CONTACT: Members of the public who wish to obtain further information regarding this announcement may contact Dr. Sue Shallal, Designated Federal Officer (DFO) for the CAAC augmented for the Ammonia Review, by telephone/voice mail at (202) 564–2057 or via email at *shallal.suhair@epa.gov* and Mr. Thomas Carpenter, DFO for the CAAC augmented for the Trimethylbenzenes Review, by telephone/voice mail at (202) 564–4885 or via email at *carpenter.thomas@epa.gov.* General information concerning the EPA SAB can be found at *http://www.epa.gov/sab.*

Technical Contact for EPA's draft assessments: For information concerning the EPA draft assessments, please contact Dr. Samantha Jones, National Center for Environmental Assessment, Office of Research and Development, U.S. EPA, 1200 Pennsylvania Avenue NW., Mail Code 8601P, Washington, DC 20460, phone (703) 347–8580 or via email at *jones.samantha@epa.gov.*

SUPPLEMENTARY INFORMATION: *Background:* The SAB was established pursuant to the Environmental Research, Development, and Demonstration Authorization Act (ERDDAA) codified at 42 U.S.C. 4365, to provide independent scientific and technical peer review, advice, consultation and recommendations to the EPA Administrator on the technical basis for EPA actions. As a Federal Advisory Committee, the SAB conducts business in accordance with the Federal Advisory Committee Act (FACA) (5 U.S.C. App. 2) and related regulations. Pursuant to FACA and EPA policy, notice is hereby given that the SAB Chemical Assessment Advisory Committee (CAAC) along with additional experts will hold public meetings to: (1) Learn about the EPA's enhancements to the process for developing Integrated Risk Information System (IRIS) health assessments for chemicals and (2) to conduct peer reviews of two draft IRIS assessments, *Toxicological Review of Ammonia* (August 2013 Draft) and *Toxicological Review of Trimethylbenzenes* (August 2013 Draft). The SAB committee and panels will comply with the provisions of FACA and all appropriate SAB Staff Office procedural policies.

EPA's Office of Research and Development has requested that the SAB conduct peer reviews of two draft documents, *Toxicological Review of Ammonia* (August 2013 Draft) and *Toxicological Review of Trimethylbenzenes* (August 2013 Draft). The EPA SAB Staff Office augmented the SAB CAAC with subject matter experts to provide advice through the chartered SAB regarding these IRIS assessments. The SAB Staff Office previously requested public nominations of experts to serve as chemical-specific experts for these peer reviews in a **Federal Register** notice published on August 28, 2013 (78:167 pp. 53144–46). Information about the formation of the SAB CAAC augmented for the Ammonia peer review can be found on the SAB Web site at *http://yosemite.epa.gov/sab/sabproduct.nsf/02ad90b136fc21ef85256eba00436459/2fe334e0bec7a3cf85257b65005c500b!OpenDocument&TableRow=2.1#2.* Information about the formation of the SAB CAAC augmented for the Trimethylbenzenes peer review can be found on the SAB Web site at *http://yosemite.epa.gov/sab/sabproduct.nsf/02ad90b136fc21ef85256eba00436459/ee1e280e77586de985257b65005d37e7!OpenDocument&TableRow=2.1#2.*

Prior to the beginning of their peer review activities, the augmented CAAC panels will meet in a plenary session to receive EPA briefings on the enhancements to the process for developing IRIS health assessments for chemicals.

Availability of the review materials: Information about these public meetings will be available on the SAB Web site (*http://www.epa.gov/sab*) prior to the meetings. Meeting materials can be accessed by using the ''calendar'' link in the blue navigation sidebar and then clicking on the date corresponding to the meeting date.

Procedures for Providing Public Input: Public comments for consideration by EPA's federal advisory committees and panels have a different purpose from public comments provided to EPA program offices. Therefore, the process for submitting comments to a federal advisory committee is different from the process used to submit comments to an EPA program office. Federal advisory committees and panels, including scientific advisory committees, provide independent advice to EPA. Members of the public can submit relevant comments pertaining to the committee's charge, meeting materials and/or the group conducting the activity. Input from the public to the SAB will have the most impact if it consists of comments that provide specific scientific or technical information or analysis for the SAB committee to consider or if it relates to the clarity or accuracy of the technical information. Members of the public wishing to provide comment should contact the Designated Federal Officer for the relevant advisory committee directly.

Oral Statements: In general, individuals or groups requesting an oral presentation will be limited to five minutes per speaker. Interested parties wishing to provide comments regarding the IRIS process enhancements or the SAB's review of the agency's *Toxicological Review of Ammonia* (August 2013 Draft) should contact Dr. Suhair Shallal, DFO, and interested parties wishing to provide comments regarding the *Toxicological Review of Trimethylbenzenes* (August 2013 Draft) should contact Mr. Thomas Carpenter, DFO in writing (preferably via email), at the contact information noted above, by February 10, 2014 to be placed on the list of public speakers for the meeting.

Written Statements: Written statements should be received in the SAB Staff Office by February 10, 2014 so that the information can be made available to the SAB Committee for consideration. Written statements should be supplied to the appropriate DFO in electronic format via email (acceptable file formats: Adobe Acrobat PDF, WordPerfect, MS Word, MS PowerPoint, or Rich Text files in IBM–PC/Windows 98/2000/XP format). It is the SAB Staff Office general policy to post written comments on the Web page for the advisory meeting or teleconference. Submitters are requested to provide an unsigned version of each document

because the SAB Staff Office does not publish documents with signatures on its Web sites. Members of the public should be aware that their personal contact information, if included in any written comments, may be posted to the SAB Web site. Copyrighted material will not be posted without explicit permission of the copyright holder.

Accessibility: For information on access or services for individuals with disabilities, please contact Dr. Sue Shallal or Mr. Thomas Carpenter at the phone number or email address noted above, preferably at least ten days prior to the meeting, to give EPA as much time as possible to process your request.

Dated: January 23, 2014.

Christopher S. Zarba,

Director, EPA Science Advisory Board Staff Office.

[FR Doc. 2014–02096 Filed 1–30–14; 8:45 am]

BILLING CODE 6560–50–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Reviewed by the Federal Communications Commission Under Delegated Authority

AGENCY: Federal Communications Commission.

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burdens, and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3520), the Federal Communications Commission (FCC or the Commission) invites the general public and other Federal agencies to take this opportunity to comment on the following information collection. Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information collection burden on small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid control number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the PRA that does not display a valid Office of Management and Budget (OMB) control number.

DATES: Written PRA comments should be submitted on or before April 1, 2014. If you anticipate that you will be submitting comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the contact listed below as soon as possible.

ADDRESSES: Direct all PRA comments to Cathy Williams, FCC, via email P*RA@fcc.gov* and to *Cathy.Williams@fcc.gov*.

FOR FURTHER INFORMATION CONTACT: For additional information about the information collection, contact Cathy Williams at (202) 418–2918.

SUPPLEMENTARY INFORMATION:

OMB Control No.: 3060–0751.

Title: Contracts and Concessions, 47 CFR 43.51.

Form No.: N/A.

Type of Review: Extension of a currently approved collection.

Respondents: Business or other for-profit.

Number of Respondents/Responses: 10 respondents; 40 responses.

Estimated Time per Response: 6–8 hours.

Frequency of Response: Annual reporting requirement; on occasion reporting requirement.

Obligation to Respond: Required to obtain or retain benefits. The statutory authority for this information collection is contained in 47 U.S.C. 154, 211, 219 and 220.

Total Annual Burden: 300 hours.

Annual Cost Burden: None.

Privacy Act Impact Assessment: No impact(s).

Nature and Extent of Confidentiality: In general, there is no need for confidentiality with this collection of information.

Needs and Uses: This collection will be submitted as an extension (no change in reporting or recordkeeping requirements) after this 60-day comment period to the Office of Management and Budget (OMB) in order to obtain the full three year clearance.

The Commission has determined that the authorized resale of international private lines inter-connected to the U.S. public switched network would tend to divert international message telephone service (IMTS) traffic from the settlements process and increase the U.S. net settlements deficit. The information will be used by the Commission in reviewing the impact, if any, that end-user private line interconnections have on the Commission's international settlements policy. The data will also enhance the ability of both the Commission and interested parties to monitor the unauthorized resale of international private lines that are interconnected to the U.S. public switched network.

Federal Communications Commission.

Marlene H. Dortch,

Secretary, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–01983 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Submitted for Review and Approval to the Office of Management and Budget (OMB)

AGENCY: Federal Communications Commission (FCC).

ACTION: Notice; request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3502—3520), the FCC invites the general public and other Federal agencies to take this opportunity to comment on the following information collection. Comments are requested concerning: Whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimates; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information collection burden on small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB Control Number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the PRA that does not display a valid OMB Control Number.

DATES: Written PRA comments should be submitted on or before March 3, 2014. If you anticipate that you will be submitting PRA comments, but find it difficult to do so within the period of time allowed by this notice, you should

advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Nicholas A. Fraser, Office of Management and Budget (OMB), via fax at 202–395–5167, or via the Internet at *Nicholas_A._Fraser@omb.eop.gov* and to Leslie Smith, Office of Managing Director (OMD), Federal Communications Commission (FCC), via the Internet at *Leslie.Smith@fcc.gov* . To submit your PRA comments by email, send them to: *PRA@fcc.gov.*

FOR FURTHER INFORMATION CONTACT: Leslie Smith, OMD, FCC, at 202–418–0217, or via the Internet at: *Leslie.Smith@fcc.gov.*

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–XXXX

Title: US Telecom Forbearance FCC 13–69 Conditions.

Form Number: N/A

Type of Review: New collection.

Respondents: Business or other for-profit.

Number of Respondents and Responses: 11 respondents; 11 responses.

Estimated Time per Response: 40–79 hours.

Frequency of Response: One-time and annual reporting requirements; recordkeeping requirement.

Obligation to Respond: Voluntary. Statutory Authority: 47 U.S.C 160, 201, 202, 218, 254(k), and 272(e).

Total Annual Burden: 2,096 hours.

Total Annual Costs: $104,800.

Privacy Act Impact Assessment: No impact(s).

Nature and Extent of Confidentiality: If respondents submit information which respondents believe is confidential, respondents may request confidential treatment of such information pursuant to section 0.459 of the Commission's rules, 47 CFR 0.459.

Needs and Uses: In a May 2013 *Memorandum Opinion and Order* (FCC 13–69), the Commission acted on a petition filed by US Telecom and granted forbearance relief to the full extent supported by the record. This collection covers conditional forbearance relief granted by the Commission from cost assignment rules, property record rules, ARMIS report 43–01, and structural separation requirements for Independent ILECs. The data, information, and documents acquired through this collection will allow the Commission to meet its statutory requirements while allowing carriers to obtain forbearance relief.

Federal Communications Commission.

Gloria J. Miles,

Federal Register Liaison, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–02005 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Reviewed by the Federal Communications Commission

AGENCY: Federal Communications Commission.

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501—3520), the Federal Communications Commission invites the general public and other Federal agencies to take this opportunity to comment on the following information collection(s). Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information burden for small business concerns with fewer than 25 employees. The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB control number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the Paperwork Reduction Act (PRA) that does not display a valid OMB control number.

DATES: Written Paperwork Reduction Act (PRA) comments should be submitted on or before April 1, 2014. If you anticipate that you will be submitting PRA comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Benish Shah, Federal Communications Commission, via the Internet at *Benish.Shah@fcc.gov*. To submit your PRA comments by email send them to: *PRA@fcc.gov*.

FOR FURTHER INFORMATION CONTACT: Benish Shah, Office of Managing Director, (202) 418–7866.

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–0773.

Title: Section 2.803 Marketing of RF Devices Prior to Equipment Authorization.

Form Number: N/A.

Type of Review: Revision of a currently approved collection.

Respondents: Businesses or other for-profit.

Number of Respondents: 10,000 respondents; 10,000 responses.

Estimated Time per Response: 0.5 hours.

Frequency of Response: One time reporting requirement and third party disclosure requirement.

Obligation to Respond: Required to obtain or retain benefits. Statutory authority for this information collection is contained in 47 U.S.C. 154(i), 302, 303, 303(r), and 307.

Total Annual Burden: 5,000 hours.

Total Annual Costs: N/A.

Nature and Extent of Confidentiality: There is no need for confidentiality.

Privacy Act Impact Assessment: N/A.

Needs and Uses: The Commission will submit this information collection to the Office of Management and Budget (OMB) after this 60 day comment period in order to obtain the full year three year clearance from them. The Commission is requesting a revision of this information collection. The Commission is reporting a program change in the burden estimates. The program change increases the number of respondents from 6,000 to 10,000 (increase of 4,000 respondents) and the total annual hours are increased from 3,000 to 5,000 hours (increase of 2,000 hours).

The Commission has established rules for the marketing of radio frequency (RF) devices prior to equipment authorization under guidelines in 47 CFR 2.803. The general guidelines in § 2.803 prohibit the marketing or sale of such equipment prior to a demonstration of compliance with the applicable equipment authorization and technical requirements in the case of a device subject to verification or Declaration of Conformity without special notification. Section 2.803(c)(2) permits limited marketing activities prior to equipment authorization, for devices that could be authorized under the current rules; could be authorized under waivers of such rules that are in effect at the time of marketing; or could be authorized under rules that have been adopted by the Commission but

that have not yet become effective. These devices may be not operated unless permitted by § 2.805.

The following general guidelines apply for third party notifications:

(a) A RF device may be advertised and displayed at a trade show or exhibition prior to a demonstration of compliance with the applicable technical standards and compliance with the applicable equipment authorization procedure provided the advertising and display is accompanied by a conspicuous notice specified in §§ 2.803(c)(2)(iii)(A) or 2.803(c)(2)(iii)(B).

(b) An offer for sale solely to business, commercial, industrial, scientific, or medical users of an RF device in the conceptual, developmental, design or pre-production stage prior to demonstration of compliance with the equipment authorization regulations may be permitted provided that the prospective buyer is advised in writing at the time of the offer for sale that the equipment is subject to FCC rules and that the equipment will comply with the appropriate rules before delivery to the buyer or centers of distribution.

(c) Equipment sold as evaluation kit may be sold to specific users with notice specified in § 2.803(c)(2)(iv)(B).

The information to be disclosed about marketing of the RF device is intended:

(1) To ensure the compliance of the proposed equipment with Commission rules; and

(2) To assist industry efforts to introduce new products to the marketplace more promptly.

The information disclosure applies to a variety of RF devices that:

(1) Is pending equipment authorization or verification of compliance;

(2) May be manufactured in the future;

(3) May be sold as kits; and

(4) Operates under varying technical standards.

The information disclosed is essential to ensuring that interference to radio communications is controlled.

Federal Communications Commission.

Gloria J. Miles,

Federal Register Liaison, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–02004 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Submitted to the Office of Management and Budget for Review and Approval

AGENCY: Federal Communications Commission.

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501—3520), the Federal Communications Commission invites the general public and other Federal agencies to take this opportunity to comment on the following information collection(s). Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information burden for small business concerns with fewer than 25 employees. The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB control number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the Paperwork Reduction Act (PRA) that does not display a valid OMB control number.

DATES: Written Paperwork Reduction Act (PRA) comments should be submitted on or before March 3, 2014. If you anticipate that you will be submitting PRA comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Nicholas A. Fraser, Office of Management and Budget, via fax at 202–395–5167 or via Internet at *Nicholas_A._Fraser@omb.eop.gov* and to Benish Shah, Federal Communications Commission, via the Internet at *Benish.Shah@fcc.gov*. To submit your PRA comments by email send them to: *PRA@fcc.gov*.

FOR FURTHER INFORMATION CONTACT: Benish Shah, Office of Managing Director, (202) 418–7866.

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–1139.

Title: FCC Consumer Broadband Services Testing and Measurement.

Form No.: N/A.

Type of Review: Revision of a currently approved collection.

Respondents: Individuals or households; business or other for-profit; and state, local or tribal government.

Number of Respondents: 501,020 respondents; 501,020 responses.

Estimated Time per Response: 1 to 200 hours.

Frequency of Response: Biennial reporting requirement and third party disclosure requirement.

Obligation to Respond: Voluntary. Statutory authority for this information collection is contained in the Broadband Data Improvement Act of 2008, Public Law 110–385, Stat 4096,

103(c)(1).

Total Annual Burden: 46,667 hours.

Total Annual Cost: N/A.

Privacy Act Impact Assessment: This information collection affects individuals or households. However, personally identifiable information (PII) is not being collected by, made available to or made accessible by the Commission but instead by third parties including SamKnows, a third party contractor, and Internet Service Provider (ISP) Partners.

Nature and Extent of Confidentiality: No personally identifying information (PII) will be transmitted to the Commission from the contractor as a matter of vendor policy and agency privacy policy. SamKnows maintains a series of administrative, technical, and physical safeguards to protect against the transmission of PII. At point of registration, individuals will be given full disclosure in a ''privacy statement'' highlighting what information will be collected. ISP Partners will receive PII about volunteers to confirm the validity of the information against their subscription records, but will be bound by a non-disclosure agreement that will maintain various administrative, technical and physical safeguards to protect the information and limit its use. ISP Partners providing support to the testing program will likewise be bound to the same series of administrative, technical and physical safeguards developed by SamKnows. In addition all third parties supporting the program directly will be bound by a ''Code of Conduct'' to ensure all participate and act in good faith and with other legally enforceable documents such as non-disclosure agreements.

Needs and Uses: The Commission will submit this revised information collection to the Office of Management and Budget (OMB) order to obtain the full three year clearance from them. The Commission is reporting a program change (there has been a program change in the reporting requirements, the number of respondents increased from 11,016 to 46,667). The Commission

is requesting OMB approval for this revision.

The Broadband Data Improvement Act of 2008, Public Law 110–385, Stat 4096, 103(c)(1) directs the Commission to collect information on the type of technology used to provide broadband to consumers, the price of such services, actual transmission speeds, and the reasons for non-adoption of broadband service.

This collection of information is necessary to complete research done for the Broadband Plan on key consumer issues including transparency and actual speeds and performance of broadband service and broadband usage and performance in schools and libraries.

The Commission's Office of Engineering and Technology (OET), Office of Strategic Planning and Policy Analysis (OSPPA) and Consumer and Governmental Affairs Bureau (CGB) and other Commission entities use the information collected under this study to assess what actual broadband speeds and performance consumers are currently receiving from providers. Our purpose is to measure the speed of broadband services provided by ISPs across service packages and geographies, rather than to assess the differences in broadband performance received by demographics. This assessment will help the Commission create standards for broadband measurements, assess the validity of ISP performance claims, and inform future steps to increasing transparency and consumer awareness of broadband service.

Federal Communications Commission.

Marlene H. Dortch,

Secretary, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–01982 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Reviewed by the Federal Communications Commission

AGENCY: Federal Communications Commission.

ACTION: Notice and request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burdens, and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3520), the Federal Communications Commission (FCC or the Commission) invites the general public and other Federal agencies to take this opportunity to comment on the following information collection. Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information collection burden on small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid control number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the PRA that does not display a valid Office of Management and Budget (OMB) control number.

DATES: Written PRA comments should be submitted on or before April 1, 2014. If you anticipate that you will be submitting comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the contact listed below as soon as possible.

ADDRESSES: Direct all PRA comments to Cathy Williams, FCC, via email *PRA@fcc.gov mailto:PRA@fcc.gov* and to *Cathy.Williams@fcc.gov mailto:Cathy.Williams@fcc.gov.*

FOR FURTHER INFORMATION CONTACT: For additional information about the information collection, contact Cathy Williams at (202) 418–2918.

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–0863.

Title: Satellite Delivery of Network Signals to Unserved Households for Purposes of the Satellite Home Viewer Act.

Form Number: Not applicable.

Type of Review: Extension of a currently approved collection.

Respondents: Business or other for-profit entities.

Number of Respondents and Responses: 848 respondents; 250,000 responses.

Estimated Time per Response: 0.50 hours.

Frequency of Response: Recordkeeping requirement, On occasion reporting requirement.

Obligation to Respond: Required to obtain or retain benefits. Statutory authority for this information collection action is contained in the Satellite Home Viewer Act, 17 U.S.C. 119. The Satellite Home Viewer Act is an amendment of the Copyright Act; and Satellite Television Extension and Localism Act of 2010, Title V of the ''American Workers, State, and Business Relief Act of 2010,'' Public Law 111–175, 124 Stat. 1218 (2010) (STELA), see footnote 3.

Total Annual Burden to Respondents: 125,000 hours.

Total Annual Costs: None.

Privacy Impact Assessment(s): No impact(s).

Nature and Extent of Confidentiality: There is no need for confidentiality with this collection of information.

Needs and Uses: 47 CFR 73.686 describes a method for measuring signal strength at a household so that the satellite and broadcast industries would have a uniform method for making an actual determination of the signal strength that a household received. The information gathered as part of the Grade B contour signal strength tests will be used to indicate whether a household is ''unserved'' by over-the-air network signals.

Satellite and broadcast industries making field strength measurements for formal submission to the Commission in rulemaking proceedings, or making such measurements upon the request of the Commission, shall follow the procedure for making and reporting such measurements which shall be included in a report to the Commission and submitted in affidavit form, in triplicate. The report shall contain the following information:

(a) Tables of field strength measurements, which for each measuring location; (b) U.S. Geological Survey topographic maps; (c) All information necessary to determine the pertinent characteristics of the transmitting installation; (d) A list of calibrated equipment used in the field strength survey; (e) A detailed description of the calibration of the measuring equipment, and (f) Terrain profiles in each direction in which measurements were made.

47 CFR 73.686 also requires satellite and broadcast companies to maintain a written record describing, for each location, factors which may affect the recorded field (i.e., the approximate time or measurement, weather, topography, overhead wiring, heights and types of vegetation, buildings and other structures, the orientation of the measuring location, objects of such shape and size that cause shadows or reflections, signals received that arrived from a direction other than that of the

transmitter, survey, list of the measured value field strength, time and date of the measurements and signature of the person making the measurements).

47 CFR 73.686(e) describes the procedures for measuring the field strength of digital television signals. These procedures will be used to determine whether a household is eligible to receive a distant digital network signal from a satellite television provider, largely rely on existing, proven methods the Commission has already established for measuring analog television signal strength at any individual location, as set forth in Section 73.686(d) of the existing rules, but include modifications as necessary to accommodate the inherent differences between analog and digital TV signals. The new digital signal measurement procedures include provisions for the location of the measurement antenna, antenna height, signal measurement method, antenna orientation and polarization, and data recording.

Therefore, satellite and broadcast industries making field strength measurements shall maintain written records and include the following information: (a) A list of calibrated equipment used in the field strength survey, which for each instrument specifies the manufacturer, type, serial number and rated accuracy, and the date of the most recent calibration by the manufacturer or by a laboratory. Include complete details of any instrument not of standard manufacture; (b) A detailed description of the calibration of the measuring equipment, including field strength meters, measuring antenna, and connecting cable; (c) For each spot at the measuring site, all factors which may affect the recorded field, such as topography, height and types of vegetation, buildings, obstacles, weather, and other local features; (d) A description of where the cluster measurements were made; (e) Time and date of the measurements and signature of the person making the measurements; (f) For each channel being measured, a list of the measured value of field strength (in units of dBμ after adjustment for line loss and antenna factor) of the five readings made during the cluster measurement process, with the median value highlighted.

Federal Communications Commission.

Gloria J. Miles,

Federal Register *Liaison, Office of the Secretary, Office of Managing Director.*

[FR Doc. 2014–02007 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Notice of Public Information Collection(s) being Reviewed by the Federal Communications Commission, Comments Requested

AGENCY: Federal Communications Commission.

ACTION: Notice; request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501—3520), the Federal Communications Commission (FCC) invites the general public and other Federal agencies to take this opportunity to comment on the following information collection(s). Comments are requested concerning: Whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and further ways to reduce the information burden for small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB Control Number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the Paperwork Reduction Act (PRA) that does not display a valid Control Number.

DATES: Written Paperwork Reduction Act (PRA) comments should be submitted on or before April 1, 2014. If you anticipate that you will be submitting comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Leslie F. Smith, Federal Communications Commission (FCC), via the Internet at *Leslie.Smith@fcc.gov.* To submit your PRA comments by email, send them to *PRA@fcc.gov.*

FOR FURTHER INFORMATION CONTACT: For additional information, contact Leslie F. Smith at (202) 418–0217, or via the Internet at *PRA@fcc.gov.*

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–0816.

Title: Local Telephone Competition and Broadband Reporting, FCC Form 477.

Form Number: FCC Form 477.

Type of Review: Revision of a currently approved collection.

Respondents: Business or other for-profit entities; not-for-profit institutions; and state, local or tribal governments.

Number of Respondents and Responses: 2,002 respondents; 4,004 responses.

Estimated Time per Response: 327 hours.

Frequency of Response: Semi-annual reporting requirement.

Obligation to Respond: Mandatory. Statutory authority for this information collection is contained in 47 U.S.C. 4(i), 201, 218–220, 251–252, 271, 303(r), 332, and 403 of the Communications Act of 1934, as amended and section 706 of the Telecommunications Act of 1996, as amended, codified in section 1302 of the Broadband Data Improvement Act, 47 U.S.C. 1302.

Total Annual Burden: 1,549,548 hours.

Total Annual Cost: $68,335,067.

Privacy Impact Assessment (PIA): No impact(s).

Nature and Extent of Confidentiality: The Commission will continue to allow respondents to certify on the submission interface that some subscribership data contained in that submission are privileged or confidential commercial or financial information and that disclosure of such information would likely cause substantial harm to the competitive position of the entity making the submission. If the Commission receives a request for, or proposes to disclose such information, the respondent would be required to show, pursuant to Commission rules for withholding from public inspection information submitted to the Commission, that the information in question is entitled to confidential treatment. We will retain our current policies and procedures regarding the protection of submitted FCC Form 477 data subject to confidential treatment, including the use of only non-company specific aggregates of subscribership data in our published reports. Most of the broadband deployment data to be collected on Form 477 as a result of modifications will be made publicly available. NTIA currently publishes similar data on the National Broadband Map Web site at *www.broadbandmap.gov.* The Commission will coordinate with NTIA to continue the publication of the National Broadband Map using the data to be collected through modifications to

Form 477. The one exception is that mobile broadband and voice providers can request confidential treatment of their deployment data by spectrum band.

Needs and Uses: FCC Form 477 gathers information on the development of local telephone competition, including telephone services and interconnected Voice over Internet Protocol (VoIP) services, and on the deployment of broadband Internet access services. FCC staff use the information to advise the Commission about the efficacy of its rules and policies adopted to implement the Telecommunications Act of 1996. The data are necessary to evaluate the status of local telecommunications competition and broadband deployment. The Commission uses the data to prepare reports that help inform consumers and policy makers on the deployment and adoption of broadband services and on developments related to competition in the local telephone service market. The Commission also uses the data to support its analyses in a variety of rulemaking proceedings under the Communications Act, including those related to fulfilling its universal service mandate.

Federal Communications Commission.

Gloria J. Miles,

Federal Register Liaison, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–02006 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Notice of Public Information Collection(s) being Reviewed by the Federal Communications Commission, Comments Requested.

AGENCY: Federal Communications Commission.

ACTION: Notice; request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3520), the Federal Communications Commission (FCC) invites the general public and other Federal agencies to take this opportunity to comment on the following information collection(s). Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimate; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and further ways to reduce the information burden for small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB Control Number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the Paperwork Reduction Act (PRA) that does not display a valid Control Number.

DATES: Written Paperwork Reduction Act (PRA) comments should be submitted on or before April 1, 2014. If you anticipate that you will be submitting comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Leslie F. Smith, Federal Communications Commission (FCC), via the Internet at *Leslie.Smith@fcc.gov.* To submit your PRA comments by email, send them to *PRA@fcc.gov.*

FOR FURTHER INFORMATION CONTACT: For additional information, contact Leslie F. Smith at (202) 418–0217, or via the Internet at *PRA@fcc.gov.*

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–0589.

Title: FCC Remittance Advice Forms, FCC Form 159/159–C, 159–B, 159–E, and 159–W.

Form Number(s): FCC Form 159 Remittance Advice, 159–C Remittance Advice Continuation Sheet, 159–B Remittance Advice Bill for Collection, 159–E Remittance Voucher, and 159–W Interstate Telephone Service Provider Worksheet.

Type of Review: Extension of a currently approved collection.

Respondents: Individuals or households; Business or other for-profit entities; Not-for-profit institutions; Federal government; and State, local, or tribal governments.

Number of Respondents and Responses: 100,220 respondents; 100,220 responses.

Estimated Time per Response: 15 minutes (0.25 hours).

Frequency of Response: On occasion and annual reporting requirements; third party disclosure.

Obligation to Respond: Required to obtain or retain benefits. Statutory Authority for this information collection is contained in the Communications Act of 1934, as amended; Section 8 (47 U.S.C. 158) for Application Fees; Section 9 (47 U.S.C. 159) for Regulatory Fees; Section 309(j) for Auction Fees; and the Debt Collection Improvement Act of 1996, Public Law 104–134, Chapter 10, Section 31001.

Total Annual Burden: 25,055 hours.

Total Annual Cost: None.

Nature and Extent of Confidentiality: There is no need for confidentiality, except for personally identifiable information (PII) that individuals may submit on one or more of these forms. FCC Form 159 series instructions includes a Privacy Act Statement. Furthermore, while the Commission is not requesting that the respondents submit confidential information to the FCC, respondents may request confidential treatment for information they believe to be confidential under 47 CFR Section 0.459 of the Commission's rules. The Commission has a system of records notice (SORN), FCC/OMD–9, ''Commission Registration System (CORES),'' to cover any PII that individuals may submit. The SORN is posted on the FCC Privacy Web page at: *http://transition.fcc.gov/omd/privacyact/records-systems.html.*

Privacy Impact Assessment (PIA): A PIA has been done and is posted on the FCC Privacy Web page at: *http://transition.fcc.gov/omd/privacyact/Privacy_Impact_Assessment.html.*

Needs and Uses: The FCC supports a series of remittance advice forms and a remittance voucher form that may be submitted in lieu of a remittance advice form when entities or individuals electronically submit a payment. A remittance advice form (or a remittance voucher form in lieu of an advice form) must accompany any payment to the Federal Communications Commission (e.g. payments for regulatory fees, application filing fees, auctions, fines, forfeitures, Freedom of Information Act (FOIA) billings, or any other debt due to the FCC. Information is collected on these forms to ensure credit for full payment, to ensure entities and individuals receive any refunds due, to service public inquiries, and to comply with the Debt Collection Improvement Act of 1996.

Federal Communications Commission.

Gloria J. Miles,

Federal Register Liaison, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–01999 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL COMMUNICATIONS COMMISSION

Information Collection Being Submitted for Review and Approval to the Office of Management and Budget (OMB)

AGENCY: Federal Communications Commission (FCC).

ACTION: Notice; request for comments.

SUMMARY: As part of its continuing effort to reduce paperwork burden and as required by the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3502–3520), the FCC invites the general public and other Federal agencies to take this opportunity to comment on the following information collection. Comments are requested concerning: whether the proposed collection of information is necessary for the proper performance of the functions of the Commission, including whether the information shall have practical utility; the accuracy of the Commission's burden estimates; ways to enhance the quality, utility, and clarity of the information collected; ways to minimize the burden of the collection of information on the respondents, including the use of automated collection techniques or other forms of information technology; and ways to further reduce the information collection burden on small business concerns with fewer than 25 employees.

The FCC may not conduct or sponsor a collection of information unless it displays a currently valid OMB Control Number. No person shall be subject to any penalty for failing to comply with a collection of information subject to the PRA that does not display a valid OMB Control Number.

DATES: Written PRA comments should be submitted on or before March 3, 2014. If you anticipate that you will be submitting PRA comments, but find it difficult to do so within the period of time allowed by this notice, you should advise the FCC contact listed below as soon as possible.

ADDRESSES: Submit your PRA comments to Nicholas A. Fraser, Office of Management and Budget (OMB), via fax at 202–395–5167, or via the Internet at *Nicholas_A._Fraser@omb.eop.gov* and to Leslie Smith, Office of Managing Director (OMD), Federal Communications Commission (FCC), via the Internet at *Leslie.Smith@fcc.gov* . To submit your PRA comments by email, send them to: *PRA@fcc.gov.*

FOR FURTHER INFORMATION CONTACT: Leslie Smith, OMD, FCC, at 202–418–0217, or via the Internet at: *Leslie.Smith@fcc.gov.*

SUPPLEMENTARY INFORMATION:

OMB Control Number: 3060–1188.

Title: Connect America Challenge Process and Certifications, FCC Form 505.

Form Number: FCC Form 505.

Type of Review: Revision of a currently approved collection.

Respondents: Business or other for-profit, not-for-profit institutions and state, local or tribal government.

Number of Respondents and Responses: 178 respondents; 178 responses.

Estimated Time per Response: 3 hours to 20 hours.

Frequency of Response: On occasion and annual reporting requirements and third party disclosure requirements.

Obligation to Respond: Required to obtain or retain benefits. Statutory authority for this information collection is contained in 47 U.S.C. 151, 154(i)-(j), 155, 201(b), 214, 218–220, 254, and 1302 of the Communications Act of 1934, as amended.

Total Annual Burden: 1,793 hours.

Total Annual Cost: None.

Privacy Impact Assessment: No impact(s).

Nature and Extent of Confidentiality: The Commission is not requesting respondents to submit confidential information to the Commission. However, respondents may request materials or information submitted to the Commission or to the Administrator be withheld from public inspection under 47 CFR 0.459 of the Commission's rules. We note that USAC must preserve the confidentiality of all data obtained from respondents; must not use the data except for purposes of administering the universal service programs; and must not disclose data in company-specific form unless directed by the Commission to do so.

Needs and Uses: In November 2011, the Commission adopted an order reforming its high-cost universal service support mechanisms. *Connect America Fund; A National Broadband Plan for Our Future; Establish Just and Reasonable Rates for Local Exchange Carriers; High-Cost Universal Service Support; Developing a Unified Intercarrier Compensation Regime; Federal-State Joint Board on Universal Service; Lifeline and Link-Up; Universal Service Reform—Mobility Fund,* WC Docket Nos. 10–90, 07–135, 05–337, 03–109; GN Docket No. 09–51; CC Docket Nos. 01–92, 96–45; WT Docket No. 10–208, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd 17663 (2011) (*USF/ICC Transformation Order*).

As part of the *USF/ICC Transformation Order,* the Commission adopted several subsequent Orders for implementing the Connect American Phase I and Phase II funding:

On May 16, 2013, the Commission adopted a second *Connect America Fund,* Report and Order, WC Docket No. 10–90, DA 13–1113. The Report and Order set forth the format and substance of the submissions carriers must make to elect Phase II funding through the state-level commitment process. Additionally, this Report and Order established the parameters for the Connect America Phase II challenge process. These parameters included requirements for what parties must submit to the Commission when making a challenge, as well as the form that parties must use in making any challenges New requirements being proposed in this information collection are the Geocoded Information for Phase I Two- and Three-Year Milestone Reports; Broadband Initiatives Program/Broadband Technology Opportunities Program Annual Milestone Reports; Phase I Investment Annual Milestone Reports; Changes in Phase I Deployments; and Connect America Phase II State-Level Commitment Elections. There will also be a 533 hour increase in the estimated hourly burden.

On May 21, 2013, the Commission adopted a third *Connect America Fund,* Report and Order, WC Docket No. 10–90, FCC 13–73. This Report and Order provided for a second round of Connect America Phase I support and specified what certifications and reporting requirements carriers must comply with if electing to accept second round support.

These Orders contained information collection requirements for which the Commission received OMB approval following an emergency request in a Notice of Action on July 9, 2013.

Then on July 15, 2013, the Commission adopted the *Connect America Fund,* Order on Reconsideration, WC Docket No. 10–90, FCC 13–97, which modified a reporting requirement contained in the May 21, 2013 Report and Order. The Order on Reconsideration made mandatory the reporting of changes in deployment locations involving census blocks that were not previously identified. This reporting had previously been optional under the original Report and Order.

This revised information collection addresses these additional requirements to carry out the programs set forth in the *USF/ICC Transformation Order.* This submission also includes an extension of the certifications related to second round Phase I funding and the requirements contained in FCC Form 505, ''Connect America Phase II

Challenge Process Form.'' Finally, the Commission has made some minor edits to the FCC Form 505 and its instructions.

Federal Communications Commission.

Marlene H. Dortch,

Secretary, Office of the Secretary, Office of Managing Director.

[FR Doc. 2014–01981 Filed 1–30–14; 8:45 am]

BILLING CODE 6712–01–P

FEDERAL DEPOSIT INSURANCE CORPORATION

Update to Notice of Financial Institutions for Which the Federal Deposit Insurance Corporation has been Appointed Either Receiver, Liquidator, or Manager

AGENCY: Federal Deposit Insurance Corporation

ACTION: Update Listing of Financial Institutions in Liquidation

SUMMARY: Notice is hereby given that the Federal Deposit Insurance Corporation (Corporation) has been appointed the sole receiver for the following financial institutions effective as of the Date Closed as indicated in the listing. This list (as updated from time to time in the **Federal Register**) may be relied upon as ''of record'' notice that the Corporation has been appointed receiver for purposes of the statement of policy published in the July 2, 1992 issue of the **Federal Register** (57 FR 29491). For further information concerning the identification of any institutions which have been placed in liquidation, please visit the Corporation Web site at www.fdic.gov/bank/individual/failed/banklist.html or contact the Manager of Receivership Oversight in the appropriate service center.

Dated: January 27, 2014.

Federal Deposit Insurance Corporation.

Pamela Johnson,

Regulatory Editing Specialist.

INSTITUTIONS IN LIQUIDATION

[In alphabetical order]

FDIC Ref. No.	Bank name	City	State	Date closed
10493	The Bank of Union	El Reno	OK	1/24/2014

[FR Doc. 2014–02056 Filed 1–30–14; 8:45 am]

BILLING CODE 6714–01–P

FEDERAL ELECTION COMMISSION

Sunshine Act Meetings

AGENCY: Federal Election Commission.

TIME AND DATE: *Tuesday, February 4, 2014 at 10 a.m.*

PLACE: 999 E Street NW., Washington, DC.

STATUS: This meeting will be closed to the public.

MATTERS TO BE DISCUSSED:

Compliance matters pursuant to 2 U.S.C. 437g.

Matters concerning participation in civil actions or proceedings or arbitration.

Information the premature disclosure of which would be likely to have a considerable adverse effect on the implementation of a proposed Commission action.

* * * * *

CONTACT PERSON FOR MORE INFORMATION:

Judith Ingram, Press Officer, Telephone: (202) 694–1220.

Shelley Garr,

Deputy Secretary of the Commission.

[FR Doc. 2014–02119 Filed 1–29–14; 11:15 am]

BILLING CODE 6715–01–P

FEDERAL RESERVE SYSTEM

Formations of, Acquisitions by, and Mergers of Bank Holding Companies

The companies listed in this notice have applied to the Board for approval, pursuant to the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*) (BHC Act), Regulation Y (12 CFR part 225), and all other applicable statutes and regulations to become a bank holding company and/or to acquire the assets or the ownership of, control of, or the power to vote shares of a bank or bank holding company and all of the banks and nonbanking companies owned by the bank holding company, including the companies listed below.

The applications listed below, as well as other related filings required by the Board, are available for immediate inspection at the Federal Reserve Bank indicated. The applications will also be available for inspection at the offices of the Board of Governors. Interested persons may express their views in writing on the standards enumerated in the BHC Act (12 U.S.C. 1842(c)). If the proposal also involves the acquisition of a nonbanking company, the review also includes whether the acquisition of the nonbanking company complies with the standards in section 4 of the BHC Act (12 U.S.C. 1843). Unless otherwise noted, nonbanking activities will be conducted throughout the United States.

Unless otherwise noted, comments regarding each of these applications must be received at the Reserve Bank indicated or the offices of the Board of Governors not later than February 27, 2014.

A. Federal Reserve Bank of Minneapolis (Jacqueline K. Brunmeier, Assistant Vice President) 90 Hennepin Avenue, Minneapolis, Minnesota 55480–0291:

1. *Stearns Financial Services, Inc. Employee Stock Ownership Plan,* Saint Cloud, Minnesota; to retain and acquire additional voting shares, for a total of 26 percent, of Stearns Financial Services, Inc., and thereby indirectly acquire additional voting shares of Stearns Bank National Association, both in Saint Cloud, Minnesota, Stearns Bank of Upsala, National Association, Upsala, Minnesota, and Stearns Bank of Holdingford, National Association, Holdingford, Minnesota.

Board of Governors of the Federal Reserve System, January 28, 2014.

Michael J. Lewandowski,

Associate Secretary of the Board.

[FR Doc. 2014–01998 Filed 1–30–14; 8:45 am]

BILLING CODE 6210–01–P

FEDERAL TRADE COMMISSION

[File No. 131 0202]

Community Health Systems, Inc. and Health Management Associates, Inc.; Analysis of Agreement Containing Consent Orders to Aid Public Comment

AGENCY: Federal Trade Commission.

ACTION: Proposed Consent Agreement.

SUMMARY: The consent agreement in this matter settles alleged violations of federal law prohibiting unfair methods of competition. The attached Analysis of Agreement Containing Consent Orders to Aid Public Comment describes both the allegations in the draft complaint and the terms of the consent orders—embodied in the consent agreement—that would settle these allegations.

DATES: Comments must be received on or before February 21, 2014.

ADDRESSES: Interested parties may file comments at *https://ftcpublic.commentworks.com/ftc/chshealthmanagementconsent* online or on paper, by following the instructions in the Request for Comments part of the **SUPPLEMENTARY INFORMATION** section below. Write ''Community Health Systems, Inc., and Health Management Associates, Inc.—Consent Agreement; File No. 131–0202'' on your comment and file your comment online at *https://ftcpublic.commentworks.com/ftc/chshealthmanagementconsenthttps://ftcpublic.commentworks.com/ftc/fidelitynationalconsent* by following the instructions on the web-based form. If you prefer to file your comment on paper, mail or deliver your comments to the following address: Federal Trade Commission, Office of the Secretary, Room H–113 (Annex D), 600 Pennsylvania Avenue NW., Washington, DC 20580.

FOR FURTHER INFORMATION CONTACT: Katherine A. Ambrogi, Bureau of Competition, (202–326–2205), 600 Pennsylvania Avenue NW., Washington, DC 20580.

SUPPLEMENTARY INFORMATION: Pursuant to Section 6(f) of the Federal Trade Commission Act, 15 U.S.C. 46(f), and FTC Rule 2.34, 16 CFR 2.34, notice is hereby given that the above-captioned consent agreement containing consent orders to cease and desist, having been filed with and accepted, subject to final approval, by the Commission, having been placed on the public record for a period of thirty (30) days. The following Analysis to Aid Public Comment describes the terms of the consent agreement, and the allegations in the complaint. An electronic copy of the full text of the consent agreement package can be obtained from the FTC Home Page (for January 22, 2014), on the World Wide Web, at *http://www.ftc.gov/os/actions.shtm.* A paper copy can be obtained from the FTC Public Reference Room, Room 130–H, 600 Pennsylvania Avenue NW., Washington, DC 20580, either in person or by calling (202) 326–2222.

You can file a comment online or on paper. For the Commission to consider your comment, we must receive it on or before February 21, 2014. Write ''Community Health Systems, Inc., and Health Management Associates, Inc.—Consent Agreement; File No. 131–0202'' on your comment. Your comment—including your name and your state—will be placed on the public record of this proceeding, including, to the extent practicable, on the public Commission Web site, at *http://www.ftc.gov/os/publiccomments.shtm.* As a matter of discretion, the Commission tries to remove individuals' home contact information from comments before placing them on the Commission Web site.

Because your comment will be made public, you are solely responsible for making sure that your comment does not include any sensitive personal information, like anyone's Social Security number, date of birth, driver's license number or other state identification number or foreign country equivalent, passport number, financial account number, or credit or debit card number. You are also solely responsible for making sure that your comment does not include any sensitive health information, like medical records or other individually identifiable health information. In addition, do not include any ''[t]rade secret or any commercial or financial information which . . . is privileged or confidential,'' as discussed in Section 6(f) of the FTC Act, 15 U.S.C. 46(f), and FTC Rule 4.10(a)(2), 16 CFR 4.10(a)(2). In particular, do not include competitively sensitive information such as costs, sales statistics, inventories, formulas, patterns, devices, manufacturing processes, or customer names.

If you want the Commission to give your comment confidential treatment, you must file it in paper form, with a request for confidential treatment, and you have to follow the procedure explained in FTC Rule 4.9(c), 16 CFR 4.9(c).[1] Your comment will be kept confidential only if the FTC General Counsel, in his or her sole discretion, grants your request in accordance with the law and the public interest.

Postal mail addressed to the Commission is subject to delay due to heightened security screening. As a result, we encourage you to submit your comment online. To make sure that the Commission considers your online comment, you must file it at *https://ftcpublic.commentworks.com/ftc/chshealthmanagementconsent* by following the instructions on the web-based forms. If this Notice appears at *http://www.regulations.gov/#!home,* you also may file a comment through that Web site.

If you file your comment on paper, write ''Community Health Systems, Inc., and Health Management Associates, Inc.—Consent Agreement; File No. 131–0202'' on your comment and on the envelope, and mail or deliver it to the following address: Federal Trade Commission, Office of the Secretary, Room H–113 (Annex D), 600 Pennsylvania Avenue NW., Washington, DC 20580. If possible, submit your paper comment to the Commission by courier or overnight service.

Visit the Commission Web site at *http://www.ftc.gov* to read this Notice and the news release describing it. The FTC Act and other laws that the Commission administers permit the collection of public comments to consider and use in this proceeding as appropriate. The Commission will consider all timely and responsive public comments that it receives on or before February 21, 2014. You can find more information, including routine uses permitted by the Privacy Act, in the Commission's privacy policy, at *http://www.ftc.gov/ftc/privacy.htm.*

Analysis of Agreement Containing Consent Orders To Aid Public Comment

I. Introduction and Background

The Federal Trade Commission (''Commission'') has accepted for public comment, subject to final approval, an Agreement Containing Consent Orders (''Consent Agreement'') from Community Health Systems, Inc. (''CHS'') and Health Management Associates, Inc. (''HMA''). The purpose of the proposed Consent Agreement is to remedy the anticompetitive effects that otherwise would result from CHS's acquisition of HMA. The proposed Consent Agreement requires CHS to divest the Riverview Regional Medical Center (''Riverview'') and all associated operations and businesses in and around Gadsden, Alabama, and the Carolina Pines Regional Medical Center (''Carolina Pines'') and all associated operations and businesses in and around Hartsville, South Carolina, to a Commission-approved acquirer, and in a manner approved by the Commission, within six months after the Decision and Order is issued. Under the proposed Consent Agreement, CHS also is required to hold separate the to-be-divested assets and maintain the

[1] In particular, the written request for confidential treatment that accompanies the comment must include the factual and legal basis for the request, and must identify the specific portions of the comment to be withheld from the public record. *See* FTC Rule 4.9(c), 16 CFR 4.9(c).

economic viability, marketability, and competitiveness of the divestiture assets, until the potential acquirer is approved by the Commission and the divestiture is complete. Finally, CHS is required to provide the Commission prior notice of any acquisition of a GAC services provider in the Gadsden Metropolitan Statistical Area and the Florence Metropolitan Statistical Area for ten years.

The proposed Consent Agreement has been placed on the public record for thirty days to solicit comments from interested persons. Comments received during this period will become part of the public record. After thirty days, the Commission again will review the proposed Consent Agreement and comments received, and decide whether it should withdraw the Consent Agreement, modify the Consent Agreement, or make it final.

On July 29, 2013, CHS and HMA signed a merger agreement pursuant to which CHS agreed to acquire HMA for $7.6 billion. The Commission's complaint alleges that the proposed acquisition, if consummated, would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. 45, by removing an actual, direct, and substantial competitor from two local markets in Alabama and South Carolina for general acute care inpatient services sold to commercial health plans. The proposed Consent Agreement would remedy the alleged violations by requiring complete divestitures in the affected markets. The divestitures will replace the competition that otherwise would be lost in the Alabama and South Carolina markets because of the proposed acquisition.

II. The Parties

Headquartered in Franklin, Tennessee, CHS is a for-profit health system that owns 135 hospitals with approximately 20,000 licensed beds in 29 states. CHS is the second-largest U.S. hospital chain and one of the largest publicly-traded operators of hospitals in the United States. CHS generated approximately $13 billion in revenue in 2012.

HMA is a for-profit health system headquartered in Naples, Florida that owns 71 hospitals in 15 states, primarily in the southeastern United States. In 2012, HMA generated $5.9 billion in revenue.

III. General Acute Care Inpatient Services

CHS's proposed acquisition of HMA poses substantial antitrust concerns in the relevant product market of general acute care inpatient services (''GAC services'') provided to commercially insured patients. GAC services consist of a broad cluster of routine inpatient services that require an overnight hospital stay. They are sold to commercial health plans, which sell benefit plans to commercially insured patients. GAC services do not include services related to psychiatric care, substance abuse, and rehabilitation services. Likewise, outpatient services are not included in GAC services because such services are characterized by different competitive conditions (*e.g.,* different competitors, lower entry barriers) and because health plans and their members generally cannot substitute those services for inpatient services in response to a small but significant and non-transitory increase in price.

GAC services markets are local in nature. Evidence gathered from market participants shows that patients strongly prefer to receive care as close to home as possible and to stay within the area where they live or work. Accordingly, the proposed acquisition raises serious antitrust concerns in two local markets for patients seeking GAC services: (1) The area that approximates Etowah County and includes the City of Gadsden, Alabama (the ''Gadsden Area''); and (2) the area that approximates Darlington County, South Carolina (the ''Darlington County Area'').

The proposed acquisition would combine the only two competitively meaningful hospitals providing GAC services to Gadsden Area patients—HMA's Riverview and CHS's Gadsden Regional Medical Center (''Gadsden Regional''). The Gadsden Area market already is highly concentrated, and the proposed merger would substantially increase concentration in that market absent relief. Post-merger, commercially insured patients in the Gadsden Area would have only CHS's hospitals as meaningful options to obtain GAC services. The presumption of anticompetitive harm created by such high levels of market concentration is supported by evidence of the close competition between Riverview and Gadsden Regional that would be eliminated by the proposed merger. Consumers in the Gadsden Area have benefited from this head-to-head competition in the form of lower health care costs and higher quality of care. Absent relief, CHS would gain additional leverage and be able to demand higher reimbursement rates from commercial health plans, and would have reduced incentives to maintain and improve its quality of care. Ultimately, these effects are felt by local patients in the form of higher premiums, co-pays, and out-of-pocket costs, as well as reduced access to high-quality care.

In South Carolina, the proposed acquisition would combine two of only three competitively meaningful hospitals providing GAC services to Darlington County Area commercially insured patients—HMA's Carolina Pines and CHS's Carolinas Hospital-Florence (''Carolinas Hospital''). Third-party McLeod Regional Medical Center (''McLeod Regional'') also serves the Darlington County Area. The Darlington County Area market is highly concentrated, and the proposed merger would substantially increase concentration in that market absent relief. Post-merger, commercially insured patients in the Darlington County Area would have only two meaningful options for GAC services—either a CHS-owned hospital or third-party McLeod Regional. The presumption of anticompetitive harm is supported by evidence of the close competition between Carolina Pines and Carolinas Hospital that would be eliminated by the proposed merger. Consumers in the Darlington County Area have benefited from this head-to-head competition in the form of lower health care costs and higher quality of care. Absent relief, CHS would gain additional leverage and be able to demand higher reimbursement rates from commercial health plans, and would have reduced incentives to maintain and improve its quality of care. Ultimately, these effects are felt by local patients in the form of higher premiums, co-pays, and out-of-pocket costs, as well as reduced access to high-quality care.

New entry or expansion is unlikely to deter or counteract the anticompetitive effects of the proposed acquisition in either market. Alabama's Certificate of Need (''CON'') statute poses a regulatory hurdle that must be overcome before constructing new healthcare facilities, expanding or modifying existing facilities, or altering inpatient services. South Carolina has a similar CON statute. Significant entry barriers also include the time and costs associated with constructing or expanding a general acute care hospital. There is no evidence of planned entry into either market or any evidence that there is unmet demand for GAC services in either market that might spur entry or expansion. Thus, it is unlikely that new entry or expansion sufficient to achieve a significant market impact will occur in a timely manner in either market.

IV. The Proposed Consent Agreement

The proposed Consent Agreement remedies the anticompetitive concerns in both local markets. The proposed Consent Agreement would maintain competition in the Gadsden Area by requiring CHS to divest Riverview and its associated operations and businesses. Similarly, the proposed Consent Agreement would fully maintain competition in the Darlington County Area by requiring CHS to divest Carolina Pines and its associated operations and businesses. Any potential buyer for either hospital is subject to the prior approval of the Commission.

The proposed Consent Agreement also requires CHS to provide transitional services to the approved acquirers for one year, as needed, to assist the acquirers with operating the divested assets as viable and ongoing businesses. Until the divestitures are completed, CHS is required to hold Riverview and Carolina Pines separate, subject to the standard terms of the Order to Hold Separate and Maintain Assets. The proposed order also appoints Curtis Lane, the senior managing director of MTS Health Partners, LP, as Hold Separate Monitor to oversee CHS's compliance with the Order to Hold Separate and Maintain Assets. Finally, the proposed order contains a ten-year prior notice requirement for acquisitions of GAC services providers in the Gadsden, Alabama Metropolitan Statistical Area or in the Florence, South Carolina Metropolitan Statistical Area, as well as compliance reporting requirements.

The hospitals to be divested are each stand-alone businesses and include all of the assets and real property necessary for a Commission-approved buyer to compete immediately and effectively in each relevant market. In addition to divestiture of the actual facilities at issue, CHS has agreed to divest the rights to all intellectual property, including the facility names, and all provider and health plan contracts associated with the facilities. Although the competitive concerns relate to GAC services to commercially insured patients only, the proposed order contemplates divestiture of all services and operations that are affiliated with the facility or facilities to be divested that are necessary to be a viable business. Specifically, CHS will divest all outpatient operations and businesses, including outpatient physician practices, associated with each hospital. This requirement is consistent with similar divestitures in prior Commission actions.

The sole purpose of this analysis is to facilitate public comment on the Consent Agreement. This analysis does not constitute an official interpretation of the Consent Agreement or modify its terms in any way.

By direction of the Commission.

Donald S. Clark,

Secretary.

[FR Doc. 2014–01942 Filed 1–30–14; 8:45 am]

BILLING CODE 6750–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Request for Comments on the Ethical Considerations of Neuroscience Research and the Application of Neuroscience Research Findings

AGENCY: Department of Health and Human Services, Office of the Secretary, Presidential Commission for the Study of Bioethical Issues.

ACTION: Notice.

SUMMARY: The Presidential Commission for the Study of Bioethical Issues is requesting public comment on the ethical considerations of neuroscience research and the application of neuroscience research findings.

DATES: To ensure consideration, comments must be received by April 1, 2014. Comments received after this date will be considered only as time permits.

ADDRESSES: Individuals, groups, and organizations interested in commenting on this topic may submit comments by email to *info@bioethics.gov* or by mail to the following address: Public Commentary, Presidential Commission for the Study of Bioethical Issues, 1425 New York Ave. NW., Suite C–100, Washington, DC 20005.

FOR FURTHER INFORMATION CONTACT: Hillary Wicai Viers, Communications Director, Presidential Commission for the Study of Bioethical Issues. Telephone: 202–233–3960. E-Mail: *hillary.viers@bioethics.gov.* Additional information may be obtained at *http://www.bioethics.gov.*

SUPPLEMENTARY INFORMATION: On November 24, 2009, the President established the Presidential Commission for the Study of Bioethical Issues (the Commission) to advise him on bioethical issues generated by novel and emerging research in biomedicine and related areas of science and technology. The Commission is charged with identifying and promoting policies and practices that ensure ethically responsible conduct of scientific research and health care delivery. Undertaking these duties, the Commission seeks to identify and examine specific bioethical, legal, and social issues related to potential scientific and technological advances; examine diverse perspectives and possibilities for international collaboration on these issues; and recommend legal, regulatory, or policy actions as appropriate.

The Commission is considering the conduct and implications of neuroscience research. On July 1, 2013, the President asked the Commission to ''identify proactively a set of core ethical standards—both to guide neuroscience research and to address some of the ethical dilemmas that may be raised by the application of neuroscience research findings.'' The President requested that the Commission seek input from ''scientists, ethicists, legal scholars, and members of the public'' to inform its deliberations.

The Commission is interested in receiving comments from individuals, groups, and professional communities regarding the ethical considerations of neuroscience research and the application of neuroscience research findings. The Commission is particularly interested in receiving public commentary regarding:

- The diversity and scope of ethical considerations related to neuroscience as a field;
- core ethical standards that guide neuroscience research, including consistency (or lack thereof) across disciplines, and potential tension among the guiding standards;
- advances in neuroscience research that raise novel ethical issues or heighten existing ethical tensions;
- whether emphasis on particular aspects of the Common Rule (or other research ethics regulations) is needed given the particular implications of some neuroscience research or whether any part of the Common Rule needs clarification in order to adequately protect participants in neuroscience research specifically;
- potential implications of discoveries that might flow from studies of the brain and questions that might arise from neuroscience research findings and their applications, including questions about the potential implications for privacy, personal agency, and moral responsibility for one's actions; stigmatization and discrimination; and the appropriate use of neuroscience in the justice system;
- strategies for integrating from a project's inception ethical considerations into neuroscience research, technological development, and scientific research generally; and

• ethical considerations concerning communication about neuroscience research and neuroscience research applications by scientists, journalists, and others.

To this end, the Commission is inviting interested parties to provide input and advice through written comments.

Comments will be publicly available, including any personally identifiable or confidential business information that they contain. Trade secrets should not be submitted.

Dated: January 17, 2014.

Lisa M. Lee,

Executive Director, Presidential Commission for the Study of Bioethical Issues.

[FR Doc. 2014–02072 Filed 1–30–14; 8:45 am]

BILLING CODE 4154–06–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Committee on Vital and Health Statistics: Meeting Standards Subcommittee

Pursuant to the Federal Advisory Committee Act, the Department of Health and Human Services (HHS) announces the following advisory committee meeting.

Name: National Committee on Vital and Health Statistics (NCVHS) Subcommittee on Standards.

Time and Date: February 19, 2014 9:00 p.m.–5:00 p.m. EST.

Place: Hubert H. Humphrey Building; 200 Independence Avenue SW., Room 705A, Washington, DC 20201. Public attendees should call (202) 690–7100 for admission to the meeting room on the day of the meeting.

Status: Open.

Purpose: The purpose of this hearing is to gather industry input on the status of selected administrative simplification topics that are a priority for 2014, including the status of development of Operating Rules for all remaining HIPAA transactions (Claims, Enrollment, Premium Payment, Prior Authorization, Claims Attachments). The meeting will also include a discussion of: the status of initial implementation of Operating Rules for Electronic Funds Transfer and Electronic Remittance Advice, which began January 1, 2014; the ICD–10 transition, in particular, the use of ICD–10 by property/casualty and workers' compensation programs; plans for adoption and use of Health Plan ID; and a review of recommendations from the Designated Standards Maintenance Organizations (DSMO) regarding the Pharmacy Prior Authorization Standard.

Contact Person For More Information: Debbie M. Jackson, Acting Executive Secretary, NCVHS, National Center for Health Statistics, Centers for Disease Control and Prevention, 2339 Toledo Road, Room 2402, Hyattsville, Maryland 20782, telephone (301) 458–4614 or Kamahanahokulani Farrar, Centers for Medicare and Medicaid Services, Office of E-Health Standards and Services, 7500 Security Boulevard, Baltimore, Maryland, 21244, telephone (410) 786–6711. Program information as well as summaries of meetings and a roster of committee members are available on the NCVHS home page of the HHS Web site: *http://www.ncvhs.hhs.gov/,* where further information including an agenda will be posted when available.

Should you require reasonable accommodation, please contact the CDC Office of Equal Employment Opportunity on (301) 458–4EEO (4336) as soon as possible.

Dated: January 24, 2014.

James Scanlon,

Deputy Assistant Secretary for Planning and Evaluation (Science and Data Policy), Office of the Assistant Secretary for Planning and Evaluation.

[FR Doc. 2014–02067 Filed 1–30–14; 8:45 am]

BILLING CODE 4151–05–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Committee on Vital and Health Statistics: Meeting Full Committee

Pursuant to the Federal Advisory Committee Act, the Department of Health and Human Services (HHS) announces the following advisory committee meeting.

Name: National Committee on Vital and Health Statistics (NCVHS), Full Committee Meeting.

Time and Date: February 20, 2014 9:00 a.m.–5:30 p.m. EDT. February 21, 2014 8:00 a.m.–12:00 p.m. EDT.

Place: Hubert H. Humphrey Building, 200 Independence Avenue SW., Room 705A, Washington, DC 20201. Public attendees should call (202) 690–7100 for admission to the meeting room on the day of the meeting.

Status: Open.

Purpose: The purpose of this meeting is to review NCVHS Status of Activities, to strategically plan for 2014 objectives and deliverables, and review and approve three action items: (1) The Committee's HIPAA Report to Congress; (2) a recommendation letter on population health data standards; and, (3) a recommendation letter on capacity submitted by the Working Group on Data Access and Use. The Committee will also be briefed on a presentation given to the HHS Data Council on the Committee's strategic plans to Support Communities as Learning Health Systems. The Working Group on HHS Data Access and Use will continue strategic discussions on community data issues.

The times shown above are for the full Committee meeting. Subcommittee issues will be included as part of the Full Committee schedule and identified as ''blocks'' on the afternoon of the first day and morning the second day. Agendas for these block sessions will be developed later and posted on the NCVHS Web site (URL below) when available.

Contact Person For More Information: Substantive program information may be obtained from Debbie M. Jackson, Acting Executive Secretary, NCVHS, National Center for Health Statistics, Centers for Disease Control and Prevention, 2339 Toledo Road, Room 2402, Hyattsville, Maryland 20782, telephone (301) 458–4614 or Kamahanahokulani Farrar, Centers for Medicare and Medicaid Services, Office of E-Health Standards and Services, 7500 Security Boulevard, Baltimore, Maryland, 21244, telephone (410) 786–6711. Summaries of meetings and a roster of committee members are available on the NCVHS home page of the HHS Web site: *http://www.ncvhs.hhs.gov/,* where further information including an agenda will be posted when available.

Should you require reasonable accommodation, please contact the CDC Office of Equal Employment Opportunity on (301) 458–4EEO (4336) as soon as possible.

Dated: January 24, 2014.

James Scanlon,

Deputy Assistant Secretary for Planning and Evaluation (Science and Data Policy), Office of the Assistant Secretary for Planning and Evaluation.

[FR Doc. 2014–02070 Filed 1–30–14; 8:45 am]

BILLING CODE 4151–05–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

[30Day–14–14BE]

Agency Forms Undergoing Paperwork Reduction Act Review

The Centers for Disease Control and Prevention (CDC) publishes a list of information collection requests under review by the Office of Management and Budget (OMB) in compliance with the Paperwork Reduction Act (44 U.S.C. Chapter 35). To request a copy of these requests, call (404) 639–7570 or send an email to *omb@cdc.gov.* Send written comments to CDC Desk Officer, Office of Management and Budget, Washington, DC 20503 or by fax to (202) 395–5806. Written comments should be received within 30 days of this notice.

Proposed Project

CDC Worksite Health Scorecard—New—National Center for Chronic Disease Prevention and Health Promotion (NCCDPHP), Centers for Disease Control and Prevention (CDC).

Background and Brief Description

The Centers for Disease Control and Prevention (CDC) is establishing the Worksite Health Scorecard, an online organizational assessment tool, to enable employers to assess the number of evidence-based health promotion

interventions or strategies in their worksites to prevent heart disease, stroke, and related conditions such as hypertension, diabetes, and obesity. The CDC Worksite Health Scorecard will support small, mid-size, and large employer with three primary goals: (1) Reduce the risk of chronic disease among employees and their families through science-based workplace health interventions and promising practices; (2) Assist employers in identifying gaps in their health promotion programs, and help them to prioritize high-impact strategies for health promotion at their worksites; and (3) Increase understanding of the organizational programs, policies, and practices that employers of various sizes and industry sectors have implemented to support healthy lifestyle behaviors and monitor changes over time.

CDC will provide outreach to and register approximately 600 employers per year to use the online survey which is open to employers of all sizes, industry sectors, and geographic locations across the country. Worksite Health Scorecard users will create a user account, complete the online assessment and receive an immediate feedback report that summarizes the current status of their worksite health program; identifies gaps in current programming; benchmarks individual employer results against other users of the system; and provides access to worksite health tools and resources to address employer gaps and priority program areas.

CDC will use the information collected to evaluate the effectiveness of the Worksite Health Scorecard in terms of (1) identifying success drivers for building and maintaining successful workplace health programs; (2) raising awareness and knowledge of science-based worksite health programs, policies and practices; and (3) develop additional worksite health tools and resources for employers. The information will also be used to evaluate the impact of the CDC Worksite Health Scorecard on employer adoption of worksite health programs, policies, and environmental supports.

OMB approval is requested for three years. Participation in the CDC Worksite Health Scorecard is voluntary and there are no costs to participants other than their time. The total estimated annualized burden hours are 300.

ESTIMATED ANNUALIZED BURDEN HOURS

Type of respondent	Form name	Number of respondents	Number of responses per respondent	Average burden per response (in hr)
Employers	CDC Worksite Health Scorecard	600	1	30/60

Leroy Richardson,

Chief, Information Collection Review Office, Office of Scientific Integrity, Office of the Associate Director for Science, Office of the Director, Centers for Disease Control and Prevention.

[FR Doc. 2014–02026 Filed 1–30–14; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

[30Day 14–0955]

Agency Forms Undergoing Paperwork Reduction Act Review

The Centers for Disease Control and Prevention (CDC) publishes a list of information collection requests under review by the Office of Management and Budget (OMB) in compliance with the Paperwork Reduction Act (44 U.S.C. Chapter 35). To request a copy of these requests, call (404) 639–7570 or send an email to *omb@cdc.gov.* Send written comments to CDC Desk Officer, Office of Management and Budget, Washington, DC 20503 or by fax to (202) 395–5806. Written comments should be received within 30 days of this notice.

Proposed Project

Early Hearing Detection and Intervention—Pediatric Audiology Links to Service (EHDI-PALS) Survey (0920–0955, Expiration 02/28/2014)—Revision—National Center on Birth Defects and Developmental Disabilities (NCBDDD), Centers for Disease Control and Prevention (CDC).

Background and Brief Description

The Division of Human Development and Disability, located within NCBDDD, promotes the health of babies, children, and adults, with a focus on preventing birth defects and developmental disabilities and optimizing the health outcomes of those with disabilities. Since the passage of the Early Hearing Detection and Intervention (EHDI) Act, 97% of newborn infants are now screened for hearing loss prior to hospital discharge. However, many of these infants have not received needed hearing tests and follow up services after their hospital discharges. The 2011 national average loss to follow-up/loss to documentation rate is at 35%. This rate remains an area of critical concern for state EHDI programs and CDC–EHDI team's goal of timely diagnosis by 3 months of age and intervention by 6 months of age.

Many states cite the lack of audiology resources as the main factor behind the high loss to follow up. To compound the problem, many pediatric audiologists may be proficient evaluating children age 5 and older but are not proficient with diagnosing infants or younger children because children age 5 and younger require a different skill set.

No existing literature or database was available to help states verify and quantify their states' true follow up capacity until this project went live in 2013.

Meeting since April 2010, the EHDI-PALS workgroup has sought consensus on the loss to follow up/loss to documentation issue facing the EHDI programs. A survey based on standard of care practice was developed for state EHDI programs to quantify the pediatric audiology resource distribution within their state, particularly audiology facilities that are equipped to provide follow up services for children age 5 and younger. After nine months of data collection, preliminary data suggested that children residing in certain regions of the United States who were loss to follow up were due to the distance parents had to travel to reach a pediatric audiology facility. For example, parents who reside in western region of Nebraska and Iowa on average have to drive over 100 miles to reach a pediatric audiology facility.

CDC is requesting an Office of Management and Budget (OMB) approval to continue collecting audiology facility information from audiologists or facility managers so both parents, physicians and state EHDI programs will have a tool to find where

the pediatric audiology facilities are located. This survey will continue to allow CDC-EHDI team and state EHDI programs to compile a systematic, quantifiable distribution of audiology facilities and the capacity of each facility to provide services for children age 5 and younger. The data collected will also allow the CDC-EHDI team to analyze facility distribution data to improve technical assistance to State EHDI programs.

Two additional questions will be added to the existing survey. The two questions will ask for more information from audiology facilities that provide services by remote telepractice technology. This information will be of vital interest and benefit for both parents who live in remote regions of the US and state EHDI programs to maximize resource coverage.

Respondents will all be audiologists who manage a facility or provide audiologic care for children age 5 and younger. To minimize burden and improve convenience, the survey will continue to be available via a secure password protected Web site. Placing the survey on the internet ensures convenient, on-demand access by the audiologists. Financial cost is minimized because no mailing fee will be associated with sending or responding to this survey.

EHDI-PALS currently has 892 facilities in the database since the beginning of the data collection. All 892 facilities' contacts will receive a brief email from the University of Maine to remind them to review their survey answers. It is estimated that approximately 800 audiologists will do so.

It takes approximately nine minutes per person to review the survey answers. Both the American Speech-Language-Hearing Association (ASHA) and American Academy of Audiology (AAA) are members of the EHDI-PALS workgroup and will continue to disseminate a request through association e-newsletters and e-announcements to all audiologists who provide services to children younger than 5 years of age to complete the EHDI-PALS survey. It is estimated that, potentially, an additional 400 new audiologists will complete the revised survey, which will take approximately nine minutes per respondent. The nine minutes calculation is based on a previous timed pre-test with six volunteer audiologists.

There are no costs to respondents other than their time. The total estimated annual burden hours are 180.

ESTIMATES OF ANNUALIZED BURDEN HOURS

Respondents	Form name	Number of respondents	Number of responses per respondent	Average burden per response (in hours)
Audiologists who have completed survey.	Annual Survey Review	800	1	9/60
New Audiologists	Revised Survey	400	1	9/60

Leroy A. Richardson,

Chief, Information Collection Review Office, Office of Scientific Integrity, Office of the Associate Director for Science, Office of the Director, Centers for Disease Control and Prevention.

[FR Doc. 2014–02027 Filed 1–30–14; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

[30-Day–14–0881]

Agency Forms Undergoing Paperwork Reduction Act Review; Data Calls for the Laboratory Response Network; Cancellation

AGENCY: Centers for Disease Control and Prevention (CDC), National Center for Emerging and Zoonotic Infectious Diseases (NCEZID), Department of Health and Human Services (HHS).

ACTION: Notice cancellation.

SUMMARY: The Centers for Disease Control and Prevention is cancelling the 30-Day Information Collection Request, 14–0881, concerning the *Data Calls for the Laboratory Response Network* (79 FR 4165), published January 24, 2014.

The purpose behind this notice cancellation is that a 60-day FRN was previously published on December 2, 2013 (78 FR 27087). The public must have 60 days to provide comment to the agency's 60-day FRN. The agency should not publish a 30-day FRN until all public comments have been received.

DATES: The 30-day FRN published on January 24, 2014 at 79 FR 4165 is withdrawn as of January 27, 2014. FOR FURTHER INFORMATION CONTACT: (404) 639–7570 or send comments to CDC: LeRoy Richardson, 1600 Clifton Road, MS D–74, Atlanta, GA 30333 or send an email to *omb@cdc.gov.*

LeRoy A. Richardson,

Chief, Information Collection Review Office, Office of Scientific Integrity, Office of the Associate Director for Science, Office of the Director, Centers for Disease Control and Prevention.

[FR Doc. 2014–01977 Filed 1–30–14; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Disease Control and Prevention

Meeting of the Community Preventive Services Task Force (Task Force)

AGENCY: Centers for Disease Control and Prevention (CDC), Department of Health and Human Services (HHS).

ACTION: Notice of meeting.

SUMMARY: The Centers for Disease Control and Prevention (CDC) announces the next meeting of the Community Preventive Services Task Force (Task Force). The Task Force is an independent, nonfederal, and uncompensated panel. Its members represent a broad range of research, practice, and policy expertise in prevention, wellness, health promotion, and public health, and are appointed by the CDC Director. The Task Force was convened in 1996 by the Department of Health and Human Services (HHS) to identify community preventive programs, services, and policies that increase healthy longevity, save lives and dollars and improve Americans' quality of life. CDC is mandated to provide ongoing administrative, research, and technical support for the

operations of the Task Force. During its meetings, the Task Force considers the findings of systematic reviews on existing research, and issues recommendations. These recommendations provide evidence-based options from which decision makers in communities, companies, health departments, health plans and healthcare systems, non-governmental organizations, and at all levels of government can choose what best meets the needs, preferences, available resources, and constraints of their constituents. The Task Force's recommendations, along with the systematic reviews of the scientific evidence on which they are based, are compiled in the *Guide to Community Preventive Services (Community Guide).*

DATES: The meeting will be held on Wednesday, February 26, 2014 from 8:30 a.m. to 5:00 p.m. EST and Thursday, February 27, 2014 from 8:30 a.m. to 2:00 p.m. EST.

ADDRESSES: The Task Force Meeting will be held at CDC Edward R. Roybal Campus, Tom Harkin Global Communications Center (Building 19), 1600 Clifton Road NE., Atlanta, GA 30333. You should be aware that the meeting location is in a Federal government building; therefore, Federal security measures are applicable. For additional information, please see Roybal Campus Security Guidelines under **SUPPLEMENTARY INFORMATION.** Information regarding meeting logistics will be available on the Community Guide Web site (*www.thecommunityguide.org*), Wednesday, January 29, 2014.

Meeting Accessability: This meeting is open to the public, limited only by space availability. All meeting attendees must RSVP to ensure the required security procedures are completed to gain access to the CDC's Global Communications Center.

U.S. citizens must RSVP by 2/12/2014.

Non U.S. citizens must RSVP by 2/5/2014 due to additional security steps that must be completed.

Failure to RSVP by the dates identified could result in an inability to attend the Task Force meeting due to the strict security regulations on federal facilities.

For Further Information and To RSVP Contact: Andrea Baeder, The Community Guide Branch; Division of Epidemiology, Analysis, and Library Services; Center for Surveillance, Epidemiology and Laboratory Services; Office of Public Health Scientific Services; Centers for Disease Control and Prevention, 1600 Clifton Road, MS–E–69, Atlanta, GA 30333, phone: (404)498–498–6876, email: *CPSTF@cdc.gov.*

SUPPLEMENTARY INFORMATION:

Purpose: The purpose of the meeting is for the Task Force to consider the findings of systematic reviews and issue findings and recommendations to help inform decision making about policy, practice, and research in a wide range of U.S. settings.

Matters to be discussed: cancer prevention and control, diabetes prevention and control, obesity prevention and control, and promoting physical activity.

Roybal Campus Security Guidelines: The Edward R. Roybal Campus is the headquarters of the U.S. Centers for Disease Control and Prevention and is located at 1600 Clifton Road, NE., Atlanta, Georgia. The meeting is being held in a Federal government building; therefore, Federal security measures are applicable.

All meeting attendees must RSVP by the dates outlined under *Meeting Accessability.* In planning your arrival time, please take into account the need to park and clear security. All visitors must enter the Roybal Campus through the entrance on Clifton Road; the guard force will direct visitors to the designated parking area. Upon arrival at the facility, visitors must present government issued photo identification (e.g., a valid federal identification badge, state driver's license, state non-driver's identification card, or passport). Non-United States citizens must complete the required security paperwork prior to the meeting date and must present a valid passport, visa, Permanent Resident Card, or other type of work authorization document upon arrival at the facility. All persons entering the building must pass through a metal detector. Visitors will be issued a visitor's ID badge at the entrance to Building 19 and will be escorted in groups of 5–10 persons to the meeting room. All items brought to HHS/CDC are subject to inspection.

Dated: January 27, 2014.

Ron A. Otten,

Acting Deputy Associate Director for Science, Centers for Disease Control and Prevention.

[FR Doc. 2014–01905 Filed 1–30–14; 8:45 am]

BILLING CODE 4163–18–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

[Document Identifiers: CMS–10515 and CMS–R–48]

Agency Information Collection Activities: Proposed Collection; Comment Request

AGENCY: Centers for Medicare & Medicaid Services, HHS.

ACTION: Notice.

SUMMARY: The Centers for Medicare & Medicaid Services (CMS) is announcing an opportunity for the public to comment on CMS' intention to collect information from the public. Under the Paperwork Reduction Act of 1995 (the PRA), federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of information (including each proposed extension or reinstatement of an existing collection of information) and to allow 60 days for public comment on the proposed action. Interested persons are invited to send comments regarding our burden estimates or any other aspect of this collection of information, including any of the following subjects: (1) The necessity and utility of the proposed information collection for the proper performance of the agency's functions; (2) the accuracy of the estimated burden; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) the use of automated collection techniques or other forms of information technology to minimize the information collection burden.

DATES: Comments must be received by *April 4, 2014:*

ADDRESSES: When commenting, please reference the document identifier or OMB control number (OCN). To be assured consideration, comments and recommendations must be submitted in any one of the following ways:

1. *Electronically.* You may send your comments electronically to *http://www.regulations.gov.* Follow the instructions for ''Comment or Submission'' or ''More Search Options'' to find the information collection document(s) that are accepting comments.

2. *By regular mail.* You may mail written comments to the following address: CMS, Office of Strategic Operations and Regulatory Affairs, Division of Regulations Development, Attention: Document Identifier/OMB Control Number ___, Room C4–26–05,

7500 Security Boulevard, Baltimore, Maryland 21244–1850.

To obtain copies of a supporting statement and any related forms for the proposed collection(s) summarized in this notice, you may make your request using one of following:

1. Access CMS' Web site address at *http://www.cms.hhs.gov/PaperworkReductionActof1995.*

2. Email your request, including your address, phone number, OMB number, and CMS document identifier, to *Paperwork@cms.hhs.gov.*

3. Call the Reports Clearance Office at (410) 786–1326.

FOR FURTHER INFORMATION CONTACT: Reports Clearance Office at (410) 786–1326

SUPPLEMENTARY INFORMATION:

Contents

This notice sets out a summary of the use and burden associated with the following information collections. More detailed information can be found in each collection's supporting statement and associated materials (see **ADDRESSES**).

CMS–10515 Payment Collections Operations Contingency Plan

CMS–R–48 Hospital Conditions of Participation and Supporting Regulations

Under the Paperwork Reduction Act (PRA) (44 U.S.C. 3501–3520), federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. The term ''collection of information'' is defined in 44 U.S.C. 3502(3) and 5 CFR 1320.3(c) and includes agency requests or requirements that members of the public submit reports, keep records, or provide information to a third party. Section 3506(c)(2)(A) of the PRA requires federal agencies to publish a 60-day notice in the **Federal Register** concerning each proposed collection of information, including each proposed extension or reinstatement of an existing collection of information, before submitting the collection to OMB for approval. To comply with this requirement, CMS is publishing this notice.

Information Collections

1. *Type of Information Collection Request:* Extension of a currently approved collection; *Title of Information Collection:* Payment Collection Operations Contingency Plan; *Use:* Under sections 1401, 1411, and 1412 of the Affordable Care Act and 45 CFR part 155 subpart D, an Exchange makes an advance determination of tax credit eligibility for individuals who enroll in Qualified Health Plan (QHP) coverage through the Exchange and seek financial assistance. Using information available at the time of enrollment, the Exchange determines whether the individual meets the income and other requirements for advance payments and the amount of the advance payments that can be used to pay premiums. Advance payments are made periodically under section 1412 of the Affordable Care Act to the issuer of the QHP in which the individual enrolls. Section 1402 of the Affordable Care Act provides for the reduction of cost sharing for certain individuals enrolled in a QHP through an Exchange, and section 1412 of the Affordable Care Act provides for the advance payment of these reductions to issuers. The statute directs issuers to reduce cost sharing for essential health benefits for individuals with household incomes between 100 and 400 percent of the Federal poverty level (FPL) who are enrolled in a silver level QHP through an individual market Exchange and are eligible for advance payments of the premium tax credit. Health insurance issuers will manually enter enrollment and payment data into a Microsoft Excel-based spreadsheet, and submit the information to HHS. The data collection will be used by HHS to make payments or collect charges from issuers under the following programs: advance payments of the premium tax credit, advanced cost-sharing reductions, and Marketplace user fees. HHS will use the information collected to make payments and collect charges in January 2014 and for a number of months thereafter, as may be required based on HHS' operational progress. *Form Number:* CMS–10515 (OCN: 0938–1217); *Frequency:* Monthly; *Affected Public:* Private sector (business or other for-profits and not-for-profit institutions); *Number of Respondents:* 575; *Total Annual Responses:* 7,475; *Total Annual Hours:* 51,175. (For policy questions regarding this collection contact Jaya Ghildiyal at 301–492–5149.)

2. *Type of Information Collection Request:* Revision of a currently approved collection; *Title of Information Collection:* Hospital Conditions of Participation and Supporting Regulations; *Use:* The information collection requirements described in this information collection request are needed to implement the Medicare and Medicaid conditions of participation (CoP) for 4,890 accredited and non-accredited hospitals and an additional 101 critical access hospitals (CAHs) that have distinct part psychiatric or rehabilitation units (DPUs). CAHs that have DPUs must comply with all of the hospital CoPs on these units. Thus, this package reflects the paperwork burden for a total of 4,991 (that is, 4,890 hospitals and 101 CAHs which include 81 CAHs that have psychiatric DPUs and 20 CAHs that have rehabilitation DPUs). The information collection requirements for the remaining 1,183 CAHs have been reported in a separate package under CMS–10239.

The CoPs and accompanying requirements specified in the supporting regulations are used by our surveyors as a basis for determining whether a hospital qualifies for a provider agreement under Medicare and Medicaid. CMS and the health care industry believe that the availability to the facility of the type of records and general content of records, which this regulation specifies, is standard medical practice and is necessary in order to ensure the well-being and safety of patients and professional treatment accountability. *Form Number:* CMS–R–48 (OCN: 0938–0328); *Frequency:* Yearly; *Affected Public:* Private sector (business or other for-profits); *Number of Respondents:* 4,991; *Total Annual Responses:* 1,342,424; Total Annual Hours: 18,84,0617. (For policy questions regarding this collection contact Scott Cooper at 410–786–9465.)

Dated: *January 28, 2014.*

Martique Jones,

Deputy Director, Regulations Development Group, Office of Strategic Operations and Regulatory Affairs.

[FR Doc. 2014–02065 Filed 1–30–14; 8:45 am]

BILLING CODE 4120–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

[Document Identifiers: CMS–10418, CMS–10507, and CMS–10157]

Agency Information Collection Activities: Submission for OMB Review; Comment Request

AGENCY: Centers for Medicare & Medicaid Services, HHS.

ACTION: Notice.

SUMMARY: The Centers for Medicare & Medicaid Services (CMS) is announcing an opportunity for the public to comment on CMS' intention to collect information from the public. Under the Paperwork Reduction Act of 1995 (PRA), federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of

information, including each proposed extension or reinstatement of an existing collection of information, and to allow a second opportunity for public comment on the notice. Interested persons are invited to send comments regarding the burden estimate or any other aspect of this collection of information, including any of the following subjects: (1) The necessity and utility of the proposed information collection for the proper performance of the agency's functions; (2) the accuracy of the estimated burden; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) the use of automated collection techniques or other forms of information technology to minimize the information collection burden.

DATES: Comments on the collection(s) of information must be received by the OMB desk officer by *March 5, 2014:*

ADDRESSES: When commenting on the proposed information collections, please reference the document identifier or OMB control number. To be assured consideration, comments and recommendations must be received by the OMB desk officer via one of the following transmissions: OMB, Office of Information and Regulatory Affairs, Attention: CMS Desk Officer, Fax Number: (202) 395–5806 *OR* Email: *OIRA_submission@omb.eop.gov*.

To obtain copies of a supporting statement and any related forms for the proposed collection(s) summarized in this notice, you may make your request using one of following:

1. Access CMS' Web site address at *http://www.cms.hhs.gov/PaperworkReductionActof1995.*
2. Email your request, including your address, phone number, OMB number, and CMS document identifier, to *Paperwork@cms.hhs.gov.*
3. Call the Reports Clearance Office at (410) 786–1326.

FOR FURTHER INFORMATION CONTACT: Reports Clearance Office at (410) 786–1326.

SUPPLEMENTARY INFORMATION: Under the Paperwork Reduction Act of 1995 (PRA) (44 U.S.C. 3501–3520), federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. The term ''collection of information'' is defined in 44 U.S.C. 3502(3) and 5 CFR 1320.3(c) and includes agency requests or requirements that members of the public submit reports, keep records, or provide information to a third party. Section 3506(c)(2)(A) of the PRA (44 U.S.C. 3506(c)(2)(A)) requires federal agencies to publish a 30-day notice in the **Federal Register** concerning each proposed collection of information, including each proposed extension or reinstatement of an existing collection of information, before submitting the collection to OMB for approval. To comply with this requirement, CMS is publishing this notice that summarizes the following proposed collection(s) of information for public comment:

1. *Type of Information Collection Request:* Revision of currently approved collection; *Title of Information Collection:* Annual MLR and Rebate Calculation Report and MLR Rebate Notices; *Use:* We will use the data collection of annual reports provided by an issuer for each state's individual, small group, and large group markets to ensure that consumers are receiving value for their premium dollar by calculating each issuer's medical loss ratio (MLR) and any rebate payments due for the respective MLR reporting year, as well as verifying the provision of any rebates and the provisions of the rebate notices. The notices will be used to ensure that consumers are receiving information about the rebate they will be receiving, how their issuer is using health care premium dollars and about the value they are receiving for their premium dollar. The notices will help provide greater transparency to consumers. We will use the recordkeeping requirements to determine issuers' compliance with the MLR requirements, including compliance with how issuers' experience is to be reported, their MLR and any rebates owing are to be calculated, distribution of rebates and provisions of rebate notices. Additionally, each issuer is required to maintain for a period of seven years all documents, records and other evidence that support the data included in each issuer's annual report to the Secretary. The 60-day **Federal Register** notice that published on November 22, 2013 (78 FR 70059) pertained to the 2013 MLR Annual Reporting Form and Instructions, and closed on January 21, 2014. We received a total of 2 public comments on 12 specific issues regarding the notice of the revised MLR PRA package. Most of the comments addressed clarifying the instructions, updates for recent guidance issuance, treatment of Student Health Plans, treatment of Affordable Care Act fees, adjusted MLR standard experience aggregation, annual Mini-med multipliers for credibility determination, reporting for both QIA and non-claims costs and reporting requirements for businesses in run-off. We considered all of the proposed suggestions and have revised the 2013 MLR Annual Reporting Form and Instructions. *Form Number:* CMS–10418 (OCN: 0938–1164); *Frequency:* Annually; *Affected Public:* Private sector (business or other for-profits and not-for-profit institutions); *Number of Respondents:* 522; *Total Annual Responses:* 3,394; *Total Annual Hours:* 294,911. (For policy questions regarding this collection contact Julie McCune at 301–492–4196.)

2. *Type of Information Collection Request:* New collection (Request for a new OMB control number); *Title of Information Collection:* State-based Marketplace Annual Reporting Tool (SMART); *Use:* The annual report is the primary vehicle to insure comprehensive compliance with all reporting requirements contained in the Affordable Care Act. It is specifically called for in section 1313(a)(1) of the Act which requires that an SBM keep an accurate accounting of all activities, receipts, and expenditures, and to submit a report annually to the Secretary concerning such accounting. We will use the information collected from states to assist in determining if a state is maintaining a compliant operational Exchange. It will also provide a mechanism to collect innovative approaches to meeting challenges encountered by the SBMs during the preceding year as well as providing information to us regarding potential changes in priorities and approaches for the upcoming year. *Form Number:* CMS–10507 (OCN: 0938–NEW); *Frequency:* Annually; *Affected Public:* State, Local, or Tribal Governments; *Number of Respondents:* 19; *Total Annual Responses:* 19; *Total Annual Hours:* 1,482. (For policy questions regarding this collection contact Shelley Bain at 301–492–4453.)

3. *Type of Information Collection Request:* Reinstatement of a previously approved collection; *Title of Information Collection:* HIPAA Eligibility Transaction System (HETS) Trading Partner Agreement (TPA); *Use:* The HETS is intended to allow the release of eligibility data to Medicare providers, suppliers or their authorized billing agents for the purposes of preparing accurate Medicare claims, determining beneficiary liability or determining eligibility for specific services. Such information may not be disclosed to anyone other than providers, suppliers or a beneficiary for whom a claim has been filed. *Form Number:* CMS–10157 (OCN: 0938–0960); *Frequency:* Yearly; *Affected Public:* Private sector (business or other for-profit and not-for-profit institutions); *Number of Respondents:* 1,000; *Total*

Annual Responses: 1,000; *Total Annual Hours:* 125. (For policy questions regarding this collection contact Ada Sanchez at 410–786–9466.)

Dated: January 28, 2014.

Martique Jones,

Deputy Director, Regulations Development Group, Office of Strategic Operations and Regulatory Affairs.

[FR Doc. 2014–02061 Filed 1–30–14; 8:45 am]

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DEPARTMENT OF HEALTH AND HUMAN SERVICES

Centers for Medicare & Medicaid Services

[CMS–9082–N]

Medicare and Medicaid Programs; Quarterly Listing of Program Issuances—

October through December 2013

AGENCY: Centers for Medicare & Medicaid Services (CMS), HHS.

ACTION: Notice

SUMMARY: This quarterly notice lists CMS manual instructions, substantive and interpretive regulations, and other **Federal Register** notices that were published from October through December 2013, relating to the Medicare and Medicaid programs and other programs administered by CMS.

FOR FURTHER INFORMATION CONTACT: It is possible that an interested party may need specific information and not be able to determine from the listed information whether the issuance or regulation would fulfill that need. Consequently, we are providing contact persons to answer general questions concerning each of the addenda published in this notice.

Addenda	Contact	Phone number
I CMS Manual Instructions	Ismael Torres	(410) 786–1864
II Regulation Documents Published in the FEDERAL REGISTER	Terri Plumb	(410) 786–4481
III CMS Rulings	Tiffany Lafferty	(410) 786–7548
IV Medicare National Coverage Determinations	Wanda Belle	(410) 786–7491
V FDA-Approved Category B IDEs	John Manlove	(410) 786–6877
VI Collections of Information	Mitch Bryman	(410) 786–5258
VII Medicare –Approved Carotid Stent Facilities	Lori Ashby	(410) 786–6322
VIII American College of Cardiology-National Cardiovascular Data Registry Sites	Marie Casey, BSN, MPH.	(410) 786–7861
IX Medicare's Active Coverage-Related Guidance Documents	Lori Ashby	(410) 786–6322
X One-time Notices Regarding National Coverage Provisions	Lori Ashby	(410) 786–6322
XI National Oncologic Positron Emission Tomography Registry Sites	Stuart Caplan, RN, MAS.	(410) 786–8564
XII Medicare-Approved Ventricular Assist Device (Destination Therapy) Facilities	Marie Casey, BSN, MPH.	(410) 786–7861
XIII Medicare-Approved Lung Volume Reduction Surgery Facilities	Marie Casey, BSN, MPH.	(410) 786–7861
XIV Medicare-Approved Bariatric Surgery Facilities	Kate Tillman, RN, MAS	(410) 786–9252
XV Fluorodeoxyglucose Positron Emission Tomography for Dementia Trials	Stuart Caplan, RN, MAS.	(410) 786–8564
All Other Information	Annette Brewer	(410) 786–6580

I. Background

The Centers for Medicare & Medicaid Services (CMS) is responsible for administering the Medicare and Medicaid programs and coordination and oversight of private health insurance. Administration and oversight of these programs involves the following: (1) Furnishing information to Medicare and Medicaid beneficiaries, health care providers, and the public; and (2) maintaining effective communications with CMS regional offices, state governments, state Medicaid agencies, state survey agencies, various providers of health care, all Medicare contractors that process claims and pay bills, National Association of Insurance Commissioners (NAIC), health insurers, and other stakeholders. To implement the various statutes on which the programs are based, we issue regulations under the authority granted to the Secretary of the Department of Health and Human Services under sections 1102, 1871, 1902, and related provisions of the Social Security Act (the Act) and Public Health Service Act. We also issue various manuals, memoranda, and statements necessary to administer and oversee the programs efficiently.

Section 1871(c) of the Act requires that we publish a list of all Medicare manual instructions, interpretive rules, statements of policy, and guidelines of general applicability not issued as regulations at least every 3 months in the **Federal Register**.

II. Revised Format for the Quarterly Issuance Notices

While we are publishing the quarterly notice required by section 1871(c) of the Act, we will no longer republish duplicative information that is available to the public elsewhere. We believe this approach is in alignment with CMS' commitment to the general principles of the President's Executive Order 13563 released January 2011entitled ''Improving Regulation and Regulatory Review,'' which promotes modifying and streamlining an agency's regulatory program to be more effective in achieving regulatory objectives. Section 6 of Executive Order 13563 requires agencies to identify regulations that may be ''outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand or repeal them in accordance with what has been learned.'' This approach is also in alignment with the President's Open Government and Transparency Initiative that establishes a system of transparency, public participation, and collaboration.

Therefore, this quarterly notice provides only the specific updates that have occurred in the 3-month period along with a hyperlink to the full listing that is available on the CMS Web site or the appropriate data registries that are used as our resources. This information is the most current up-to-date information and will be available earlier than we publish our quarterly notice. We believe the Web site list provides more timely access for beneficiaries,

providers, and suppliers. We also believe the Web site offers a more convenient tool for the public to find the full list of qualified providers for these specific services and offers more flexibility and ''real time'' accessibility. In addition, many of the Web sites have listservs; that is, the public can subscribe and receive immediate notification of any updates to the Web site. These listservs avoid the need to check the Web site, as notification of updates is automatic and sent to the subscriber as they occur. If assessing a Web site proves to be difficult, the contact person listed can provide information.

III. How to Use the Notice

This notice is organized into 15 addenda so that a reader may access the subjects published during the quarter covered by the notice to determine whether any are of particular interest. We expect this notice to be used in concert with previously published notices. Those unfamiliar with a description of our Medicare manuals should view the manuals at *http://www.cms.gov/manuals.*

Authority: (Catalog of Federal Domestic Assistance Program No. 93.773, Medicare—Hospital Insurance, Program No. 93.774, Medicare—Supplementary Medical Insurance Program, and Program No. 93.714, Medical Assistance Program)

Dated: January 24, 2014.

Kathleen Cantwell,

Director, Office of Strategic Operations and Regulatory Affairs.

Publication Dates for the Previous Four Quarterly Notices

We publish this notice at the end of each quarter reflecting information released by CMS during the previous quarter. The publication dates of the previous four Quarterly Listing of Program Issuances notices are: November 9, 2012 (77 FR 67368), May 3, 2013 (78 FR 26038) July 26, 2013 (78 FR 45233), and November 8, 2013 (78 FR 67153). For the purposes of this quarterly notice, we are providing only the specific updates that have occurred in the 3-month period along with a hyperlink to the website to access this information and a contact person for questions or additional information.

Addendum I: Medicare and Medicaid Manual Instructions (October through December 2013)

The CMS Manual System is used by CMS program components, partners, providers, contractors, Medicare Advantage organizations, and State Survey Agencies to administer CMS programs. It offers day-to-day operating instructions, policies, and procedures based on statutes and regulations, guidelines, models, and directives. In 2003, we transformed the CMS Program Manuals into a web user-friendly presentation and renamed it the CMS Online Manual System.

How to Obtain Manuals

The Internet-only Manuals (IOMs) are a replica of the Agency's official record copy. Paper-based manuals are CMS manuals that were officially released in hardcopy. The majority of these manuals were transferred into the Internet-only manual (IOM) or retired. Pub 15-1, Pub 15-2 and Pub 45 are exceptions to this rule and are still active paper-based manuals. The remaining paper-based manuals are for reference purposes only. If you notice policy contained in the paper-based manuals that was not transferred to the IOM, send a message via the CMS Feedback tool.

Those wishing to subscribe to old versions of CMS manuals should contact the National Technical Information Service, Department of Commerce, 5301 Shawnee Road, Alexandria, VA 22312 Telephone (703-605-6050). You can download copies of the listed material free of charge at: http://cms.gov/manuals.

How to Review Transmittals or Program Memoranda

Those wishing to review transmittals and program memoranda can access this information at a local Federal Depository Library (FDL). Under the FDL program, government publications are sent to approximately 1,400 designated libraries throughout the United States. Some FDLs may have arrangements to transfer material to a local library not designated as an FDL. Contact any library to locate the nearest FDL. This information is available at http://www.gpo.gov/libraries/

In addition, individuals may contact regional depository libraries that receive and retain at least one copy of most federal government publications, either in printed or microfilm form, for use by the general public. These libraries provide reference services and interlibrary loans; however, they are not sales outlets. Individuals may obtain information about the location of the nearest regional depository library from any library. CMS publication and transmittal numbers are shown in the listing entitled Medicare and Medicaid Manual Instructions. To help FDLs locate the materials, use the CMS publication and transmittal numbers. For example, to find the Medicare Claims Processing publication titled Maintenance and Update of the Temporary Hook Created to Hold OPPS Claims that Include Certain Drug HCPCS Codes use CMS-Pub. 100-04, Transmittal No. 2797.

Addendum I lists a unique CMS transmittal number for each instruction in our manuals or program memoranda and its subject number. A transmittal may consist of a single or multiple instruction(s). Often, it is necessary to use information in a transmittal in conjunction with information currently in the manual. For the purposes of this quarterly notice, we list only the specific updates to the list of manual instructions that have occurred in the 3-month period. This information is available on our website at www.cms.gov/Manuals.

Transmittal Number	Manual/Subject/Publication Number
	Medicare General Information (CMS-Pub. 100-01)
80	Manual Updates to Clarify SNF Claims Processing Hospital Insurance (Part A) for Inpatient Hospital, Hospice, Home Health and Skilled Nursing Facility (SNF) Services - A Brief Description Starting a Benefit Period Ending a Benefit Period Definition of Inpatient for Ending a Benefit Period
81	Update to Medicare Deductible, Coinsurance and Premium Rates for 2013 Basis for Determining the Part A Coinsurance Amounts Part B Annual Deductible Part B Premium
82	Update to Medicare Deductible, Coinsurance and Premium Rates for 2014 Basis for Determining the Part A Coinsurance Amounts Part B Annual Deductible Part B Premium

Medicare Benefit Policy (CMS-Pub. 100-02)	
172	Home Health - Clarification to Benefit Policy Manual Language on Confined to the Home Definition Patient Confined to the Home
173	Table of Contents Rural Health Clinic (RHC) and Federally Qualified Health Center (FQHC) General Information RHC General Information
174	Implementation of Changes in the End-Stage Renal Disease Prospective Payment System (ESRD PPS) for Calendar Year (CY) 2014 ESRD Prospective Payment System (PPS) Base Rate ESRD PPS Case-Mix Adjustments
175	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
176	Manual Updates to Clarify Skilled Nursing Facility (SNF), Inpatient Rehabilitation Facility (IRF), Home Health (HH), and Outpatient (OPT) Coverage Pursuant to Jimmo vs. Sebelius Inpatient Rehabilitation Facility Medical Necessity Criteria Definition of Measurable Improvement Determination of Coverage Patient's Place of Residence Skilled Nursing Care Observation and Assessment of the Patient's Condition When Only the Specialized Skills of a Medical Professional Can Determine Patient's Status Management and Evaluation of a Patient Care Plan Teaching and Training Activities Catheters Wound Care Ostomy Care Venipuncture Student Nurse Visits Psychiatric Evaluation, Therapy, and Teaching Skilled Therapy Services General Principles Governing Reasonable and Necessary Physical Therapy, Speech-Language Pathology Services, and Occupational Therapy Application of the Principles to Physical Therapy Services Application of the General Principles to Speech-Language Pathology Services Application of the General Principles to Occupational Therapy Assessment Illustration of Covered Services Skilled Nursing Facility Level of Care – General Skilled Services Defined Principles for Determining Whether a Service is Skilled Documentation to Support Skilled Care Determinations Specific Examples of Some Skilled Nursing or Skilled Rehabilitation Services Observation and Assessment of Patient's Condition Teaching and Training Activities Direct Skilled Nursing Services to Patients Direct Skilled Therapy Services to Patients General
	Application of Guidelines Speech -Language Pathology Occupational Therapy Daily Skilled Services Defined Services Provided on an Inpatient Basis as a "Practical Matter" Coverage of Outpatient Rehabilitation Therapy Services (Physical Therapy, Occupational Therapy, and Speech-Language Pathology Services) Under Medical Insurance Care of a Physician/Nonphysician Practitioner (NPP) Plans of Care for Outpatient Physical Therapy, Occupational Therapy, or Speech-Language Pathology Services Requirement That Services Be Furnished on an Outpatient Basis Reasonable and Necessary Outpatient Rehabilitation Therapy Services Documentation Requirements for Therapy Services Practice of Physical Therapy Practice of Occupational Therapy Services Furnished by a Therapist in Private Practice (TPP) Physical Therapy, Occupational Therapy and Speech-Language Pathology Services Provided Incident to the Services of Physicians and Non-Physician Practitioners (NPP)
177	Implementation of Changes in the End-Stage Renal Disease Prospective Payment System (ESRD PPS) for Calendar Year (CY) 2014 ESRD Prospective Payment System (PPS) Base Rate ESRD PPS Case-Mix Adjustments
178	Expansion of Medicare Telehealth Services for CY 2014 Eligibility Criteria List of Medicare Telehealth Services
Medicare National Coverage Determination (CMS-Pub. 100-03)	
157	Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity (Effective September 24, 2013)
158	Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity (Effective September 24, 2013) Treatment of Obesity Intestinal Bypass Surgery Gastric Balloon for Treatment of Obesity Surgery for Diabetes
Medicare Claims Processing (CMS-Pub. 100-04)	
2797	Maintenance and Update of the Temporary Hook Created to Hold OPPS Claims that Include Certain Drug HCPCS Codes
2798	Quarterly Update to the Medically Unlikely Edits (MUEs), Version 8.0 Effective January 1, 2014
2799	Annual Medicare Physician Fee Schedule (MPFS) Files Delivery and Implementation Annual Medicare Physician Fee Schedule File Information
2800	Announcement of Medicare Rural Health Clinic (RHC) and Federally Qualified Health Centers (FQHC) Payment Rate Increases
2801	Instructions for Retrieving the 2014 Pricing and HCPCS Data Files through

	CMS' Mainframe Telecommunications System
2802	2014 Annual Update of Healthcare Common Procedure Coding System (HCPCS) Codes for Skilled Nursing Facility (SNF) Consolidated Billing (CB) Update SNF CB Annual Update Process for Fiscal Intermediaries (FIs)/A/B MACs Annual Update Process
2803	Medicare Claims Processing Pub. 100-04 Chapter 24 Update Introduction to Electronic Data Interchange (EDI) for Medicare Fee For Services Requirement for EDI Audience for this Chapter Scope of this Chapter Acronyms and Definitions General EDI Legislative Background The America Reinvestment and Recovery Act (ARRA) HIPAA and ARRA on Security and Privacy Administrative Simplification and Compliance Act (ASCA) EDI Enrollment and Registration (AKA Trading Partner Agreements) EDI Enrollment New Enrollments and Maintenance of Existing Enrollments Submitter Number Network Service Vendor (NSV) Agreement Electronic Remittance Advice (ERA) Enrollment Form Centers for Medicare and Medicaid Services – Medicare Fee-For-Service HIPAA Transaction Standards as Designated by CMS Transactions Used in the Acknowledgment of Receipt of Inbound Claims Change Request (CR) to Communicate Policy Medicare FFS Contractors (A/B MAC, DME MAC, CEDI) Certification Test Program and Annual Recertification Activities Security Requirements A/B MACs, DME MACs, and CEDI Data Security and Confidentiality Requirements A/B MAC, DME MACs and CEDI Audit Trails Security-Related Requirements for A/B MACs, and CEDI Arrangements With Clearinghouses and Billing Services Release of Medicare Data EDI Enrollment and EDI Claim Record Retention General EDI Outreach Activities A/B MAC and DME MACMAC Analysis of Internal Information Contact With New Providers Production and Distribution of Information to Increase Use of EDI Production and Distribution of Material to Market EDI User Guidelines Technical Assistance to EDI Trading Partners Training Content and Frequency Free Claim Submission Software Newsletters/Bulletin Board/Internet Publication of EDI Information Provider Guidelines for Choosing a Vendor Vendor Selection Provision of EDI User Guidelines Provision and Maintenance of a Directory of Billing Software Vendors and Clearinghouses Operating Rules for Electronic Transactions Telecommunications, Internet and Dial-up System Availability Media Telecommunications and Transmission Protocols Translators Common Edits and Enhancements Module (CEM) – General Description Across All Versions Claim Numbering Receipt Control and Balancing Acknowledgements Outbound File Compliance Check Common Edits and Enhancement Module (CEM) Code Sets Requirements Handling of Poorly Formed/Invalid Flat Files for a 277CA Unique Specifications for DME CEDI Claim Numbering CEDI Receipt Control and Balancing CEDI Acknowledgments for ASC X12 5010 and NCPDP D.O. Transactions EDI Testing Accuracy Limitation on Testing of Multiple Providers that Use the Same Clearinghouse, Billing Service, or Vendor Software EDI Receiver Testing by A/B MACs and CEDI Changes in Provider's System or Vendor's Software and Use of Additional EDI Formats Delimiters Nulls Direct Data Entry (DDE) Screens PWK Background PWK Workflow Provider Responsibility Contractor Responsibility A/B MACs, and CEDI Edit Requirements Key Shop and Optical Character Recognition Claim Key Shop and Optical Character Recognition (OCR)/Image Character Recognition (ICR) Mapping to ASC X12N Based Flat File Key Shop and Image Processing Trading Partner and Contractor Crossover Claim Requirements Remittance Advice and Standard Paper Remittances Payments Payment Floor Requirement Alternative to EFT Electronic Funds Transfer (EFT) Tri-Partite Bank Agreement Health Care Provider Taxonomy Code (HPTC) Requirements General HIPAA EDI Requirements Contractor Reporting of Operational and Workload (CROWD) Reporting National Council for Prescription Drug Program (NCPDP) Claim Requirements

2804	New Waived Tests
2805	Mandatory Reporting of an 8-Digit Clinical Trial Number on Claims Billing Requirements for Providers Billing Routine Costs of Clinical Trials Involving a Category A IDE Billing Requirements for Providers Billing Routine Costs of Clinical Trials Involving a Category B IDE Payment for Qualifying Clinical Trial Services Billing Requirements – General Requirements for Billing Routine Costs of Clinical Trials
2806	Changes to the Laboratory National Coverage Determination (NCD) Software for ICD-10 Codes
2807	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2808	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2809	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2810	Modifications to the National Coordination of Benefits Agreement (COBA) Crossover Process Consolidated Claims Crossover Process
2811	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2812	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2813	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2814	2014 Annual Type of Service (TOS) Update Type of Service
2815	Updates to the Medicare Claims Processing Internet-Only Manual (IOM) Decision Logic Used by the Pricer on Claims Payer Only Codes Utilized by Medicare Bills with Covered and Noncovered Days Billing in Benefits Exhaust and No-Payment Situations
2816	Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity ICD Procedure Codes for Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity (A/MACs only)
2817	Quarterly Update to the Correct Coding Initiative (CCI) Edits, Version 20.0, Effective January 1, 2014
2818	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2819	Fiscal Year (FY) 2014 Inpatient Prospective Payment System (IPPS) and Long Term Care Hospital (LTCH) PPS Changes Provider Specific File
2820	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2821	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2822	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2823	Calendar Year (CY) 2014 Annual Update for Clinical Laboratory Fee Schedule and Laboratory Services Subject to Reasonable Charge Payment
2824	New Influenza Virus Vaccine Code Healthcare Common Procedure Coding System (HCPCS) and Diagnosis Codes Table of Preventive and Screening Services CWF Edits on FI/AB MAC Claims CWF Edits on Carrier/AB MAC Claims CWF A/B Crossover Edits for FI/AB MAC and Carrier/AB MAC Claims
2825	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
2826	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2827	Transcatheter aortic valve replacement (TAVR) - Implementation of Permanent CPT Coding Requirements for TAVR Services Furnished on or After January 1, 2013 Claims Processing Requirements for TAVR Services on Professional Claims Claims Processing Requirements for TAVR Services on Inpatient Hospital Claims
2828	Home Health Prospective Payment System (PPS) Low Utilization Payment Adjustment (LUPA) Add-On Factors Adjustments of Episode Payment – Low Utilization Payment Adjustments (LUPAs)
2829	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2830	Quarterly Update to the Correct Coding Initiative (CCI) Edits, Version 20.1, Effective April 1, 2014
2831	Implementation of Changes in the End-Stage Renal Disease Prospective Payment System (ESRD PPS) for Calendar Year (CY) 2014
2832	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
2833	Home Health Agency Reporting Requirements for the Certifying Physician and the Physician Who Signs the Plan of Care
2834	Announcement of Medicare Rural Health Clinic (RHC) and Federally Qualified Health Centers (FQHC) Payment Rate Increases
2835	Quarterly Update of HCPCS Codes Used for Home Health Consolidated Billing Enforcement
2836	CY 2014 Update for Durable Medical Equipment, Prosthetics, Orthotics and Supplies (DMEPOS) Fee Schedule Gap-filling DMEPOS Fees
2837	Change to the Reasonable Charge Update for 2014 for Splints, Casts and Certain Intraocular Lenses Inflation Indexed Charge (IIC) for Nonphysician Services
2838	January 2014 Integrated Outpatient Code Editor (I/OCE) Specifications Version 15.0
2839	Implementation of Changes in the End-Stage Renal Disease Prospective Payment System (ESRD PPS) for Calendar Year (CY) 2014
2840	Summary of Policies in the CY 2014 Medicare Physician Fee Schedule (MPFS) Final Rule and the Telehealth Originating Site Facility Fee Payment

	Amount
2841	Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity General - Bariatric Surgery for Treatment of Co-Morbid Conditions Related to Morbid Obesity ICD Procedure Codes for Bariatric Surgery for Treatment of Co-Morbid Conditions R ICD Diagnosis Codes for Bariatric Surgery related to Morbid Obesity (A/MACs only) ICD Diagnosis Codes for BMI ≥35 ICD Codes for Type II Diabetes Mellitus Complicatio Claims Guidance for Payment MAC Billing Requirements
2842	Form CMS-1500 Instructions: Revised for Form Version 02/12 Health Insurance Claim Form CMS-1500 Items 1-11 Patient and Insured Information Items11a-13 Patient and Insured Information Items 14-33 Provider of Service or Supplier Information
2843	Medicare Claims Processing Pub. 100-04, Chapter 22 Update Section 10 Background Section 20 General Remittance 30 Remittance Balancing Section 30 Remittance Balancing 40/40.1 ASC X12 835 Section 40 Electronic Remittance Advice 40/40.3 Electronic Remittance Advice Data sent to Banks Section 40/40.1 ASC X12 83540 Section 40/40.2 Generating an ERA if Required Data is Missing or Invalid 50/50.1 The Do-Not-Forward Initiative Section 40/40.3 Electronic Remittance Advice Data sent to Banks 50/50.2/50.2.2 A/B MAC (B)/DME MAC SPR Format Section 40/40.4 Medicare Standard Electronic PC-Print Software for Institutional Providers Medicare Standard Electronic PC-Print Software for Institutional Providers Section 40/40.6 Asc X12 835 Implementation Guide (IG) or Technical Report 3 (TR3) Section 50 Standard Paper Remittance Advice Section 50/50.1 The Do-Not-Forward Initiative Section 50/50.2 SPR Formats Section 50/50.2/50.2.1 A/B MAC (A)/A/B Mac (HH) SPR Format Section 50/50.2/50.2.2 A/B MAC (B)/DME MAC SPR Format Section 60 Remittance Advice Codes Section 60/60.1 Group Code Section 60/60.2 Claim Adjustment Reason Codes Section 60/60.3 Remittance Advice Remark Codes Section 80 CAQH CORE Mandated Operating Rules Section 80/80.1 CAQH CARE 350 - Health Care Claim Payment /Advice (835) Infrastructure Rule Section 80/80.1.1 Version X12/5010X221 Companion Guide Section 80/80.2 Uniform Use of CARCs and Rarcs Rule Section 80/80.3 EFT Enrollment Data Rule Section 80/80.4 ERA Enrollment Form
2844	2014 Annual Update to the Therapy Code List Application of Financial Limitations Functional Reporting
2845	January 2014 Update of the Hospital Outpatient Prospective Payment System (OPPS)
2846	January 2014 Update of the Ambulatory Surgical Center (ASC) Payment System
2847	Emergency Update to the CY 2014 Medicare Physician Fee Schedule Database (MPFSDB)
2848	Expansion of Medicare Telehealth Services for CY 2014 Eligibility Criteria List of Medicare Telehealth Services
Medicare Secondary Payer (CMS-Pub. 100-05)	
98	The Medicare Contractors and the Shared Systems Shall Send the Correct Cost Avoided Indicator and Special Project Type to the Common Working File (CWF) so the Correct Savings is applied both to the Medicare Secondary Payer (MSP) Savings Report and the Originating Contractor Recording Savings
Medicare Financial Management (CMS-Pub. 100-06)	
229	Notice of New Interest Rate for Medicare Overpayments and Underpayments-- 1st qtr Notification for FY 2014
Medicare State Operations Manual (CMS-Pub. 100-07)	
92	State Operations Manual (SOM) Chapter 3 Policy and Nomenclature revisions for Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) CMS Authority to Terminate Medicare and Medicaid Participation Decision to Terminate or Deny Payment for Medicaid Facilities Termination of Title XIX-Only NFs and ICFs/IID Look-Behind" Termination or Cancellation of ICF/IID Agreement by the Secretary Look-Behind" Termination of a NF or ICF/IID by the Secretary Denial of Payments in Lieu of Termination of ICFs/IID Authority to Deny Payment for Any New Admissions for ICFs/IID Duration of Denial of Payment and Subsequent Termination of an ICF/IID Sanctions for ICFs/IID – or Nonimmediate Jeopardy General Introduction Examples of Alternative Sanctions Appropriate Resources for Directed In-Service Training Programs Services for Which Federal Financial Participation (FFP) May Be Continued After Termination of a Medicaid Provider Agreement or Nonrenewal or Cancellation of an ICF/IID Provider Agreement General Processing of Immediate Jeopardy Terminations Termination Processing Sequence- Noncompliance With CoPs or Conditions for Coverage (Excluding SNFs) Terminating Medicaid ICF/IID Eligibility Based on "Look-Behind" Determination

	No Immediate Threat to Patients' Health and Safety Hearing on 1910(b) Cancellation of Medicaid Eligibility Appeals of Adverse Actions for Medicaid Non-State Operated NFs (Non-State Operated) and ICFs/IID (Not Applicable to Federal Terminations of Medicaid Facilities) Informal Reconsideration (Applies to ICFs/IID for Denial of Payment for New Admissions Only)
93	State Operations Manual (SOM) Chapter 1 revisions for Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) Medicaid Provisions Waivers of Standards Look-Behind Authority Meaning of Certification
94	State Operations Manual (SOM) Appendix J, Guidance to Surveyors: Intermediate Care Facilities for Individuals with Intellectual Disabilities, nomenclature revisions.
95	Revised Appendix A, Interpretive Guidelines for Hospitals, Appendix L, Interpretive Guidelines for Ambulatory Surgical Centers and Appendix W, Interpretive Guidelines for Critical Access Hospitals
96	State Operations Manual (SOM) Chapter 4, Policy and Nomenclature revisions for Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) Reporting of Possible Certification Fraud Health Professional Qualifications Education, Training, and Experience Review of Certification Data Scope of Survey Facility Workload (SNF/NF) Line Item Justifications for SA Direct and Indirect Costs Preparation of Budget Request Preparation of State Survey Agency Quarterly Expenditure Report, Long-Term Care Facility Workload, Form CMS-435
97	State Operations Manual (SOM) Chapter 7, Revisions for Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) Waiver of 7-Day Registered Nurse (RN) Requirement for Skilled Nursing Facilities Waivers of Nurse Staffing Requirements in Nursing Facilities Emphasis Components and Applicability
98	State Operations Manual (SOM) Chapter 9, Exhibits, Revisions for Intermediate Care Facilities for Individuals with Intellectual Disabilities (ICF/IID) Immediate Care Facility-Individuals with Intellectual Disabilities Survey Report-Crucial Data Extract, CMS 3070B(E) Immediate Care Facility for Individuals with Intellectual Disabilities Survey Report, Form CMS-3070G Model Telegram-Notice of Termination to a Medicaid ICF/IID Following "Look Behind" Survey: Immediate and Serious Threat to Patient Health and Safety
Medicare Program Integrity (CMS-Pub. 100-08)	
489	100% Prepayment Review and Random Review Instructions Prepayment Review of Claims Reassignment to Part A Critical Access Hospitals billing under Method II (CAH IIII)
490	Reassignment to Part A Critical Access Hospitals billing under Method II (CAH II) Special Processing Guidelines for Form CMS-855A, Form CMS-855 B, Form CMS-855I and Form CMS-855R Processing Form CMS-855R Applications Referrals to the Quality Improvement Organization (QIO)
491	Removal of Existing Material in Chapter 14 of the Program Integrity Manual
492	Additional Updates to Chapter 15 of the Program Integrity Manual (PIM) Practice Location Information Owning and Managing Organizations Contractor Jurisdictional Issues Establishing an Effective Date of Medicare Billing Privileges Application Fees Revocation Letter Guidance Model Revocation Letter for Part B Suppliers and Certified Providers and Suppliers Additional Home Health Agency (HHA) Review Activities Provider and Supplier Revalidations
493	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
494	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
495	Recalcitrant Provider Procedures Recalcitrant Providers Issues to Consider Before Referring a Recalcitrant Provider Case to CMS CMS Approval/Disapproval for Notification for a Recalcitrant Provider/Supplier Case Submission Case Format for Referring Recalcitrant Providers/Suppliers
496	Tracking Medicare Contractors' Postpayment Reviews
497	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
498	Notifying the Provider of Postpayment Review Results Notifying the Provider
499	Update to Chapter 15 of the Program Integrity Manual Final Adverse Actions Section 4 of the Form CMS-855B Contact Persons Ambulance Attachment Supervising Physicians Examining Whether a CHOW May Have Occurred Tie-In/Tie-Out Notices and Referrals to the State/RO Ambulatory Surgical Centers (ASCs)/Portable X-ray Suppliers (PXRS) Tie-In/Tie-Out Notices and Referrals to the State/RO Special Instructions for Certified Providers, ASCs, and Portable X-ray Suppliers Model Letter Guidance

	Revocations Other Identified Revocations
500	Third-party Additional Documentation Request CERT Update Third-party Additional Documentation Request
Medicare Contractor Beneficiary and Provider Communications (CMS-Pub. 100-09)	
00	None
Medicare End Stage Renal Disease Network Organizations (CMS Pub 100-14)	
00	None
Medicare Managed Care (CMS-Pub. 100-16)	
00	None
Medicare Business Partners Systems Security (CMS-Pub. 100-17)	
12	CMS Business Partners Systems Security Manual Additional Requirements for MACs CMS Contracting Officer's Representative (COR) Principal Systems Security Officer (SSO) Systems Security Program Management Control Components Reporting Requirements System Security Plan (SSP) Risk Assessment (RA) Contingency Planning Certification Annual FISMA Assessment (FA) Plan of Action and Milestones (POA&M) Background Timing Requirements for Compliance Conditions System Security Profile Authorization To Operate Patch Management Security Configuration Management Security Technical Implementation Guides (STIG) United States Government Configuration Baseline (USGCB) Standard National Institute of Standards and Technology (NIST) Security Level by Information Type Minimum System Security Requirements – High Encryption Requirements for Data Leaving Data Centers Internet Security
Demonstrations (CMS-Pub. 100-19)	
92	None Medicare Intravenous Immune Globulin (IVIG) Demonstration
One Time Notification (CMS-Pub. 100-20)	
1301	Virtual Data Center Contract (VDC) Workload Realignment
1302	Braille and Large Print Medicare Summary Notices
1303	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
1304	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
1305	Denial for Power Mobility Device (PMD) Claim from a Supplier of Durable Medical, Orthotics, Prosthetics, and Supplies (DMEPOS) When Ordered By a Non-Authorized Provider
1306	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
1307	The Coordination of Benefits Contractor (COBC) to Remove and No Longer Apply Federal Tax Information (FTI) Received through the Internal Revenue Service (IRS), Social Security Administration (SSA), Centers for Medicare and Medicaid Services (CMS) Medicare Secondary Payer (MSP) Data Match Program on the Common Working File (CWF).
1308	MREP and PC Print Updates for Operating Rules Phase III 360 Rule Compliance
1309	FISS Claims Processing Update for Ambulance Services
1310	HCPCS Analysis CR for Conversion of Old HCPCS Code to New
1311	Informational Unsolicited Response (IUR) or Reject for Ambulance SNF to SNF Transfer
1312	Common Working File (CWF) and Fiscal Intermediary Standard System (FISS) Informational Unsolicited Response (IUR) or Denial of Inpatient Services Related to a Hospice Terminal Diagnosis
1313	Termination of the Common Working File ELGA, ELGH, HIQA, HIQH, and HUQA Part A Provider Queries
1314	Implementation of the Award for the Jurisdiction K (JK) Part A and Part B Medicare Administrative Contractor (A/B MAC) to National Government Services
1315	Immediate Suspension of Postpayment Patient Status Reviews of Inpatient Hospital Admissions 10/1/13-12/31/13
1316	Implement Operating Rules - Phase III ERA EFT: CORE 360 Uniform Use of Claim Adjustment Reason Codes (CARC) and Remittance Advice Remark Codes (RARC) Rule - Update from CAQH CORE - October 1, 2013 version 3.0.3
1317	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
1318	Use of Claim Adjustment Reason Code 23
1319	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
1320	Revised Beneficiary Liability and Messages Associated with Denials for Claims for Services Furnished to Incarcerated Beneficiaries
1321	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
1322	Merge of the Daily CMS-1522 PULSE Roll-Up Number Report Data for A/B MAC Workloads.
1323	Medicare Appeals System (MAS) Level 1 Implementation
1324	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
1325	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction
1326	Informational Unsolicited Response (IUR) or Reject for Ambulance SNF to SNF Transfer
1327	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction
1328	Issued to a specific audience, not posted to Internet/Intranet due to Sensitivity of Instruction

1329	Immediate Suspension of Postpayment Patient Status Reviews of Inpatient Hospital Admissions 10/1/13-12/31/13
1330	Revised Beneficiary Liability and Messages Associated with Denials for Claims for Services Furnished to Incarcerated Beneficiaries
1331	Issued to a specific audience, not posted to Internet/Intranet due to Confidentiality of Instruction

Addendum II: Regulation Documents Published in the Federal Register (October through December 2013)

Regulations and Notices

Regulations and notices are published in the daily **Federal Register**. To purchase individual copies or subscribe to the **Federal Register,** contact GPO at www.gpo.gov/fdsys. When ordering individual copies, it is necessary to cite either the date of publication or the volume number and page number.

The **Federal Register** is available as an online database through GPO Access. The online database is updated by 6 a.m. each day the **Federal Register** is published. The database includes both text and graphics from Volume 59, Number 1 (January 2, 1994) through the present date and can be accessed at http://www.gpoaccess.gov/fr/index.html. The following website http://www.archives.gov/federal-register/ provides information on how to access electronic editions, printed editions, and reference copies.

This information is available on our website at: http://www.cms.gov/quarterlyproviderupdates/downloads/Regs-4Q13QPU.pdf

For questions or additional information, contact Terri Plumb (410-786-4481).

Addendum III: CMS Rulings

CMS Rulings are decisions of the Administrator that serve as precedent final opinions and orders and statements of policy and interpretation. They provide clarification and interpretation of complex or ambiguous provisions of the law or regulations relating to Medicare, Medicaid, Utilization and Quality Control Peer Review, private health insurance, and related matters.

The rulings can be accessed at http://www.cms.gov/Regulations-and-Guidance/Guidance/Rulings. For questions or additional information, contact Tiffany Lafferty (410-786-7548).

Addendum IV: Medicare National Coverage Determinations (October through December 2013)

Addendum IV includes completed national coverage determinations (NCDs), or reconsiderations of completed NCDs, from the quarter covered by this notice. Completed decisions are identified by the section of the NCD Manual (NCDM) in which the decision appears, the title, the date the publication was issued, and the effective date of the decision. An NCD is a determination by the Secretary for whether or not a particular item or service is covered nationally under the Medicare Program (title XVIII of the Act), but does not include a determination of the code, if any, that is assigned to a particular covered item or service, or payment determination for a particular covered item or service. The entries below include information concerning completed decisions, as well as sections on program and decision memoranda, which also announce decisions or, in some cases, explain why it was not appropriate to issue an NCD. Information on completed decisions as well as pending decisions has also been posted on the CMS website. For the purposes of this quarterly notice, we list only the specific updates that have occurred in the 3-month period. This information is available at: www.cms.gov/medicare-coverage-database/. For questions or additional information, contact Wanda Belle (410-786-7491).

Title	NCDM Section	Transmittal Number	Issue Date	Effective Date
TAVR Code Update	NCD20.32	TR2827	11/29/2013	01/06/2014
Changes to the Laboratory National Coverage Determination (NCD) Software for ICD-10 Codes	NCD190	TN2806	11/06/2013	01/06/2014
Bariatric Facility Certification Requirements	NCD100.1	TN 157	11/20/2013	12/17/2013

Addendum V: FDA-Approved Category B Investigational Device Exemptions (IDEs) (October through December 2013)

Addendum V includes listings of the FDA-approved investigational device exemption (IDE) numbers that the FDA assigns. The listings are organized according to the categories to which the devices are assigned (that is, Category A or Category B), and identified by the IDE number. For the purposes of this quarterly notice, we list only the specific updates to the Category B IDEs as of the ending date of the period covered by this notice and a contact person for questions or additional information.

For questions or additional information, contact John Manlove (410-786-6877).

Under the Food, Drug, and Cosmetic Act (21 U.S.C. 360c) devices fall into one of three classes. To assist CMS under this categorization process, the FDA assigns one of two categories to each FDA-approved investigational device exemption (IDE). Category A refers to experimental IDEs, and Category B refers to non-experimental IDEs. To obtain more information about the classes or categories, please refer to the notice published in the April 21, 1997 **Federal Register** (62 FR 19328).

IDE	Device	Start Date
G120295	Medtronic Activa PC+S System	10/02/2013
G130206	Opthalmic Viscosurgical Device/Viscoelastic	10/03/2013
G130202	Medtronic Symplicity Renal Denervation System; Medtronic Arctic Front Advance Cardiac Cryoablation System	10/03/2013
G130186	Activa PC+S Neurostimulation System	10/09/2013
G130210	System, Endovascular Graft, Aortic Aneurysm Treatment	10/10/2013
BB15721	Magnetic-Activated Cell Sorter (CliniMACS, Miltenyi) for CD34+ Selection of G-CSF Mobilized Allogenic Hemotopoietic Stem and Progenitor Cells; Chemotherapy	10/10/2013
G130211	Leica Biosystems Bond Oracle Her2 IHC Assay	10/17/2013
G130216	Sprint Quattro Model 6946M	10/17/2013
BB15651	The Tissue Genesis (TGI) Icellator Cell Isolation System (Icellator)	10/17/2013
G130175	Aquesys Glaucoma Implant	10/18/2013
G130212	Thermal Regulating System	10/18/2013
G130215	Deep Brain Stimulation (DBS) Therapy for Treatment Resistant Depression	10/18/2013
G130220	My Maps: Initial Evaluation of Software For a Patient-Driven Cochlear Implant Mapping Strategy	10/24/2013
G130219	Met/Cen-7 IQFish Probe Mix	10/25/2013
G130221	Stent, Carotid & Temporary Carotid Catheter For Embolic Capture	10/25/2013
G130230	Ventana Anti-PD-L1	10/31/2013
G120180	Masters Series 15 MM Rotatable Mechanical Heart Valve	10/31/2013
G120302	1GL-1	11/07/2013
G130176	Robotic Arm Interactive Orthopedic System (RIO) With Total Knee Arthroplasty Application	11/08/2013
G130238	DEXCOM G4 Platinum Continous Glucose Monitoring System	11/13/2013
G130239	PATHWAY HER-2/neu (4B5) Rabbit Monoclonal Primary Antibody	11/14/2013
G130141	Diagnostic/Ablation Deflectable Tip Catheter	11/15/2013
G130122	Enabler-P Catheter System 6000	11/15/2013
G130114	Bioteque Cup Assembly	11/15/2013
G130246	Nucleus 6 Cochlear Implant System	11/20/2013
G130241	Autogen NG CRT-D, Autogen NG ICD	11/20/2013
G130023	Doxorubicin-Eluting LC Beads	11/21/2013
G100100	Swallow Expansion Device	11/22/2013
G130247	ONYX Liquid Embolic System and Apollo ONYX Delivery Micro-Catheter	11/22/2013
G130252	ECHOPULSE	11/26/2013
G130257	Optiscanner 5000 Glucose Monitoring System	11/27/2013
G130250	Constellation Multiple Electrode Recording and Pacing Catheter	12/04/2013
G120119	Babylog VN500 HFOV Mode	12/04/2013
G130214	Contour Embolization Particules 500-719 Microns	12/04/2013
G130222	Acuity X4 Lead	12/04/2013
G130266	Cook Zenith Multi-Branch TAAA Stent-Graft (Zenith T-Branch Endovascular Graft	12/12/2013
G130166	Medtronic Model 37604 Activa PC+S Implantable Neurostimulator System	12/13/2013
G130267	HAC-Coil Deep Transcranial Magnetic Stimulation (DTMS) Device For The Treatment of Obsessive Compulsive Disorder (OCD)	12/13/2013
G130271	SUPARTZ	12/18/2013
G130274	LabCorp Clinical Trials Assay for ADRB1 Genotype (Arg/Gly)	12/18/2013
G130253	Medtronic Activa PC+S	12/19/2013
G130155	EndoMaxxx EVT Fully Covered Esophageal Stent	12/19/2013
G120232	Gore Viabahn Baloon Expandable Endoprosthesis (Viabahan BX)	12/20/2013
G130283	EmboSphere Microspheres	12/23/2013
G130279	Heartware Left Ventricular Assist Device System	12/24/2013

Addendum VI: Approval Numbers for Collections of Information (October through December 2013)

All approval numbers are available to the public at Reginfo.gov. Under the review process, approved information collection requests are assigned OMB control numbers. A single control number may apply to several related information collections. This information is available at www.reginfo.gov/public/do/PRAMain. For questions or additional information, contact Mitch Bryman (410-786-5258).

Addendum VII: Medicare-Approved Carotid Stent Facilities, (October through December 2013)

Addendum VII includes listings of Medicare-approved carotid stent facilities. All facilities listed meet CMS standards for performing carotid artery stenting for high risk patients. On March 17, 2005, we issued our decision memorandum on carotid artery stenting. We determined that carotid artery stenting with embolic protection is reasonable and necessary only if performed in facilities that have been determined to be competent in performing the evaluation, procedure, and follow-up necessary to ensure

optimal patient outcomes. We have created a list of minimum standards for facilities modeled in part on professional society statements on competency. All facilities must at least meet our standards in order to receive coverage for carotid artery stenting for high risk patients. For the purposes of this quarterly notice, we are providing only the specific updates that have occurred in the 3-month period. This information is available at: http://www.cms.gov/MedicareApprovedFacilitie/CASF/list.asp#TopOfPage For questions or additional information, contact Lori Ashby (410-786-6322).

Facility	Provider Number	Effective Date	State
The following facility is a new listing for this quarter.			
Floyd Memorial Hospital and Health Services 1850 State Street New Albany, IN 47150	1497798847	10/17/2013	IN
Medical Center of Southeast Oklahoma 1800 University Boulevard Durant, OK 74701	370014	10/17/2013	OK
St. Anthony Hospital 11600 W 2nd Place Lakewood, CO 80228	060015	10/17/2013	CO
Highline Medical Center 16251 Sylvester Road SW Burien, WA 98166	500011	10/17/2013	WA
Saint Elizabeth Regional Medical Center 555 South 70th Street Lincoln, NE 68510	280020	08/22/2013	NE
Kennedy University Hospital-Washington Township 435 Hurffville-Cross Keys Road Turnersville, NJ 08012	1386746592	12/06/2013	NJ
Editorial changes (shown in bold) were made to the facilities listed below.			
FROM: St. John's Regional Health Center **TO: Mercy Hospital Springfield** 1235 East Cherokee Street Springfield, MO 65804-2263	260065	06/14/2005	MO
FROM: Parkview Hospital **TO: Parkview Hospital, Inc. d/b/a Parkview Regional Medical Center** 11109 Parkview Plaza Drive Fort Wayne, IN 46845	150021	05/11/2005	IN

Addendum VIII: American College of Cardiology's National Cardiovascular Data Registry Sites (October through December 2013)

Addendum VIII includes a list of the American College of Cardiology's National Cardiovascular Data Registry Sites. We cover implantable cardioverter defibrillators (ICDs) for certain clinical indications, as long as information about the procedures is reported to a central registry. Detailed descriptions of the covered indications are available in the NCD. In January 2005, CMS established the ICD Abstraction Tool through the Quality Network Exchange (QNet) as a temporary data collection mechanism. On October 27, 2005, CMS announced that the American College of Cardiology's National Cardiovascular Data Registry (ACC-NCDR) ICD Registry satisfies the data reporting requirements in the NCD. Hospitals needed to transition to the ACC-NCDR ICD Registry by April 2006.

Effective January 27, 2005, to obtain reimbursement, Medicare NCD policy requires that providers implanting ICDs for primary prevention clinical indications (that is, patients without a history of cardiac arrest or spontaneous arrhythmia) report data on each primary prevention ICD procedure. Details of the clinical indications that are covered by Medicare and their respective data reporting requirements are available in the Medicare NCD Manual, which is on the CMS website at http://www.cms.hhs.gov/Manuals/IOM/itemdetail.asp?filterType=none&filterByDID=99&sortByDID=1&sortOrder=ascending&itemID=CMS014961

A provider can use either of two mechanisms to satisfy the data reporting requirement. Patients may be enrolled either in an Investigational Device Exemption trial studying ICDs as identified by the FDA or in the ACC-NCDR ICD registry. Therefore, for a beneficiary to receive a Medicare-covered ICD implantation for primary prevention, the beneficiary must receive the scan in a facility that participates in the ACC-NCDR ICD registry. The entire list of facilities that participate in the ACC-NCDR ICD registry can be found at www.ncdr.com/webncdr/common

For the purposes of this quarterly notice, we are providing only the specific updates that have occurred in the 3-month period. This information is available by accessing our website and clicking on the link for the American College of Cardiology's National Cardiovascular Data Registry at: www.ncdr.com/webncdr/common. For questions or additional information, contact Marie Casey, BSN, MPH (410-786-7861).

Facility	City	State
The following facilities are new listings for this quarter.		
Memorial Hospital of Union County	Marysville	OH
Mount St Mary's Hospital	Lewistown	NY
Hospital Pavia Santurce	San Juan	PR
The following facilities are terminated as of this quarter.		
New York Presbyterian Hospital	New York	NY
Christus Santa Rosa Hospital-City Center	San Antonio	TX
Tobey Hospital	Wareham	MA
University Hospitals Richmond Medical Center	Richmond Heights	OH
Skyridge Medical Center	Cleveland	TN

Facility	City	State
The following facilities are new listings for this quarter.		
Kaiser Permanente - Panorama City	Panorama City	CA
Fallbrook Hospital	Fallbrook	CA

Addendum IX: Active CMS Coverage-Related Guidance Documents (October through December 2013)

There are no CMS coverage-related guidance documents published in the October through December 2013 quarter. To obtain the document, visit the CMS coverage website at http://www.cms.gov/medicare-coverage-database/details/medicare-coverage-document-details.aspx?MCDId=23. For questions or additional information, contact Lori Ashby (410-786-6322).

Addendum X: List of Special One-Time Notices Regarding National Coverage Provisions (October through December 2013)

There were no special one-time notices regarding national coverage provisions published in the October through December 2013 quarter. This information is available at www.cms.hhs.gov/coverage. For questions or additional information, contact Lori Ashby (410-786-6322).

Addendum XI: National Oncologic PET Registry (NOPR) (October through December 2013)

Addendum XI includes a listing of National Oncologic Positron Emission Tomography Registry (NOPR) sites. We cover positron emission tomography (PET) scans for particular oncologic indications when they are performed in a facility that participates in the NOPR.

In January 2005, we issued our decision memorandum on **positron emission tomography** (PET) scans, which stated that CMS would cover PET scans for particular oncologic indications, as long as they were performed in the context of a clinical study. We have since recognized the National Oncologic PET Registry as one of these clinical studies. Therefore, in order for a beneficiary to receive a Medicare-covered PET scan, the beneficiary must receive the scan in a facility that participates in the registry. For the purposes of this quarterly notice, we list only the specific updates to the listing of National Oncologic Positron Emission Tomography Registry (NOPR) in the October through December 2013 quarter. This information is available at http://www.cms.gov/MedicareApprovedFacilitie/NOPR/list.asp#TopOfPage.

For questions or additional information, contact Stuart Caplan, RN, MAS (410-786-8564).

The following facilities were removed from the NOPR listing as of this quarter.		
Facility Name	Provider Number	State
ACMH Hospital One Nolte Drive Kittanning PA 16201	390163	PA
Advanced Imaging Center 16110 Jog Road, 200 Delray Beach FL 33446	U2049	
Advanced Imaging Center 615 Valley View Drive, Suite 101 Moline IL 61265	702970	IL
Advanced Medical Imaging San Saba 215 N San Saba, Suite 107 San Antonio, TX 78207	00BC90	TX
Advanced Medical Imaging Stone Oak 540 Oak Centre, Suite 100 San Antonio, TX 78258	00BC90	TX
Advanced Medical Specialties 9035 Sunset Drive, Suite 102 Miami, FL 33173	K7806	FL
Advanced Radiological PET Imaging, PC 2334 30th Avenue Lower Level Antoria, NY 11102	05677	NY
Advanced Radiology GBMC MRI and PET CT 6715 N Charles Street Baltimore, MD 21204	527L	MD
Adventist Health PET/CT - Feather River 5974 Pertz Road Paradise CA 95969	ZZZ318852	CA
Adventist Health PET/CT – Hanford 450 N Greenfield Avenue Hanford CA 93230	ZZZ318852	CA
Adventist Health PET/CT – Redbud 18th Avenue at Hwy 53, P.O. Box 6710 Clear Lake CA 95422	ZZZ318852	CA
Adventist Health PET/CT - St Helena 10 Woodland Road St Helena CA 94574	ZZZ318852	CA
Adventist Health PET/CT – Ukiah 275 Hospital Drive Ukiah CA 95482	ZZZ318852	CA
Advocate Good Samaritan 3815 Highland Avenue Downers Grove IL 60515	140288	IL
Alexian Brothers Medical Center 820 Biesterfield Road Elk Grove Village IL 60007	1265577191	IL
Allen Memorial Hospital 1825 Logan Avenue Waterloo IA 50703	160110	IA
Allison Cancer Center 301 North N Street Midland, TX 79701	140414744	TX
Alpha Med Physicians Group 17333 S LaGrange Road Suite 200 Tinley Park IL 60477	610860	IL
Altru Hospital 1200 S. Columbia Road Grand Forks ND 58201	350019	ND
American Fork Hospital 170 North 1100 East American Fork UT 84003	460023	UT
American Radiology Services – Bethesda 6430 Rockledge Drive, Suite 100 Bethesda, MD 20817	G00000	MD

The following facilities were removed from the NOPR listing as of this quarter.		
Angel Williamson Imaging Center - Ft. Walton Beach 1013-D Mar-Walt Drive Ft. Walton Beach, FL 32547	39953A	FL
Angel Williamson Imaging Center – Pensacola 5120 Bayou Boulevard, Suite 9 Pensacola, FL 32503	39953	FL
Appleton Medical Center 1818 N Meade Street Appleton, WI 54911	520160	WI
ARA imaging - Rock Creek 2120 N Mays, #220 Round Rock, TX 78664	20-1651590	TX
ARA imaging – Southwood 1701 W Ben White Boulevard, #170 Austin, TX 78704	20-1651590	TX
ARH Hazard 100 Medical Center Drive Hazard KY 41701	520795508	KY
Aria Hospital Red Lion & Knights Rd Philadelphia PA 19114 Phone #: 215-612-4173	1801963343	PA
Audrain Medical Center 620 E Monroe Street Mexico, MO 65202 Phone #: 573-582-8210	1952390122	MO
Aurora BayCare Medical Center 2845 Greenbrier Road Green Bay WI 54308	520193	WI
Aurora Lakeland Medical Center W3985 County Rd NN Elkhorn WI 53121	520102	WI
Aurora Medical Center Oshkosh 855 N. Westhaven Drive Oshkosh, WI 54904	590198	WI
Austin, Radiological Assn - San Marcos 1348 B Hwy 123 South San Marcos, TX 78666	74-1597116	TX
Avera Sacred Heart Cancer Center 501 Summit Street Yankton SD 57078	430012	SD
Baptist M & S Imaging Center – Downtown 215 E. Quincy Suite #100 San Antonio, TX 78215	FTA078	TX
Baptist M & S Imaging Center 7888 Fredericksburg Road San Antonio, TX 78228	FTA078	TX
Bay Area Hospital 1775 Thompson Road Coos Bay OR 97420	30090	OR
Bay Area Medical Center 3100 Shore Drive Marinette WI 54143	520113	WI
Baylor Medical Center at Irving North MacArthur Boulevard Irving TX 75061	450079	TX
Beebe Health Campus dba Beebe Medical Center 18941 John J Williams Highway Rehoboth DE 19971	80007	DE
Beloit Memorial Hospital 1969 West Hart Road Beloit WI 53511	520100	WI
Benefis Healthcare 1101 26th Street South Great Falls MT 59405	270012	MT
Bethesda Health City 2623 S Seacrest Boulevard Boynton Beach, FL 33435	40237	FL
Bluegrass Regional Imaging, LLC	1871542670	KY

The following facilities were removed from the NOPR listing as of this quarter.		
701 Bob-O-Link Drive Suite 245 Lexington KY 40504		
BodyScan of Louisville LLC 7807 Shelbyville Road, Suite 201 Louisville, KY 40222	9372701	KY
Boynton Beach EFL Imaging Center, LLC 2300 S Congress Avenue Boynton Beach, FL 33426	272376000	FL
Bozeman Deaconess Hospital 915 Highland Boulevard Bozeman MT 59715	1720079619	MT
California Imaging and Treatment Center 3000 Oak Road, #111 Walnut Creek, CA 95497	ZZZ27175Z	CA
Cancer Care and Hematology Specialists (CCHSC) 8915 West Golf Road Niles IL 60714-5825	355030	IL
Cancer Center of Kansas 818 N Emporia Street Suite 100 Wichita, KS 67214	110217	KS
Cancer Care Centers of Brevard 1430 S Pine Street Melbourne, FL 32901	39835	FL
Cape Cod PET/CT Services LLC 55 Fogg Road Weymouth MA 02190	0010594	MA
Capital Health System 1 Capital Way Pennington, NJ 08534 Phone #: 609-537-7333	310044	NJ
Carson Tahoe Regional Healthcare 2874 N Carson St 3rd Floor Carson City NV 89706	290019	NV
Cayuga Medical Center @ Ithaca 101 Dates Drive Ithaca NY 14850	330307	NY
Centerpoint Medical Center 19600 E. 39th Street Independence, MO 64057 Phone #: 816-698-7132	260095	MO
Central Baptist Diagnostic Center 100 Southland Drive Suite B Lexington, KY 40503	9375001	KY
Central Florida Regional Hospital 1401 W. Seminole Boulevard Sanford FL 32771	100161	FL
Central Texas Medical Center 1301 Wonder World Drive San Marcos, TX 78666	450272	TX
Central Virginia Imaging, LLC 1900 Tate Springs Road Suite 21 Lynchburg VA 24501	1578594412	VA
Chilton Memorial Hospital 97 West ParkWay Pompton Plains NJ 07444	310017	NJ
CHRISTUS Central Louisiana Imaging Center 3704 N Boulevard Alexandria LA 71301	190019	LA
Columbia, St Mary's Hospital 2025 E Newport Avenue, Columbia, Campus Milwaukee, WI 53211	520051	WI
Commonwealth Hematology Oncology 216 Southtown Drive Danville, KY 40422	1285687178	KY
Community Hospital 10020 Donald S. Powers Drive Munster IN 46321	140125	IN
Community Hospital, New Port Richey 5637 Marine Parkway New Port Richey FL 34652	100191	FL

The following facilities were removed from the NOPR listing as of this quarter.		
Community Hospital of Bryan 433 W. High Street Bryan, OH 43506 Phone #: 419-636-1131	360121	OH
Community Hospitals and Wellness Centers 433 W. High Street Bryan OH 43506	360121	OH
Cotton-O'Neil Cancer Center 1414 SW 8th Street Topeka KS 66606	1811944457	KS
Decatur PET Imaging 2774 W Decatur Road Decatur GA 30033	47BBBLP	GA
Delta County Memorial Hospital 1501 East 3rd Street Delta CO 81416	1417935446	CO
Desert Radiologists 3930 S Eastern Avenue Las Vegas NV 89119	VWCCBT	NV
Diagnostic Imaging Services, LLC 11110 Medical Campus Road, Suite 204 Hagerstown MD 21742	1114982808	MD
Diagnostic PET/CT of Chattanooga 2205 McCallie Avenue, Suite 400 A Chattanooga, TN 37404 Phone #: 423-643-0738	621846872	TN
Diagnostic Radiology Systems, Inc. 1010 Medical Center Drive Powderly KY 42366	936601	KY
Dixie Regional Medical Center 544 South 400 East St. George UT 84790	460021	UT
Doctors Hospital at Renaissance, Ltd 5501 S. McColl Road Edinburg TX 78359	450869	TX
Duncan Regional Hospital 1700 Whisenant Drive PO Box 100 Duncan OK 73534	370023	OK
East Alabama Medical Center-Auburn Diagnostic Imaging 1527 Professional Parkway Auburn AL 36830	29	AL
EPIC Imaging Center 233 NE 102 Avenue Portland OR 97220	0000WCGNQ	OR
EVDI Medical Imaging - East Mesa 6424 E. Broadway Road Suite 101 Mesa AZ 85206	1164434098	AZ
First Imaging of the Carolinas 30 Memorial Drive Pinehurst NC 29374	2346997	NC
Florida Cancer Institute - New Hope 4003 Mariner Boulevard Spring Hill FL 34609	K4006	FL
Florida Cancer Institute - NPR 8763 River Crossing Boulevard New Port Richey FL 34655	1427017326	FL
Florida Cancer Specialists- HLD 4371 Veronica S. Shoemaker Boulevard Fort Myers FL 33916 Phone #: 239-274-8200	1760590962	FL
Florida Hospital Flagler 60 Memorial Medical Parkway Palm Coast, FL 32164 Phone #: 386-586-4370	100118	FL
Fresno Imaging Center 6191 N. Rhesta Avenue Fresno CA 93710		CA

The following facilities were removed from the NOPR listing as of this quarter.		
Gerald Champion Regional Medical Center 2669 N. Scenic Drive Alamogordo NM 88310	320004	NM
Glendale Adventist Medical Center 1509 Wilson Terrace Glendale CA 91206	1831188275	CA
Good Samaritan PET/CT and Imaging Services 1245 Montauk Highway West Islip NY 11795	330286	NY
Griffin Hospital 130 Division Street Derby CT 06418	70031	CT
Health Village Imaging 11301 Route 72 West Suite 100 Manahawkin NJ 08050	1194810978	NJ
Hennepin County Medical Center 701 Park Avenue Minneapolis MN 55415 Radiology - P4; Phone #: 612-873-7566	240004	MN
Henry Ford Wynandotte Hospital PET Imaging 23050 West Road Brownstown, MI 48183 Phone #: 734-246-9151	230146	MI
Home Hospital GLHS 2400 South Street Lafayette IN 47904	150109	IN
Hudson Valley Radiology Associates of Westchester 115 Main Street Tuckahoe NY 10707	1174574115	NY
Huntsman Cancer Hospital 2000 Circle of Hope, Suite 2121 Salt Lake City UT 84112-5550	460009	UT
Huron Valley-Sinai Hospital 1 William Carl Drive Commerce, MI 48382	23-0277	MI
Imaging Center of North Central Indiana, INC 2201 W Boulevard Kokomo, IN 46902	224110	IN
Immanuel-St. Josephs Mayo Health System 1025 Marsh Street Mankato MN 56002-8673	240093	MN
Intermed Oncology Associates, S.C. 6701 159th Street Tinley Park IL 60477	610860	IL
John Randolph Medical Center 411 W. Randolph Road Hopewell VA 23860	490020	VA
Johnson City Medical Center 400 North State of Franklin Johnson City, TN 37642	440063	TN
Johnson Memorial Hospital 1125 W. Jefferson Street Franklin IN 46131-2675 PO Box 549	150001	IN
Julia Rackley Perry Memorial Hospital 530 Park Avenue East Princeton IL 61356	141337	IL
Kell West Regional Hospital 5420 Kell West Boulevard Wichita Falls TX 76310	450827	TX
Kentucky Metabolic Imaging 2425 Regency Road Suite B Lexington KY 40503	9366001	KY
Kingston Diagnostic Center 167 Schwenk Drive Kingston, NY 12401	W1L921	NY

The following facilities were removed from the NOPR listing as of this quarter.		
Kuakini Medical Center 347 N Kuakini Street Honolulu HI 96817 Phone #: 808-547-9549	120007	HI
Lafayette General Medical Center-LGI 1211 Coolidge Boulevard Suite 201 Lafayette LA 70503	1275536799	LA
Lake City Imaging, LLD DBA Invision - Lake City 3140 NW Medical Center Land, Suite 100 Lake City, FL 32055 Phone #: 386-755-2020	1295038115	FL
Lake Pointe Imaging Center 1005 West Ralph Hall Parkway, #121 Rockwall TX 75032		
LaPorte Hospital & Healthcare Services 1007 Lincolnway LaPorte IN 46350	150006	IN
Larchmont Imaging Associates, LLC 210 Ark Road Mt. Laurel NJ 08054	517216	NJ
Lemmen Holton Cancer Pavilion 145 Michigan Street, NE Grand Rapids MI 49503	230038	MI
Lexington Clinic 1221 South Broadway Lexington KY 40504	169	KY
LifeScan Minnesota 6525 France Avenue S, Suite 225 Edina, MN 55435	470000014	MN
Lourdes Hospital 1530 Lone Oak Road Paducah KY 42003	1346244126	KY
Maine Medical Center 100 Campus Drive Scarborough, ME 04074 Phone #: 207-662-6203	200009	ME
Mankato Clinic 1421 Premier Drive Mankato MN 56001	1629044029	MN
Maple Grove Fairview 14500 99th Ave North Maple Grove MN 55369	1841315165	MN
Mary Bird Perkins Covington 1203 Southe Tyler Covington, LA 70433 Phone #: 985-875-2234	1295833580	LA
Mass. Mobile PET, P.C. Newburyport 25 Highland Avenue Newburyport MA 01950	327086	MA
Mayo Clinic Rochester 10, 3rd Avenue NW Rochester MN 55905 Charlton Building	1922074434	MN
Meadowbrook PET Associates 1695 Huntington Pike Meadowbrook PA 19046	064866	PA
Medical Doctors Imaging, Inc. 2020 Court Street Redding CA 96001	1235161480	CA
MedSpecialists Imaging Center 1064 Keene Road Dunedin FL 34698	AB585	FL
Memorial Hermann Southeast 11800 Astoria Boulevard Houston TX 77089	741152597	TX
Memorial Hospital and Health Care Center 800 W. 9th Street Jasper IN 47546 Phone #: 812-482-0656	1003895947	IN

The following facilities were removed from the NOPR listing as of this quarter.		
Memorial Hospital of Union County 500 London Avenue Marysville OH 43040	360092	OH
Mercy Health System 1000 Mineral Point Avenue Janesville WI 53548	520066	WI
Mercy Medical Center - Cedar Rapids 701 Tenth Street SE Cedar Rapids IA 52403	16-0079	IA
Mercy Medical Center – Dubuque 250 Mercy Drive Dubuque IA 52001	1659348506	IA
Mercy Medical Center - North Iowa 1000 4th Street SW Mason City, IA 50401	160064	IA
Middlesex Hospital 534 Saybrook Road Middletown CT 06457	70020	CT
MidMichigan Medical Center – Midland 4005 Orchard Drive Midland, MI 48670 Phone #: 989-839-3430	230222	MI
Midwest Radiologic Imaging – 214790 4087 Gateway Boulevard Newburgh IN 47630	214790	IN
Midwest Radiologic Imaging 4087 Gateway Boulevard Newburgh IN 47630	1144217241	IN
MMI/St. Mary's Hospital 51 US Route 1 Suite O Scarborough, ME 04074	327079	ME
MMI/Mid Coast Hospital 51 US Route 1 Suite O Scarborough ME 04074	327079	ME
MMI/Maine Medical Center 51 US Route 1 Suite O Scarborough ME 04074	327079	ME
MMI/Maine General Waterville 51 US Route 1 Suite O Scarborough ME 04074	327079	ME
Molecular Imaging at Sequoia Imaging Center 4949 W. Cypress Avenue Visalia CA 93277	ZZZ27463Z	CA
Modality Integration Services, Inc 1854 SW Greenway Circle West Linn, OR 97068		OR
Monongalia General Hospital 1200 J. D. Anderson Drive Morgantown WV 26505	510024	WV
Monroe Clinic 515 22nd Avenue Monroe, WI 53566	520028	WI
Mt Carmel Regional Medical Center 1102 East Centennial Drive Pittsburg, KS 66762	014041	KS
Murray-Calloway County Hospital 803 Poplar Street Murray KY 42071	1073504981	KY
National Medical Imaging – Langhorne 2 Doublewoods Road, Suite B Langhorne PA 19047	024513	PA
Nebraska Health Imaging 7819 Dodge Street Omaha NE 68114	098975	NE
New England PET Imaging Manchester One Elliot Way Manchester NH 03103	327081	NH
New England PET Imaging System 70 East Street Methuen MA 01844	327081	MA

The following facilities were removed from the NOPR listing as of this quarter.		
New England PET of Greater Lowell 295 Varnum Avenue Lowell, MA 01854	327080	MA
New Jersey State Open MRI 155 State Street Hackensack NJ 07601	85238	NJ
New Mexico Oncology Hematology Consultants, Ltd. 4901 Lang Ave NE Albuquerque NM 87109	850367056	NM
New Rochelle Radiology Associates, PC 175 Memorial Highway New Rochelle NY 10801	W05571	NY
North Memorial Medical 3435 West Broadway Robbinsdale MN 55422	1851344907	MN
North Texas Regional Cancer Center 3705 W 15th Street Plano TX 75075	00543K	TX
Northeast Radiology 3839 Danbury Road Brewster NY 10509	1134118607	NY
Northern Michigan Hospital 416 Connable Avenue Petoskey MI 49770		MI
Northwest Community Hospital 800 W Central Road Arlington Heights, IL 60005	36-2340313	IL
Norton Hospital 315 E. Broadway Louisville KY 40202	180088	KY
Norton Premier Diagnostic Imaging 10019 Forest Green Boulevard Louisville KY 40299	18-0088	KY
NYOH Mobile PET/CT Imaging – Ellis 600 McLellan Street mc#7 Schenectady NY 12304 Phone #: 518-262-9000	1609863448	NY
OConnor Hospital 2105 Forest Avenue San Jose CA 95128-1471	50153	CA
Oncology Hematology Associates of Central Illinois 8940 N. Wood Sage Road Peoria IL 61615		
Oncology Hematology Associates of Southwest IN 3699 Epworth Road Newburgh IN 47630	1710150222	IN
Oncology Hematology West, P.C. 17201 Wright Street, Suite 100 Omaha NE 68130	1932178530	NE
Orange City Area Health System 1000 Lincoln Circle SE Orange City IA 51041	161360	IA
Oregon Advanced Imaging 881 O'Hare Parkway Medford, OR 97504	R114546	OR
Oxford Valley Diagnostic Center 940 Town Center Drive Langhorne, PA 19047 Suite F50	232745550	PA
Parkway Ventures Inc 9000 Franklin Square Drive Baltimore MD 21237 Franklin Square Hospital Center	FMN002	MD
Parkwest Imaging 3676 Parker Boulevard Pueblo CO 81008	455838	CO
Patient Comprehensive Cancer Center 4352 North Josey Lane Carrollton TX 75010	0083BY	TX

The following facilities were removed from the NOPR listing as of this quarter.		
PET Imaging at the Lake 5000 Hennessy Boulevard Baton Rouge LA 70809	5C868	LA
PET Imaging of Tulsa 6711 S Yale Avenue, Suite 104 Tulsa, OK 74136	400522320	OK
PET Imaging Radiology, PSC Paseo San Pablo 100 Bayamon, PR 00961 Edif Dr Arturo Cadilla Suite 208	0085142	PR
Pet Medical Imaging Center 3264 North Evergreen Drive Grand Rapids MI 49525	0P02650	MI
Pitt County Memorial Hospital 2100 Stantonsburg Road Greenville, NC 27835	56-0585243	NC
Presbyterian Hospital Huntersville 10030 Gilead Road Huntersville, NC 28078 Phone: 704-316-4000	3400053	NC
Providence Park Hospital NOVI 47601 Grand River Avenue Novi MI 48374	230019	MI
Puget Sound PET Imaging 6808 220th Street SW Mountlake Terrace WA 98043 Suite 150	115162600	WA
Putnam Hospital Center 670 Stoneleigh Avenue Carmel NY 10512	330273	NY
Quantum PET - Apple Hill 37 Monument Road York PA 17403	40635	PA
Quantum PET - Holy Spirit Hospital 890 Poplar Church Road Camp Hill PA 17011	40635	PA
Queen of the Valley 1000 Trancas Street Napa CA 94558	941243669	CA
Quest Imaging Medical Associates 9602 Stockdale Highway Bakersfield, CA 93311 Phone #: 661-633-5000	1942236443	CA
Radiation Oncology @ WFUBMC Radiation Oncology Medical Center Boulevard Winston-Salem NC 27152 Wake Forest University Baptist Medical Center - Comprehensive Cancer Center	340047	NC
Radiology Associates of Brooklyn LLP 2021 Ave X Brooklyn NY 11235-2905	1134244916	NY
Raritan Bay Medical Center 1 Hospital Plaza Old Bridge, NJ 08857	310039	NJ
RCOA-Adventist Health-Sequoia 4949 W Cypress Avenue Visalia CA 93271	1427198696	CA
RCOA Imaging Services 1108 Minnequa Avenue Pueblo CO 81004	475748	CO
RCOA Imaging Services 11937 US Highway 271 Tyler TX 75708	FTN022	TX
Regional West Medical Center 4021 Avenue B Scottsbluff NE 69361	1639101199	NE

The following facilities were removed from the NOPR listing as of this quarter.		
Regions Imaging Center 401 Phalen Boulevard, 41101C St. Paul MN 55101		
Renaissance Imaging Center at Northridge Hospital 18436 Roscoe Boulevard Northridge, CA 91325 Phone #: 818-435-1436	1487608931	CA
Reno Diagnostic Centers 590 Eureka Avenue Reno, NV 89512	1518904994	NV
Riverside Diagnostic Center 120 Kings Way Williamsburg VA 23188	490052	VA
Riverview Hospital Association 410 Dewey Street Wisconsin Rapids WI 54495	520033	WI
Robert L. B. Tobin Diagnostic Imaging Center Wurzbach Drive, Suite U113 San Antonio TX 78229	00867N	TX
Rutland Regional Medical Center: Diagnostic Imaging 160 Allen Street Rutland VT 05701	470005	VT
Saint Francis Hospital 114 Woodland Street Hartford, CT 06105	07-0002	CT
Saint Joseph's Hospital - Nuclear Medicine 611 St. Joseph Avenue Marshfield WI 54449	520037	WI
Saint Vincent's Comprehensive Cancer Center 325 West 15th Street New York, NY 10011	330290	NY
St. Anthony Hospital 1601 SE Court Avenue Pendelton, OR 97801 Phone #: 541-278-3228	381319	OR
St. Elizabeth Health Center 1044 Belmont Avenue Youngstown, OH 44501	360064	OH
St. Helena Hospital 10 Woodland Road St Helena CA 94574	50013	CA
St. John's Mercy Hospital 851 5th Street Washington MO 63090	260052	MO
St. Louis University Hospital 3665 Vista Avenue St Louis, MO 63110	000050109	MO
St. Luke's North PET 153 Brodhead Road Bethlehem PA 18017	390049	PA
St. Vincent Hospital PO Box 13508 Green Bay WI 54307	520075	WI
Samaritan North Health Center 9000 N. Main Street Dayton OH 45415	360052	OH
Sarasota Memorial PET 5350 University Parkway Sarasota FL 34238	U1775	FL
Sentara Mobile PET/CT – Careplex 5900 Lake Wright Drive, Suite B Norfolk, VA 23502	250605	VA
Sentara Mobile PET/CT – Williamsburg 5900 Lake Wright Drive, Suite B Norfolk, VA 23502	250605	VA
Sky Lakes Medical Center 2865 Daggett Avenue Klamath Falls OR 97601	380050	OR

The following facilities were removed from the NOPR listing as of this quarter.		
South Central Regional Medical Center 1220 Jefferson Street Laurel, MS 39440 Phone: 601-426-4054	250058	MS
South Lake Hospital 1900 Don Wickham Drive Clermont, FL 34711 Phone #: 352-394-4071	100051	FL
Southeast Georgia Health System 2415 Parkwood Drive Brunswick GA 31520	110025	GA
Southern New Mexico Cancer 150 Road Runner Parkway Las Cruces NM 88011	752131429	NM
Southern Ohio Medical Center 1121 Kinneys Lane Portsmouth OH 45662	360008	OH
Southwest General Medical Center 18181 Pearl Road Strongsville, OH 44136 Phone #: 440-816-4771	1154353993	OH
Southwest Washington Medical Center 400 NE Mother Joseph Place Vancouver WA 98668	500050	WA
Southwestern Vermont Medical Center 100 Hospital Drive Bennington, VT 05201 Phone #: 802-447-5112	1205865789	VT
Sutter Medical Foundation – West 2700 Low Court Fairfield, CA 94533 Phone #: 707-432-2511	ZZZ30412Z	CA
Stevens Community Medical Center 400 East 1st Street Morris, MN 56267 PO Box 660; Phone #: 320-589-1313	241363	MN
Swedish Covenant Hospital 5145 N California Avenue Chicago IL 60625	362179813	IL
Tanner Medical Center 119 Ambulance Drive Carrollton GA 30117	110011	GA
Texas Cancer Center -Sherman 2800 Hwy 75 North Sherman, TX 75090	00543K	TX
Texas Oncology Cancer Center Sugar Land 1350 First Colony Boulevard Sugar Land TX 77479	0073F	TX
Texas Oncology – Grapevine 1631 Lancaster Drive, Suite 150 Grapevine, TX 76051 Phone #: 817-281-9080	1033386578	TX
Texas Oncology PA-Mckinney 4510 Medical Center Drive #215 Mckinney, TX 75069	00543K	TX
The Cancer Center at Kishwaukee Community Hospital 10 Health Services Drive Dekalb, IL 60115	140286	IL
The Cancer Center at Lake Manassas 7901 Lake Manassas Drive Gainesville VA 20155	1518024934	VA
The Christ Hospital 2139 Auburn Avenue Cincinnati OH 45219	360163	OH
The Iowa Clinic / PETCO LLC 1221 Pleasant Street Des Moines IA 50309	I5819	IA

The following facilities were removed from the NOPR listing as of this quarter.		
The Pottsville Hospital and Warne Clinic 420 South Jackson Street Pottsville PA 17901	390030	PA
Thibodaux Regional Medical Center 602 North Acadia Road Thibodaux LA 70301	190004	LA
Toledo Clinic, Inc. 4235 Secor Road Toledo OH 43623	1144217894	OH
Tyler PET 415 South Fleishel Avenue Tyler TX 75702	752131429	TX
UAMS PET Center 4301 West Markham Street Little Rock AR 72205	50528	AR
UCSD Center for Molecular 11388 Sorrento Valley Road, Suite 100 San Diego CA 92121	TG302	CA
UMDNJ-University Hospital 30 Bergen Street Newark NJ 07101 ADMC 5 Room 575 P.O. Box 1709	221775306	NJ
United Radiology - Silver Spring PO Box 34979 West Bethesda, MD 20827	FMN007	MD
University Nuclear Medicine, Inc 105 Parker Hall 3435 Main Street Buffalo NY 14214	14414A	NY
UPMC - PET Imaging Facility 200 Lothrop Street 9th Floor B-wing PUH Pittsburgh, PA 15213	390164	PA
Valley Imaging Partnership 1401 W Merced Avenue #103 West Covina, CA 91790	TP035	CA
Via RADIOLOGY- Meridian Pavilion 11011 Meridian Avenue North #101 Seattle WA 98133	8859612	WA
WCA Hospital PO Box 840 207 Foote Avenue Jamestown NY 14701	330239	NY
West Michigan Cancer Center 200 N Park Street Kalamazoo MI 49007	0N66660	MI
Westfields Hospital 535 Hospital Road New Richmond WI 54017 Phone #: 715-243-2735	520026	WI
Wheaton Franciscan Healthcare Franklin 10101 S 27th Street Franklin WI 53132	520204	WI
William Beaumont Hospital - Royal Oak 3601 West 13 Mile Road Royal Oak MI 48073-6769	23030	MI
William W. Backus Hospital 326 Washington Street Norwich CT 06360	70024	CT
Windber Medical Center 600 Somerset Avenue Winber PA 15963	390112	PA
X-RAY Associates at Santa Fe 490 A West Zia Road, Suite 130 Santa Fe NM 87505	2258263	NM

Addendum XII: Medicare-Approved Ventricular Assist Device (Destination Therapy) Facilities (October through December 2013)

Addendum XII includes a listing of Medicare-approved facilities that receive coverage for ventricular assist devices (VADs) used as destination therapy. All facilities were required to meet our standards in order to receive coverage for VADs implanted as destination therapy. On October 1, 2003, we issued our decision memorandum on VADs for the clinical indication of destination therapy. We determined that VADs used as destination therapy are reasonable and necessary only if performed in facilities that have been determined to have the experience and infrastructure to ensure optimal patient outcomes. We established facility standards and an application process. All facilities were required to meet our standards in order to receive coverage for VADs implanted as destination therapy.

For the purposes of this quarterly notice, we are providing only the specific updates that have occurred to the list of Medicare-approved facilities that meet our standards in the 3-month period. This information is available at http://www.cms.gov/MedicareApprovedFacilitie/VAD/list.asp#TopOfPage. For questions or additional information, contact Marie Casey, BSN, MPH (410-786-7861).

Facility	Provider Number	Date Approved	State
The following facilities are new listings for this quarter.			
Lehigh Valley Hospital 1200 S. Cedar Crest Boulevard Allentown, PA 18105	390133	10/30//2013	PA
UCSF Medical Center 505 Parnassus Avenue San Francisco, CA 94143	050454	10/16/2012	CA
Albany Medical Center Hospital 43 New Scotland Avenue Albany, NY 12208	33-0013	11/06/2013	NY
York Hospital 1001 South George Street York, PA 17405	390046	11/22/2013	PA

Addendum XIII: Lung Volume Reduction Surgery (LVRS) (October through December 2013)

Addendum XIII includes a listing of Medicare-approved facilities that are eligible to receive coverage for lung volume reduction surgery. Until May 17, 2007, facilities that participated in the National Emphysema Treatment Trial were also eligible to receive coverage. The following three

types of facilities are eligible for reimbursement for Lung Volume Reduction Surgery (LVRS):

- National Emphysema Treatment Trial (NETT) approved (Beginning 05/07/2007, these will no longer automatically qualify and can qualify only with the other programs);
- Credentialed by the Joint Commission (formerly, the Joint Commision on Accreditation of Healthcare Organizations (JCAHO)) under their Disease Specific Certification Program for LVRS; and
- Medicare approved for lung transplants.

Only the first two types are in the list. There were no updates to the listing of facilities for lung volume reduction surgery published in the October through December 2013 quarter. This information is available at www.cms.gov/MedicareApprovedFacilitie/LVRS/list.asp#TopOfPage. For questions or additional information, contact Marie Casey, BSN, MPH (410-786-7861).

Addendum XIV: Medicare-Approved Bariatric Surgery Facilities (October through December 2013)

Addendum XIV includes a listing of Medicare-approved facilities that meet minimum standards for facilities modeled in part on professional society statements on competency. All facilities must meet our standards in order to receive coverage for bariatric surgery procedures. On February 21, 2006, we issued our decision memorandum on bariatric surgery procedures. We determined that bariatric surgical procedures are reasonable and necessary for Medicare beneficiaries who have a body-mass index (BMI) greater than or equal to 35, have at least one co-morbidity related to obesity and have been previously unsuccessful with medical treatment for obesity. This decision also stipulated that covered bariatric surgery procedures are reasonable and necessary only when performed at facilities that are: (1) certified by the American College of Surgeons (ACS) as a Level 1 Bariatric Surgery Center (program standards and requirements in effect on February 15, 2006); or (2) certified by the American Society for Bariatric Surgery (ASBS) as a Bariatric Surgery Center of Excellence (BSCOE) (program standards and requirements in effect on February 15, 2006).

For the purposes of this quarterly notice, we list only the specific updates to Medicare-approved facilities that meet CMS's minimum facility standards for bariatric surgery and have been certified by ACS and/or ASMBS in the 3-month period. This information is available at www.cms.gov/MedicareApprovedFacilitie/BSF/list.asp#TopOfPage. For questions or additional information, contact Kate Tillman, RN, MAS (410-786-9252).

Facility	Provider Number	Date Approved	State
The following facilities are new listings for this quarter.			
Clara Maass Medical Center 1 Clara Maass Drive Belleville, NJ 07109	1902901333	09/17/2013	NJ
Hamilton Surgery Center, LLC d/b/a Community Surgery Center Hamilton 9700 East 146th Street, Suite 100 Noblesville, IN 46060	1376780916	06/18/2013	IN
Editorial changes (shown in bold) were made to the facilities listed below.			
FROM: Christus Schumpert Health System **TO: Christus Schumpert Highland** **1453 East Bert Kouns Industrial Loop** **Shreveport, LA 71105**	190041	12/02/2005	LA
Physicians' Specialty Hospital 3873 North Parkview Drive Fayetteville, AR 72703	**1821249533**	08/16/2010	AR
West Georgia Health System 1514 Vernon Road LaGrange, GA 30240	**1821221144**	10/23/2012	GA
FROM: Presbyterian Hospital **TO: Novant Health Presbyterian Medical Center** 200 Hawthorne Lane Charlotte, NC 28204	1881647204	06/06/2007	NC

Addendum XV: FDG-PET for Dementia and Neurodegenerative Diseases Clinical Trials (October through December 2013)

There were no FDG-PET for Dementia and Neurodegenerative Diseases Clinical Trials published in the October through December 2013 quarter.

This information is available on our website at www.cms.gov/MedicareApprovedFacilitie/PETDT/list.asp#TopOfPage. For questions or additional information, contact Stuart Caplan, RN, MAS (410-786-8564).

[FR Doc. 2014–02069 Filed 1–30–14; 8:45 am]
BILLING CODE 4120–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Administration for Children and Families

Notice of Meetings for Early Head Start-Child Care Partnerships

AGENCY: Administration for Children and Families, HHS.

ACTION: Notice of public meetings via webinar and telephone call-in.

SUMMARY: This public meeting is to obtain input on the creation of Early Head Start (EHS)-Child Care Partnerships that were authorized by the 2014 Omnibus Act, which was released on January 17, 2014. The purpose of this meeting is to provide an open door forum for public input in order to help the Department of Health and Human Services as we develop future planning activities.

To help us best develop Early Head Start with local child care centers and family child care providers serving low-income infants and toddlers, this notice invites the public to learn about partnerships and provide information that may assist the Agency at two public meetings held via webinar and telephone call-in.

DATES: Two public meetings will be held on February 6, 2014, and February 7, 2014. The dates and times for each meeting will be:

February 6, 2014: 4:00–5:00 p.m. EST

February 7, 2014: 4:00–5:00 p.m. EST

Registration and Additional Information: We request that interested persons register online with the Child Care Communications Management Center (CMC) to participate in one or more meetings via either webinar or by telephone. Interested persons may register for the February 6 meeting at: *https://www3.gotomeeting.com/register/905737662,* or the February 7 meeting at: *https://www3.gotomeeting.com/register/539737118.*

The contact at CMC is Karen Limsi, who can be reached by telephone at 240–399–8729 and by email at *klimsi@blhtech.com.* Interested persons should register at least the day before the meeting in which they wish to participate.

Each public meeting is scheduled for one hour, but will end sooner if participants have finished providing input before the time period expires.

The format for the meetings is intended to allow participants to provide input and to respond to the input provided by others. We especially request input from entities interested in creating partnerships.

To help interested individuals prepare for the meetings, we invite review of the 2014 Omnibus Appropriations bill. The full text is set forth at: *http://www.gpo.gov/fdsys/pkg/BILLS-113hr3547enr/pdf/BILLS-113hr3547enr.pdf*

Written comments may be submitted at: *EHS.CCPartnerships@acf.hhs.gov* until Midnight February 7, 2014.

SUPPLEMENTARY INFORMATION: The expansion of EHS-Child Care Partnerships is a key component in President Obama's Early Learning Plan. These partnerships will extend the provision of high-quality early learning opportunities to more children from birth to age 3. Bolstering EHS-Child Care Partnerships promises to build a more seamless system for providing high-quality, full-day, full-year services to support children's development and parents' workforce needs.

These public meetings will be primarily listening sessions for the Agency and potentially an opportunity for dialogue among participants. We believe that the input received at the public meetings will be most helpful in providing the Agency with background information and broadening awareness of relevant issues of potential partnerships between Early Head Start grantees to develop partnerships with local child care centers and family child care providers serving low-income infants and toddlers. We will not respond to presentations during the meetings and will not regard them as formal comments that must be addressed by the Agency.

Dated: January 27, 2014.

Linda K. Smith,

Deputy Assistant Secretary for Early Childhood Development.

[FR Doc. 2014–02035 Filed 1–30–14; 8:45 am]
BILLING CODE 4184–40–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

Food and Drug Administration

[Docket No. FDA–2014–N–0001]

Vaccines and Related Biological Products Advisory Committee; Notice of Meeting

AGENCY: Food and Drug Administration, HHS.

ACTION: Notice.

This notice announces a forthcoming meeting of a public advisory committee of the Food and Drug Administration (FDA). At least one portion of the meeting will be closed to the public.

Name of Committee: Vaccines and Related Biological Products Advisory Committee.

General Function of the Committee: To provide advice and recommendations to the Agency on FDA's regulatory issues.

Date and Time: The meeting will be held on February 28, 2014, from approximately 8 a.m. to 4:20 p.m.

Location: FDA White Oak Campus, 10903 New Hampshire Ave., Bldg. 31 Conference Center, the Great Room (rm. 1503 B and C), Silver Spring, MD 20993–0002. Information regarding special accommodations due to a disability, visitor parking, and transportation may be accessed at *http://www.fda.gov/AdvisoryCommittees/default.htm*; under the heading ''Resources for You,'' click on ''Public Meetings at the FDA White Oak Campus.'' Please note that visitors to the White Oak Campus must enter through Building 1.

For those unable to attend in person, the meeting will also be webcast. The link for the webcast is available at *https://collaboration.fda.gov/vrbpac/*

Contact Person: Prabhakara Atreya or Denise Royster, Center for Biologics Evaluation and Research (HFM–71), Food and Drug Administration, 1401 Rockville Pike, Rockville, MD 20852, 301–827–0314, or FDA Advisory Committee Information Line, 1–800–741–8138 (301–443–0572 in the Washington, DC area). A notice in the **Federal Register** about last minute modifications that impact a previously announced advisory committee meeting cannot always be published quickly enough to provide timely notice. Therefore, you should always check the Agency's Web site at *http://www.fda.gov/AdvisoryCommittees/default.htm* and scroll down to the appropriate advisory committee meeting link, or call the advisory committee information line to learn about possible modifications before coming to the meeting.

Agenda: On February 28, 2014, the committee will meet in open session to hear an overview of the research program in the Laboratory of Respiratory Viral Diseases, Division of Viral Products, Office of Vaccines Research and Review, Center for Biologics Evaluation and Research, FDA. The committee will then discuss and make recommendations on the selection of strains to be included in the influenza virus vaccine for the 2014 to 2015 influenza season.

FDA intends to make background material available to the public no later than 2 business days before the meeting. If FDA is unable to post the background material on its Web site prior to the meeting, the background material will be made publicly available at the location of the advisory committee meeting, and the background material will be posted on FDA's Web site after the meeting. Background material is available at *http://www.fda.gov/AdvisoryCommittees/Calendar/default.htm.* Scroll down to the appropriate advisory committee meeting link.

Procedure: On February 28, 2014, between approximately 8 a.m. and 9:30 a.m. and between approximately 10 a.m. and 4:20 p.m., the meeting is open to the public. Interested persons may present data, information, or views, orally or in writing, on issues pending before the committee. Written submissions may be made to the contact person on or before February 21, 2014. Oral presentations from the public will be scheduled between approximately 2:20 p.m. and 3:20 p.m. on February 28, 2014. Those individuals interested in making formal oral presentations should notify the contact person and submit a brief statement of the general nature of the evidence or arguments they wish to present, the names and addresses of proposed participants, and an indication of the approximate time requested to make their presentation on or before February 13, 2014. Time allotted for each presentation may be limited. If the number of registrants requesting to speak is greater than can be reasonably accommodated during the scheduled open public hearing session, FDA may conduct a lottery to determine the speakers for the scheduled open public hearing session. The contact person will notify interested persons regarding their request to speak by February 14, 2014.

Closed Committee Deliberations: On February 28, 2014, between approximately 9:30 a.m. and 10 a.m., the meeting will be closed to permit discussion where disclosure would constitute a clearly unwarranted invasion of personal privacy (5 U.S.C. 552b(c)(6)). The committee will discuss the report of the intramural research programs and make recommendations regarding personnel staffing decisions.

Persons attending FDA's advisory committee meetings are advised that the Agency is not responsible for providing access to electrical outlets.

FDA welcomes the attendance of the public at its advisory committee meetings and will make every effort to accommodate persons with physical disabilities or special needs. If you require special accommodations due to a disability, please contact Prabhakara Atreya or Denise Royster at least 7 days in advance of the meeting.

FDA is committed to the orderly conduct of its advisory committee meetings. Please visit our Web site at *http://www.fda.gov/AdvisoryCommittees/AboutAdvisoryCommittees/ucm111462.htm* for procedures on public conduct during advisory committee meetings.

Notice of this meeting is given under the Federal Advisory Committee Act (5 U.S.C. app. 2).

Dated: January 27, 2014.

Jill Hartzler Warner,

Acting Associate Commissioner for Special Medical Programs.

[FR Doc. 2014–01979 Filed 1–30–14; 8:45 am]

BILLING CODE 4160–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

Proposed Collection; 60-day Comment Request: National Institutes of Health Loan Repayment Programs

SUMMARY: In compliance with the requirement of Section 3506(c)(2)(A) of the Paperwork Reduction Act of 1995, for opportunity for public comment on proposed data collection projects, the Division of Loan Repayment, National Institutes of Health (NIH), will publish periodic summaries of proposed projects to be submitted to the Office of Management and Budget (OMB) for review and approval.

Written comments and/or suggestions from the public and affected agencies should address one or more of the following points: (1) Whether the proposed collection of information is necessary for the proper performance of the function of the agency, including whether the information will have practical utility; (2) the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on those who are to respond, including the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology.

To Submit Comments and For Further Information: To request more information on the proposed project or to obtain a copy of the data collection plans and instruments, contact: Steve Boehlert, Director of Operations, Division of Loan Repayment, National Institutes of Health, 6011 Executive Blvd., Room 206 (MSC 7650), Bethesda, Maryland 20892–7650. Steve may be contacted via email at *BoehlerS@od.nih.gov* or by calling 301–451–4465. Formal requests for additional plans and instruments must be requested in writing.

Comment Due Date: Comments regarding this information collection are best assured of having their full effect if received within 60 days of the date of this publication.

Proposed Collection: National Institutes of Health Loan Repayment Programs.

Type of Information Collection Request: Extension of a currently approved collection (OMB No. 0925–0361, expiration date 06/30/14).

Form Numbers: NIH 2674–1, NIH 2674–2, NIH 2674–3, NIH 2674–4, NIH 2674–5, NIH 2674–6, NIH 2674–7, NIH 2674–8, NIH 2674–9, NIH 2674–10, NIH 2674–11, NIH 2674–12, NIH 2674–13, NIH 2674–14, NIH 2674–15, NIH 2674–16, NIH 2674–17, NIH 2674–18, and NIH 2674–19.

Need and Use of Information Collection: The NIH makes available financial assistance, in the form of educational loan repayment, to M.D., Ph.D., Pharm.D., D.D.S., D.M.D., D.V.M., D.P.M., DC, and N.D. degree holders, or the equivalent, who perform biomedical or behavioral research in NIH intramural laboratories or as extramural grantees or scientists funded by domestic non-profit organizations for a minimum of 2 years (3 years for the General Research LRP) in research areas supporting the mission and priorities of the NIH.

The AIDS Research Loan Repayment Program (AIDS–LRP) is authorized by Section 487A of the Public Health Service Act (42 U.S.C. 288–1); the Clinical Research Loan Repayment Program for Individuals from Disadvantaged Backgrounds (CR–LRP) is authorized by Section 487E (42 U.S.C. 288–5); the General Research Loan Repayment Program (GR–LRP) is authorized by Section 487C of the Public Health Service Act (42 U.S.C. 288–3); the Clinical Research Loan Repayment Program (LRP–CR) is authorized by Section 487F (42 U.S.C. 288–5a); the Pediatric Research Loan Repayment Program (PR–LRP) is authorized by Section 487F (42 U.S.C. 288–6); the Extramural Clinical Research LRP for Individuals from Disadvantaged Backgrounds (ECR–LRP)

is authorized by an amendment to Section 487E (42 U.S.C. 288–5); the Contraception and Infertility Research LRP (CIR–LRP) is authorized by Section 487B (42 U.S.C. 288–2); and the Health Disparities Research Loan Repayment Program (HD–LRP) is authorized by Section 485G (42 U.S.C. 287c–33).

The Loan Repayment Programs can repay up to $35,000 per year toward a participant's extant eligible educational loans, directly to financial institutions. The information proposed for collection will be used by the Division of Loan Repayment to determine an applicant's eligibility for participation in the program.

Frequency of Response: Initial application and one or two-year renewal application.

Affected Public: Individuals or households; Nonprofits; and Businesses or other for-profit.

Type of Respondents: Physicians, other scientific or medical personnel, and institutional representatives.

OMB approval is requested for 3 years. There are no costs to respondents other than their time. The total estimated annualized burden hours are 34,925.

ESTIMATED ANNUALIZED BURDEN HOURS

Type of respondent	Number of respondents	Estimated number of responses per respondent	Average burden hours per response	Annual burden hours requested
Intramural LRPs				
Initial Applicants	20	1	10	200
Advisors/Supervisors	20	1	1	20
Recommenders	60	1	30/60	30
Subtotal	100			250
Extramural LRPs				
Initial Applicants	1,800	1	11	19,800
Advisors/Supervisors	1,600	1	1	1,600
Recommenders	5,400	1	30/60	2,700
Subtotal	8,800			24,100
Intramural LRPs				
Renewal Applicants	40	1	7	280
Advisors/Supervisors	40	1	2	80
Subtotal	80			360
Extramural LRPS				
Renewal Applicants	930	1	8	7,440
Advisors/Supervisors	690	1	2	1,380
Recommenders	2,790	1	30/60	1,395
Subtotal	4,410			10,215

Dated: January 27, 2014.

Adrienne Boice,

Project Clearance Liaison, Division of Loan Repayment, NIH.

[FR Doc. 2014–02018 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Dental & Craniofacial Research; Notice of Closed Meeting Pursuant to Section 10(d) of the Federal Advisory Committee Act, as Amended (5 U.S.C. App.), Notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Dental and Craniofacial Research Special Emphasis Panel; RFA: DE–14–003

Date: February 28, 2014.

Time: 8:00 a.m. to 5:00 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, #602, 6701 Rockledge Drive, Bethesda, MD 20892.

Contact Person: Jayalakshmi Raman, Ph.D., Scientific Review Officer, Scientific Review Branch, National Institute of Dental and Craniofacial Research, One Democracy Plaza, Room 670, Bethesda, MD 20892–4878, 301–594–2904, *ramanj@mail.nih.gov*.

(Catalogue of Federal Domestic Assistance Program Nos. 93.121, Oral Diseases and Disorders Research, National Institutes of Health, HHS)

Dated: January 27, 2014.

David Clary,

Program Analyst, Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01916 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Diabetes and Digestive and Kidney Diseases; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. App.), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose

confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, NIDDK MAPP (M3 and M4) Application Telephone Review.

Date: February 26, 2014.

Time: 2:00 p.m. to 5:30 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard,Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Xiaodu Guo, MD, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 761, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–4719, *guox@extra.niddk.nih.gov*.

(Catalogue of Federal Domestic Assistance Program Nos. 93.847, Diabetes, Endocrinology and Metabolic Research; 93.848, Digestive Diseases and Nutrition Research; 93.849, Kidney Diseases, Urology and Hematology Research, National Institutes of Health, HHS)

Dated: January 27, 2014

David Clary,

Program Analyst, Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01919 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Diabetes and Digestive and Kidney Diseases; Notice of Closed Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. App.), notice is hereby given of the following meetings.

The meetings will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, NIDDK MAPP (M3 and M4) Application Telephone Review.

Date: February 26, 2014.

Time: 5:30 p.m. to 6:30 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Xiaodu Guo, MD, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 761, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–4719, *guox@extra.niddk.nih.gov*.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, Metagenomic Studies of the Gut Microbiomes of Obese and Lean Twins.

Date: March 7, 2014.

Time: 12:00 p.m. To 2:00 p.m.

Agenda: To Review And Evaluate Grant Applications.

Place: National Institutes Of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, Md 20892, (Telephone Conference Call).

Contact Person: Thomas A. Tatham, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 760, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–3993, *tathamt@mail.nih.gov*.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, NASH CRN Applications.

Date: March 11, 2014.

Time: 12:00 p.m. to 3:00 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Jian Yang, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 755, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–7799, *yangj@extra.niddk.nih.gov*.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, Systems Biology.

Date: March 20, 2014.

Time: 11:00 a.m. to 12:00 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Thomas A. Tatham, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 760, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–3993, *tathamt@mail.nih.gov*.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel, Intestinal Stem Cells U01s.

Date: April 17, 2014.

Time: 8:00 a.m. to 4:30 p.m.

Agenda: To review and evaluate grant applications.

Place: Residence Inn Bethesda, 7335 Wisconsin Avenue, Bethesda, MD 20814.

Contact Person: Maria E. Davila-Bloom, Ph.D., Scientific Review Officer, Review Branch, DEA, NIDDK, National Institutes Of Health, Room 758, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–7637, *davila-bloomm@extra.niddk.nih.gov*.

(Catalogue of Federal Domestic Assistance Program Nos. 93.847, Diabetes, Endocrinology and Metabolic Research; 93.848, Digestive Diseases and Nutrition Research; 93.849, Kidney Diseases, Urology and Hematology Research, National Institutes of Health, HHS)

Dated: January 27, 2014.

David Clary,

Program Analyst Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01920 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Diabetes and Digestive and Kidney Diseases; Notice of Meetings

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. App.), notice is hereby given of the following meetings.

The meetings will be open to the public as indicated below, with attendance limited to space available. Individuals who plan to attend and need special assistance, such as sign language interpretation or other reasonable accommodations, should notify the Contact Person listed below in advance of the meetings.

The meetings will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Initial Review Group; Kidney, Urologic and Hematologic Diseases D Subcommittee.

Date: March 5–6, 2014.

Open: March 5, 2014, 8:00 a.m. to 8:30 a.m.

Agenda: To review policy and procedures.

Place: Embassy Suites Hotel, 300 Military Road, Washington, DC 20015.

Closed: March 5, 2014, 8:30 a.m. to 5:00 p.m.

Agenda: To review and evaluate grant applications.

Place: Embassy Suites Hotel, 4300 Military Road, Washington, DC 20015.*Closed:* March 6, 2014, 8:00 a.m. to 5:00 p.m.

Agenda: To review and evaluate grant applications.

Place: Embassy Suites Hotel, 4300 Military Road, Washington, DC 20015.

Contact Person: Barbara A. Woynarowska, Ph.D., Scientific Review Administrator, Review Branch, DEA, NIDDK, National Institutes of Health, Room 754, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 402–7172, *woynarowskab@niddk.nih.gov.*

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Initial Review Group; Diabetes, Endocrinology and Metabolic Diseases B Subcommittee.

Date: March 5–7, 2014.

Open: March 5, 2014, 3:00 p.m. to 3:30 p.m.

Agenda: To review policy and procedures.

Place: Residence Inn Bethesda, 7335 Wisconsin Avenue, Bethesda, MD 20814.

Closed: March 5, 2014, 3:30 p.m. to 6:00 p.m.

Agenda: To review and evaluate grant applications.

Place: Residence Inn Bethesda, 7335 Wisconsin Avenue, Bethesda, MD 20814.

Closed: March 6, 2014, 8:00 a.m. to 5:00 p.m.

Agenda: To review and evaluate grant applications.

Place: Residence Inn Bethesda, 7335 Wisconsin Avenue, Bethesda, MD 20814.

Closed: March 7, 2014, 8:00 a.m. to 5:00 p.m.

Agenda: To review and evaluate grant applications.

Place: Residence Inn Bethesda, 7335 Wisconsin Avenue, Bethesda, MD 20814.

Contact Person: John F. Connaughton, Ph.D., Chief, Chartered Committees Section, Review Branch, DEA, NIDDK, National Institutes of Health, Room 753, 6707 Democracy Boulevard, Bethesda, MD 20892–5452, (301) 594–7797, *connaughtonj@extra.niddk.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.847, Diabetes, Endocrinology and Metabolic Research; 93.848, Digestive Diseases and Nutrition Research; 93.849, Kidney Diseases, Urology and Hematology Research, National Institutes of Health, HHS)

Dated: January 27, 2014.

David Clary,

Program Analyst, Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01921 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute of Diabetes and Digestive and Kidney Diseases; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. App.), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute of Diabetes and Digestive and Kidney Diseases Special Emphasis Panel; Approaches to Develop Drug Therapies for Diarrhea

Date: March 28, 2014

Time: 4:00 p.m. to 5:45 p.m.

Agenda: To review and evaluate grant applications

Place: National Institutes of Health, Two Democracy Plaza, 6707 Democracy Boulevard, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Maria E. Davila-Bloom, Ph.D., Scientific Review Officer Review Branch, DEA, NIDDK National Institutes of Health Room 758, 6707 Democracy Boulevard Bethesda, MD 20892–5452 (301) 594–7637 *davila-bloomm@extra.niddk.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.847, Diabetes, Endocrinology and Metabolic Research; 93.848, Digestive Diseases and Nutrition Research; 93.849, Kidney Diseases, Urology and Hematology Research, National Institutes of Health, HHS)

Dated: January 27, 2014.

David Clary,

Program Analyst, Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01915 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HEALTH AND HUMAN SERVICES

National Institutes of Health

National Institute on Aging; Notice of Closed Meeting

Pursuant to section 10(d) of the Federal Advisory Committee Act, as amended (5 U.S.C. App.), notice is hereby given of the following meeting.

The meeting will be closed to the public in accordance with the provisions set forth in sections 552b(c)(4) and 552b(c)(6), Title 5 U.S.C., as amended. The grant applications and the discussions could disclose confidential trade secrets or commercial property such as patentable material, and personal information concerning individuals associated with the grant applications, the disclosure of which would constitute a clearly unwarranted invasion of personal privacy.

Name of Committee: National Institute on Aging Special Emphasis Panel; MsFLASH: Living a Healthy Menopause.

Date: February 21, 2014.

Time: 2:00 p.m. to 4:00 p.m.

Agenda: To review and evaluate grant applications.

Place: National Institutes of Health, Gateway Building, 7201 Wisconsin Avenue, Bethesda, MD 20892, (Telephone Conference Call).

Contact Person: Isis S. Mikhail, MD, MPH, DRPH, Scientific Review Officer, National Institute on Aging, Gateway Building, 7201 Wisconsin Avenue, Suite 2C212, Bethesda, MD 20892, 301–402–7702, *MIKHAILI@mail.nih.gov.*

(Catalogue of Federal Domestic Assistance Program Nos. 93.866, Aging Research, National Institutes of Health, HHS).

Dated: January 27, 2014.

Melanie J. Gray,

Program Analyst, Office of Federal Advisory Committee Policy.

[FR Doc. 2014–01917 Filed 1–30–14; 8:45 am]

BILLING CODE 4140–01–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5756–N–02]

60-Day Notice of Proposed Information Collection: HUD-Owned Real Estate Dollar Home Sales Program

AGENCY: Office of the Assistant Secretary for Housing—Federal Housing Commissioner, HUD.

ACTION: Notice.

SUMMARY: HUD is seeking approval from the Office of Management and Budget (OMB) for the information collection described below. In accordance with the Paperwork Reduction Act, HUD is

requesting comment from all interested parties on the proposed collection of information. The purpose of this notice is to allow for 60 days of public comment.

DATES: *Comments Due Date: April 1, 2014.*

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB Control Number and should be sent to: Colette Pollard, Reports Management Officer, QDAM, Department of Housing and Urban Development, 451 7th Street SW., Room 4176, Washington, DC 20410–5000; telephone 202–402–3400 (this is not a toll-free number) or email at *Colette.Pollard@hud.gov* for a copy of the proposed forms or other available information. Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Relay Service at (800) 877–8339.

FOR FURTHER INFORMATION CONTACT: Ivery W. Himes, Director, Single Family Asset Management, Department of Housing and Urban Development, 451 7th Street SW., Washington, DC 20410; email Ivery Himes at *Ivery.w.Himes@hud.gov* or telephone 202–708–1672. This is not a toll-free number. Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Relay Service at (800) 877–8339.

Copies of available documents submitted to OMB may be obtained from Ms. Himes.

SUPPLEMENTARY INFORMATION: This notice informs the public that HUD is seeking approval from OMB for the information collection described in Section A.

A. Overview of Information Collection

Title of Information Collection: HUD-Owned Real Estate Dollar Home Sales Program.

OMB Approval Number: 2502–0569.

Type of Request: extension of currently approved collection.

Form Number: HUD–9548 (Sales Contract).

Description of the need for the information and proposed use: This information collection is used to determine the eligibility of prospective program participants and in binding contracts between purchasers of acquired single family assets and HUD through the Dollar Home Sales Program. The sale of these properties makes it possible for local government to rehabilitate the homes and make them available as low and moderate income housing.

Respondents (i.e. affected public): Not-for-profit institutions.

Estimated Number of Respondents: 38.

Estimated Number of Responses: 567.

Frequency of Response: on occasion.

Average Hours per Response: 10 minutes to 1 hour.

Total Estimated Burdens: 363.

B. Solicitation of Public Comment

This notice is soliciting comments from members of the public and affected parties concerning the collection of information described in Section A on the following:

(1) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;

(2) The accuracy of the agency's estimate of the burden of the proposed collection of information;

(3) Ways to enhance the quality, utility, and clarity of the information to be collected; and

(4) Ways to minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

HUD encourages interested parties to submit comment in response to these questions.

Authority: Section 3507 of the Paperwork Reduction Act of 1995, 44 U.S.C. Chapter 35.

Dated: January 27, 2014.

Laura M. Marin,

Associate General Deputy Assistant Secretary for Housing-Associate Deputy Federal Housing Commissioner.

[FR Doc. 2014–02034 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5752–N–09]

30-Day Notice of Proposed Information Collection: Section 8 Renewal Policy Guide

AGENCY: Office of the Chief Information Officer, HUD.

ACTION: Notice.

SUMMARY: HUD has submitted the proposed information collection requirement described below to the Office of Management and Budget (OMB) for review, in accordance with the Paperwork Reduction Act. The purpose of this notice is to allow for an additional 30 days of public comment.

DATES: *Comments Due Date: March 3, 2014.*

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB Control Number and should be sent to: HUD Desk Officer, Office of Management and Budget, New Executive Office Building, Washington, DC 20503; fax: 202–395–5806. Email: *OIRA_Submission@omb.eop.gov.*

FOR FURTHER INFORMATION CONTACT: Colette Pollard, Reports Management Officer, QDAM, Department of Housing and Urban Development, 451 7th Street SW., Washington, DC 20410; email Colette Pollard at *Colette.Pollard@hud.gov* or telephone 202–402–3400. Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Relay Service at (800) 877–8339. This is not a toll-free number. Copies of available documents submitted to OMB may be obtained from Ms. Pollard.

SUPPLEMENTARY INFORMATION: This notice informs the public that HUD has submitted to OMB a request for approval of the information collection described in Section A. The **Federal Register** notice that solicited public comment on the information collection for a period of 60 days was published on July 30, 2013.

A. Overview of Information Collection

Title of Information Collection: Section 8 Renewal Policy Guide.

OMB Approval Number: 2502–0587.

Type of Request: Revision of a currently approved collection.

Form Number:

Contract Renewal Request Form (HUD–9624)(decreased usage).

OCAF Rent Adjustment Worksheet (HUD–9625)(decreased usage).

Comparability Study Comparison Worksheet, (HUD–9626) (Auto OCAF Letters).

Section 515 and Section 221 (d) (3) BMIR Worksheet (HUD–9627) (Auto OCAF Letters).

Other New Construction and Sub-Rehab Worksheet (HUD–9628).

Appraiser Certification (HUD–9629).

Rent Comparability Grid (HUD–9630).

One Year Notification Owner Does Not Intend to Renew (HUD–9631).

One Year Notification Letter Owner Intends to Renew (HUD–9632).

Use Agreement (HUD–9633).

Addendum to Agreement to Enter Into.

Housing Assistance Payments Contract (HUD–9634).

Appendix 15–3 Project Capital Needs Assessments and Replacement.

Reserve Escrow (HUD–9635).

Projects Preparing a Budget-Based Rent Increase (HUD–9636).
Basic Renewal Contract—One Year Term (HUD–9637).
Basic Renewal Contract—Multi-Year Term (HUD–9638).
Renewal Contract for Mark-Up-To-Market Project (HUD–9639).
Housing Assistance Payments Preservation Renewal Contract (HUD–9640).
Interim (Full) Mark-To-Market Renewal Contract (HUD–9641).
Interim (Lite) Mark-To-Market Renewal Contract (HUD–9642).
Full Mark-To-Market Renewal Contract (HUD–9643).
Watch List Renewal Contract (HUD–9644).
Project Based Assistance Payments Amendment Contract Moderate Rehabilitation (HUD–9645).
Project Based Section Housing Assistance Payments Extension of Renewal Contract (HUD–9646).
Consent to Assignment of HAP Contract as Security for Financing (HUD–9649).
Consent to Assignment of HAP Contract as Security for FNMA Financing (HUD–9651).
Request to Renew Using Non-Section 8 Units in the Section 8 Project as a Market Rent Ceiling (HUD–9652).
Request to Renew Using FMR's as Market Ceiling (HUD–9653).
Addendum to Renewal Contract (HUD–9654).
Rent Comparability Study (HUD–9655).
Rent Comparability Grid (HUD–9656).
Completing the Rent Comparability Grid (HUD–9657).
Required Contents for Rent Comparability Study (HUD–9658).
Project-Based Section 8 Housing Assistance Payments-During Rehabilitation (HUD–9913).
Project-Based Section 8 Housing Assistance Payments-Post Rehabilitation (HUD–9914).
Rider to Original Section 8 Housing Assistance Payments Contract (HUD–9915).

Description of the need for the information and proposed use: The modifications of the Section 8 renewal policy and recent legislation are implemented to address the essential requirement to preserving low income rental housing affordability and availability. The Section 8 Renewal Policy Guide will include recent legislation modifications for renewing of expiring Section 8 policy(ies) Guidebook, as authorized by the Code of Federal Regulations 24 CFR part 401 and 24 CFR part 402.

The Multifamily Housing Reform and Affordability Act of 1997 (MAHRA) for fiscal year 1998 (public law 105–65, enacted on October 27, 1997), required that expiring Section 8 project-based assistance contracts be renewed under MAHRA. Established in the MAHRA policies renewal of Section 8 project-based contracts rent are based on market rents instead of the Fair Market Rent (FMR) standard.

MAHRA renewals submission should include a Rent Comparability Study (RCS). If the RCS indicated rents were at or below comparable market rents, the contract was renewed at current rents adjusted by Operating Cost Adjustment Factor (OCAF), unless the Owner submitted documentation justifying a budget-based rent increase or participation in Mark-Up-To-Market. The case is that no renewal rents could exceed comparable market rents. If the RCS indicated rents were above comparable market rents, the contract was referred to the Office of Affordable Housing Preservation (OAHP) for debt restructuring and/or rent reduction.

The Preserving Affordable Housing for Senior Citizens and Families Into the 21st Century Act of 1999 (public law 106–74, enacted on October 20, 1999), modified MAHRA.

The Section 8 Renewal Policy Guide sets forth six renewal options from which a project owner may choose when renewing their expiring Section 8 contract: Option One—Mark-Up-To-Market, Option Two—Other Contract Renewal with Current Rents at or Below Comparable Market Rents, Option Three—Referral to the Office of Affordable Preservation (OAHP), Option Four- Renewal of Projects Exempted From OMHAR, Option Five—Renewal of Portfolio Reengineering Demonstration or Preservation Projects, and Option Six—Opt Outs.

Owners should select one of six options which are applicable to their project and should submit contract renewal on an annual basis to renew contract.

The Section 8 Renewal Guide sets forth six renewal options from which a project owner may choose when renewing their expiring Section 8 contracts.

Option One (Mark -Up- To-Market).
Option Two (Other Contract Renewals with Current Rents at or Below Comparable Market Rents.
Option Three (Referral to the Office of Multifamily Housing Assistant Restructuring—OHAP).
Option Four (Renewal of Projects Exempted from OHAP).
Option Five (Renewal of Portfolio Reengineering Demonstration or Preservation Projects)
Option Six (Opt-Outs).

Respondents (i.e. affected public): Business and Other for profit.

Estimated Number of Respondents: 25,439.

Estimated Number of Responses: 25,439.

Frequency of Response: On occasion.

Average Hours per Response: 1 hours.

Total Estimated Burdens: 24,680.

B. Solicitation of Public Comment

This notice is soliciting comments from members of the public and affected parties concerning the collection of information described in Section A on the following:

(1) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) The accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Ways to enhance the quality, utility, and clarity of the information to be collected; and (4) Ways to minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses. HUD encourages interested parties to submit comment in response to these questions.

Authority: Section 3507 of the Paperwork Reduction Act of 1995, 44 U.S.C. Chapters 35.

Dated: January 23, 2014.

Colette Pollard,

Department Reports Management Officer, Office of the Chief Information Officer.

[FR Doc. 2014–02030 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5752–N–10]

30-Day Notice of Proposed Information Collection: Multifamily Project Monthly Accounting Reports

AGENCY: Office of the Chief Information Officer, HUD.

ACTION: Notice.

SUMMARY: HUD has submitted the proposed information collection requirement described below to the Office of Management and Budget (OMB) for review, in accordance with the Paperwork Reduction Act. The purpose of this notice is to allow for an additional 30 days of public comment.

DATES: *Comments Due Date: March 3, 2014.*

ADDRESSES: Interested persons are invited to submit comments regarding this proposal. Comments should refer to the proposal by name and/or OMB Control Number and should be sent to: HUD Desk Officer, Office of Management and Budget, New Executive Office Building, Washington, DC 20503; fax: 202–395–5806. Email: *OIRA_Submission@omb.eop.gov.*

FOR FURTHER INFORMATION CONTACT: Colette Pollard, Reports Management Officer, QDAM, Department of Housing and Urban Development, 451 7th Street, SW., Washington, DC 20410; email Colette Pollard at *Colette.Pollard@hud.gov* or telephone 202–402–3400. Persons with hearing or speech impairments may access this number through TTY by calling the toll-free Federal Relay Service at (800) 877–8339. This is not a toll-free number. Copies of available documents submitted to OMB may be obtained from Ms. Pollard.

SUPPLEMENTARY INFORMATION: This notice informs the public that HUD has submitted to OMB a request for approval of the information collection described in Section A. The **Federal Register** notice that solicited public comment on the information collection for a period of 60 days was published on November 4, 2013.

A. Overview of Information Collection

Title of Information Collection: Multifamily Project Monthly Accounting Reports

OMB Approval Number: 2502–0108.

Type of Request: Extension of a currently approved collection.

Form Number: HUD–93479, HUD–93480, and HUD–9348.

Description of the need for the information and proposed use: This information is necessary for HUD to monitor compliance with contractual agreements and to analyze cash flow trends as well as occupancy and rent collection levels.

Respondents (i.e. affected public): Business and Other for profit.

Estimated Number of Respondents: 13,646.

Estimated Number of Responses: 491,256.

Frequency of Response: Monthly.

Average Hours per Response: 3.5 hours.

Total Estimated Burdens: 573,132.

B. Solicitation of Public Comment

This notice is soliciting comments from members of the public and affected parties concerning the collection of information described in Section A on the following:

(1) Whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (2) The accuracy of the agency's estimate of the burden of the proposed collection of information; (3) Ways to enhance the quality, utility, and clarity of the information to be collected; and (4) Ways to minimize the burden of the collection of information on those who are to respond; including through the use of appropriate automated collection techniques or other forms of information technology, e.g., permitting electronic submission of responses. HUD encourages interested parties to submit comment in response to these questions.

Authority: Section 3507 of the Paperwork Reduction Act of 1995, 44 U.S.C. Chapters 35.

Dated: *January 23, 2014.*

Colette Pollard,

Department Reports Management Officer, Office of the Chief Information Officer.

[FR Doc. 2014–02031 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket Number FR–5752–N–11]

30-Day Notice of Information Collection: Comprehensive Listing of Transactional Documents for Mortgagors, Mortgagees and Contractors

AGENCY: Office of the Chief Information Officer, HUD.

ACTION: Notice.

SUMMARY: On March 14, 2013, HUD published in the **Federal Register** a notice that announced that FHA's healthcare facility documents completed the notice and comment processes under the Paperwork Reduction Act of 1995 (PRA), and had been assigned a control number, 2502–0605, by the Office of Management and Budget (OMB). The assignment of a control number concluded a 10-month process through which HUD solicited public comment to update 115 healthcare facility documents to reflect current policy and practices, to improve accountability by all parties involved in FHA's healthcare facility transactions and strengthen risk management.

On September 10, 2013, published a notice in the **Federal Register** that solicited, for a period of 60 days, public comment on this collection solely on the issue of which healthcare facility documents are eligible for electronic submission. HUD did not address this issue as part of the previous notice and comment process, but recognized the importance, efficiency, and reduction of burden that electronic submission of documents can achieve, and solicited public comment on the healthcare facility documents that HUD had determined may be submitted, but are not required to be submitted, electronically.

The purpose of this notice is to allow for an additional 30 days of public comment.

DATES: *Comment Due Date:* March 3, 2014.

ADDRESSES: Interested persons are invited to submit comments regarding this notice. Communications must refer to the above docket number and title. There are two methods for submitting public comments:

1. Submission of Comments by Mail. Comments may be submitted by mail to the Regulations Division, Office of General Counsel, Department of Housing and Urban Development, 451 7th Street, SW., Room 10276, Washington, DC 20410–0500.

2. Electronic Submission of Comments. Comments may be submitted electronically through the Federal eRulemaking Portal at *www.regulations.gov.* HUD strongly encourages commenters to submit comments electronically. Electronic submission of comments allows the commenter maximum time to prepare and submit a comment, ensures timely receipt by HUD, and enables HUD to make them immediately available to the public. Comments submitted electronically through the *www.regulations.gov* Web site can be viewed by other commenters and interested members of the public. Commenters should follow the instructions provided on that site to submit comments electronically.

Note: To receive consideration as public comments, comments must be submitted through one of the two methods specified above. Again, all submissions must refer to the docket number and title of the notice.

No Facsimile Comments. Facsimile (fax) comments are not acceptable.

Public Inspection of Public Comments. All properly submitted comments and communications will be available for public inspection and downloading at *www.regulations.gov* under the docket number for this notice.

FOR FURTHER INFORMATION CONTACT: John M. Hartung, Director, Policy and Risk Management Division, Office of Residential Care Facilities, Office of Healthcare Programs, Office of Housing,

U.S. Department of Housing and Urban Development, 1222 Spruce Street, Room 3.203, St. Louis, MO 63103–2836; telephone (314) 418–5238 (this is not a toll-free number). Persons with hearing or speech disabilities may access this number through TTY by calling the toll-free Federal Relay Service at (800) 877–8339.

SUPPLEMENTARY INFORMATION:

I. Background

A. 2012 PRA Process on Substance of Healthcare Facility Documents

On May 3, 2012, at 77 FR 26304, and consistent with the PRA, HUD published a notice in the **Federal Register** seeking public comment for a period of 60 days (60-day Notice) on HUD's proposed update and revisions to a set of production, underwriting, asset management, closing, and other documents used in connection with transactions involving healthcare facilities, excluding hospitals (collectively, the healthcare facility documents), that are insured pursuant to section 232 of the National Housing Act (Section 232). In conjunction with publication of the 60-day Notice, the proposed revised healthcare facility documents (115 documents) were made available at: *www.hud.gov/232forms.* In addition to presenting unmarked versions of the documents, this Web site, to the extent applicable, presented the proposed healthcare facility documents as a redline/strikeout against the updated multifamily rental project closing documents to highlight the changes made to facilitate a healthcare transaction. Where the proposed healthcare facility documents were based on existing healthcare facility documents, the proposed healthcare facility documents, in addition to being presented in an unmarked format, were presented in redline/strikeout format so that reviewers could see the changes proposed to the existing healthcare facility documents.[1]

As a special outreach to the public on proposed changes to the healthcare facility documents and Section 232 program regulations, HUD hosted a forum on May 31, 2012, in Washington, DC. (See *http://portal.hud.gov/hudportal/HUD?src=/press/multimedia/videos.*) While comments were raised and discussed at the forum, HUD encouraged forum participants to file written comments through the *www.regulations.gov* Web site so that all comments would be more easily accessible to interested parties. All comments, whether submitted through www.regulations.gov or raised at the forum, were considered in the development of the revised documents which were published on November 21, 2012 (77 FR 69870), and for which, consistent with the PRA, comment was solicited for an additional 30 days (30-day Notice).

In the 30-day Notice, HUD identified substantive changes that were made to the healthcare facility documents in response to public comments submitted on the 60-day Notice, responded to significant issues raised by the commenters, and identified proposed additional changes based on further consideration of certain issues. As was the case with the 60- day Notice, HUD posted on its Web site the further revised healthcare facility documents in (1) a clean format, and (2) in redline/strikeout format, to show the changes made from the versions posted with issuance of the 60-day Notice.

On March 14, 2013, at 78 FR 16279, HUD published in the **Federal Register** a notice that announced the approval of the healthcare facility documents under the PRA and the assignment of a control number, 2502–0605, by OMB. In addition to announcing the assignment of an OMB control number, HUD advised in the May 14, 2013, notice that additional changes were made to the healthcare facility documents in response to comments submitted on the 30-day Notice. In the March 14, 2013, notice, HUD highlighted additional changes made to the healthcare facility documents, and once again, provided on HUD's Web site at *www.hud.gov/232forms,* the final versions of the documents in clean and redline/strikeout formats so that reviewers could see the final changes made to the documents and the clean final versions of the documents.

B. 2013 PRA Process on Eligibility of Electronic Submission

On September 10, 2013, at 78 FR 55282, HUD published in the **Federal Register** a notice solely seeking comment on the issue of which healthcare facility documents may be submitted electronically. Questions arose on this issue after conclusion of the 2012 PRA process. Because of the considerable comment solicited and received during the 2012 PRA process on the substance of the documents, and which just concluded in March 2013, the September 30, 2013, notice did not seek further comment on the provisions of the documents and the estimate of burden.

In the September 30, 2013, notice, HUD advised that consistent with current practice, HUD requires applications for mortgage insurance to be submitted electronically, and that therefore any healthcare facility documents submitted as part of an application for mortgage insurance must be submitted electronically. Of the other healthcare facility documents, HUD identified 13 documents that must be submitted with original signatures, in hard copy format. These documents are the following: Healthcare Regulatory Agreement—Borrower (HUD–92466–ORCF); Healthcare Regulatory Agreement—Operator (HUD–92466A–ORCF); Management Certification—Residential Care Facility (HUD–9839–ORCF); Lender Certification (HUD–92434–ORCF); Offsite Bond— Dual Obligee (HUD–92479–ORCF); Performance Bond—Dual Obligee (HUD–92452–ORCF); Payment Bond (HUD–92452A–ORCF); Request for Endorsement (HUD–92455–ORCF); Request for Final Endorsement (HUD–92023–ORCF); Guide for Opinion for Mater Tenant's Counsel (HUD–92335–ORCF); Healthcare Regulatory Agreement—Master Tenant (HUD–92337–ORCF); Guide for Opinion of Borrower's Counsel (HUD–91725–ORCF); and Guide for Opinion of Operator's Counsel and Certification (HUD–92325–ORCF). For any of the remaining healthcare facility documents other than the application documents or the listed 13 documents, the September 30, 2013, notice advised that HUD neither requires nor prohibits that any of the remaining documents be submitted electronically. Electronic submission is an option.

In the 2012 PRA process, HUD's 30-day Notice, HUD listed in a table all the documents for which approval under the PRA was sought and provided the burden hours and costs calculated for preparation of and submission of each of documents and provided a total aggregate annual cost of $4,393,301. (See 77FR 69887–69889).

In the September 30, 2013, notice, HUD included the table below, which provides a breakdown of the estimated costs involved in hard copy preparation and shipping, and estimates a $450,000 annual savings in costs if documents are

[1] Along with the 60-day Notice, HUD published in the **Federal Register** on May 3, 2012, at 77 FR 26218, a proposed rule that proposed to strengthen regulations for HUD's Section 232 program to reflect current policy and practices, and to improve accountability and strengthen risk management. A final rule following the May 3, 2012, proposed rule, and taking into consideration public comment received on the proposed rule, was published on September 7, 2012, at 77 FR 55120.

submitted electronically rather than in hard copy.

Item	Cost per Item	Costs
Printing by Lender	1,500 pages at $.04 per page	$60.00
Lender Box Preparation	50 per hour and two hours per box	100.00
Shipping by Lender to HUD in Field	1—40 lb. box	20.00
HUD processing preparation (Field and HQ)	50 per hour and 1 hour per box	50.00
Shipping by HUD Field to HQ	1—40 lb. box	20.00
Total		$250.00 per box
Estimated # Boxes per project	3	
Estimated # of projects per year	600	
Total Annual Costs	(# of boxes x # of projects x cost per box)	$450,000.00

Therefore, in accordance with 5 CFR 1320.8(d)(1), HUD is soliciting, for an additional 30 days, comments from members of the public and interested parties on:

(1) Whether the documents identified by HUD for originally signed, hard copy submission are necessary in such format for proper performance of the transactions in which the documents are used;

(2) Whether any of the documents not identified as necessary for originally signed, hard copy submission should be submitted only in originally signed, hard copy;

(3) The accuracy of the agency's estimate of the reduced burden and reduced costs for submission of documents electronically;

(4) Whether electronic submission of application documents enhances the utility and efficiency of the transactions in which the documents are used;

(5) Whether electronic submission of other documents enhances the utility and efficiency of the transactions in which the documents are used; and

(6) Additional ways, through information technology, to minimize the burden of the collection of information on those who are to respond.

Comments must be received by *March 3, 2014.* Comments must refer to the proposal by name and docket number (FR–5623–N–05) and may be sent to the *www.regulations.gov* portal provided under the **ADDRESSES** section of this notice or to: HUD Desk Officer, Office of Management and Budget, New Executive Office Building, Washington, DC 20503, Fax number: (202) 395–6947.

Dated: January 28, 2014.

Colette Pollard,

Department Reports Management Officer, Office of the Chief Information Officer.

[FR Doc. 2014–02060 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5750–N–05]

Federal Property Suitable as Facilities to Assist the Homeless

AGENCY: Office of the Assistant Secretary for Community Planning and Development, HUD.

ACTION: Notice.

SUMMARY: This Notice identifies unutilized, underutilized, excess, and surplus Federal property reviewed by HUD for suitability for use to assist the homeless.

FOR FURTHER INFORMATION CONTACT: Juanita Perry, Department of Housing and Urban Development, 451 Seventh Street SW., Room 7266, Washington, DC 20410; telephone (202) 402–3970; TTY number for the hearing- and speech-impaired (202) 708–2565 (these telephone numbers are not toll-free), or call the toll-free Title V information line at 800–927–7588.

SUPPLEMENTARY INFORMATION: In accordance with 24 CFR part 581 and section 501 of the Stewart B. McKinney Homeless Assistance Act (42 U.S.C. 11411), as amended, HUD is publishing this Notice to identify Federal buildings and other real property that HUD has reviewed for suitability for use to assist the homeless. The properties were reviewed using information provided to HUD by Federal landholding agencies regarding unutilized and underutilized buildings and real property controlled by such agencies or by GSA regarding its inventory of excess or surplus Federal property. This Notice is also published in order to comply with the December 12, 1988 Court Order in *National Coalition for the Homeless* v. *Veterans Administration,* No. 88–2503–OG (D.D.C.).

Properties reviewed are listed in this Notice according to the following categories: Suitable/available, suitable/unavailable, and suitable/to be excess, and unsuitable. The properties listed in the three suitable categories have been reviewed by the landholding agencies, and each agency has transmitted to HUD: (1) Its intention to make the property available for use to assist the homeless, (2) its intention to declare the property excess to the agency's needs, or (3) a statement of the reasons that the property cannot be declared excess or made available for use as facilities to assist the homeless.

Properties listed as suitable/available will be available exclusively for homeless use for a period of 60 days from the date of this Notice. Where property is described as for ''off-site use only'' recipients of the property will be required to relocate the building to their own site at their own expense. Homeless assistance providers interested in any such property should send a written expression of interest to HHS, addressed to Theresa Ritta, Office of Enterprise Support Programs, Program Support Center, HHS, room 12–07, 5600 Fishers Lane, Rockville, MD 20857; (301) 443–2265. (This is not a toll-free number.) HHS will mail to the interested provider an application packet, which will include instructions for completing the application. In order to maximize the opportunity to utilize a suitable property, providers should submit their written expressions of interest as soon as possible. For complete details concerning the processing of applications, the reader is encouraged to refer to the interim rule governing this program, 24 CFR part 581.

For properties listed as suitable/to be excess, that property may, if subsequently accepted as excess by GSA, be made available for use by the homeless in accordance with applicable law, subject to screening for other Federal use. At the appropriate time,

HUD will publish the property in a Notice showing it as either suitable/available or suitable/unavailable.

For properties listed as suitable/unavailable, the landholding agency has decided that the property cannot be declared excess or made available for use to assist the homeless, and the property will not be available.

Properties listed as unsuitable will not be made available for any other purpose for 20 days from the date of this Notice. Homeless assistance providers interested in a review by HUD of the determination of unsuitability should call the toll free information line at 1–800–927–7588 for detailed instructions or write a letter to Ann Marie Oliva at the address listed at the beginning of this Notice. Included in the request for review should be the property address (including zip code), the date of publication in the **Federal Register**, the landholding agency, and the property number.

For more information regarding particular properties identified in this Notice (i.e., acreage, floor plan, existing sanitary facilities, exact street address), providers should contact the appropriate landholding agencies at the following addresses: *Agriculture:* Ms. Debra Kerr, Department of Agriculture, Reporters Building, 300 7th Street SW., Room 300, Washington, DC 20024, (202)- 720–8873; *Air Force:* Ms. Connie Lotfi, Air Force Real Property Agency, 2261 Hughes Avenue, Suite 156, Lackland AFB, TX, 78236–9852, (210)-395–9512; *Army:* Ms. Veronica Rines, Office of the Assistant Chief of Staff for Installation Management, Department of Army, Room 5A128, 600 Army Pentagon, Washington, DC 20310, (571)-256–8145; *Energy:* Mr. David Steinau, Department of Energy, Real Estate Division (MA–651), Office of Property Management, 1000 Independence Ave. SW., Washington, DC, 20585, (202)-287–1503; *GSA:* Mr. Flavio Peres, General Services Administration, Office of Real Property Utilization and Disposal, 1800 F Street NW., Room 7040 Washington, DC 20405, (202) 501–0084; *Interior:* Mr. Michael Wright, Acquisition & Property Management, Department of the Interior, MS–4262, 1849 C Street, Washington, DC, 20240, (202)-513–0795

Navy: Mr. Steve Matteo, Department of the Navy, Asset Management Division, Naval Facilities Engineering Command, Washington Navy Yard, 1330 Patterson Ave. SW., Suite 1000, Washington, DC 20374; (202)685–9426 (These are not a toll-free numbers).

Dated: January 23, 2014.

Mark Johnston,

Deputy Assistant Secretary for Special Needs.

TITLE V, FEDERAL SURPLUS PROPERTY PROGRAM FEDERAL REGISTER REPORT FOR 01/31/2014

SUITABLE/AVAILABLE PROPERTIES

BUILDING

Ohio

Glenn Research Center
6100 Columbus Ave.
Sandusky OH 44870
Landholding Agency: GSA
Property Number: 54201410002
Status: Excess
GSA Number: 1–Z–OH–0598–AB
Directions: Disposal Agency: GSA; Landholding Agency: NASA
Comments: 6,424 sq. ft.; 20+ months vacant; repairs needed; contact GSA for more info.

Wyoming

Quarters 96
Grand Teton National Park
Moran WY 83013
Landholding Agency: Interior
Property Number: 61201410001
Status: Excess
Comments: Off-site removal only; foundation damage/cracks; repairs required for use; contamination; contact Interior for more information.

UNSUITABLE PROPERTIES

BUILDING

Arkansas

Tract 12–111- Sundberg, Kenneth House
100 Granger Drive
Hot Springs AR 71901
Landholding Agency: Interior
Property Number: 61201410002
Status: Excess
Comments: Documented deficiencies; structurally unsound; in collapsed condition; not movable; attempt to relocate will result in complete collapse.
Reasons: Extensive deterioration

California

1453-Banning Barracks
10045 Gilman Rd.
Banning CA 92220
Landholding Agency: Agriculture
Property Number: 15201410001
Status: Excess
Comments: Landlocked; can only be reached by crossing private property and there is no established right or means of entry
Reasons: Not accessible by road

Idaho

CFA–690 (Applied Science Lab)
1955 N. Fremont Ave.
Idaho Falls ID 83415
Landholding Agency: Energy
Property Number: 41201410001
Status: Unutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

CFA–689 (Technical Center)
1955 N. Fremont Ave.
Idaho Falls ID 83415
Landholding Agency: Energy
Property Number: 41201410002
Status: Unutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

CFA–688
(Technical Service Center)
1955 N. Fremont Ave.
Idaho Falls ID 83415
Landholding Agency: Energy
Property Number: 41201410003
Status: Unutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

CFA–632
(Storage Building)
1955 N. Fremont Ave.
Idaho Falls ID 83415
Landholding Agency: Energy
Property Number: 41201410004
Status: Unutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

CFA–607
(Office Building)
1955 N. Fremont Ave.
Idaho Falls ID 83415
Landholding Agency: Energy
Property Number: 41201410005
Status: Unutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

Mississippi

USDA Monitoring and Residue An
3505 25th Avenue
Gulfport MS 39501
Landholding Agency: GSA
Property Number: 54201410001
Status: Surplus
GSA Number: 4–A–MS–0571–AA
Directions: Disposal Agency: GSA; land holding Agency: Agriculture; 13 bldgs.
Comments: Two bldgs. adjacent to property (i.e., Coca-Cola & GCP laboratories, Inc. (pharmaceutical co.) houses a variety of flammable ingredients used for the soft drink bottling and pharmaceutical manufacturing.
Reasons: Within 2000 ft. of flammable or explosive material

Tennessee

4 Buildings
Milan AAP
Milan TN 38358
Landholding Agency: Army
Property Number: 21201340035
Status: Excess
Directions: I0205; I0206; I0207; T0114
Comments: Public access denied & no alternative method to gain access without compromising National Security.
Reasons: Secured Area

LAND

Nevada

Parcel I
Nellis AFB
Nellis NV
Landholding Agency: Air Force
Property Number: 18201410001
Status: Underutilized
Comments: Public access denied and no alternative method to gain access w/out compromising national security
Reasons: Secured Area

Virginia

Vacant Land, Joint Expeditionary Base Little Creek Fort Story
Located Next to Building 3850
Virginia Beach VA 23459
Landholding Agency: Navy
Property Number: 77201410001
Status: Unutilized
Comments: Public access denied and no alternative method to gain access without compromising national security.
Reasons: Secured Area

[FR Doc. 2014–01739 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

[Docket No. FR–5700–FA–12]

Announcement of Funding Awards for Healthy Homes Technical Studies Program for Fiscal Year (FY) 2013

AGENCY: Office of Healthy Homes and Lead Hazard Control, HUD.

ACTION: Announcement of Funding Awards.

SUMMARY: In accordance with Section 102(a)(4)(C) of the Department of Housing and Urban Development Reform Act of 1989, this announcement notifies the public of funding decisions made by the Department in a competition for funding under the Office of Healthy Homes and Lead Hazard Control (OHHLHC), Healthy Homes Technical Studies Grant Program Notice of Funding Availability. This announcement contains the name and address of the award recipients and the amounts of awards under the Consolidated and Further Appropriations Act, 2013.

FOR FURTHER INFORMATION CONTACT: Matthew E. Ammon, Department of Housing and Urban Development, Office of Healthy Homes and Lead Hazard Control, Room 8236, 451 Seventh Street SW., Washington, DC 20410, telephone 202–402–4337. Hearing- and speech-impaired persons may access the number above via TTY by calling the toll free Federal Relay Service at 1–800–877–8339.

SUPPLEMENTARY INFORMATION: HUD announced the FY 2013 awards on August 16, 2013. These awards were the result of a competition posted on the Internet at *Grants.gov* on January 15, 2013, for the Healthy Homes Technical Studies Grant Program. The purpose of the competition was to award funding for cooperative agreements for the Office of Healthy Homes and Lead Hazard Control Grant Program.

Applications were scored and selected on the basis of selection criteria contained in this Notice. A total of $10,499,595 was awarded under the Consolidated and Further Continuing Appropriations Act, 2013 (Pub. L. 113–6, approved May 13, 2013). In accordance with Section 102(a)(4)(C) of the Department of Housing and Urban Development Reform Act of 1989 (103 Stat. 1987; 42 U.S.C. 3545), the Department is publishing the names, addresses, and the amount of these awards as follows:

Alaska Native Tribal Health Consortium, 4000 Ambassador Drive, Anchorage, AK 99508–5909, $743,044; American Lung Association of the Upper Midwest, 3000 Kelly Lane, Springfield, IL 62711–6226, $690,558; Sinai Health System, 1500 S. California, Chicago, IL 60608–1797, $749,931; The Board of Trustees of the University of Illinois, Office of Sponsored Programs & Research Administration, 1901 South First Street, Suite A, Champaign, IL 61820–7406, $747,566; Tulane University, 1430 Tulane Avenue, EP 15, New Orleans, LA 70112–2632, $748,610; University of Massachusetts Lowell, One University Avenue, Lowell, MA 01854–2827, $749,999; University of Maryland, Baltimore County, 1000 Hilltop Circle, Baltimore, MD 21250–0001, $749,856; The Children's Mercy Hospital, 2401 Gillham Road, Kansas City, MO 64108–4619, $748,727; North Carolina State University, Research Administration, 2701 Sullivan Drive, Admin Services III, Box 7514, Raleigh, NC 27695–7514, $735,264; Rutgers, The State University of New Jersey, Office of Research and Sponsored Programs, ASB III, 3 Rutgers Plaza, New Brunswick, NJ 08901–8559, $342,905; Rutgers, The State University of New Jersey, 3 Rutgers Plaza, ASB III, 2nd Floor New Brunswick, NJ 08901–8559, $687,000; Board of Regents, NSHE, obo University of Nevada, Las Vegas, 4505 S. Maryland Parkway, Box 451055, Las Vegas, NV 89154–1055, $650,000; The Trustees of Columbia University in the City of New York, 630 West 168th Street—Box 49, New York, NY 10032–3702, $722,378; Case Western Reserve University, 10900 Euclid Avenue, Cleveland, OH 44106–4919, $749,952; The University of Texas at Austin, Office of Sponsored Projects, 101 E. 27th Street, Austin, TX 78712–1532, $683,805.

Date: January 23, 2014.

Matthew E. Ammon,

Deputy Director, Office of Healthy Homes and Lead Hazard Control.

[FR Doc. 2014–02058 Filed 1–30–14; 8:45 am]

BILLING CODE 4210–67–P

DEPARTMENT OF THE INTERIOR

Bureau of Indian Affairs

[AAK6006100 A11550000.999900]

Final Environmental Impact Statement for the Proposed Fee-to-Trust Conveyance of Property and Casino Project for the Stockbridge-Munsee Community, Wisconsin in the Town of Thompson, Sullivan County, New York

AGENCY: Bureau of Indian Affairs, Interior.

ACTION: Notice of availability.

SUMMARY: This notice advises the public that the Bureau of Indian Affairs (BIA) is making available for public review the Final Environmental Impact Statement (FEIS) for the proposed conveyance of 330 ± acres of land into trust status and construction of a gaming complex. The purpose of the proposed action is to help meet the Stockbridge-Munsee Community's (Tribe's) socio-economic needs.

DATES: The Record of Decision (ROD) on the proposed action will be issued on or after March 3, 2014, providing a 30 day waiting period after the Environmental Protection Agency (EPA) issues their Notice of Availability (NOA) of the FEIS in the **Federal Register**.

ADDRESSES: You may mail, hand carry or telefax written comments to Franklin Keel, Regional Director, Eastern Regional Office, Bureau of Indian Affairs, 545 Marriott Drive, Suite 700, Nashville, Tennessee 37214, Telefax (615) 564–6701. Please see the **SUPPLEMENTARY INFORMATION** section of this notice for directions for submitting comments and locations where copies of the FEIS are available.

FOR FURTHER INFORMATION CONTACT: Chester McGhee, (615) 564–6830.

SUPPLEMENTARY INFORMATION: The Tribe has requested that the BIA take into trust 330 acres of land on which the Tribe proposes to construct a casino, hotel, parking areas and other facilities. As this request is for land that is off of the Tribe's reservation to be taken into trust for gaming purposes, the Tribe has submitted applications under both the Indian Reorganization Act (25 U.S.C.

465 as implemented in 25 CFR part 151) and the Indian Gaming Reorganization Act (25 U.S.C. 2719 as implemented in 25 CFR part 292). The proposed project is located in the Town of Thompson, New York, just off State Route 17 (future I–86).

The proposed project includes the development of a 350,000 sf gaming facility and a 750-room hotel. The gaming facility would include a casino floor, food and beverage areas (consisting of a buffet, specialty restaurant, bar and coffee bar type facilities), meeting space, guest support services, offices and security area. A multipurpose/event center would cater to 2,700 visitors. Access to the casino would be provided from State Route 17 to County Highway 161. The FEIS considers a range of project alternatives, including: (1) Preferred casino-hotel complex; (2) reduced casino size; (3) alternative financial ventures; (4) different site locations; (5) different site plans and (5) no action.

The preferred casino-hotel complex alternative has been selected as the Tribe's Preferred Alternative as discussed in the FEIS. The information and analysis contained in the FEIS, as well as its evaluation and assessment of the Tribe's Preferred Alternative, are intended to assist the Department of the Interior (Department) in its review of the issues presented in the Tribe's application. The Preferred Alternative does not necessarily reflect the Department's final decision because the Department must further evaluate all of the criteria listed in 25 CFR part 151 and 25 CFR part 292. The Department's consideration and analysis of the applicable regulations may lead to a final decision that selects an alternative other than the Preferred Alternative, including no action, or a variant of the Preferred Alternative or another one of the alternatives analyzed in the FEIS.

Environmental issues addressed in the FEIS include land and water resources, air quality, biological resources, cultural and paleontological resources, socioeconomic conditions, transportation and circulation, land use, public services, noise, hazardous materials, visual resources, environmental justice, cumulative effects, indirect effects and mitigation.

The BIA has afforded other government agencies and the public extensive opportunity to participate in the preparation of this EIS. The BIA published a Notice of Intent (NOI) to prepare the EIS for the proposed action in the **Federal Register** on November 20, 2003 (68 FR 65467). The BIA held a public scoping meeting on December 4, 2003. A Notice of Availability for the Draft EIS (DEIS) was published in the **Federal Register** on February 11, 2005 (70 FR 7257). The DEIS was available for public comment until March 28, 2005. The BIA held a public hearing on the DEIS on March 10, 2005. An FEIS, which contained updated analyses in response to public comment, was prepared and submitted to the BIA in November 2006. That FEIS was not released because the underlying land-to-trust application was denied in January 2008. Despite a Notice of Cancellation on March 6, 2008 (73 FR 12204), the environmental review process remained open and was reactivated when the land-into-trust application was reinstated by the BIA in August 2011. That 2006 FEIS was updated based on the passage of time, and the updated FEIS document is now being released for circulation to the public.

Directions for Submitting Comments: Please include your name, return address and the caption, ''FEIS Comments, Stockbridge-Munsee Community, Wisconsin, Trust Acquisition and Casino Project'' on the first page of your written comments.

Public Availability of the FEIS: Copies of the FEIS will be available for viewing at the following locations during normal business hours:

- E.B. Crawford Public Library, 393 Broadway, Monticello, New York.
- Town Supervisor, Town of Thompson Town Hall, 4052 State Route 42, Monticello, New York.
- County Chairman, Sullivan County Government Center, 100 North Street, Monticello, New York.

Public Comment Availability: Comments, including names and addresses of respondents, will be available for public review at the mailing address for the BIA Eastern Regional Office shown in the **ADDRESSES** section during regular business hours, 8:00 a.m. to 4:30 p.m. (unless otherwise shown), Monday through Friday, except holidays. Before including your address, phone number, email address, or other personal identifying information in your comment, you should be aware that your entire comment—including your personal identifying information—may be made publicly available at any time. While you may request us in your comment to withhold your personal identifying information from public review, we cannot guarantee that we will be able to do so.

Authority: This notice is published in accordance with section 1503.1 of the Council on Environmental Quality regulations (40 CFR Parts 1500 through 1508) implementing the procedural requirements of the National Environmental Policy Act of 1969, as amended (42 U.S.C. 4321 *et seq.*), and the Department of Interior Manual (516 DM 1–6), and is in the exercise of authority delegated to the Assistant Secretary—Indian Affairs by 209 DM 8.1.

Dated: January 17, 2014.

Kevin K. Washburn,

Assistant Secretary—Indian Affairs.

[FR Doc. 2014–01682 Filed 1–30–14; 8:45 am]

BILLING CODE 4310–W7–P

DEPARTMENT OF THE INTERIOR

Bureau of Indian Affairs

[145A2100DD/AAK3000000/ A0T500000.000000]

Snoqualmie Indian Tribe—Liquor Control Ordinance

AGENCY: Bureau of Indian Affairs, Interior.

ACTION: Notice.

SUMMARY: This notice publishes the Snoqualmie Indian Tribe's Liquor Control Ordinance. The ordinance regulates and controls the possession, sale, and consumption of liquor within the Snoqualmie Indian Tribe's Indian country. This ordinance allows for the possession and sale of alcoholic beverages within the jurisdiction of the Snoqualmie Indian Tribe, will increase the ability of the tribal government to control the distribution and possession of liquor within their jurisdiction, and at the same time, will provide an important source of revenue, the strengthening of the tribal government, and the delivery of tribal services.

DATES: *Effective Date:* This Ordinance is effective January 31, 2014.

FOR FURTHER INFORMATION CONTACT: Betty Scissons, Tribal Government Specialist, Northwest Regional Office, Bureau of Indian Affairs, 911 NE 11th Avenue, Portland, OR 97232, Phone: (503) 231–6723; Fax: (503) 231–6731: or Dee Springer, Office of Indian Services, Bureau of Indian Affairs, 1849 C Street NW., MS–4513–MIB, Washington, DC 20240; Telephone (202) 513–7640.

SUPPLEMENTARY INFORMATION: Pursuant to the Act of August 15, 1953, Public Law 83–277, 67 Stat. 586, 18 U.S.C. 1161, as interpreted by the Supreme Court in *Rice* v. *Rehner,* 463 U.S. 713 (1983), the Secretary of the Interior shall certify and publish in the **Federal Register** notice of adopted liquor ordinances for the purpose of regulating liquor transactions in Indian country. The Snoqualmie Indian Tribe's Tribal Council adopted Resolution #02–2014 to enact the Alcoholic Beverage Control

Act authorizing the certification and publication of the Snoqualmie Liquor Control Ordinance on January 9, 2014.

This notice is published in accordance with the authority delegated by the Secretary of the Interior to the Assistant Secretary—Indian Affairs. I certify that the Snoqualmie Indian Tribes' Tribal Council adopted Resolution #02–2014 to enact the Alcoholic Beverage Control Act authorizing the certification and publication of the Snoqualmie Liquor Control Ordinance on January 9, 2014.

Dated: January 28, 2014.

Kevin K. Washburn,

Assistant Secretary—Indian Affairs.

The Snoqualmie Indian Tribe's Liquor Control Ordinance shall read as follows:

SECTION 1.0—INTRODUCTION

1.1 Title

This Chapter shall be known as the ''Snoqualmie Tribal Liquor Control Ordinance'' and shall be codified as Title 8, Chapter 3 of the Snoqualmie Tribal Code.

1.2 Authority

This Ordinance is enacted pursuant to the Act of August 15, 1953, 67 Stat. 586, codified at 18 U.S.C. 1161, by the authority of the Snoqualmie Tribal Council enumerated in Article VIII of the Constitution of the Snoqualmie Tribe of Indians, and in conformity with applicable Washington State laws and all attendant agreements with the State of Washington.

1.3 Purpose

The purpose of this Ordinance is to regulate and control the possession and sale of liquor on the Snoqualmie Tribe's trust land. The enactment of this Ordinance governing liquor possession and sale on the Snoqualmie Tribe's trust land will increase the ability of the Snoqualmie Tribal Council to control the sale, distribution and possession of liquor on the Snoqualmie Tribe's trust land and will provide an important source of revenue for the continued operation and strengthening of the Snoqualmie tribal government and the delivery of tribal government services.

1.4 Effective Date

This Ordinance shalt be effective upon certification by the Secretary of the Interior and its publication in the **Federal Register**.

SECTION 2.0—DECLARATION OF PUBLIC POLICY AND PURPOSE

(a) The introduction possession and sale of liquor on the trust land is a matter of special concern to the Tribe.

(b) Federal law currently prohibits the introduction of liquor into Indian Country (18 U.S.C. 1154), except as provided therein and expressly delegates to tribes the decision regarding when and to what extent liquor transactions shall be permitted (18 U.S.C. 1161).

(c) The Tribal Council recognizes that a need still exists for strict tribal regulation and control over liquor transactions within trust land because of the many potential problems associated with the unregulated or inadequately regulated sale, possession, distribution, and consumption of liquor. The Tribal Council finds that tribal control and regulation of liquor is necessary to achieve maximum economic benefit to the Tribe, to protect the health and welfare of tribal members, and to address specific concerns relating to alcohol use on the trust land.

(d) It is in the best interests of the Tribe to enact an ordinance governing liquor sales on trust land. Further, the Tribe has determined that the purchase, distribution and sale of liquor shall take place only at tribally-owned enterprises and/or tribally licensed establishments operating on trust land.

2.2 Definitions

As used in this title, the following words shall have the following meanings unless the context clearly requires otherwise:

(a) ''Alcohol'' means that substance known as ethyl alcohol, hydrated oxide of ethyl, ethanol, or spirits of wine, which is commonly produced by the fermentation or distillation of grain, starch, molasses, or sugar, or other substances including all dilutions and mixtures of this substance from whatever source or by whatever process produced.

(b) ''Alcoholic Beverage'' is synonymous with the term ''liquor'' as defined in Section 2.2(d) of this Chapter.

(c) ''Beer'' means any beverage such as beer, ale, lager beer, stout, and porter obtained by the alcoholic fermentation of an infusion or decoction of pure hops, or pure extract of hops and pure barley malt or other wholesome grain or cereal in pure water and containing not more than eight percent of alcohol by weight, and not less than one-half of one percent of alcohol by volume. For the purposes of this title, any such beverage containing more than eight percent of alcohol by weight shall be referred to as ''strong beer.''

(d) ''Liquor'' includes the four varieties of liquor herein defined (alcohol, spirits, wine, and beer), includes all fermented, spirituous, vinous, or malt liquor or combinations thereof, and mixed liquor, a part of which is fermented, spirituous, vinous or malt liquor, or otherwise intoxicating; and every liquid or solid or semisolid or other substance, patented or not containing alcohol, spirits, wine, or beer, and all drinks or drinkable liquids and all preparations or mixtures capable of human consumption, and any liquid, semisolid, solid, or other substance, which contains more than one percent of alcohol by weight shall be conclusively deemed to be intoxicating. Liquor does not include confections or food products that contain one percent or less of alcohol by weight. ''Malt Liquor'' means beer, strong beer, ale, stout and porter.

(e) ''Package'' means any container or receptacle used for holding liquor.

(f) ''Public Place'' includes state or county or tribal or federal highways or roads; buildings and grounds used for school purposes: public dance halls and grounds adjacent thereto; soft drink establishments, public buildings, public meeting halls, lobbies, halls and dining rooms of hotels, restaurants, theaters, gaming facilities, entertainment centers, stores, garages, and filling stations which are open to and/or are generally used by the public and to which the public is permitted to have unrestricted access; public conveyances of all kinds and character; and all other places of like or similar nature to which the general public has unrestricted right of access, and which are generally used by the public. For the purpose of this Ordinance, ''Public Place'' shall also include any establishment other than a single family home which is designed for or may be used by more than just the owner of the establishment.

(g) ''Sale'' and ''Sell'' includes exchange, barter and traffic; and also includes the selling or supplying or distributing by any means whatsoever of liquor, or of any liquid known or described as beer or by any name whatsoever commonly used to describe malt or brewed liquor or of wine by any person to any person.

(h) ''Spirits'' means any beverage, which contains alcohol obtained by distillation, including wines exceeding twenty-four percent of alcohol by weight.

(i) ''Wine'' means any alcoholic beverage obtained by fermentation of fruits, (grapes, berries, apples, et cetera) or other agricultural product containing sugar, to which any saccharine substances may have been added before, during or after fermentation, and containing not more than twenty-four percent of alcohol by volume, including sweet wines fortified with wine spirits,

such as port, sherry, muscatel, and angelica, not exceeding twenty-four percent of alcohol by volume and not less than one-half of one percent of alcohol by volume. For purposes of this Chapter, any beverage containing no more than fourteen percent of alcohol by volume when bottled or packaged by the manufacturer shall be referred to as ''table wine,'' and any beverage containing alcohol in an amount more than fourteen percent by volume when bottled or packaged by the manufacturer shall be referred to as ''fortified wine.'' However, ''fortified wine'' shall not include: (i) Wines that are both sealed or capped by cork closure and aged two years or more; and (ii) wines that contain more than fourteen percent alcohol by volume solely as a result of the natural fermentation process and that have not been produced with the addition of wine spirits, brandy, or alcohol.

(j) ''General Council'' means the General Council of the Snoqualmie Indian Tribe, which is composed of the voting membership of the Tribe.

(k) ''Tribal Council'' means the Snoqualmie Tribal Council, which is the governing body of the Tribe.

(l) ''Alcohol Beverage Control Office'' means the Tribal department which may be established by the Tribal Council for purposes carrying out the provisions of this Ordinance.

(m) ''Trust Land'' means those lands which are held in trust by the United States for the Tribe and not for any individual Indian.

(n) ''Tribe'' means the Snoqualmie Indian Tribe, a federally recognized sovereign Indian tribe.

2.3 Powers of Enforcement

2.3.1 The Tribal Council

In furtherance of this ordinance, the Tribal Council shall have the following powers and duties:

(a) To publish and enforce rules and regulations adopted by the Tribal Council governing the sale, manufacture, distribution, and possession of alcoholic beverages on the trust land;

(b) To employ managers, accountants, security personnel, inspectors and such other persons as shall be reasonably necessary to allow the Tribal Council to perform its functions, all of whom shall be tribal employees;

(c) To authorize the Alcohol Beverage Control Office to issue licenses permitting the sale or manufacture or distribution of liquor on the trust land and to revoke such licenses as provided herein;

(d) To hold hearings on violations of this ordinance or for the issuance or revocation of licenses hereunder;

(e) To bring suit in the appropriate court to enforce this ordinance as necessary;

(f) To make such reports as may be required by the General Council;

(g) To create the Alcohol Beverage Control Office which shall be authorized to collect fees levied or set by the Tribal Council, to keep accurate records, books, and accounts, and otherwise fulfill the duties prescribed in this Ordinance; and

(h) To determine and seek damages for violations of the Ordinance.

2.3.2 Limitations on Powers

In the exercise of its powers and duties under this Ordinance, the Tribal Council and its individual members shall not:

(a) Accept any gratuity, compensation or other thing of value from any liquor wholesaler, retailer or distributor or from any licensee;

(b) Waive the inherent sovereign immunity of the Tribe from suit without the express written consent of the Tribal Council.

2.3.3 Inspection Right

The premises on which liquor is sold or distributed shall be open for inspection by the Tribal Council at all reasonable times for the purpose of ascertaining whether the rules and regulations of the Tribal Council and this Ordinance are being complied with.

SECTION 3.0—SALES OF LIQUOR

3.1 License Required

Sales of liquor and alcoholic beverages within the exterior boundaries of trust land may only be made at businesses at designated Public Places which hold a tribal liquor license. Persons in possession of valid liquor licenses issued by the State of Washington may continue to operate under a Washington State license until such time as an application for a tribal license has been either approved or denied as provided for by Section 4 of this Ordinance.

3.2 Sales for Cash

All liquor sales within the trust land boundaries shall be on a cash only basis and no credit shall be extended to any person, organization, or entity; except that, this provision does not prevent the payment for purchases with the use of credit or debit cards.

3.3 Sale for Personal Consumption

All sales shall be for the personal use and consumption of the purchaser. Resale of any alcoholic beverage purchased within the exterior boundaries of the Trust Land is prohibited. Any person who is not licensed pursuant to this Ordinance who purchases an alcoholic beverage within the boundaries of the trust land and sells it, whether in the original container or not, shall be guilty of a violation of this Ordinance and shall be subject to paying damages to the Tribe as set forth herein.

SECTION 4.0—LICENSING

4.1 Procedure

In order to control the proliferation of establishments on the trust land which sell or serve liquor by the bottle or by the drink, all persons or entities which desire to sell liquor within the exterior boundaries of the trust land must apply to the Tribe for a license to sell or serve liquor. Persons in possession of valid liquor licenses issued by the State of Washington who apply for a tribal license may continue to operate under a Washington State license until such time as the application for a tribal license has been either approved or denied.

4.2 Application

Any person or entity applying for a license to sell or serve liquor on trust land must complete the application provided for this purpose by the Tribe and pay such application fee as may be set from time to time by the Alcohol Beverage Control Office or, in the absence thereof, the Tribal Council, for this purpose. The application must be filled out completely in order to be considered.

4.3 Issuance License

The Alcohol Beverage Control Office or, in the absence thereof, the Tribal Council may issue a license if it believes that such issuance is in the best interests of the Tribe and its members. Such decision shall be final.

4.4 Period of License

Each license may be issued for a period not to exceed two (2) years from the date of issuance.

4.5 Renewal of License

A licensee may renew its license if the licensee has complied in full with this Ordinance; provided, however, that the Alcohol Beverage Control Office or, in the absence thereof, the Tribal Council may refuse to renew a license if it finds that doing so would not be in the best interests of the health, safety and welfare of the Tribe and its members.

4.6 Revocation of License

The Alcohol Beverage Control Office or, in the absence thereof, the Tribal Council may revoke a license for reasonable cause upon notice and hearing at which the licensee is given an opportunity to respond to any charges against it and to demonstrate why the license should not be suspended or revoked.

4.7 Transferability of License

Licenses issued by the Alcohol Beverage Control Office or, in the absence thereof, the Tribal Council shall not be transferable and may only be utilized by the person or entity in whose name it was issued.

SECTION 5.0—TAXES

[RESERVED]

SECTION 6.0—RULES, REGULATIONS, AND ENFORCEMENT

(a) In any proceeding under this Ordinance, conviction of one unlawful sale or distribution of liquor shall establish prima facie intent of unlawfully keeping liquor for sale, selling liquor or distributing liquor in violation of this Ordinance.

(b) Any person who shall sell or offer for sale or distribute or transport in any manner, liquor in violation of this ordinance, or who shall operate or shall have liquor for sale in his possession without a license, shall be guilty of a violation of this Ordinance subjecting him or her to civil damages assessed by the Tribal Council.

(c) Any person within the boundaries of the trust land who buys liquor from any person other than a properly licensed facility shall be guilty of a violation of this Ordinance.

(d) Any person who keeps or possesses liquor upon his person or in any place or on premises conducted or maintained by his principal or agent with the intent to sell or distribute it contrary to the provisions of this title, shall be guilty of a violation of this Ordinance.

(e) Any person who knowingly sells liquor to a person under the influence of liquor shall be guilty of a violation of this Ordinance.

(f) Any person engaging wholly or in part in the business of carrying passengers for hire, and every agent, servant, or employee of such person, who shall knowingly permit any person to drink liquor in any public conveyance, shall be guilty of a violation of this Ordinance. Any person who shall drink liquor in a public conveyance shall be guilty of a violation of this Ordinance.

(g) No person under the age of 21 years shall consume, acquire or have in his possession any liquor or alcoholic beverage. No person shall permit any other person under the age of 21 to consume liquor on his premises or any premises under his control except in those situations set out in this section. Any person violating this section shall be guilty of a separate violation of this Ordinance for each and every drink so consumed.

(h) Any person who shall sell or provide any liquor to any person under the age of 21 years shall be guilty of a violation of this Ordinance for each such sale or drink provided.

(i) Any person who transfers in any manner an identification of age to a person under the age of 21 years for the purpose of permitting such person to obtain liquor shall be guilty of an offense; provided that corroborative testimony of a witness other than the underage person shall be a requirement of finding a violation of this Ordinance.

(j) Any person who attempts to purchase an alcoholic beverage through the use of false or altered identification which falsely purports to show the individual to be over the age of 21 years shall be guilty of violating this ordinance.

(k) Any person guilty of a violation of this Ordinance shall be liable to pay the Tribe the amount of $500 per violation as civil damages to defray the Tribe's cost of enforcement of this ordinance.

When requested by the provider of liquor, any person shall be required to present official documentation of the bearer's age, signature and photograph. Official documentation includes one of the following:

(1) Driver's license or identification card validly issued by any state department of motor vehicles;

(2) United States Active Duty Military identification;

(3) Passport;

(4) Snoqualmie Tribal Identification Card.

(l) Liquor which is possessed, including for sale, contrary to the terms of this Ordinance is declared to be contraband. Any Tribal agent, employee or officer who is authorized by the Tribal Council to enforce this section shall seize all contraband and preserve it in accordance with the provisions established for the preservation of impounded property.

(m) Upon being found in violation of the Ordinance, the party shall forfeit all right, title and interest in the items seized which shall become the property of the Tribe.

SECTION 7.0—ABATEMENT OF NUISANCE

(a) Any room, house, building, vehicle, structure, or other place where liquor is sold, manufactured, bartered, exchanged, given away, furnished, or otherwise disposed of in violation of the provision of this ordinance or of any other Tribal law relating to the manufacture, importation, transportation, possession, distribution, and sale of liquor, and all property kept in and used in maintaining such place, is hereby declared to be a nuisance.

(b) The Chairperson of the Tribal Council shall, upon vote of the Tribal Council, institute and maintain an action in the name of the Tribe to abate and perpetually enjoin any nuisance declared under this section in the Snoqualmie Tribal Court. In addition to all other remedies at Tribal law, the Snoqualmie Tribal Court may also order the room, house, building, vehicle, structure, or place closed for a period of one (1) year or until the owner, lessee, tenant, or occupant thereof shall give bond of sufficient sum of not less than $25,000 payable to the Tribe and conditioned that liquor will not be thereafter manufactured, kept, sold, bartered, exchanged, given away, furnished, or otherwise disposed of thereof in violation of the provisions of this Ordinance or of any other applicable Tribal law and that he will pay all fines, costs and damages assessed against him for any violation of this Ordinance or other Tribal laws. If any conditions of the bond be violated, the bond may be recovered for the use of the Tribe.

(c) In all instances where any person has been found in violation of this Ordinance relating to the manufacture, importation, transportation, possession, distribution, and sale of liquor, the Snoqualmie Tribal Court may abate as a nuisance any real estate or other property involved in the violation of the Ordinance, and violation of this Ordinance shall be prima facie evidence that the room, house, building, vehicle, structure, or place again which such action is brought is a public nuisance.

(d) Nothing in this section shall be deemed or construed as a waiver of the Tribe's inherent sovereign immunity from unconsented suit.

SECTION 8.0—SEVERABILITY AND EFFECTIVE DATE

(a) If any provision or application of this Ordinance is determined by review to be invalid, such determination shall not be held to render ineffectual the remaining portions of this ordinance or

to render such provisions inapplicable to other persons or circumstances.

(b) This Ordinance shall be effective on such date as the Secretary of the Interior certifies this Ordinance and publishes the same in the **Federal Register**.

(c) Any and all prior enactments of the Tribal Council which are inconsistent with the provisions of this Ordinance are hereby rescinded.

SECTION 9.0—AMENDMENT

This Ordinance may only be amended by a vote of the Tribal Council.

[FR Doc. 2014–02097 Filed 1–30–14; 8:45 am]

BILLING CODE 4310–4J–P

DEPARTMENT OF THE INTERIOR

Bureau of Land Management

[LLNV912000 L10200000.PH0000 LXSS0006F0000; 14–08807; MO#4500061004]

Correction: Notice of Public Meeting: Resource Advisory Councils, NV

AGENCY: Bureau of Land Management, Interior.

ACTION: Correction.

SUMMARY: On Friday, January 3, 2014, the Bureau of Land Management published the Notice of Public Meeting: Resource Advisory Councils, NV (79 FR 406). The address listed for this meeting was incorrect.

On page 406, in the second column, on lines 40 through 42, the address for the meeting should be corrected to: ''High Desert Inn, 3015 Idaho Street, Elko, NV, 89801.''

Matthew Spangler,

BLM Nevada Acting Deputy Chief, Communications.

[FR Doc. 2014–01931 Filed 1–30–14; 8:45 am]

BILLING CODE 4310–HC–P

DEPARTMENT OF THE INTERIOR

Bureau of Land Management

[LLOR957000–L63100000–HD0000–14XL1116AF: HAG14–0054]

Filing of Plats of Survey: Oregon/Washington

AGENCY: Bureau of Land Management, Interior.

ACTION: Notice.

SUMMARY: The plats of survey of the following described lands are scheduled to be officially filed in the Bureau of Land Management, Oregon State Office, Portland, Oregon, 30 days from the date of this publication.

Willamette Meridian

Oregon

T. 12 S., R. 3 E., accepted January 14, 2014

T. 33 S., R. 1 W., accepted January 14, 2014

T. 11 S., R. 1 E., accepted January 14, 2014

T. 16 S., R. 6 W., accepted January 17, 2014

Washington

T. 9 N., R. 27 E., accepted January 14, 2014

ADDRESSES: A copy of the plats may be obtained from the Public Room at the Bureau of Land Management, Oregon State Office, 1220 SW. 3rd Avenue, Portland, Oregon 97204, upon required payment.

FOR FURTHER INFORMATION CONTACT: Kyle Hensley, (503) 808–6132, Branch of Geographic Sciences, Bureau of Land Management, 1220 SW. 3rd Avenue, Portland, Oregon 97204. Persons who use a telecommunications device for the deaf (TDD) may call the Federal Information Relay Service (FIRS) at 1–800–877–8339 to contact the above individual during normal business hours. The FIRS is available 24 hours a day, 7 days a week, to leave a message or question with the above individual. You will receive a reply during normal business hours.

SUPPLEMENTARY INFORMATION: A person or party who wishes to protest against this survey must file a written notice with the Oregon State Director, Bureau of Land Management, stating that they wish to protest. A statement of reasons for a protest may be filed with the notice of protest and must be filed with the Oregon State Director within thirty days after the protest is filed. If a protest against the survey is received prior to the date of official filing, the filing will be stayed pending consideration of the protest. A plat will not be officially filed until the day after all protests have been dismissed or otherwise resolved.

Before including your address, phone number, email address, or other personal identifying information in your comment, you should be aware that your entire comment—including your personal identifying information—may be made publicly available at any time. While you can ask us in your comment to withhold your personal identifying information from public review, we cannot guarantee that we will be able to do so.

Timothy J. Moore,

Acting, Chief Cadastral Surveyor of Oregon/Washington.

[FR Doc. 2014–01987 Filed 1–30–14; 8:45 am]

BILLING CODE 4310–$$–P

DEPARTMENT OF THE INTERIOR

National Park Service

[NPS–PWR–PWRO–14060;PPPWSAMO00/PX.DSAMO0003.00.1]

Notice of Intent to Prepare a Joint Environmental Impact Statement/Environmental Impact Report for Trail Management Plan, Santa Monica Mountains National Recreation Area, Ventura and Los Angeles Counties, California

AGENCY: National Park Service, Interior.

ACTION: Notice of Intent.

SUMMARY: The original Notice of Intent to prepare the Trail Management Plan was published in the **Federal Register** on January 16, 2003, with an estimated completion date of 2004 for the joint EIS/EIR. The National Park Service (NPS) and state of California partner agencies conducted public scoping meetings in 2005 and gathered public comments on conceptual trail policies and map alternatives needed to prepare the Draft EIS/EIR. Owing to lack of funding, the NPS and partner agencies were unable to continue preparation of the EIS/EIR after the 2005 public scoping effort. State and federal funding for the EIS/EIR has now been secured, and the agencies are reinitiating joint preparation of the Trail Management Plan (TMP) and combined EIS/EIR. The NPS is the lead agency responsible for preparing the EIS, and the California Department of Parks and Recreation (CDPR) is the lead agency responsible for preparing the EIR. The Santa Monica Mountains Conservancy (SMMC) and the Mountains Recreation and Conservation Authority (MRCA) will be cooperating agencies in the EIS/EIR effort. Following publication of this Notice, CDPR will reissue a Notice of Preparation to initiate the preparation of a joint EIS/EIR pursuant to the requirements of the California Environmental Policy Act (CEQA).

DATES: All written public scoping comments must be postmarked or transmitted not later than April 1, 2014.

Further Information: Periodically updated materials about the integrated EIS/EIR process will be made available via mailings, regional and local news

media, and at the SMMNRA TMP project Web site (*http://parkplanning.nps.gov/smmnra-tmp*) and the SMMNRA Web page (*http://www.nps.gov/samo/parkmgmt/tmp-index.htm*). For further information, contact Melanie Beck, Outdoor Recreation Planner, Santa Monica Mountains National Recreation Area, National Park Service, 401W. Hillcrest Dr., Thousand Oaks, CA 91360 (805) 370–2346.

Background: The Santa Monica Mountains National Recreation Area (SMMNRA) encompasses 153,250 acres, with approximately 84,000 acres of public parkland and protected open space, with the rest in private or other government ownership. Within the SMMNRA, there is a 500-mile public trail network made up of trails and dirt service roads. The greater Santa Monica Mountains trail network adjacent to the national recreation area features over 80 additional miles of public trails, several of which feed into the recreation area. Public lands and the trails in the national recreation area are managed by federal, state, and local agencies with varying management policies. Additionally, much of the trail network consists of utility and old ranch roads that were inherited with the land and are not necessarily constructed to public trail management standards. After almost 35 years of continuous land acquisition, the public trail network has grown significantly, and several trails now cross parkland jurisdictional boundaries. There is the need to formulate an interagency trail plan to compile trail management policies to facilitate a seamless recreational experience for a variety of trail users and to prepare a vision for the final trail network and development of trail-related facilities, ranging from trail network signs to backcountry trail camps.

The NPS, CDPR, SMMC, and MRCA will jointly prepare a TMP and integrated EIS/EIR intended to establish the overall, coordinated, long-range direction of future management and development and completion of the trail network. Based on identified desired conditions for park natural, cultural, and recreational resources, the TMP will prescribe actions to support interagency management of the trail network throughout the national recreation area. The TMP will include a trail map depicting the planned trail network use designation and management actions. The planning and environmental analysis associated with the TMP could result in a program that would modify current trail policies, recreational use patterns, and future trail openings and closures.

Scope of EIS/EIR: The Draft TMP EIS/EIR will address environmental and social impacts associated with the national recreation area's existing and proposed trail network and related facilities. Environmental issues will include, but not be limited to, sensitive plant and animal habitat, cultural and archaeological resource sites, erosion and water resources; soils and geology, and visitor safety. Social issues will include, but not be limited to, allowable uses and user conflicts on trails; trail network public access; compatibility with gateway communities and local neighborhoods; trail network and facilities compliance with Americans with Disabilities Act requirements. Feasibility of trail network management and operation will also be considered.

The Draft TMP EIS/EIR will evaluate alternative trail network designs and supportive interagency practices to manage the network. In addition to ''no action'' and ''agency preferred'' alternatives, at this time it is expected that other alternatives may be needed to address contrasting recreational use patterns. All foreseeable environmental impacts of the alternatives will be evaluated, and an ''environmentally preferred'' alternative will be identified. The alternatives will be based on input from the community, an evaluation of environmental constraints using current environmental condition information, trail network maintenance feasibility, and visitor recreational use surveys conducted in the national recreation area.

Public Engagement: Public scoping for a proposed interagency trail plan began with the community-based Santa Monica Mountains Area Recreational Trails (SMMART) project that culminated in the 1997 SMMART Report (available for review at *www.nps.gov/samo/trails*). The SMMART Report contains community and user group recommendations regarding missing links in the trail network, backcountry camps along the regional Backbone Trail System, trail network sign guidelines, multiple use trail guidelines, and trail system design. The report also put forth a list of priority coordination issues not addressed in the SMMART project, including interagency cooperation, volunteer commitment, and multi-agency trail crew and equipment sharing.

In addition, numerous trail network-related comments were received during public scoping and the Draft EIS comment period for the 2003 *Santa Monica Mountains National Recreation Area General Management Plan.* All relevant information derived from these two processes will be considered while preparing the Draft TMP EIS/EIR.

Following the January 2003 publication of the original Notice of Intent in the **Federal Register**, the NPS conducted a series of public scoping sessions in September 2005 to solicit comments on conceptual trail map alternatives. Three conceptual alternative trail network maps were presented at seven meetings held throughout the SMMNRA area. Relevant information received from 320 participants mostly concerned trail use designations, trail networks, new trailhead locations, modes of access, and amenities needed. Respondents also recommended equestrian backcountry camps along the Backbone Trail, and supported plans for managing mountain biking and the need for additional patrol and educational outreach. This information will continue to be considered while preparing the Draft TMP EIS/EIR.

Presently, the NPS anticipates hosting several public scoping meetings within SMMNRA to conclude the public scoping efforts for the Draft TMP EIS/EIR. These will be scheduled not later than two weeks prior to the end of the 60 day scoping period—confirmed details will be posted on the project Web sites, and announced via local and regional media. In addition, a scoping newsletter will be distributed to publicize meeting details and provide a summary of issues and concerns developed through past scoping efforts, as well as to present information about the overall TMP planning process. The scoping summary newsletter will be available on both the SMMNRA Web site *http://www.nps.gov/samo/parkmgmt/tmp-index.htm* and the TMP project Web site *http://parkplanning.nps.gov/smmnra-tmp,* and will mailed to the current TMP contact list.

How to Comment: The NPS encourages comments about new issues and concerns that can inform the conservation planning and environmental impact analysis for the proposed TMP. The most useful comments are those that provide new environmental information, and suggest reasonable design alternatives the park should consider while initiating TMP EIS/EIR preparation. Comments submitted previously for the 1997 SMMART project, the 2003 SMMNRA GMP, or the original TMP scoping process will also be fully considered, with no need to resubmit those comments.

All written comments must be transmitted, postmarked, or hand-delivered as follows. You may provide your response electronically at the TMP Web site *http://parkplanning.nps.gov/smmnra-tmp,* or you may mail or fax your written comments to Superintendent David Szymanski, Santa Monica Mountains National Recreation Area, Attn: Trail Management Plan, 401 W. Hillcrest Drive, Thousand Oaks, CA 91360, Fax (805) 370–1850. Written comments may also be hand-delivered at the public scoping meetings or to the address noted above.

Before including your address, phone number, email address, or other personal identifying information in your comment, you should be aware that your entire comment—including your personal identifying information—may be made publicly available at any time. While you can ask us in your comment to withhold your personal identifying information from public review, we cannot guarantee that we will be able to do so.

Also, comments in any format (written or electronic) submitted by an individual or organization on behalf of another individual or organization will not be accepted.

Decision Process: After analysis of all responses and information received during the scoping period, a Draft EIS/EIR will be prepared (at this time, release of the document is expected to occur in mid-2014). Availability of the Draft EIS/EIR for review and written comment will be officially announced in the **Federal Register**, through local and regional news media, the above-listed Web sites, and direct mailing. Comments on the draft TMP EIS/EIR will be duly considered in preparing the Final EIS/EIR. Thereafter, but not sooner than 30 days after the release of the Final EIS/EIR, a Record of Decision will be prepared for the EIS and the final steps for the EIR Notice of Determination will be followed in accordance with CEQA. As a delegated EIS, the official responsible for approving the Record of Decision is the Regional Director, Pacific West Region, National Park Service; subsequently the official responsible for NPS implementation of the approved Trail Management Plan will be the Superintendent, Santa Monica Mountains National Recreation Area.

Dated: November 13, 2013.

Christine S. Lehnertz,

Regional Director.

[FR Doc. 2014–01675 Filed 1–30–14; 8:45 am]

BILLING CODE 4312–FF–P

DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

[S1D1S SS08011000 SX066A000 67F 134S180110; S2D2S SS08011000 SX066A00 33F 13xs501520]

Notice of Proposed Information Collection; Request for Comments

AGENCY: Office of Surface Mining Reclamation and Enforcement, Interior.

ACTION: Notice and request for comments.

SUMMARY: In compliance with the Paperwork Reduction Act of 1995, the Office of Surface Mining Reclamation and Enforcement (OSM) is announcing its intention to request renewed approval for the collection of information for Rights of Entry.

DATES: Comments on the proposed information collection must be received by April 4, 2014, to be assured of consideration.

ADDRESSES: Mail comments to John Trelease, Office of Surface Mining Reclamation and Enforcement, 1951 Constitution Avenue NW, Room 203—SIB, Washington, DC 20240. Comments may also be submitted electronically to *jtrelease@osmre.gov*.

FOR FURTHER INFORMATION CONTACT: To receive a copy of the information collection request contact John Trelease at (202) 208–2783, or electronically at *jtrelease@osmre.gov*.

SUPPLEMENTARY INFORMATION: The Office of Management and Budget (OMB) regulations at 5 CFR 1320, which implement provisions of the Paperwork Reduction Act of 1995 (Pub. L. 104–13), require that interested members of the public and affected agencies have an opportunity to comment on information collection and recordkeeping activities [see 5 CFR 1320.8 (d)]. This notice identifies an information collection that OSM will be submitting to OMB for extension. This collection is contained in 30 CFR 877.

OSM has revised burden estimates, where appropriate, to reflect current reporting levels or adjustments based on reestimates of burden or respondents and costs. OSM will request a 3-year term of approval for this information collection activity.

Comments are invited on: (1) The need for the collection of information for the performance of the functions of the agency; (2) the accuracy of the agency's burden estimates; (3) ways to enhance the quality, utility and clarity of the information collection; and (4) ways to minimize the information collection burden on respondents, such as use of automated means of collection of the information. A summary of the public comments will accompany OSM's submission of the information collection request to OMB.

Before including your address, phone number, email address, or other personal identifying information in your comment, you should be aware that your entire comment–including your personal identifying information—may be made publicly available at any time. While you can ask us in your comment to withhold your personal identifying information from public review, we cannot guarantee that we will be able to do so.

This notice provides the public with 60 days in which to comment on the following information collection activity:

Title: 30 CFR 877—Rights of Entry.

OMB Control Number: 1029–0055.

Summary: This regulation establishes procedures for non-consensual entry upon private lands for the purpose of abandoned mine land reclamation activities or exploratory studies when the landowner refuses consent or is not available.

Bureau Form Number: None.

Frequency of Collection: Once.

Description of Respondents: State and Tribal abandoned mine land reclamation agencies.

Total Annual Responses: 12.

Total Annual Burden Hours: 1008.

Total Annual Non-wage Costs: $1,080 for publication costs.

Dated: *January 16, 2014.*

Stephen M. Sheffield,

Acting Chief, Division of Regulatory Support.

[FR Doc. 2014–02059 Filed 1–30–14; 8:45 am]

BILLING CODE 4310–05–P

DEPARTMENT OF LABOR

Office of the Secretary

Agency Information Collection Activities; Submission for OMB Review; Comment Request; Slope and Shaft Sinking Plans

ACTION: Notice.

SUMMARY: The Department of Labor (DOL) is submitting the Mine Safety and Health Administration (MSHA) sponsored information collection request (ICR) titled, ''Slope and Shaft Sinking Plans,'' to the Office of Management and Budget (OMB) for review and approval for continued use, without change, in accordance with the Paperwork Reduction Act of 1995 (PRA), 44 U.S.C. 3501 et seq.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: A copy of this ICR with applicable supporting documentation; including a description of the likely respondents, proposed frequency of response, and estimated total burden may be obtained free of charge from the RegInfo.gov Web site at *http://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201311–1219–001* (this link will only become active on the day following publication of this notice) or by contacting Michel Smyth by telephone at 202–693–4129, TTY 202–693–8064, (these are not toll-free numbers) or sending an email to *DOL_PRA_PUBLIC@dol.gov*.

Submit comments about this request by mail or courier to the Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for DOL–MSHA, Office of Management and Budget, Room 10235, 725 17th Street NW., Washington, DC 20503; by Fax: 202–395–6881 (this is not a toll-free number); or by email: *OIRA_submission@omb.eop.gov*. Commenters are encouraged, but not required, to send a courtesy copy of any comments by mail or courier to the U.S. Department of Labor-OASAM, Office of the Chief Information Officer, Attn: Departmental Information Compliance Management Program, Room N1301, 200 Constitution Avenue NW., Washington, DC 20210; or by email: *DOL_PRA_PUBLIC@dol.gov*.

FOR FURTHER INFORMATION CONTACT: Michel Smyth by telephone at 202–693–4129, TTY 202–693–8064, (these are not toll-free numbers) or by email at *DOL_PRA_PUBLIC@dol.gov*.

Authority: 44 U.S.C. 3507(a)(1)(D).

SUPPLEMENTARY INFORMATION: The ICR seeks to extend PRA authorization for the information collection requirements specified in regulations 30 CFR 77.1900. Federal Mine Safety and Health Act of 1977 section 103(h), 30 U.S.C. 813(h), authorizes the MSHA to collect information necessary to carry out its duty in protecting the safety and health of miners. The regulatory requirement requires an underground coal mine operator to submit for MSHA approval a plan that will provide for the safety of workers in each slope or shaft that is commenced or extended from the surface to the underground coal mine.

This information collection is subject to the PRA. A Federal agency generally cannot conduct or sponsor a collection of information, and the public is generally not required to respond to an information collection, unless it is approved by the OMB under the PRA and displays a currently valid OMB Control Number. In addition, notwithstanding any other provisions of law, no person shall generally be subject to penalty for failing to comply with a collection of information that does not display a valid Control Number. *See* 5 CFR 1320.5(a) and 1320.6. The DOL obtains OMB approval for this information collection under Control Number 1219–0019.

OMB authorization for an ICR cannot be for more than three (3) years without renewal, and the current approval for this collection is scheduled to expire on March 31, 2014. The DOL seeks to extend PRA authorization for this information collection for three (3) more years, without any change to existing requirements. The DOL notes that existing information collection requirements submitted to the OMB receive a month-to-month extension while they undergo review. For additional substantive information about this ICR, see the related notice published in the **Federal Register** on November 4, 2013 (78 FR 66071).

Interested parties are encouraged to send comments to the OMB, Office of Information and Regulatory Affairs at the address shown in the **ADDRESSES** section within 30 days of publication of this notice in the **Federal Register**. In order to help ensure appropriate consideration, comments should mention OMB Control Number 1219–0019. The OMB is particularly interested in comments that:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

Agency: DOL–MSHA.

Title of Collection: Slope and Shaft Sinking Plans.

OMB Control Number: 1219–0019.

Affected Public: Private Sector—businesses or other for-profits.

Total Estimated Number of Respondents: 31.

Total Estimated Number of Responses: 68.

Total Estimated Annual Burden Hours: 1,360.

Total Estimated Annual Other Costs Burden: $51.

Dated: January 27, 2014.

Michel Smyth,

Departmental Clearance Officer.

[FR Doc. 2014–02012 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–43–P

DEPARTMENT OF LABOR

Office of the Secretary

Agency Information Collection Activities; Submission for OMB Review; Comment Request; Rigging Equipment for Material Handling Standard

ACTION: Notice.

SUMMARY: On January 31, 2014, the Department of Labor (DOL) will submit the Occupational Safety and Health Administration (OSHA) sponsored information collection request (ICR) titled, the ''Rigging Equipment for Material Handling Standard,'' to the Office of Management and Budget (OMB) for review and approval for continued use, without change, in accordance with the Paperwork Reduction Act of 1995 (PRA), 44 U.S.C. 3501 *et seq.*

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: A copy of this ICR with applicable supporting documentation; including a description of the likely respondents, proposed frequency of response, and estimated total burden may be obtained free of charge from the RegInfo.gov Web site at *http://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201401–1218–005* (this link will only become active on February 1, 2014) or by contacting Michel Smyth by telephone at 202–693–4129, TTY 202–693–8064, (these are not toll-free numbers) or sending an email to *DOL_PRA_PUBLIC@dol.gov*.

Submit comments about this request by mail or courier to the Office of Information and Regulatory Affairs, Attn: OMB Desk Officer for DOL–OSHA, Office of Management and Budget, Room 10235, 725 17th Street NW., Washington, DC 20503; by Fax: 202–395–6881 (this is not a toll-free number); or by email: *OIRA_submission@omb.eop.gov*. Commenters are encouraged, but not required, to send a courtesy copy of any comments by mail or courier to the U.S. Department of Labor-OASAM, Office of

the Chief Information Officer, Attn: Departmental Information Compliance Management Program, Room N1301, 200 Constitution Avenue NW., Washington, DC 20210; or by email: *DOL_PRA_PUBLIC@dol.gov*.

FOR FURTHER INFORMATION CONTACT: Contact Michel Smyth by telephone at 202–693–4129, TTY 202–693–8064, (these are not toll-free numbers) or sending an email to *DOL_PRA_PUBLIC@dol.gov*.

Authority: 44 U.S.C. 3507(a)(1)(D).

SUPPLEMENTARY INFORMATION: This ICR seeks to maintain PRA authorization for the information collection requirements contained in the Rigging Equipment for Material Handling Standard regulations at 29 CFR 1926.251(b)(1), (b)(6)(i), (b)(6)(ii), (c)(15)(ii), (e)(1)(i), (ii), and (iii) and (f)(2) that require affixing identification tags or markings on rigging equipment, developing and maintaining inspection records, and retaining proof-testing certificates. These information collection requirements are subject to the PRA. A Federal agency generally cannot conduct or sponsor a collection of information, and the public is generally not required to respond to an information collection, unless it is approved by the OMB under the PRA and displays a currently valid OMB Control Number. In addition, notwithstanding any other provisions of law, no person shall generally be subject to penalty for failing to comply with a collection of information that does not display a valid Control Number. *See* 5 CFR 1320.5(a) and 1320.6. The DOL obtains OMB approval for this information collection under Control Number 1218–0233.

OMB authorization for an ICR cannot be for more than three (3) years without renewal, and the current approval for this collection is scheduled to expire on January 31, 2014. The DOL seeks to extend PRA authorization for this information collection for three (3) more years, without any change to existing requirements. The DOL notes that existing information collection requirements submitted to the OMB receive a month-to-month extension while they undergo review. For additional substantive information about this ICR, see the related notice published in the **Federal Register** on November 25, 2013 (78 FR 70326).

Interested parties are encouraged to send comments to the OMB, Office of Information and Regulatory Affairs at the address shown in the **ADDRESSES** section by March 3, 2014. In order to help ensure appropriate consideration, comments should mention OMB Control Number 1218–0233. The OMB is particularly interested in comments that:

- Evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- Evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- Enhance the quality, utility, and clarity of the information to be collected; and
- Minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., permitting electronic submission of responses.

Agency: DOL–OSHA.

Title of Collection: Rigging Equipment for Material Handling Standard.

OMB Control Number: 1218–0233.

Affected Public: Private Sector—businesses or other for-profits.

Total Estimated Number of Respondents: 900.

Total Estimated Number of Responses: 181,625.

Total Estimated Annual Burden Hours: 130,764.

Total Estimated Annual Other Costs Burden: $0.

Dated: January 27, 2014.

Michel Smyth,

Departmental Clearance Officer.

[FR Doc. 2014–01944 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–26–P

DEPARTMENT OF LABOR

Employment and Training Administration

Comment Request for Information Collection for the Workforce Innovation Fund (WIF) Grant Program, New Collection.

AGENCY: Employment and Training Administration (ETA), Labor.

ACTION: Notice.

SUMMARY: The Department of Labor, as part of its continuing effort to reduce paperwork and respondent burden, conducts a preclearance consultation program to provide the general public and federal agencies with an opportunity to comment on proposed and/or continuing collections of information in accordance with the Paperwork Reduction Act of 1995 (PRA95) [44 U.S.C. 3506(c)(2)(A)]. This program helps to ensure that requested data can be provided in the desired format, reporting burden (time and financial resources) is minimized, collection instruments are clearly understood, and the impact of collection requirements on respondents can be properly assessed. Currently, the Employment and Training Administration is soliciting comments concerning the collection of data about Workforce Innovation Fund (WIF) [SGA/DFA PY–11–05] grant program.

DATES: Written comments must be submitted to the office listed in the addressee's section below on or before April 1, 2014.

ADDRESSES: Submit written comments to Employment and Training Administration, Office of Workforce Investment, Division of WIA Adult Services and Workforce System, 200 Constitution Avenue NW., Room S–4209, Washington, DC 20210, Attention: Wendy Slee. Telephone number: 202–693–3046 (this is not a toll-free number). Individuals with hearing or speech impairments may access the telephone number above via TTY by calling the toll-free Federal Information Relay Service at 1–877–889–5627 (TTY/TDD). Fax: 202–693–3817. Email: *workforce.innovation@dol.gov*. A copy of the proposed information collection request (ICR) can be obtained by contacting the person listed above.

SUPPLEMENTARY INFORMATION:

I. Background

The WIF was created as a grant program by the Full-Year Continuing Appropriations Act, 2011 (in Sec. 1801, Title VIII, Div. B of Pub. L. 112–10), and the first round of grants was awarded in June 2012, with service delivery beginning in 2013. According to this Act, the WIF was established to ''carry out projects that demonstrate innovative strategies or replicate effective evidence-based strategies that align and strengthen the workforce investment system in order to improve program delivery and education and employment outcomes for program beneficiaries.'' One of the purposes of the WIF grants is to contribute to the documentation of evidence-based practice within the field of workforce development.

This document requests approval to collect information to meet the reporting and recordkeeping requirements of the WIF grant program. In applying for the WIF grant program, grantees agreed to submit quarterly reports—both narrative and performance reports—that describe

project activities and outcomes that relate to the project and document the training or labor market information approaches used by the grantee. The quarterly performance narrative report will provide a format for a detailed account of program activities, accomplishments, and progress toward performance outcomes during the quarter. These reports will collect aggregate information on participants' grant progress and accomplishments, grant challenges, grant technical assistance needs and success stories and lessons learned through five questions—four programmatic questions and one performance question. Because WIF grants tackle a range of employment and training services and strategies, each grant will have a unique set of performance goals and outcome measures designed by the grantee for the specific innovation and project being pursued in the grant. The fifth of the five questions in the quarterly performance narrative report will ask for performance data based on the unique grant performance measures and key project milestones identified by each grantee.

The information from these reports will be used to evaluate the performance of the WIF projects; manage performance risk; and collect lessons that are learned in terms of processes, strategies, and performance from the projects. The Employment and Training Administration (ETA) will use the data to help inform policy about the workforce and possible changes in structures and policies that enable a closer alignment and integration of workforce development, education, human services, social insurance, and economic development programs. The data will also be used to determine what technical assistance needs the WIF grantees have so that ETA can provide such assistance to support improvement of grantee outcomes.

The information provided in the quarterly performance narrative reports, including the lessons learned through innovative projects, is necessary for increasing the body of knowledge about what works in workforce development. This information collection maintains a reporting and record-keeping system for a minimum level of information collection that is necessary to hold WIF grantees appropriately accountable for the Federal funds they receive and to allow the Department to fulfill its oversight and management responsibilities.

To reduce grantee burden, grantees will only report on performance measures they identify in their project that are specifically applicable to their grant. This approach minimizes the reporting burden on grantees and encourages grantees to identify and document a new set of achievements and performance measures that apply directly to the grant projects.

II. Review Focus

The Department of Labor is particularly interested in comments which:

- evaluate whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility;
- evaluate the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;
- enhance the quality, utility, and clarity of the information to be collected; and
- minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology, e.g., permitting electronic submissions of responses.

III. Current Actions

Type of Review: New collection.

Title: Workforce Innovation Fund grant program.

OMB Number: 1205–0NEW.

Affected Public: Workforce Innovation Fund grant recipients.

Form(s): Quarterly narrative and performance reports.

Total Annual Burden Cost for Respondents: $0.

ESTIMATED TOTAL BURDEN HOURS

Data collection activity	Number of respondents	Frequency	Total responses	Average time per response	Burden hours
Quarterly Performance Narrative Report	26	Quarterly	104	20	2080

Comments submitted in response to this comment request will be summarized and/or included in the request for OMB approval of the ICR; they will also become a matter of public record.

Signed at Washington, DC, this 30th day of December, 2013.

Eric M. Seleznow,

Acting Assistant Secretary for Employment and Training Administration, Labor.

[FR Doc. 2014–02084 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–FN–P

DEPARTMENT OF LABOR

Bureau of Labor Statistics

Comment Request

AGENCY: Bureau of Labor Statistics, Labor.

ACTION: Notice of solicitation of comments.

SUMMARY: In 2009, the Consumer Expenditure Surveys Division started the Gemini Project for the purpose of researching, developing, and implementing an improved survey design for the Consumer Expenditure Survey (CE). The objective of the redesign is to improve the quality of the survey estimates through a verifiable reduction in measurement error, with a particular focus on underreporting. While reducing measurement error, the new survey design would also combat the decline in response rates seen in recent years. In June 2013, a comprehensive redesign proposal was completed. As development, testing, and evaluation of the new CE survey proceeds, BLS would like feedback on the new survey design and the data that would be available from the survey from current data users and other interested parties.

DATES: Written comments must be submitted to the office listed in the **ADDRESSES** section of this notice on or before April 1, 2014.

ADDRESSES: Send comments to Bill Passero, Division of Consumer Expenditure Surveys, Bureau of Labor Statistics, Room 3985, 2 Massachusetts Avenue NE., Washington, DC 20212 or by email to: *GeminiOutreach@bls.gov*.

FOR FURTHER INFORMATION CONTACT: Bill Passero, Division of Consumer Expenditure Surveys, Bureau of Labor Statistics, telephone number 202–691–5126 (this is not a toll-free number), or by email to: *GeminiOutreach@bls.gov.*

SUPPLEMENTARY INFORMATION:

I. Background

The proposed CE redesign includes two waves of data collection set 12 months apart. Each wave contains the same interview structure consisting of two visits and a 1-week diary. Visit 1 is an in-person interview made up of two parts. The first part identifies the roster of the household, while the second is a recall interview that collects large, easily-recalled household expenditures. Additionally, Visit 1 incorporates instructions to collect relevant expenditure records for the Visit 2 records-based interview, as well as training for and placement of the electronic, individual diaries. Following Visit 1, an electronic web-based diary (accessible via PC, smartphone, or other mobile device) is maintained for one week by each household member 15 years old and older. Visit 2 is an in-person, records-based interview on household expenditures that can reasonably be found in records such as receipts, utility bills, and bank statements.

Incentives are provided to respondents to encourage participation in the CE. The proposed incentive structure for the new design includes a $2 prepaid cash incentive per household sent with an advance letter, a $20 household incentive (debit card) provided after Visit 1, a $20 individual incentive (debit card) for each member who completes the diary, and a $20 or $30 household incentive (debit card) after Visit 2. Pending further research and discussion, the Visit 1 $20 household incentive may be provided with the advance letter and activated upon completion of the Visit 1 interview.

With this redesign, the CE aims to create a survey that uses technology to encourage real-time data capture, individual diaries to reduce proxy reporting, shortened interview length to reduce respondent burden, record use to improve data quality, and incentives to address respondent motivation.

II. Further Information

For further information about the proposed new CE design, please visit *http://www.bls.gov/cex/geminiproject.htm*. This Web page provides information on the history of the Gemini project, including vision and scope, an overview of the redesign, and links to presentations and papers related to the redesign.

III. Desired Focus of Comments

Comments and recommendations are requested from the public on the proposed CE redesign. The proposed new design described here may change based on input from the public.

The BLS welcomes comments on any aspect of the CE redesign but is especially interested in comments on:

- Enhancements or limitations the proposed new design will have on the use of the data.
- Features of the new design that are particularly appealing or problematic.
- Information and lead time that would be needed prior to the implementation of the new design to aid users in adapting to the new design.

Signed at Washington, DC, this 28th day of January 2014.

Kimberley Hill,

Chief, Division of Management Systems, Bureau of Labor Statistics.

[FR Doc. 2014–02028 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–24–P

DEPARTMENT OF LABOR

Occupational Safety and Health Administration

[Docket No. OSHA–2010–0040]

Concrete and Masonry Construction Standard; Extension of the Office of Management and Budget's (OMB) Approval of Information Collection (Paperwork) Requirements

AGENCY: Occupational Safety and Health Administration (OSHA), Labor.

ACTION: Request for public comments.

SUMMARY: OSHA solicits public comments concerning its proposal to extend the Office of Management and Budget's (OMB) approval of the information collection requirements specified in the Standard on Concrete and Masonry Construction (29 CFR part 1926, subpart Q).

DATES: Comments must be submitted (postmarked, sent, or received) by April 1, 2014.

ADDRESSES:

Electronically: You may submit comments and attachments electronically at *http://www.regulations.gov,* which is the Federal eRulemaking Portal. Follow the instructions online for submitting comments.

Facsimile: If your comments, including attachments, are not longer than 10 pages you may fax them to the OSHA Docket Office at (202) 693–1648.

Mail, hand delivery, express mail, messenger, or courier service: When using this method, you must submit a copy of your comments and attachments to the OSHA Docket Office, OSHA Docket No. OSHA–2010–0040, U.S. Department of Labor, Occupational Safety and Health Administration, Room N–2625, 200 Constitution Avenue NW., Washington, DC 20210. Deliveries (hand, express mail, messenger, and courier service) are accepted during the Department of Labor's and Docket Office's normal business hours, 8:15 a.m. to 4:45 p.m., e.t.

Instructions: All submissions must include the Agency name and the OSHA docket number (OSHA–2010–0040) for the Information Collection Request (ICR). All comments, including any personal information you provide, are placed in the public docket without change, and may be made available online at *http://www.regulations.gov.* For further information on submitting comments see the ''Public Participation'' heading in the section of this notice titled **SUPPLEMENTARY INFORMATION**.

Docket: To read or download comments or other material in the docket, go to *http://www.regulations.gov* or the OSHA Docket Office at the address above. All documents in the docket (including this **Federal Register** notice) are listed in the *http://www.regulations.gov* index; however, some information (e.g., copyrighted material) is not publicly available to read or download from the Web site. All submissions, including copyrighted material, are available for inspection and copying at the OSHA Docket Office. You may also contact Theda Kenney at the address below to obtain a copy of the ICR.

FOR FURTHER INFORMATION CONTACT: Theda Kenney or Todd Owen, Directorate of Standards and Guidance, OSHA, U.S. Department of Labor, Room N–3609, 200 Constitution Avenue NW., Washington, DC 20210; telephone (202) 693–2222.

SUPPLEMENTARY INFORMATION:

I. Background

The Department of Labor, as part of its continuing effort to reduce paperwork and respondent (i.e., employer) burden,

conducts a preclearance consultation program to provide the public with an opportunity to comment on proposed and continuing information collection requirements in accord with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506(c)(2)(A)). This program ensures that information is in the desired format, reporting burden (time and costs) is minimal, collection instruments are clearly understood, and OSHA's estimate of the information collection burden is accurate. The Occupational Safety and Health Act of 1970 (the OSH Act) (29 U.S.C. 651 et seq.) authorizes information collection by employers as necessary or appropriate for enforcement of the OSH Act or for developing information regarding the causes and prevention of occupational injuries, illnesses, and accidents (29 U.S.C. 657). The OSH Act also requires that OSHA obtain such information with minimum burden upon employers, especially those operating small businesses, and to reduce to the maximum extent feasible unnecessary duplication of efforts in obtaining information (29 U.S.C. 657).

The warning signs/barriers required by paragraph 1926.701(c)(2) reduce exposure of non-essential workers to the hazards of post-tensioning operations, principally a failed rope or wire striking a worker and causing serious injury. The requirements to lockout and tag ejection systems and other hazardous equipment (e.g., compressors, mixers, screens or pumps used for concrete and masonry construction) specified by paragraphs 1926.702(a)(2), (j)(1), and (j)(2) warn equipment operators not to activate their equipment if another worker enters the equipment to perform a task (e.g., cleaning, inspecting, maintaining, repairing), thereby preventing injury or death.

Construction contractors and workers use the drawings, plans, and designs required by paragraph 1926.703(a)(2) to provide specific instructions on how to construct, erect, brace, maintain, and remove shores and formwork if they pour concrete at the job site. Paragraph 1926.705(b) requires employers to mark the rated capacity of jacks and lifting units. This requirement prevents overloading and subsequent collapse of jacks and lifting units, as well as their loads, thereby sparing exposed workers from serious injury or death.

II. Special Issues for Comment

OSHA has a particular interest in comments on the following issues:

- Whether the proposed information collection requirements are necessary for the proper performance of the Agency's functions, including whether the information is useful;
- The accuracy of OSHA's estimate of the burden (time and costs) of the information collection requirements, including the validity of the methodology and assumptions used;
- The quality, utility, and clarity of the information collected; and
- Ways to minimize the burden on employers who must comply; for example, by using automated or other technological information collection and transmission techniques.

III. Proposed Actions

OSHA is requesting that OMB extend its approval of the information collection requirements specified in the Concrete and Masonry Construction Standard. The Agency is requesting an adjustment increase of 1,168 burden hours (from 11,603 to 12,771 burden hours). The increase is a result of an increase in the number of construction worksites from 725,199 to 798,199.

Type of Review: Extension of a currently approved collection.

Title: Concrete and Masonry Construction Standard (29 CFR part 1926, subpart Q).

OMB Control Number: 1218–0095.

Affected Public: Business or other for-profits.

Number of Respondents: 798,160.

Frequency of Responses: On occasion.

Total Responses: 159,632.

Average Time per Response: Five minutes (.08 hour) to post or place warning signs, locks, or tags.

Estimated Total Burden Hours: 12,771.

Estimated Cost (Operation and Maintenance): $0.

IV. Public Participation—Submission of Comments on this Notice and Internet Access to Comments and Submissions

You may submit comments in response to this document as follows: (1) Electronically at *http://www.regulations.gov,* which is the Federal eRulemaking Portal; (2) by facsimile (fax); or (3) by hard copy. All comments, attachments, and other material must identify the Agency name and the OSHA docket number for the ICR (Docket No. OSHA–2010–0040). You may supplement electronic submissions by uploading document files electronically. If you wish to mail additional materials in reference to an electronic or facsimile submission, you must submit them to the OSHA Docket Office (see the section of this notice titled **ADDRESSES**). The additional materials must clearly identify your electronic comments by your name, date, and the docket number so the Agency can attach them to your comments.

Because of security procedures, the use of regular mail may cause a significant delay in the receipt of comments. For information about security procedures concerning the delivery of materials by hand, express delivery, messenger, or courier service, please contact the OSHA Docket Office at (202) 693–2350, (TTY (877) 889–5627).

Comments and submissions are posted without change at *http://www.regulations.gov.* Therefore, OSHA cautions commenters about submitting personal information such as social security numbers and date of birth. Although all submissions are listed in the *http://www.regulations.gov* index, some information (e.g., copyrighted material) is not publicly available to read or download from this Web site. All submissions, including copyrighted material, are available for inspection and copying at the OSHA Docket Office. Information on using the *http://www.regulations.gov* Web site to submit comments and access the docket is available at the Web site's ''User Tips'' link.

Contact the OSHA Docket Office for information about materials not available from the Web site and for assistance in using the Internet to locate docket submissions.

V. Authority and Signature

David Michaels, Ph.D., MPH, Assistant Secretary of Labor for Occupational Safety and Health, directed the preparation of this notice. The authority for this notice is the Paperwork Reduction Act of 1995 (44 U.S.C. 3506 et seq.) and Secretary of Labor's Order No. 1–2012 (77 FR 3912).

Signed at Washington, DC, on January 28, 2014.

David Michaels,

Assistant Secretary of Labor for Occupational Safety and Health.

[FR Doc. 2014–02016 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–26–P

DEPARTMENT OF LABOR

Occupational Safety and Health Administration

[Docket No. OSHA–2013–0025]

Proposed Revocation of Permanent Variances Granted for Chimney Construction

AGENCY: Occupational Safety and Health Administration (OSHA), Labor.

ACTION: Notice proposing to revoke permanent variances and requesting comment.

SUMMARY: In this notice, the Occupational Safety and Health Administration (''OSHA'' or the ''Agency'') is proposing to revoke permanent variances that it granted between 1973 and 2010 to 24 companies engaged in chimney construction (hereafter, ''previous variances''). The previous variances provided the companies with an alternative means of complying with provisions of OSHA standards regulating boatswains' chairs, personnel platforms, and hoist towers. On October 2, 2013, OSHA published a **Federal Register** notice (78 FR 60900) in which it updated the previous variances with a single, permanent variance (''the uniform variance''). The 2013 **Federal Register** notice granted the uniform variance to a number of the companies that held previous variances.

OSHA determined that, compared to the previous variances, the uniform variance: (1) provides more consistency across the conditions specified by the variance, thereby expediting OSHA's enforcement of the conditions; (2) allows employers to use updated technology and industry practices; and (3) increases worker safety. Therefore, OSHA is proposing to revoke the previous variances and to invite employers not covered by the uniform variance to submit applications for an equivalent variance.

DATES: Parties affected by this proposed action must submit comments and requests for a hearing (postmarked, sent, or received) by March 3, 2014.

ADDRESSES: *Electronic.* Submit comments and requests for a hearing electronically at *http://www.regulations.gov,* which is the Federal eRulemaking Portal. Follow the instructions online for submitting comments, and clearly indicate the docket number in the submission (OSHA–2013–0025).

Facsimile. OSHA allows facsimile transmission of comments that are 10 pages or fewer in length (including attachments), as well as hearing requests. Send these comments and requests to the OSHA Docket Office at (202) 693–1648; OSHA does not require hard copies of comments or hearing requests.

Instead of transmitting facsimile copies of attachments that supplement their comments (e.g., studies and journal articles), commenters may submit these attachments to the OSHA Docket Office, Technical Data Center, Room N–2625, OSHA, U.S. Department of Labor, 200 Constitution Ave. NW., Washington, DC 20210. These attachments must clearly identify the sender's name, date, subject, and docket number (i.e., OSHA–2013–0025) so that the Agency can attach them to the appropriate comments.

Regular mail, express delivery, hand delivery, and messenger (courier) service. Submit comments and any additional material (e.g., studies and journal articles), as well as hearing requests, to the OSHA Docket Office, Docket No. OSHA–2013–0025, Technical Data Center, Room N–2625, OSHA, U.S. Department of Labor, 200 Constitution Ave. NW., Washington, DC 20210; telephone: (202) 693–2350 (OSHA's TTY number is (877) 889–5627). Contact the OSHA Docket Office for information about security procedures concerning the delivery of materials by express delivery, hand delivery, and messenger service. The hours of operation for the OSHA Docket Office and Department of Labor are 8:15 a.m. to 4:45 p.m., e.t.

Instructions. All submissions must include the Agency name and the OSHA docket number (i.e., OSHA Docket No. OSHA–2013–0025). OSHA will place comments and other material, including any personal information, in the public docket without revision, and these comments and material will be available online at *http://www.regulations.gov.* Therefore, the Agency cautions commenters about submitting statements they do not want made available to the public, or submitting comments that contain personal information (either about themselves or others) such as Social Security numbers, birth dates, and medical data.

Docket. To read or download comments or other material in the docket, go to *http://www.regulations.gov* or to the OSHA Docket Office at the address above. The electronic docket for this proposed revocation established at *http://www.regulations.gov* lists most of the documents in the docket; however, some information (e.g., copyrighted material) is not publicly available to read or download through this Web site. All submissions, including copyrighted material, are available for inspection and copying at the OSHA Docket Office. Contact the OSHA Docket Office for assistance in locating docket submissions.

FOR FURTHER INFORMATION CONTACT: Information regarding this notice is available from the following sources:

Press inquiries: Contact Mr. Frank Meilinger, Director, OSHA Office of Communications, U.S. Department of Labor, 200 Constitution Avenue NW., Room N–3647, Washington, DC 20210; telephone: (202) 693–1999; email: *Meilinger.francis2@dol.gov.*

General and technical information: Contact David Johnson, Director, Office of Technical Programs and Coordination Activities, Directorate of Technical Support and Emergency Management, Occupational Safety and Health Administration, U.S. Department of Labor, 200 Constitution Avenue NW., Room N–3655, Washington, DC 20210; telephone: (202) 693–2110; email: *johnson.david.w@dol.gov.* OSHA's Web page includes information about the Variance Program (see *http://www.osha.gov/otpca/nrtl/index.html*).

Copies of the ***Federal Register*** *notice:* Electronic copies of this **Federal Register** notice are available at *http://www.regulations.gov.* This **Federal Register** notice, as well as other relevant information, also is available on OSHA's Web page at *http://www.osha.gov.*

SUPPLEMENTARY INFORMATION:

I. Background

A. Previous Chimney-Related Construction Variances

From 1973 to through 2010, the Agency granted permanent variances to a number of chimney-related construction companies from the provisions of the OSHA standards that regulate boatswains' chairs, personnel platforms, and hoist towers, specifically, paragraph (o)(3) of 29 CFR 1926.452 and paragraphs (c)(1) through (c)(4), (c)(8), (c)(13), (c)(14)(i), and (c)(16) of 29 CFR 1926.552.[1] Several of these early variances (hereafter, ''the previous variances'') limited the scope of the variances only to chimneys constructed using jump-form construction techniques and procedures (see, for example, 38 FR 8545 granted April 3, 1973, and 71 FR 10557 granted March 1, 2006), while more recently granted chimney-construction variances, limited the scope of the variances to the construction of tapered chimneys using jump-form construction techniques and procedures (see, for example, 75 FR 22424; April 28, 2010). In addition, the conditions specified in the previous variances became somewhat inconsistent over time, and none of these variances kept pace with updated construction methods used by, and technological advances taking place in, the chimney-construction industry.

[1] See 38 FR 8545 (April 3, 1973), 44 FR 51352 (August 31, 1979), 50 FR 20145 (May 14, 1985), 50 FR 40627 (October 4, 1985), 52 FR 22552 (June 12, 1987), 68 FR 52961 (September 8, 2003), 70 FR 72659 (December 6, 2005), 71 FR 10557 (March 1, 2006), 72 FR 6002 (February 8, 2007), 74 FR 34789 (July 17, 2009), 74 FR 41742 (August 18, 2009), and 75 FR 22424 (April 28, 2010).

B. Grant of the Uniform Chimney-Construction Variance

In the period from November 2012 through January 2013, 15 employers involved in chimney construction submitted applications for a new permanent variance under Section 6(d) of the Occupational Safety and Health Act of 1970 (29 U.S.C. 655) and 29 CFR 1905.11 (''Variances and other relief under section 6(d)''). The applicants construct, renovate, repair, maintain, inspect, and demolish tall chimneys and similar structures made of concrete, brick, and steel. This work, which occurs throughout the United States, requires the employers to transport employees and construction tools and materials to and from elevated worksites located inside and outside these structures.

As in the past, the employers sought a permanent variance from paragraph (o)(3) of 29 CFR 1926.452, which regulates the tackle used to rig a boatswain's chair, as well as paragraphs (c)(1) through (c)(4), (c)(8), (c)(13), (c)(14)(i), and (c)(16) of 29 CFR 1926.552, which regulate personnel platforms and hoist towers. OSHA consolidated these variance applications into a single application and published the uniform variance application, along with a request for public comment, in the **Federal Register** on March 21, 2013 (78 FR 17432). On October 2, 2013, the Agency granted the permanent variance (hereafter, ''the uniform variance'') in a notice published in the **Federal Register** (78 FR 60900). The scope of the uniform variance included both chimneys and chimney-related structures (such as silos and towers), as well as jump-form and slip-form construction [2] techniques and procedures, regardless of structural configuration. Additionally, the uniform variance added or revised conditions that improved worker safety, including: Condition 3 (Definitions), which defines 29 key terms used in the variance, usually technical terms, for the purpose of standardizing and clarifying the meaning of these terms; Condition 5 (Hoist Machines), which updates the requirements for the design and use of hoist machines based on guidance provided by American National Standards Institute (ANSI) A10.22–2007; and Condition 6 (Methods of Operation), which expands and clarifies the training requirements for both the operators of the hoist machine and the employees who ride in the cage (this condition adopted several provisions of ANSI A10.22–2007). (See the table and preamble in 78 FR 60900, 60904–60910, for an extensive description of the differences between the uniform variance and a previous variance published in 2010.)

In view of the Agency's history with the variances granted for chimney-related construction, OSHA determined that it should replace the previously granted variances (1973 through 2010) with the recently published uniform variance. In doing so, OSHA believes that the uniform variance, compared to the outdated previous variances: (1) Provides more consistency across the conditions specified by the variance, thereby expediting OSHA's enforcement of the conditions; (2) allows employers to use updated technology and industry practices; and (3) increases worker safety.

In developing the uniform variance, OSHA sent a letter on December 21, 2012, to all employers holding previous chimney-construction variances (see Ex. OSHA–2013–0025–0001 for a sample letter). The letter informed them of the process of developing a uniform variance, and of OSHA's plan to revoke all previous chimney-construction variances once OSHA published the uniform variance. In response to this letter, 15 chimney-construction employers holding previous variances applied for the new uniform variance.

II. Multi-State Variances

Twenty-seven states have safety and health plans approved by OSHA under Section 18 of the Occupational Safety and Health (OSH) Act (29 U.S.C. 667) and 29 CFR part 1952 (''Approved State Plans for Enforcement of State Standards'').[3] Of these states, 18 states have standards identical to the Federal OSHA standards. These states are: Alaska, Arizona, Hawaii, Indiana, Iowa, Kentucky, Maryland, Minnesota, Nevada, New Mexico, North Carolina, Oregon, Puerto Rico, South Carolina, Tennessee, Vermont, Virginia, and Wyoming. Accordingly, the revocation action proposed in this notice would apply to the previous variances granted in the 18 states that have standards identical to the Federal OSHA standards.

The State-Plan programs operated by Hawaii, Iowa, Kentucky, and South Carolina either declined to accept the terms of previous variances or stated that affected employers must apply to the state program for a state variance prior to initiating chimney construction. Because these State-Plan programs elected to exercise control over the variances, this proposed revocation action would not apply to any chimney-construction variances granted under these State-Plan programs.

State-Plan programs operated by four states (California, Michigan, Utah, and Washington) have requirements in their construction standards for the tackle used to rig a boatswain's chair, personnel platforms, and hoist towers that differ from the requirements specified by the Federal OSHA standards. In these cases, only the State-Plan program has authority to issue variances from these requirements. Therefore, the proposed revocation action described herein would not apply to any variances issued by these states involving these requirements.

III. Supplementary Information

The following table provides information about the previous variances granted by OSHA between 1973 and 2010 for chimney construction, and which are subject to the proposed revocation action described in this notice.[4] Refer to the **Federal Register** citation in the table to obtain detailed information about these previous variances.

[2] Throughout this notice, OSHA uses the terms ''jump-form construction'' and ''slip-form construction'' instead of ''jump-form formwork construction'' and ''slip-form formwork construction,'' respectively.

[3] State-Plan programs operated by four states and one territory (Connecticut, Illinois, New Jersey, New York, and the Virgin Islands) limit their occupational safety and health authority to public-sector (i.e., state and local government) employers only. Federal OSHA retains authority over private-sector employers in these states and territory; therefore, private-sector employers in these states and territory are subject to the previous variances granted by Federal OSHA, and to the revocation action proposed herein. Twenty-one states and one territory operate State-Plan programs that exercise occupational safety and health authority over both public-sector employers and private-sector employers; these states and territory are: Alaska, Arizona, California, Hawaii, Indiana, Iowa, Kentucky, Maryland, Michigan, Minnesota, Nevada, New Mexico, North Carolina, Oregon, Puerto Rico, South Carolina, Tennessee, Utah, Vermont, Virginia, Washington, and Wyoming. The application of this proposed revocation action to these State-Plan programs would vary depending on several factors described later in this section.

[4] As noted above, the previous variances addressed the requirements of paragraph (o)(3) of 29 CFR 1926.452, which regulates the tackle used to rig a boatswain's chair, and paragraphs (c)(1) through (c)(4), (c)(8), (c)(13), (c)(14)(i), and (c)(16) of 29 CFR 1926.552, which regulate personnel platforms and hoist towers.

TABLE 1—PREVIOUS CHIMNEY VARIANCES

Name of employer (company)	Variance or Docket No.	Date granted	FEDERAL REGISTER citation	Applied for uniform variance?
Airtek-Karrena Chimney Corporation	V–79–3	08/31/79	44 FR 51350	No
Avalotis Corporation	OSHA–2009–005	04/28/10	75 FR 22424	Yes
Bowen Engineering Corporation (merged with Mid-Atlantic Boiler and Chimney, Inc., formerly Alberici-Mid Atlantic, LLC)*.	V–04–1	O3/01/06	71 FR 10557	Yes
Calaveras Power Partners, Inc.	OSHA–2007–0046	07/17/09	74 FR 34789	No
Commonwealth Dynamics, Inc.	V–04–1	03/01/06	71 FR 10557	Yes
Continental-Heine Chimney Company, Inc.	V–73–13	04/03/73	38 FR 8545	No
Francis Hankin and Company, Inc.	V–77–12; V–77–6	08/31/79	44 FR 51352	No
Gibraltar Chimney International, LLC	OSHA–2007–004	08/18/09	74 FR 41742	Yes
Hamon Custodis (formerly Custodis Construction Co. Inc., then Custodis Cuttrell, Inc.)*.	V–73–13	04/03/73	38 FR 8545	Yes
Hoffman, Inc.	OSHA–2007–004	08/18/09	74 FR 41742	Yes
International Chimney Corporation	V–04–2	12/06/05	70 FR 72659	Yes
Karrena-International, LLC	V–04–2	12/06/05	70 FR 72659	Yes
Kiewit Power Constructors Co.***	OSHA–2007–004	08/18/09	74 FR 41742	Yes
Matrix Service, Inc.	OSHA–2007–0046	07/17/09	74 FR 34789	No
Matrix SME, Inc. (formerly Matrix Service Industrial Contractors, Inc.)*	V–04–2	12/06/05	70 FR 72659	Yes
NAES Power Contractors (formerly American Boiler & Chimney Company)*	V–02–1	09/08/03	68 FR 52961	Yes
Oak Park Chimney Corporation	V–02–1	09/08/03	68 FR 52961	No
PDM Steel Service Centers (formerly Pittsburgh-Des Moines Steel Company)*.	V–77–12; V–77–6	08/31/79	44 FR 51352	No
Pullman Power, LLC (formerly M. W. Kellogg Co., then Pullman Power Products Corporation)*.	V–73–13	04/03/73	38 FR 8545	Yes
R and P Industrial Chimney Co., Inc.	V–04–1	03/01/06	71 FR 10557	Yes
Rust Constructors, Inc. (formerly Rust Engineering Company)*	V–73–13	04/03/73	38 FR 8545	No
T. E. Ibberson Company	OSHA–2007–0046	07/17/09	74 FR 34789	Yes
TIC-The Industrial Company	OSHA–2007–0046	07/17/09	74 FR 34789	Yes
Zachry Construction Corporation	OSHA–2007–0046	07/17/09	74 FR 34789	No

*The first name is the current name of the company; names in parentheses are, first, the name listed on the original variance, followed by any subsequent names.

**Includes a subsequent interim order granted 03/26/07.

IV. Proposed Revocation of Previous Variances

Based on its review of the record and the findings described in this **Federal Register** notice, OSHA determined that the conditions specified in the uniform variance published on October 2, 2013 (78 FR 60900) provide consistent and technologically sound measures designed to replace and supersede the previous chimney-construction variances granted by OSHA prior to 2010. Accordingly, OSHA finds that the uniform variance, compared to the previous variances: (1) Provides more consistency across the conditions specified by the variance, thereby expediting OSHA's enforcement of the conditions; (2) allows employers to use updated technology and industry practices; and (3) increases worker safety. Therefore, under the authority granted by 29 CFR 1905.13(a)(2), OSHA is proposing to revoke the previous chimney-construction variances. Consequently, employers involved in chimney construction would either have to comply with the requirements of paragraph (o)(3) of 29 CFR 1926.452 and paragraphs (c)(1) through (c)(4), (c)(8), (c)(13), (c)(14)(i), and (c)(16) of 29 CFR 1926.552 or, if granted a uniform variance, comply with the conditions of that variance. OSHA granted the uniform variance to the following 15 employers:

- Avalotis Corp; 400 Jones Street, Verona, PA 15147
- Bowen Engineering Corporation (merged with Mid-Atlantic Boiler & Chimney, Inc., (formerly Alberici Mid-Atlantic, LLC)), 8802 N. Meridian St. Indianapolis, IN 46260
- Commonwealth Dynamics, Inc., 95 Court Street, Portsmouth, NH 03801
- Gibraltar Chimney International, LLC, 92 Cooper Ave. Tonawanda, NY 14150
- Hamon Custodis, Inc. (formerly Custodis Construction Co., Inc., then Custodis Cuttrell, Inc.), 58 East Main Street, Somerville, NJ 08876
- Hoffmann, Inc., 6001 49th Street South, Muscatine, IA 52761
- International Chimney Corporation, 55 South Long Street, Williamsville, NY 14221
- Karrena International Chimney, 57 South Long Street, Williamsville, NY 14221
- Kiewit Power Constructors Co., 9401 Renner Blvd., Lenexa, KS 66219
- Matrix SME, Inc. (formerly Matrix Service Industrial Contractors, Inc.), 1510 Chester Pike, Suite 500, Eddystone, PA 19022
- NAES Power Contractors (formerly American Boiler and Chimney Company), 167 Anderson Rd., Cranberry Township, PA 16066
- Pullman Power, LLC (formerly M. W. Kellogg Co., then Pullman Power Products Corporation), 6501 E. Commerce Avenue, Suite 200, Kansas City, MO 64120
- R and P Industrial Chimney Co., Inc., 244 Industrial Parkway, Nicholasville, KY 40356
- T. E. Ibberson Company, 828 5th St. South, Hopkins, MN 55343
- TIC-The Industrial Company, 9780 Mt. Pyramid Ct., Suite 100, Englewood, CO 80112

Eight employers hold previous variances and did not apply for the uniform variance. These employers are:

- Airtek-Karrena Chimney Corporation, 1776 Heritage Drive, Quincy, MA 02171
- Calaveras Power Partners, Inc., P. O. Box 241769, San Antonio, TX 78224
- Continental-Heine Chimney Company, Inc., 127 North Dearborne Street, Chicago, IL 60602
- Francis Hankin and Company, Inc., 117 Crockford Boulevard, Scarborough, Ontario, Canada, MIR 3B9

- Matrix Service, Inc., 3810 Bakerview Spur, Bellingham, WA 98226
- Oak Park Chimney Corporation, 1800 Des Plaines Avenue, Forest Park, IL 60130
- PDM Steel Service Centers (formerly Pittsburgh-Des Moines Steel Company) 3535 East Myrtle Street, Stockton, CA 95205
- Rust Constructors, Inc. (formerly Rust Engineering Co.), 2 Perimeter Park South, Suite 300W, Birmingham, AL 35243
- Zachry Construction Corporation, 527 Logwood, San Antonio TX 78221

Under the proposed revocation action, these employers would have to comply with the requirements of paragraph (o)(3) of 29 CFR 1926.452 and paragraphs (c)(1) through (c)(4), (c)(8), (c)(13), (c)(14)(i), and (c)(16) of 29 CFR 1926.552 when engaged in chimney construction. OSHA would invite these employers, and any other employers seeking an alternative means of complying with these provisions, to submit applications for a variance containing conditions that are equivalent to the conditions specified by the uniform variance.

V. Authority and Signature

David Michaels, Ph.D., MPH, Assistant Secretary of Labor for Occupational Safety and Health, U.S. Department of Labor, 200 Constitution Ave., NW., Washington, DC, authorized the preparation of this notice. OSHA is issuing this notice under the authority specified by 29 U.S.C. 655, Secretary of Labor's Order No. 1–2012 (76 FR 3912; Jan. 25, 2012), and 29 CFR part 1905.

Signed at Washington, DC, on January 28, 2014.

David Michaels,

Assistant Secretary of Labor for Occupational Safety and Health.

[FR Doc. 2014–02015 Filed 1–30–14; 8:45 am]

BILLING CODE 4510–26–P

NATIONAL CREDIT UNION ADMINISTRATION

Agency Information Collection Activities: Submission to OMB for Reinstatement, with Change, of a Previously Approved Collection; Comment Request

AGENCY: National Credit Union Administration (NCUA).

ACTION: Request for comment.

SUMMARY: The NCUA intends to submit the following information collection to the Office of Management and Budget (OMB) for review and clearance under the Paperwork Reduction Act of 1995 (Pub. L. 104–13, 44 U.S.C. Chapter 35). This information collection is published to obtain comments from the public. Financial and statistical information is collected on a monthly basis and is used by NCUA to monitor financial and statistical trends in corporate credit unions and to allocate examination and supervision resources.

DATES: Comments will be accepted until April 1, 2014.

ADDRESSES: Interested parties are invited to submit written comments to the NCUA Contact and the OMB Reviewer listed below:

NCUA Contact: Tracy Crews, National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428, Fax No. 703–837–2861, Email: *OCIOPRA@ncua.gov.*

OMB Reviewer: Office of Management and Budget, ATTN: Desk Officer for the National Credit Union Administration, Office of Information and Regulatory Affairs, Washington, DC 20503.

FOR FURTHER INFORMATION CONTACT: Requests for additional information, a copy of the information collection request, or a copy of submitted comments should be directed to Tracy Crews at the National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314–3428, or at (703) 518–6444.

SUPPLEMENTARY INFORMATION:

I. Abstract and request for comments

NCUA is amending/reinstating the collection for 3133–0067. The Federal Credit Union Act, 12 U.S.C. 1782(a)(1), requires federally insured credit unions to make reports of condition to the NCUA Board upon dates the Board selects. NCUA collects the financial and statistical information on a monthly basis and uses it to monitor financial and statistical trends in corporate credit unions and to allocate examination and supervision resources. If this information was not collected, NCUA would not be able to effectively fulfill its primary mission of regulating and supervising credit unions. The burden on the industry continues to decline as a result of mergers of corporate credit unions.

NCUA requests that you send your comments on this collection to the location listed in the **ADDRESSES** section. Your comments should address: (a) the necessity of the information collection for the proper performance of NCUA, including whether the information will have practical utility; (b) the accuracy of our estimate of the burden (hours and cost) of the collection of information, including the validity of the methodology and assumptions used; (c) ways we could enhance the quality, utility, and clarity of the information to be collected; and (d) ways we could minimize the burden of the collection of the information on the respondents such as through the use of automated collection techniques or other forms of information technology. It is NCUA's policy to make all comments available to the public for review.

II. Data

Title: Corporate Credit Union Monthly Call Report.

OMB Number: 3133–0067.

Form Number: NCUA 5310.

Type of Review: Reinstatement, with change, of a previously approved collection.

Description: NCUA utilizes the information to monitor financial conditions in corporate credit unions, and to allocate supervision and examination resources.

Respondents: Corporate credit unions, or ''banker's banks'' for natural person credit unions.

Estimated No. of Respondents/Record keepers: 15.

Estimated Burden Hours Per Response: 8 hours.

Frequency of Response: Monthly.

Estimated Total Annual Burden Hours: 1,440 hours.

Estimated Total Annual Cost: $72,000.

By the National Credit Union Administration Board on January 17, 2014.

Gerard Poliquin,

Secretary of the Board.

[FR Doc. 2014–01909 Filed 1–30–14; 8:45 am]

BILLING CODE 7535–01–P

NATIONAL LABOR RELATIONS BOARD

Sunshine Act Meetings: February 2014

TIME AND DATES: All meetings are held at 2:00 p.m.
Tuesday, February 4;
Wednesday, February 5;
Thursday, February 6;
Tuesday, February 11;
Wednesday, February 12;
Thursday, February 13;
Tuesday, February 18;
Wednesday, February 19;
Thursday, February 20.

PLACE: Board Agenda Room, No. 11820, 1099 14th St., NW., Washington, DC 20570

STATUS: Closed.

MATTERS TO BE CONSIDERED: Pursuant to § 102.139(a) of the Board's Rules and Regulations, the Board or a panel

thereof will consider ''the issuance of a subpoena, the Board's participation in a civil action or proceeding or an arbitration, or the initiation, conduct, or disposition . . . of particular representation or unfair labor practice proceedings under section 8, 9, or 10 of the [National Labor Relations] Act, or any court proceedings collateral or ancillary thereto.'' See also 5 U.S.C. 552b(c)(10).

CONTACT PERSON FOR MORE INFORMATION: Henry Breiteneicher, Associate Executive Secretary, (202) 273–2917.

Dated: January 29, 2014.

William B. Cowen,

Solicitor.

[FR Doc. 2014–02168 Filed 1–29–14; 4:15 pm]

BILLING CODE 7545–01–P

NATIONAL SCIENCE FOUNDATION

Notice of Permit Applications Received Under the Antarctic Conservation Act of 1978

AGENCY: National Science Foundation.

ACTION: Notice of Permit Applications Received under the Antarctic Conservation Act of 1978, Public Law 95–541.

SUMMARY: The National Science Foundation (NSF) is required to publish a notice of permit applications received to conduct activities regulated under the Antarctic Conservation Act of 1978. NSF has published regulations under the Antarctic Conservation Act at Title 45 Part 670 of the Code of Federal Regulations. This is the required notice of permit applications received.

DATES: Interested parties are invited to submit written data, comments, or views with respect to this permit application by March 3, 2014. This application may be inspected by interested parties at the Permit Office, address below.

ADDRESSES: Comments should be addressed to Permit Office, Room 755, Division of Polar Programs, National Science Foundation, 4201 Wilson Boulevard, Arlington, Virginia 22230.

FOR FURTHER INFORMATION CONTACT: Adrian Dahood, ACA Permit Officer, at the above address or *ACApermits@nsf.gov* or (703) 292–7149.

SUPPLEMENTARY INFORMATION: The National Science Foundation, as directed by the Antarctic Conservation Act of 1978 (Pub. L. 95–541), as amended by the Antarctic Science, Tourism and Conservation Act of 1996, has developed regulations for the establishment of a permit system for various activities in Antarctica and designation of certain animals and certain geographic areas a requiring special protection. The regulations establish such a permit system to designate Antarctic Specially Protected Areas.

Application Details

Permit Application: 2014–029

1. *Applicant:* William Detrich, Dept. of Marine and Environmental Sciences, Northeastern University Marine Science Center.

Activity for Which Permit is Requested

ASPA; A permit is requested to enter ASPA 152 (Western Bransfield Strait) and ASPA 153 (Eastern Dallmann Bay) using the ARSV Laurence M. Gould to capture Antarctic fish by trawling and trapping. The collected fish would be used to study the effects of a warming Southern Ocean on development of the embryos of Antarctic fishes. Data collected under this permit would be part of a long-term (28 year) dataset. Approximately 50 hours of trawling would be conducted in ASPA 152 and approximately 20 hours would be conducted in ASPA 153. Sixteen traps would be set and allowed to soak for a total of 3 days.

It is anticipated that that approximately 400 hundred individual fish representing four species of ice fish (Notothenia coriiceps, Chaenocephalus aceratus, Champsocephalus gunnari, Gobionotothen gibberifrons) would be captured in the ASPAs and used in the study. Live fishes would be transported to the aquarium facilities at Palmer Station for experimentation. Breeding and biochemical experiments would be conducted. All experimental animals would be humanely euthanized and properly disposed of outside the ASPAs

Location

ASPA 152 Western Bransfield Strait and ASPA 153 Eastern Dallmann Bay.

Dates

March 15, 2014 to May 19, 2014.

Nadene G. Kennedy,

Polar Coordination Specialist, Division of Polar Programs.

[FR Doc. 2014–02087 Filed 1–30–14; 8:45 am]

BILLING CODE 7555–01–P

NUCLEAR REGULATORY COMMISSION

[Docket No. NRC–2013–0213]

Agency Information Collection Activities: Submission for the Office of Management and Budget (OMB) Review; Comment Request

AGENCY: Nuclear Regulatory Commission.

ACTION: Notice of the OMB review of information collection and solicitation of public comment.

SUMMARY: The U.S. Nuclear Regulatory Commission (NRC) has recently submitted to OMB for review the following proposal for the collection of information under the provisions of the Paperwork Reduction Act of 1995 (44 U.S.C. Chapter 35). The NRC hereby informs potential respondents that an agency may not conduct or sponsor, and that a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. The NRC published a **Federal Register** notice with a 60-day comment period on this information collection on September 30, 2013 (78 FR 59979).

1. *Type of submission, new, revision, or extension:* New.
2. *The title of the information collection:* Voluntary Reporting of Planned Licensing Request Submittals.
3. *Current OMB approval number:* 3150–XXXX.
4. *The form number if applicable:* N/A.
5. *How often the collection is required:* Annually.
6. *Who will be required or asked to report:* All operating power reactors whose licensing actions are handled by the Office of Nuclear Reactor Regulation, Division of Operating Reactor Licensing.
7. *An estimate of the number of annual responses:* 62.
8. *The estimated number of annual respondents:* 62.
9. *An estimate of the total number of hours needed annually to complete the requirement or request:* 310.
10. *Abstract:* The NRC is seeking information on the licensing actions that licensees plan to submit over the next three years. The information would be used by the Office of Nuclear Reactor Regulation to better plan its resource utilization. Specifically, the office would use the information to (1) inform its budget development, (2) identify potential impacts from multiple actions utilizing the same resources, (3) develop solutions, if possible, to resource conflicts, and (4) communicate scheduling impacts to stakeholders.

The public may examine and have copied for a fee publicly available documents, including the final supporting statement, at the NRC's Public Document Room, Room O–1F21, One White Flint North, 11555 Rockville Pike, Rockville, Maryland 20852. The OMB clearance requests are available at the NRC's Web site: *http://www.nrc.gov/public-involve/doc-comment/omb/.* The document will be available on the NRC's home page site for 60 days after the signature date of this notice.

Comments and questions should be directed to the OMB reviewer listed below by March 3, 2014. Comments received after this date will be considered if it is practical to do so, but assurance of consideration cannot be given to comments received after this date.

Danielle Y. Jones, Desk Officer, Office of Information and Regulatory Affairs (3150–XXXX), NEOB–10202, Office of Management and Budget, Washington, DC 20503.

Comments can also be emailed to Danielle_Y_Jones@omb.eop.gov or submitted by telephone at 202–395–1741.

The Acting NRC Clearance Officer is Kristen Benney, telephone: 301–415–6355.

Dated at Rockville, Maryland, this 27th day of January, 2014.

For the Nuclear Regulatory Commission.

Fajr Majeed,

Acting NRC Clearance Officer, Office of Information Services.

[FR Doc. 2014–01955 Filed 1–30–14; 8:45 am]

BILLING CODE 7590–01–P

NUCLEAR REGULATORY COMMISSION

[NRC–2012–0277]

Proposed Dewey-Burdock Project in Fall River and Custer Counties, South Dakota, for In-Situ Leach Uranium Milling Facilities

AGENCY: Nuclear Regulatory Commission.

ACTION: Final supplemental environmental impact statement; issuance.

SUMMARY: Notice is hereby given that the U.S. Nuclear Regulatory Commission (NRC) published the Final Supplemental Environmental Impact Statement (SEIS) (NUREG–1910, Supplement 4) for the Dewey-Burdock In-Situ Uranium Recovery (ISR) Project. By letter dated August 10, 2009, Powertech USA, Inc. (Powertech) submitted an application to the NRC for a new source materials license for the Dewey-Burdock ISR Project, which Powertech proposes to be located in Fall River and Custer Counties, South Dakota. Powertech is proposing to recover uranium from the Dewey-Burdock Project site using the in-situ recovery process.

ADDRESSES: Please refer to Docket ID NRC–2012–0277 when contacting the NRC about the availability of information regarding this document. You may access publicly-available information related to this action by the following methods:

- *Federal Rulemaking Web site:* Go to *http://www.regulations.gov* and search for Docket ID NRC–2012–0277. Address questions about NRC dockets to Carol Gallagher; telephone: 301–287–3422; email: *Carol.Gallagher@nrc.gov.* For technical questions, contact the individual listed in the **FOR FURTHER INFORMATION CONTACT** section of this document.
- *NRC's Agencywide Documents Access and Management System (ADAMS):* You may access publicly available documents online in the NRC Library at *http://www.nrc.gov/reading-rm/adams.html.* To begin the search, select ''ADAMS Public Documents'' and then select ''*Begin Web-based ADAMS Search.''* For problems with ADAMS, please contact the NRC's Public Document Room (PDR) reference staff at 1–800–397–4209, 301–415–4737, or by email to *pdr.resource@nrc.gov.* The ADAMS accession number for each document referenced in this notice (if that document is available in ADAMS) is provided the first time that a document is referenced. The ''Final SEIS (NUREG–1910, Supplement 4) is available in ADAMS under Accession Nos. ML14024A477 and ML14024A478.
- *NRC's PDR:* You may examine and purchase copies of public documents at the NRC's PDR, Room O1–F21, One White Flint North, 11555 Rockville Pike, Rockville, Maryland 20852.

FOR FURTHER INFORMATION CONTACT: Ms. Haimanot Yilma, Office of Federal and State Materials and Environmental Management Programs, U.S. Nuclear Regulatory Commission, Washington DC, 20555–0001; telephone: 301–415–8029, email: *Haimanot.Yilma@nrc.gov.*

SUPPLEMENTARY INFORMATION: Under the NRC's environmental protection regulations in part 51 of Title 10 of the *Code of Federal Regulations* (10 CFR), that implement the National Environmental Policy Act of 1969 (NEPA), preparation of an Environmental Impact Statement (EIS) or supplement to an EIS (SEIS) is required for issuance of a license to possess and use source material for uranium milling (see 10 CFR 51.20(b)(8)).

In May 2009, the NRC staff issued NUREG–1910, ''Generic Environmental Impact Statement for In-Situ Leach Uranium Milling Facilities'' (herein referred to as the GEIS). In the GEIS, NRC assessed the potential environmental impacts from construction, operation, aquifer restoration, and decommissioning of an ISR facility located in four specific geographic regions of the western United States. The proposed Dewey-Burdock ISR Project is located within the Nebraska-South Dakota-Wyoming Uranium Milling Region identified in the GEIS. This final SEIS supplements the GEIS and incorporates by reference relevant portions from the GEIS, and uses site-specific information from the applicant's license application and other independent sources to fulfill the requirements in 10 CFR 51.20(b)(8).

The final SEIS was prepared in response to an application submitted by Powertech by letter dated August 10, 2009. The applicant proposes the construction, operation, aquifer restoration, and decommissioning of an in-situ recovery facility to recover uranium.

The final SEIS was prepared by the NRC and its contractor, the Center for Nuclear Waste Regulatory Analyses (CNWRA), in cooperation with the U.S. Bureau of Land Management (BLM), in compliance with NEPA, and the NRC's regulations for implementing NEPA (10 CFR part 51).

The proposed Dewey-Burdock project will be located approximately 21 km [13 mi] north-northwest of Edgemont, South Dakota, in northern Fall River and southern Custer Counties. The proposed facility would encompass approximately 4,282 hectares (ha) (10,580 acres [ac]), which consists of two contiguous mining units: the Burdock Unit and the Dewey Unit.

The final SEIS is being issued as part of the NRC's process to decide whether to issue a license to Powertech pursuant to 10 CFR part 40. In this final SEIS, the NRC staff has assessed the potential environmental impacts from the construction, operation, aquifer restoration, and decommissioning of the proposed Dewey-Burdock project. The NRC staff accessed the impacts of the proposed action and its alternatives on land use; historical and cultural resources; visual and scenic resources; climatology, meteorology and air quality; geology, minerals and soils; water resources; ecological resources; socioeconomics; environmental justice; noise; traffic and transportation; public

and occupational health and safety; and waste management. Additionally, the final SEIS analyzes and compares the benefits and costs of the proposed action. In preparing this final SEIS, the NRC staff also considered, evaluated, and addressed the public comments received on the draft SEIS published on November 26, 2012 (77 FR 70486). Appendix E of final SEIS captures the public's comments and the NRC's responses.

In doing so, the NRC staff evaluated site-specific data and information from the Dewey-Burdock ISR Project to determine if Powertech's proposed activities and the site characteristics were consistent with those evaluated in the GEIS. The NRC then determined which relevant sections of, and impact conclusions in, the GEIS could be incorporated by reference. The NRC staff also determined if additional data or analysis was needed to assess the potential environmental impacts for a specific environmental resource area. The NRC documented its assessments and conclusions in the final SEIS.

In addition to the action proposed by Powertech, the NRC staff addressed the no-action alternative, as well as alternative wastewater disposal options under the proposed action. All the alternatives were analyzed in detail. The no-action alternative serves as a baseline for comparison of the potential environmental impacts of the proposed action.

After weighing the impacts of the proposed action and comparing the alternatives, the NRC staff, in accordance with 10 CFR 51.911(d), sets forth its recommendation regarding the proposed action. Unless safety issues mandate otherwise, the NRC staff recommends that the proposed action be approved (*i.e.,* the NRC should issue a source material license for the proposed Dewey-Burdock ISR Project).

The final SEIS for the proposed Dewey-Burdock project may also be accessed on the internet at *http://www.nrc.gov/reading-rm/doc-collections/nuregs/staff/* by selecting ''NUREG–1910'' or on the NRC's Dewey-Burdock ISR Project Web page at *http://www.nrc.gov/materials/uranium-recovery/license-apps/dewey-burdock/dewey-burdock-app-docs.html.* Additionally, a copy of the final SEIS will be available at the following public libraries:

Edgemont Public Library, 412 2nd Avenue, Edgemont, SD 57735.
Rapid City Public Library, 610 Quincy Street, Rapid City, SD 57701–3630.
Custer County Library, 447 Crook Street, Custer, SD 57730.
Weston County Library, 23 West Main Street, Newcastle, WY 82701.
Hot Springs Public Library, 145 N. Chicago Street, Hot Springs, SD 57747.
Oglala Lakota College Library, P.O. Box 310, Kyle, SD 57752.

Dated at Rockville, Maryland, this 24th day of January 2014.

For the Nuclear Regulatory Commission.

Christepher McKenney,

Acting Deputy Director, Environmental Protection and Performance Assessment Directorate, Division of Waste Management and Environmental Protection, Office of Federal and State Materials and Environmental Management Programs.

[FR Doc. 2014–02043 Filed 1–30–14; 8:45 am]

BILLING CODE 7590–01–P

NUCLEAR REGULATORY COMMISSION

Advisory Committee on Reactor Safeguards; Notice of Meeting

In accordance with the purposes of Sections 29 and 182b of the Atomic Energy Act (42 U.S.C. 2039, 2232b), the Advisory Committee on Reactor Safeguards (ACRS) will hold a meeting on February 5–7, 2014, 11545 Rockville Pike, Rockville, Maryland.

WEDNESDAY, FEBRUARY 5, 2014, CONFERENCE ROOM T2–B1, 11545 ROCKVILLE PIKE, ROCKVILLE, MARYLAND

8:30 a.m.–8:35 a.m.: Opening Remarks by the ACRS Chairman (Open)—The ACRS Chairman will make opening remarks regarding the conduct of the meeting.

8:35 a.m.–10:30 a.m.: Monticello Maximum Extended Load Line Limit Analysis Plus (MELLLA+) License Amendment Request (Open/Closed)—The Committee will hear presentations by and hold discussions with representatives of the NRC staff and Northern States Power Company of Minnesota (NSPM) regarding the Monticello Maximum Extended Load Line Limit Analysis Plus license amendment request and the associated staff safety evaluation report. [**Note:** A portion of this meeting may be closed in order to discuss and protect information designated as proprietary, pursuant to 5 U.S.C. 552b(c)(4).]

10:45 a.m.–12:45 p.m.: Proposed Revisions to 10 CFR Part 61 (Open)—The Radiation Protection and Nuclear Materials Subcommittee will discuss with the Full Committee the results of meetings regarding proposed revisions to 10 CFR Part 61.

1:45 p.m.–3:45 p.m.: Draft Report on the Biennial ACRS Review of the NRC Safety Research Program (Open)—The Committee will discuss the draft report on the biennial ACRS review of the NRC Safety Research Program.

4:00 p.m.–6:00 p.m.: Preparation of ACRS Reports (Open/Closed)—The Committee will discuss proposed ACRS reports on matters discussed during this meeting. The Committee will also discuss a proposed response to the August 1, 2013, EDO letter to the ACRS regarding a proposed rulemaking on station blackout mitigation strategies. [**NOTE:** A portion of this session may be closed in order to discuss and protect information designated as proprietary, pursuant to 5 U.S.C. 552b(c)(4).]

THURSDAY, FEBRUARY 6, 2014, CONFERENCE ROOM T–2B1, 11545 ROCKVILLE PIKE, ROCKVILLE, MARYLAND

8:30 a.m.–10:00 a.m.: Future ACRS Activities/Report of the Planning and Procedures Subcommittee (Open/Closed)—The Committee will discuss the recommendations of the Planning and Procedures Subcommittee regarding items proposed for consideration by the Full Committee during future ACRS Meetings, and matters related to the conduct of ACRS business, including anticipated workload and member assignments. [**Note:** A portion of this meeting may be closed pursuant to 5 U.S.C. 552b (c) (2) and (6) to discuss organizational and personnel matters that relate solely to internal personnel rules and practices of ACRS, and information the release of which would constitute a clearly unwarranted invasion of personal privacy.]

10:00 a.m.–10:15 a.m.: Reconciliation of ACRS Comments and Recommendations (Open)—The Committee will discuss the responses from the NRC Executive Director for Operations to comments and recommendations included in recent ACRS reports and letters.

10:30 a.m.–12:30 p.m.: Preparation for ACRS Meeting with the Commission (Open)—The Committee will discuss a list of topics in preparation for the meeting with the Commission.

1:30 p.m.–6:00 p.m.: Preparation of ACRS Reports (Open/Closed)—The Committee will continue its discussion of proposed ACRS reports on matters discussed during this meeting. The Committee will also discuss a proposed response to the August 1, 2013, EDO letter to the ACRS regarding a proposed rulemaking on station blackout mitigation strategies. [**Note:** A portion of this session may be closed in order to discuss and protect information designated as proprietary, pursuant to 5 U.S.C. 552b(c)(4).]

FRIDAY, FEBRUARY 7, 2014, CONFERENCE ROOM T–2B1, 11545 ROCKVILLE PIKE, ROCKVILLE, MARYLAND

8:30 a.m.–5:30 p.m.: Preparation of ACRS Reports (Open/Closed)—The Committee will continue its discussion of proposed ACRS reports on matters discussed during this meeting. The Committee will also discuss a proposed response to the August 1, 2013, EDO letter to the ACRS regarding a proposed rulemaking on station blackout mitigation strategies. [**Note:** A portion of this session may be closed in order to discuss and protect information designated as proprietary, pursuant to 5 U.S.C. 552b(c)(4).]

5:30 p.m.–6:00 p.m.: Miscellaneous (Open)—The Committee will continue its discussion of matters related to the conduct of Committee activities and specific issues that were not completed during previous meetings.

Procedures for the conduct of and participation in ACRS meetings were published in the **Federal Register** on November 8, 2013 (78 FR 67205–67206). In accordance with those procedures, oral or written views may be presented by members of the public, including representatives of the nuclear industry. Persons desiring to make oral statements should notify Quynh Nguyen, Cognizant ACRS Staff (Telephone: 301–415–5844, Email: *Quynh.Nguyen@nrc.gov*), 5 days before the meeting, if possible, so that appropriate arrangements can be made to allow necessary time during the meeting for such statements. In view of the possibility that the schedule for ACRS meetings may be adjusted by the Chairman as necessary to facilitate the conduct of the meeting, persons planning to attend should check with the Cognizant ACRS staff if such rescheduling would result in major inconvenience.

Thirty-five hard copies of each presentation or handout should be provided 30 minutes before the meeting. In addition, one electronic copy of each presentation should be emailed to the Cognizant ACRS Staff one day before meeting. If an electronic copy cannot be provided within this timeframe, presenters should provide the Cognizant ACRS Staff with a CD containing each presentation at least 30 minutes before the meeting.

In accordance with Subsection 10(d) Public Law 92–463, and 5 U.S.C. 552b(c), certain portions of this meeting may be closed, as specifically noted above. Use of still, motion picture, and television cameras during the meeting may be limited to selected portions of the meeting as determined by the Chairman. Electronic recordings will be permitted only during the open portions of the meeting.

ACRS meeting agenda, meeting transcripts, and letter reports are available through the NRC Public Document Room at *pdr.resource@nrc.gov,* or by calling the PDR at 1–800–397–4209, or from the Publicly Available Records System (PARS) component of NRC's document system (ADAMS) which is accessible from the NRC Web site at *http://www.nrc.gov/reading-rm/adams.html* or http://www.nrc.gov/reading-rm/doc-collections/ACRS/.

Video teleconferencing service is available for observing open sessions of ACRS meetings.

Those wishing to use this service should contact Mr. Theron Brown, ACRS Audio Visual Technician (301–415–8066), between 7:30 a.m. and 3:45 p.m. (ET), at least 10 days before the meeting to ensure the availability of this service. Individuals or organizations requesting this service will be responsible for telephone line charges and for providing the equipment and facilities that they use to establish the video teleconferencing link. The availability of video teleconferencing services is not guaranteed.

Dated: January 27, 2014.

Andrew L. Bates,

Advisory Committee Management Officer.

[FR Doc. 2014–02037 Filed 1–30–14; 8:45 am]

BILLING CODE 7590–01–P

PEACE CORPS

Information Collection Request; Submission for OMB Review

AGENCY: Peace Corps.

ACTION: 60-day notice and request for comments.

SUMMARY: The Peace Corps will be submitting the following information collection request to the Office of Management and Budget (OMB) for review and approval. The purpose of this notice is to allow 60 days for public comment in the **Federal Register** preceding submission to OMB. We are conducting this process in accordance with the Paperwork Reduction Act of 1995 (44 USC Chapter 35).

DATES: Comments must be submitted on or before April 1, 2014.

ADDRESSES: Comments should be addressed to Denora Miller, FOIA/Privacy Act Officer, Peace Corps, 1111 20th Street, NW., Washington, DC 20526. Denora Miller can be contacted by telephone at 202–692–1236 or email at *pcfr@peacecorps.gov.* Email comments must be made in text and not in attachments.

FOR FURTHER INFORMATION CONTACT: Denora Miller at Peace Corps address above.

SUPPLEMENTARY INFORMATION: Within the purview of Coverdell World Wise Schools, the Speakers Match program connects an educator with a returned Peace Corps Volunteer to present about his/her overseas experience. The interaction between the returned Volunteer, the educator, and his or her students is used to foster classroom activities and learning experiences relating to the Volunteer's country of service and the Peace Corps. In order to participate in the program and be matched with a returned Volunteer, the educator must complete the Speakers Match Online Request Form. This form is available on the Peace Corps World Wise Schools Web site under the Speakers Match section.

Title: World Wide Schools- Speakers Match: Request for a Speaker.

OMB Control Number: 0420–0539.

Type of Request: Extension without change of a currently approved collection.

Affected Public: Individuals and households.

Respondents Obligation to Reply: Voluntary.

Burden to the Public

a. Estimated number of respondents 300
b. Estimated average burdern per response: 10 minutes
c. Frequency of response: One time
d. Annual reporting burden: 50 hours
e. Estimated annual cost to respondents: $0.00

General Description of Collection: The Speakers Match Online Request Form is the first point of contact with the participating educator. The information is used to make a suitable match between the educator and a returned Peace Corps Volunteer. The information will be collected as a one-time submission on a continuous basis and with permission may be shared with the media, Congress, returned Volunteer groups, educational institutions, and other government agencies.

Request For Comment: Peace Corps invites comments on whether the proposed collections of information are necessary for proper performance of the functions of the Peace Corps, including whether the information will have practical use; the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the information to be collected; and, ways to minimize

the burden of the collection of information on those who are to respond, including through the use of automated collection techniques, when appropriate, and other forms of information technology.

This notice is issued in Washington, DC on January 24, 2014.

Denora Miller,

FOIA/Privacy Act Officer, Management.

[FR Doc. 2014–01945 Filed 1–30–14; 8:45 am]

BILLING CODE 6051–01–P

PEACE CORPS

Information Collection Request: Submission for OMB Review

AGENCY: Peace Corps.

ACTION: 60-day notice and request for comments.

SUMMARY: The Peace Corps will be submitting the following information collection request to the Office of Management and Budget (OMB) for review and approval. The purpose of this notice is to allow 60 days for public comment in the **Federal Register** preceding submission to OMB. We are conducting this process in accordance with the Paperwork Reduction Act of 1995 (44 USC Chapter 35).

DATES: Comments must be submitted on or before April 1, 2014.

ADDRESSES: Comments should be addressed to Denora Miller, FOIA/Privacy Act Officer, Peace Corps, 1111 20th Street NW., Washington, DC 20526. Denora Miller can be contacted by telephone at 202–692–1236 or email at *pcfr@mailto:ddunevant@peacecorps.gov peacecorps.gov.* Email comments must be made in text and not in attachments.

FOR FURTHER INFORMATION CONTACT: Denora Miller at Peace Corps address above.

SUPPLEMENTARY INFORMATION: The Peace Corps and Paul D. Coverdell World Wise Schools need this information officially to enroll educators in the Correspondence Match program. The information is used to make suitable matches between the educators and currently serving Peace Corps Volunteers.

Title: Correspondence Match Educator Online Enrollment Form.

OMB Control Number: 0420–0540.

Type of Request: Extension without change of a currently approved collection.

Affected Public: Individuals and households.

Respondents Obligation to Reply: Voluntary.

Burden to the Public:

a. Estimated number of respondents: 10,000
b. Estimated average burden per response: 10 minutes
c. Frequency of response: One time
d. Annual reporting burden: 1667
e. Estimated annual cost to respondents: $0.00

General Description of Collection: The Correspondence Match Educator Enrollment Form is the first point of contact with the participating educator. It is Coverdell World Wise Schools' fundamental source of information from educators interested in participating in the Correspondence Match program. The information is used to make a suitable match between the educator and a Peace Corps Volunteer serving overseas. The information will be collected continuously as teachers choose to enroll, or continue participation, in the Correspondence Match program.

Request For Comment: Peace Corps invites comments on whether the proposed collections of information are necessary for proper performance of the functions of the Peace Corps, including whether the information will have practical use; the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the information to be collected; and, ways to minimize the burden of the collection of information on those who are to respond, including through the use of automated collection techniques, when appropriate, and other forms of information technology.

This notice is issued in Washington, DC on January 24, 2014.

Denora Miller,

FOIA/Privacy Act Officer, Management.

[FR Doc. 2014–01946 Filed 1–30–14; 8:45 am]

BILLING CODE 6051–01–P

RAILROAD RETIREMENT BOARD

Proposed Collection; Comment Request

SUMMARY: In accordance with the requirement of Section 3506 (c)(2)(A) of the Paperwork Reduction Act of 1995 which provides opportunity for public comment on new or revised data collections, the Railroad Retirement Board (RRB) will publish periodic summaries of proposed data collections.

Comments are invited on: (a) Whether the proposed information collection is necessary for the proper performance of the functions of the agency, including whether the information has practical utility; (b) the accuracy of the RRB's estimate of the burden of the collection of the information; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d) ways to minimize the burden related to the collection of information on respondents, including the use of automated collection techniques or other forms of information technology.

Title and purpose of information collection: Self-Employment/Corporate Officer Work and Earnings Monitoring; OMB 3220–0202.

Section 2 of the Railroad Retirement Act (RRA) provides for the payment of disability annuities to qualified employees. Section 2 also provides that if the Railroad Retirement Board (RRB) receives a report of an annuitant working for a railroad or earning more than prescribed dollar amounts from either nonrailroad employment or self-employment, the annuity is no longer payable, or can be reduced, for the months worked. The regulations related to the nonpayment or reduction of the annuity by reason of work are prescribed in 20 CFR 220.160–164.

Some activities claimed by the applicant as ''self-employment'' may actually be employment for someone else (e.g. training officer, consultant, salesman). 20 CFR 216.22 9 (c) states, for example, that an applicant is considered an employee, and not self-employed, when acting as a corporate officer, since the corporation is the applicant's employer. Whether the RRB classifies a particular activity as self-employment or as work for an employer depends upon the circumstances in each case. The circumstances are prescribed in 20 CFR 216.21–216–23.

Certain types of work may actually indicate an annuitant's recovery from disability. Regulations related to an annuitant's recovery form disability of work are prescribed in 20 CFR 220.17–220–20.

In addition, the RRB conducts continuing disability reviews, (also known as a CDR) to determine whether the annuitant continues to meet the disability requirements of the law. Payment of disability benefits and/or a beneficiary's period of disability will end if medical evidence or other information shows that an annuitant is not disabled under the standards prescribed in Section 2 of the RRA. Continuing disability reviews are generally conducted if one or more of the following conditions are met: (1) the annuitant is scheduled for a routine periodic review, (2) the annuitant returns to work and successfully completes a trial work period, (3) substantial earnings are posted to the annuitant's wage record, or (4)

information is received from the annuitant or a reliable source that the annuitant has recovered or returned to work. Provisions relating to when and how often the RRB conducts disability reviews are prescribed in 20 CFR 220.186.

To enhance program integrity activities, the RRB utilizes Form G–252, Self-Employment/Corporate Officer Work and Earnings Monitoring. Form G–252 obtains information from a disability annuitant who claims to be self-employed or a corporate officer or who the RRB determines to be self-employed or a corporate officer after a continuing disability review. The continuing disability review may be prompted by a report of work, return to railroad service, an allegation of a medical improvement or a routine disability review call-up. The information gathered is used to determine entitlement and/or continued entitlement to, and the amount of, the disability annuity, as prescribed in 20 CFR 220.176. Completion is required to retain benefits. One response is required of each respondent. The RRB proposes no changes to Form G–252.

ESTIMATE OF ANNUAL RESPONDENT BURDEN

[The estimated annual respondent burden is as follows]

Form number	Annual responses	Time (minutes)	Burden (hours)
G–252	100	20	33
Total	100		33

Additional Information or Comments: To request more information or to obtain a copy of the information collection justification, forms, and/or supporting material, contact Dana Hickman at (312) 751–4981 or *Dana.Hickman@RRB.GOV.* Comments regarding the information collection should be addressed to Charles Mierzwa, Railroad Retirement Board, 844 North Rush Street, Chicago, Illinois 60611–2092 or emailed to *Charles.Mierzwa@RRB.GOV.* Written comments should be received within 60 days of this notice.

Charles Mierzwa,

Chief of Information Resources Management.

[FR Doc. 2014–01975 Filed 1–30–14; 8:45 am]

BILLING CODE 7905–01–P

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71407; File Nos. SR–FINRA–2013–031]

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Order Approving the Proposed Rule Change Relating to Participation on the Alternative Display Facility

January 27, 2014.

I. Introduction

On July 18, 2013, the Financial Industry Regulatory Authority, Inc. (''FINRA'') filed with the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'') [1] and Rule 19b–4 thereunder,[2] a proposed rule change to amend FINRA Rules 6271 and 6272 regarding the requirements for members seeking registration as FINRA Alternative Display Facility (''ADF'') Market Participants (the ''Proposal'').

The Proposal was published for comment in the **Federal Register** on August 1, 2013.[3] The Commission received three comment letters on the Proposal.[4] FINRA responded to each of the three comment letters individually.[5] On September 10, 2013, the Commission extended the time period in which to either approve, disapprove, or to institute proceedings to determine whether to approve or disapprove the Proposal, to October 30, 2013.[6] On October 30, 2013, the Commission instituted proceedings to determine whether to approve or disapprove the Proposal.[7] This order approves the proposed rule change.

II. Background

Current ADF Registration Requirements

The ADF is a quotation collection and trade reporting facility. According to FINRA, the ADF provides (1) ADF market participants (*i.e.,* ADF-registered market makers (''ADF Market Makers'') or electronic communications networks (''ECNs'' and, with ''ADF Market Makers'', ''ADF Market Participants'')) with the ability to post quotations or display orders in NMS stocks and (2) all member firms that participate in the ADF the ability to view quotations and report transactions in NMS stocks to the Securities Information Processors (''SIPs'') for consolidation and dissemination of data to vendors and ADF Market Participants.[8] FINRA states that the ADF is also designed to deliver real-time data to FINRA for regulatory purposes, including enforcement of

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] *See* Securities Exchange Act Release No. 70048 (July 26, 2013), 78 FR 46652 (''Notice'').

[4] *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from David Harris, Chairman and CEO, National Stock Exchange, Inc., dated September 9, 2013 (''NSX Letter''), letter to Elizabeth M. Murphy, Secretary, Commission, from David Harris, Chairman and CEO, National Stock Exchange, Inc., dated November 26, 2013 (''NSX Letter II''), and letter to Elizabeth M. Murphy, Secretary, Commission, from Janet McGinness, Executive Vice President and Corporate Secretary, General Counsel, NYSE Markets, dated January 7, 2014 (''NYSE Letter'').

[5] *See* Letter to Elizabeth M. Murphy, Secretary, Commission, from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA, dated October 25, 2013 (''FINRA Response''); Letter to Elizabeth M. Murphy, Secretary, Commission, from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA, dated December 11, 2013 (''FINRA Response II''); and letter to Elizabeth M. Murphy, Secretary, Commission, from Stephanie M. Dumont, Senior Vice President and Director of Capital Markets Policy, FINRA, dated January 23, 2014 (''FINRA Response III'').

[6] *See* Securities Exchange Act Release No. 70358, 78 FR 56967 (September 16, 2013) (SR–FINRA–2013–031).

[7] *See* Securities Exchange Act Release No. 70776, 78 FR 66405 (November 5, 2013) (SR–FINRA–2013–031).

[8] *See* Notice, 78 FR at 46652. The ADF was initially approved by the Commission on July, 24, 2002, in connection with the SEC's approval of SuperMontage and Nasdaq's registration as a national securities exchange. *See* Securities Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002); *see also* NASD *Notice to Members* 02–45 (August 2002). At that time, the ADF was approved for Nasdaq-listed securities for a nine-month pilot period to provide FINRA members with an alternative to the Nasdaq systems for reporting quotations and transactions in Nasdaq UTP Plan securities. On September 28, 2006, the SEC approved amendments to extend the ADF's functionality to all NMS stocks. *See* Securities Exchange Act Release No. 54537 (September 28, 2006), 71 FR 59173 (October 6, 2006); *see also* NASD *Notice to Members* 06–67 (November 2006). The ADF was approved on a permanent basis for NMS stocks on January 26, 2007. *See* Securities Exchange Act Release No. 55181 (January 26, 2007), 72 FR 5093 (February 2, 2007).

requirements imposed by Regulation NMS.[9]

FINRA rules provide that ADF Market Participants (*i.e.,* either registered reporting ADF Market Makers or registered reporting ADF ECNs)[10] must register as ADF market makers or ECNs before making a market or displaying orders on the ADF.[11] Members are required to register as ADF Market Participants by applying to FINRA, which includes certifying the member's good standing with FINRA and demonstrating compliance with the net capital and other financial responsibility provisions of the Act.[12] Before displaying quotations or orders on the ADF, ADF Trading Centers[13] must also execute and comply with a Certification Record to certify the ADF Trading Center's compliance efforts with its obligations under Regulation NMS.[14]

Status of the ADF and Other FINRA Transparency Facilities

According to FINRA, no member has registered with FINRA as a registered reporting ADF Market Maker since the ADF was launched in 2002, and there have been four members that, at various points in time, were registered as Registered Reporting ADF ECNs.[15] Since the second quarter of 2010, FINRA states that there have been no ADF Market Participants.[16]

FINRA states that in 2011, it began the process of updating and migrating all of its transparency facilities (including the FINRA Trade Reporting Facilities, the Trade Reporting and Compliance Engine (''TRACE''), and the ADF) off of independent technology platforms and onto a new, single, updated technology platform known as the Multi Product Platform (''MPP'').[17] FINRA originally scheduled the migration of the ADF onto MPP last, anticipating onboarding of a new ADF Market Participant no sooner than mid-2014.[18]

According to FINRA, several of its members have discussed the possibility with FINRA of becoming an ADF Market Participant, and some have asked whether the migration of the ADF to MPP could be accelerated.[19] FINRA states that such acceleration requires delaying the migration of other FINRA facilities onto MPP, reallocating resources, shifting scheduling, and implementing ADF-specific enhancements and hosting in the new technology environment—all of which, in turn, impose significant costs on FINRA, including prolonging the substantially higher expenses associated with the legacy OTC Equity Trade Reporting Facility (''ORF'') infrastructure (*i.e.,* legacy ORF support costs are significantly higher than the expected costs of supporting the ORF in the new MPP technology environment).[20] In addition to the costs of accelerating the migration of the ADF onto MPP, FINRA claims that bringing the new ADF base infrastructure live in the MPP technology environment to accommodate an ADF Market Participant will impose significant direct costs on FINRA related to building and testing the new ADF component on the MPP infrastructure and also related to paying for SIP capacity usage allocations as well as various related costs.[21] FINRA estimates that the MPP component re-sequencing necessary to accommodate ADF acceleration and the costs associated with bringing the ADF base infrastructure live will conservatively cost FINRA in excess of $3 million.[22]

Proposed Amendments to the ADF Rules

FINRA proposes to consolidate into a single rule (FINRA Rule 6271) the existing requirements that a member must meet to register as an ADF Market Participant and introduce new requirements that potential ADF Market Participants must meet to participate on the ADF. According to FINRA, these new requirements are intended to mitigate the substantial financial risks to FINRA of accelerating the migration of the ADF onto MPP or of building out the ADF base platform to accommodate an ADF Market Participant.[23]

ADF Deposit Amount

The Proposal would, in part, add several new requirements into the application that members must complete to become ADF Market Participants. The new provisions require that a member seeking to become an ADF Market Participant: (i) Provide FINRA with reasonable monthly projections of the volume of data that the member anticipates submitting to the ADF; (ii) agree to submit the ADF Deposit Amount[24] in

[9] *See* 17 CFR 242.600.

[10] *See* FINRA Rule 6220(a)(3), (12), (13).

[11] *See* FINRA Rule 6271.

[12] *See* FINRA Rule 6271(b).

[13] An ''ADF Trading Center'' is a registered reporting ADF Market Maker or registered reporting ADF ECN that is a ''Trading Center,'' as defined in Rule 600(b)(78) of SEC Regulation NMS, and that is certified to display its quotations or orders through the ADF. *See* FINRA Rule 6220(a)(4); *see also* 17 CFR 242.600(b)(87).

[14] *See* FINRA Rules 6220(a)(5), 6250(a)(7); NASD *Notice to Members* 06–67 (November 2006); *see also* SR–NASD–2006–091, Exhibit 3.

[15] *See* Notice, 78 FR at 46653.

[16] *See id.*

[17] *See id.*

[18] *See id.* After the ADF is migrated to MPP, however, FINRA claims that it will only have the ADF base infrastructure completed. FINRA estimates that it would take at least an additional six months to complete further specific build-outs necessary to accommodate an individual ADF Market Participant seeking to quote on or report trades to the ADF. To determine the specific build-outs necessary to support a new ADF Market Participant, a member would need to provide FINRA with estimated volume projections of quotation and trade reporting activity that would flow through the ADF. *See id.*

[19] *See id.*

[20] *See id.*

[21] *See id.*

[22] *See id.*

[23] *See id.* For example, FINRA Rule 6271 would specify that a member seeking registration as an ADF Market Participant must file an application with FINRA, execute the Certification Record, and execute a Participant Agreement. Rule 6271(a)(1) would require a potential ADF Market Participant to file an application with FINRA in which the member would provide various specifications and certifications.

The first three requirements of the application, which specify whether the member is seeking registration in Nasdaq and/or CQS securities, certify the member's good standing with FINRA, and demonstrate compliance with the net capital and other financial responsibility provisions of the Act, are the same as the requirements currently in Rule 6271(b). The Proposal would also codify other current requirements into a single rule. *See id.,* 78 FR at 46654.

[24] The Proposal requires potential ADF Market Participants to agree to submit an ''ADF Deposit Amount'' in five equal installments into an escrow account. The proposed rule change defines the ''ADF Deposit Amount'' as $500,000 if the member requests that FINRA accelerate the ADF migration or if the member begins quoting on or reporting trades to the ADF within 90 calendar days after an ADF Market Participant that requested acceleration of the ADF migration begins quoting on or reporting trades to the ADF. For all other ADF Participants, the ADF Deposit Amount is $250,000. FINRA claims that this is designed to ensure that applicable volume commitments are met.

FINRA is proposing to establish the two separate levels of the ADF Deposit Amount to reflect the differing costs FINRA claims it will incur under either of two scenarios. Because FINRA states that it will incur significantly higher costs if the migration of the ADF is accelerated at a member's request, FINRA has proposed an ADF Deposit Amount of $500,000 should the member request such acceleration. Additionally, to ensure that ADF Market Participants benefitting from an acceleration of the ADF onto MPP are treated equally, FINRA proposes to charge $500,000 to any member that begins quoting on or reporting trades to the ADF within ninety (90) days after an existing ADF Market Participant that requested acceleration of the ADF migration begins quoting on or reporting trades to the ADF. According to FINRA, this amount, which, as noted above, FINRA claims is substantially lower than the actual costs FINRA will incur by amending the current MPP migration schedule reflects an appropriate balance between ensuring that FINRA is able to recover a portion of the costs associated with an accelerated migration while not representing a significant financial barrier to participation on the ADF, particularly since members can potentially recover 100% of the ADF Deposit Amount over the two-year term and up to 80% of the ADF Deposit Amount in the first quarter of their participation on the ADF through the credit structure for market data revenue described below.

Continued

five equal installments into an escrow account at a bank mutually acceptable to the member and FINRA on a timetable as agreed to by the member and FINRA (the ''ADF Escrow Account''); (iii) agree that failing to submit quotes and report trades to the ADF for a two-year period (the ''ADF Quoting Term'') will result in the forfeiture of some or all of the ADF Deposit Amount; (iv) agree that failing to submit 75% of the member's trade and quote volume in NMS stocks to the ADF (the ''ADF Quoting Requirement'') will result in the forfeiture of some or all of the ADF Deposit Amount; and (v) agree to the other ADF Deposit Terms set forth in the rule.

FINRA contends that these new provisions are designed to ensure that FINRA can recover a portion of the costs associated with accelerating the migration of the ADF to MPP and bringing a new ADF Market Participant onto the ADF if the ADF Market Participant fails to participate on the ADF as anticipated. FINRA also argues that certain provisions of the application are designed to (1) provide FINRA the information necessary to ensure the ADF can accommodate the volume of data the member anticipates submitting to the ADF and (2) establish the basis upon which FINRA will be safeguarded by ensuring that the potential ADF Market Participant will bear some of the financial responsibility should FINRA undertake the efforts and incur the costs necessary to bring the ADF Market Participant onto the ADF, only to have the ADF Market Participant fail to participate at all or at the agreed level.[25]

ADF Market Data Rebate

The Proposal includes a means for ADF Market Participants to earn back the ADF Deposit Amount (the ''ADF Market Data Rebate''). Specifically, the Proposal provides that for every $1.00 received by FINRA from the National Market System (''NMS'') SIP data plans associated with ADF activity attributable, as determined in FINRA's sole discretion, to the member's trading activity on the ADF, the member shall receive $0.50 out of the ADF Escrow Account. Thus, an ADF Market Participant could recover an amount equal to one-half of the SIP market data revenue generated by the ADF Market Participant's trading activity on the ADF. The ADF Market Data Rebate would be paid on a quarterly basis after FINRA has received its quarterly disbursement from the NMS SIP data plans.[26] According to FINRA, this provides for a reasonable opportunity for FINRA to recover some of its costs of re-sequencing the MPP rollout by virtue of the SIP market data revenue split.

In addition, the Proposal provides that the ADF Market Participant is only entitled to receive an amount up to 80% of the ADF Deposit Amount pursuant to this provision and is not entitled to the remaining 20% of the ADF Deposit Amount until the end of the ADF Quoting Term, assuming its trading activity has earned the requisite market data revenue from the SIPs. To the extent that the ADF Market Participant opts to stop participating on the ADF before the end of the ADF Quoting Term or stop meeting its ADF Quoting Requirement before the end of the ADF Quoting Term (*i.e.,* chooses to quote or trade through another trading venue), it would be free to do so but could potentially forfeit some or all of the remaining ADF Deposit Amount.[27]

The Proposal also includes certain provisions designed to protect FINRA if a member requests that the ADF be migrated to MPP on an accelerated basis or if FINRA undertakes efforts to build out the system to support the member, and in either instance, the member fails to participate.[28] The proposed rule change provides that one-fifth of the ADF Deposit Amount shall be released to FINRA if, in any calendar month beginning with the fourth calendar month following certification of the ADF Market Participant to quote on or report trades to the ADF, the ADF Market Participant fails to submit 75% of the member's quoting and trade reporting activity to the ADF.

Finally, the proposed rule change would make clear that a member would become an ADF Market Participant only after (i) the member received a notice of approval from FINRA that its application was accepted, (ii) the member executed the Certification Record, and (iii) FINRA executed the Participant Agreement.

III. Discussion and Findings

After carefully considering the Proposal, the comments submitted, and FINRA's responses to the comments, for the reasons discussed below the Commission finds that FINRA responded appropriately to the concerns raised and that the Proposal is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association.[29] In particular, the Commission finds that the proposed rule change is consistent with the provisions of (1) Section 15A(b)(6) of the Act,[30] which requires, in part, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest, (2) Section 15A(b)(5) of the Act,[31] which requires, among other

Moreover, FINRA believes that permitting potential participants to earn back the entire deposit amount is more equitable than charging potential ADF Market Participants a one-time payment without the ability to recover some, or all, of the amount. The Proposal reduces the ADF Deposit Amount to $250,000 if the member has not requested an accelerated migration or does not become an ADF Market Participant within 90 days after another ADF Market Participant that had requested acceleration (*i.e.,* paid an escrow amount of $500,000) begins quoting on or reporting trades to the ADF. According to FINRA, the lower amount reflects the fact that the costs to FINRA are significantly reduced under these circumstances because the ADF base platform will have already been migrated to MPP. However, although reduced, FINRA anticipates such costs will still be significantly higher than the $250,000 deposit amount in such a scenario based on costs related to possible additional hardware and software deployments, paying for SIP capacity usage allocations, and costs related to general staff labor, support and testing. *See* Notice, 78 FR at 46654–55.

[25] The Proposal includes several required terms for the handling of the ADF Deposit Amount (referred to as ''ADF Deposit Terms''), including the methods for ADF Market Participants to recover some or all of the ADF Deposit Amount as a result of meeting its participation commitments (or due to FINRA's inability to meet its obligations) and methods for FINRA to receive the funds if commitments are not met. The proposed rule change retains some flexibility in the precise terms of any agreements between FINRA and potential ADF Market Participants to ensure that any unique circumstances can be addressed by permitting *de minimis* additions or qualifications to the ADF Deposit Terms, provided both FINRA and the member agree to those additions or qualifications. *See* Notice, 78 FR at 46655.

[26] Charges or credits as a result of SIP audit recoveries, which typically are *de minimis* as compared to the overall revenue paid, would not be included in the calculation. *See id.*

[27] *See id.* If FINRA does not make the ADF available within nine months of an ADF Market Participant's first deposit of the ADF Deposit Amount into the ADF Escrow Account, one-fifth of the ADF Deposit Amount will be released from such ADF Escrow Account to the ADF Market Participant. An additional one-fifth of the initial ADF Deposit Amount will be released to the ADF Market Participant every month thereafter that FINRA has not made the ADF available, until all funds have been released from such ADF Escrow Account.

[28] In addition, if a member is sold (other than a sale to an entity that would otherwise meet the FINRA qualifications as an ADF Market Participant), goes out of business, otherwise does not meet its obligations, or fails to complete the process for becoming an ADF Market Participant, the member will forfeit the ADF Deposit Amount, or any lesser amount remaining in the ADF Escrow Account, and all funds will be released from the ADF Escrow Account to FINRA. *See id.*

[29] In approving this proposed rule change, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. *See* 15 U.S.C. 78c(f).

[30] 15 U.S.C. 78*o*-3(b)(6).

[31] 15 U.S.C. 78*o*-3(b)(5).

things, that FINRA rules provide for the equitable allocation of reasonable dues, fees and other charges among members and issuers and other persons using any facility or system that FINRA operates or controls, and (3) Section 15A(b)(9) [32] of the Act, which requires, in part, that FINRA rules do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

The Commission received two comment letters from the same commenter in response to the Proposal.[33] The commenter, NSX, contends that the Proposal is inconsistent with Sections 15A(b)(5), (6), and (9) of the Act.[34] NSX generally argues that FINRA has not demonstrated that: (1) the proposed ADF Deposit Amount and credit provisions are reasonable or equitably allocated, and (2) the proposed ADF Deposit Amount, the accompanying credit provisions, and the proposed 75% quoting requirement impose an inappropriate burden on competition. The Commission also received a comment letter from NYSE Euronext (''NYSE'') that argues that the Proposal read in conjunction with FINRA's existing ADF fees, is not consistent with Section 15A(b)(9) of the Act.[35]

Section 15A(b)(5) of the Act mandates that ''[t]he rules of the association provide for the equitable allocation of reasonable dues, fees, and other charges among members and issuers and other persons using any facility or system which the association operates or controls.'' [36] NSX argues that that FINRA ''fails to meet its burden of adequately articulating and justifying the reasonableness of the ADF Participant fees.'' [37] NSX questions whether it is consistent with the Act for FINRA to (1) charge the same ADF Deposit Amount regardless of a potential ADF Participant's use of the ADF and (2) offer the ADF at a cost which will be spread among all FINRA members and not just ADF Participants.[38] NSX argues that charging the same ADF Deposit Amount for all ADF Market Participants ''appears to discriminate against smaller ADF Market Participants and may pose an unreasonable barrier of entry for them. . .'' [39] NSX also contends that reasonableness of the ADF Deposit Amount and ADF Market Data Rebate can only be determined after analyzing total cost, projected volume, source of funds, and future fees. Accordingly, NSX argues, the Proposal is deficient as it does not disclose the specific percentage that the Deposit Amount is of total development costs.[40] In its second letter, NSX reiterates these concerns, stating that the proposal fails to disclose the specific percentage of total development costs that the Proposed Participant Fee represents and how FINRA intends to cover the remaining development costs, and noting that the Proposal contains ''little to no information on the ADF operational costs and how FINRA intends to cover those associated costs.'' [41]

In response, FINRA contends that it has provided enough information to demonstrate that the ADF Deposit Amount is reasonable.[42] In particular, FINRA included detailed cost estimates regarding the accelerated ADF migration. In addition, FINRA notes in establishing the ADF Deposit Amount it considered its ability to recover costs and whether the ADF Deposit Amount would preclude potential ADF Market Participants from using the ADF.[43] FINRA believes that the Deposit Amounts are reasonable because they represent a portion of the costs FINRA will incur and are recoverable wholly or in part by the ADF Market Participant.[44] Finally, FINRA disputes NSX's argument that it is required to include a forecast of all future fees as part of its analysis of the reasonableness of the fees contemplated in the Proposal.[45] FINRA also believes the additional information requested by NSX would be speculative and of limited utility.[46]

With regard to NSX's argument that the proposed ADF Deposit Amount does not take into account the ADF Market Participant's total quotation or trading volume, FINRA responds the fixed ADF Deposit Amount is not tied to the amount of usage since costs of on-boarding each participant are fixed and do not vary by ADF Market Participant.[47] In addition, FINRA claims that the ADF Deposit Amount is designed to defray costs but not cover costs entirely. Imposing all costs only on ADF Market Participants, FINRA argues, would discourage new ADF Market Participants from joining the ADF and reduce potential ADF revenue thereby increasing ADF-related losses.[48] Further, FINRA notes that, absent the Proposal, FINRA would incur all of the costs regarding the migration and operation of the ADF without the potential to offset such costs.[49] Finally, FINRA argues that the ADF Deposit Amount reflects an ''appropriate balance between helping to defray the costs of migrating and operating the ADF while not making participation in the ADF cost-prohibitive'' that is reasonable in light of projected $3 million total costs cited in its Proposal and an equitable allocation among ADF Participants and its member firms.[50]

The Commission does not believe, as NSX suggests, that FINRA has presented an insufficient basis to determine the reasonableness of the ADF Deposit Amount and Market Data Rebate. Neither does the Commission accept NSX's argument that FINRA is necessarily required to disclose the total development and operation costs, projected volume, source of funds used to fund the ADF and any future fees. The Commission, furthermore, does not agree with NSX's claim that the Proposal establishes an inequitable allocation of fees among its members. Rather, the Commission believes that, by requiring individual members to provide a portion of the specific costs that FINRA would incur to accommodate a member's request to either accelerate the migration of the ADF or otherwise use the ADF, the Deposit Amount is a reasonable and equitable allocation of costs among FINRA's members. In addition, the ADF Deposit Amount and Market Data Rebate provide a fair and equitable way for FINRA to recover costs associated with onboarding a new ADF Participant while allowing an ADF Participant to earn back its deposit.

[32] 15 U.S.C. 78*o*-3(b)(9).

[33] *See* NSX Letter and NSX Letter II.

[34] *See* NSX Letter at 1.

[35] NYSE Letter at 1.

[36] 15 U.S.C. 78*o*-3(b)(5).

[37] NSX Letter at 1.

[38] *Id.* at 3–4.

[39] NSX Letter II at 6.

[40] *See* NSX Letter at 2.

[41] NSX Letter II at 6.

[42] *See* FINRA Response at 2 and FINRA Response II at 4.

[43] *See* FINRA Response at 3–4.

[44] FINRA Response II at 5.

[45] *Id.* at 5 and FINRA Letter at 6. NSX also argues that the Proposal is not consistent with Section 15A(b)(6) of the Act, which provides that ''the rules of an association are designed . . . to protect investors and the public interest; and are not designed to permit unfair discrimination ''between customers, issuers, brokers, or dealers.'' 15 U.S.C. 78*o*-3(b)(5). Specifically, NSX claims that the Proposal may raise issues with respect to an ADF Participant's ability to comply with its best execution obligation. *See* NSX Letter, at 5. FINRA responds that this concern is misplaced since the Quoting Requirement relates to posting of quotes and the reporting of trades, whereas best execution obligation implicates a broker-dealer's handling of customer orders for execution. *See* FINRA Response, at 6 n. 11.

[46] *See* FINRA Response at 5 and FINRA Response II at 5.

[47] *See* FINRA Response at 3 and FINRA Response II at 5.

[48] FINRA Response at 3–4.

[49] FINRA Response at 3 n. 5 and FINRA Response II at 5.

[50] *See* FINRA Response at 4.

Section 15A(b)(9) of the Act provides that ''[t]he rules of the association do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.'' [51] NSX argues that FINRA fails to adequately address whether the Proposal imposes a burden on competition for other self-regulatory organization (''SRO''s) such as NSX.[52] According to NSX, the Proposal is an unfair subsidy of FINRA's trading facility and that by charging ''below cost or subsidized rates to ADF Market Participants, FINRA would have an unfair advantage against other exchanges that are offering competitive alternatives.''[53] NSX argues that ADF users should be required to self-fund the ADF platform.[54] In addition, NSX claims that the ADF Deposit Amount and the requirement to send at least 75% of quotes and trades to FINRA amount to an unprecedented burden on competition because the ADF Quoting Requirement would make it economically unfeasible for any other SRO that provides order delivery functionality to compete with FINRA.[55]

FINRA responds that NSX's assertion that FINRA is either subsidizing the operation of the ADF or operating at a loss and that this results in an unfair competitive advantage against exchanges attempting to offer order delivery alternatives to the ADF is misleading.[56] FINRA states that the ADF Deposit Amount is not an unfair subsidy; rather it is designed to recoup expenses it incurs in connection with the addition of new ADF Market Participants and the ADF Migration.[57] FINRA notes that the Proposal is ''intended to avoid the need for FINRA to subsidize all of the costs associated with'' the ADF.[58] Moreover, FINRA notes that the ADF Quoting Requirement is not an unnecessary or appropriate burden on competition because it is not a requirement to use the ADF, and is only a means to earn back the ADF Deposit Amount.[59] According to FINRA, therefore, meeting the ADF Quoting Requirement is voluntary and at the discretion of an ADF Market Participant.[60]

The Commission does not believe that the Proposal constitutes an unnecessary or inappropriate burden on competition. In addition, the Commission does not agree with NSX's argument that the Quoting Requirement would make it economically unfeasible for any other SRO that provides order delivery functionality to compete. To the extent that ECNs choose to use the ADF Platform because the ADF offers better facilities and a more favorable price structure, such a result is not an unnecessary or inappropriate burden on competition.

In its comment letter, NYSE suggests that the combination of FINRA's existing ADF fee schedule contained in Rule 7510—in which the Quotation Update Charge to be paid by an ADF Market Participant varies commensurate with the number of trades reported through the ADF by that ADF Market Participant—and the fees contained in the Proposal is inconsistent with Section 15A(b)(9) because they make it economically prohibitive for an ADF Participant to quote on the ADF but trade report elsewhere.[61]

FINRA responds by reiterating that the proposed ADF Deposit Amount is designed to reasonably and equitably allow FINRA to recoup costs related to the ADF migration and the addition of a new ADF Market Participant that the provision by which an ADF Market Participant may earn back some or all of its ADF Deposit Amount is designed to provide an incentive for an ADF Market Participant to remain active on the ADF and to utilize the ADF capacity that FINRA has incurred costs to provide.[62] FINRA states that this, in turn, will reduce the likelihood that FINRA will incur unnecessary expenditures in connection with the ADF migration, and will increase the probability of FINRA recouping a reasonable amount of the costs involved with launching a new ADF Market Participant from that ADF Market Participant rather than recover those costs from fees paid by all FINRA members.[63] FINRA believes the only new issue raised by NYSE relates to FINRA's existing quotation fee structure in Rule 7510(b) rather than the Proposal itself.[64] As an initial matter, FINRA believes that such comments are not appropriately directed to this filing, as Rule 7510 has been previously filed and made effective under the Act.[65] FINRA further argues that both the proposed and existing fee structure fairly impose costs on those members whose quotation and trading activity creates system capacity demands, as well as provide incentives to quote and trade report to the ADF, which also generates revenue for FINRA to support the costs of operating the ADF.[66] FINRA believes that an ADF Market Participant currently would consider both its quoting and trading activity when determining its desired level of activity on the ADF, and the Proposal, pursuant to which an ADF Market Participant would ascertain its ability to earn back some or all of its ADF Deposit Amount, is consistent with this analysis.[67] The Commission believes that FINRA has satisfied its burden to demonstrate that the Proposal is consistent with the Act.

IV. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[68] that the proposed rule change (SR–FINRA–2013–031), is hereby approved.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[69]

Kevin M. O'Neill,

Deputy Secretary.

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[51] 15 U.S.C. 78o–3(b)(9).

[52] NSX Letter at 5.

[53] NSX Letter II at 3.

[54] *Id.* at 3–4.

[55] *Id.* at 4.

[56] FINRA Response II at 2–3.

[57] *See* FINRA Response at 6 and FINRA Response II at 3.

[58] FINRA Response II at 3.

[59] FINRA Response at 6.

[60] *Id.* at 6–7 and FINRA Response II at 3.

[61] NYSE Letter at 1–2.

[62] FINRA Response III at 3.

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] *Id.*

[68] 15 U.S.C. 78s(b)(2).

[69] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71404; File No. SR–CHX–2014–01]

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Amend the Order Cancellation Fee

January 27, 2014.

Pursuant to Section 19(b)(1) [1] of the Securities Exchange Act of 1934 (''Act'') [2] and Rule 19b–4 thereunder,[3] notice is hereby given that on January 15, 2014, the Chicago Stock Exchange, Inc. (''CHX'' or ''Exchange'') filed with the Securities and Exchange Commission (the ''Commission'') the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

[1] 15 U.S.C. 78s(b)(1).

[2] 15 U.S.C. 78a.

[3] 17 CFR 240.19b–4.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CHX proposes to amend Section E.8 of its Schedule of Fees and Assessments (the ''Fee Schedule'') to amend the Order Cancellation Fee. The text of this proposed rule change is available on the Exchange's Web site at *http://www.chx.com/rules/proposed_rules.htm,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to amend Section E.8 of the Fee Schedule to amend the Order Cancellation Fee. Specifically, the Exchange proposes to adopt proposed Section E.8(c) to provide an exemption from Order Cancellation Fees for a given month if an Account Symbol [4] meets an Average Daily Volume (''ADV'') requirement for that month. The Exchange does not propose to substantively amend the Order Cancellation Fee in any other way.

Current Order Cancellation Fee

Under SR–CHX–2012–15,[5] the Exchange adopted the current formula-based Order Cancellation Fee detailed under Section E.8 of the Fee Schedule, amended under SR–CHX–2013–11 [6] and SR–CHX–2013–12,[7] which assesses a daily cancellation fee per Account Symbol and security, if the order cancellation ratio exceeds a designated threshold. In sum, the formula subtracts from the total daily number of ''Wide'' or ''W'' orders [8] in a given security the product of ''Near'' or ''N'' orders [9] in the same security submitted by the Participant in the Regular Trading Session in a given day and its corresponding ''N'' order multiplier or ''Nmult.'' [10] The difference is then divided by ''E,'' which is defined as the greater of the number one (1) or the sum of all Wide and Near orders in a given security that are submitted and executed (in whole or in part) in the Regular Trading Session (excluding cross transactions) on a given day.

If the resulting value is equal to or greater than the corresponding ''Cancellation Ratio'' for that security, found under paragraph (b), a corresponding Order Cancellation Fee would apply to the Participant for that day's activity in that security. If, however, the value is less than the corresponding Cancellation Ratio, the Participant would not be assessed a fee. Currently, the Cancellation Ratio and other values listed under paragraph (b) are consistent for Tape A, B, and C securities. Although the fee is assessed daily, Account Symbols are only billed after the end of the month.

The purpose of the Order Cancellation Fee is to recoup some of the costs associated with administering and processing large numbers of cancelled orders and to incent Participants to post marketable orders and, thereby, promote liquidity and single-sided order executions on the Exchange.[11]

Proposed ADV Exemption

Since the Order Cancellation Fee became operative on November 1, 2012, the Exchange has observed that some Account Symbols have been billed Order Cancellation Fees notwithstanding exceptionally high ADV in securities subject to the Order Cancellation Fee. That is, despite consistent order sending and cancellation activity throughout the course of the month, some high ADV Trading Accounts exhibited unusually low ADV on one or two trading days and were consequently billed Order Cancellation Fees for the month because the Order Cancellation Fee is assessed daily. The Exchange submits that the need for an Order Cancellation Fee for a Trading Account is obviated if it provides valuable single-sided order executions and revenue to the Exchange. This is because such exceptionally high ADV Trading Accounts support the purpose of the Order Cancellation Fee (*e.g.,* to promote single-sided order executions), regardless of order cancellation activity.

The current Order Cancellation Fee does not permit Trading Accounts to leverage exceptionally high ADV attained over the course of a month to eliminate the Order Cancellation Fee assessed due to unusually weak trading days. Thus, in order to more equitably apply the current Order Cancellation Fee, the Exchange now proposes to adopt proposed Section E.8(c), which provides that all Order Cancellation Fees assessed to an Account Symbol in a given month shall be waived if the ADV attributable to the Account Symbol for the month is equal to or greater than 100,000 shares from single-sided orders executed at or greater than $1.00/share.[12] Trades resulting from cross orders and single-sided orders executed below $1.00/share shall not be included in the ADV calculation because such

[4] An ''Account Symbol'' identifies a specific ''Trading Account,'' as defined under CHX Article 1, Rule 1(ll). The terms are used interchangeably throughout this filing.

[5] *See* Securities Exchange Act Release No. 68219 (November 13, 2012), 77 FR 69673 (November 20, 2012) (SR–CHX–2012–15) (''Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Amend Its Order Cancellation Fee'').

[6] *See* Securities Exchange Act Release No. 69701 (June 5, 2013), 78 FR 35082 (June 11, 2013) (SR–CHX–2013–11) (''Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Amend the Order Cancellation Fee'').

[7] *See* Securities Exchange Act Release No. 69903 (July 1, 2013), 78 FR 40788 (July 8, 2013) (SR–CHX–2013–12) (''Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Amend the Single-Sided Order Fees and Credits and the Order Cancellation Fee'').

[8] Section E.8(a) of the Fee Schedule provides that "'W' equals the number of Wide orders in a security priced at $1.00/share or more, that is submitted during the Regular Trading Session, through an Account Symbol, on a given day. An order shall be considered Wide if any one of the following conditions are met:

The order price of the security is inferior to the National Best Bid (''NBB'') for a buy order or National Best Offer (''NBO'') for a sell order at the time the order is received by the Matching System and the difference between the order price and the NBB or NBO is equal to or greater than the corresponding Threshold Away Amount of the particular security; or

The order is voluntarily cancelled by the order sender prior to the expiration of its corresponding Minimum Duration (expressed in milliseconds) after acceptance by the Matching System, without any executions; or

An order marked ''Do Not Display,'' pursuant to Article 1, Rule 2(c)(2).''

[9] Section E.8(a) of the Fee Schedule provides that "'N' equals the number of Near orders (which must be display eligible) in a security priced at $1.00/share or more submitted in the Regular Trading Session, through an Account Symbol, on a given day. A Near order is:

An order where the difference between the order price and the NBB or NBO is less than the corresponding Threshold Away Amount of the particular security; and

Where the order is not voluntarily cancelled by the order sender prior to either (1) the expiration of the Minimum Duration of the particular security or (2) a partial execution of the order, whichever is earlier.''

[10] Section E.8(a) of the Fee Schedule provides that '' 'Nmult' is the corresponding multiplier value to be applied against 'N'.''

[11] *See supra* note 5.

[12] The 100,000 shares value was determined based on historical trading activity on the Exchange and shall only be modified by a proposed rule filing pursuant to Rule 19b-4 under the Act.

orders are not subject to the Order Cancellation Fee.[13] Moreover, the proposed exemption will be applied at the Account Symbol level and not at a security-specific level. That is, if a Trading Account meets the 100,000 shares ADV requirement for a given month, all Order Cancellation Fees assessed under the Account Symbol for the month will be waived. Correspondingly, the Exchange proposes to amend the first paragraph of current Section E.8(a) to provide that the Order Cancellation Fee is subject to the proposed exemption as stated under proposed paragraph (c). The following example illustrates this exemption.

Example. Assume that a Participant Trading Permit [14] holder has two Trading Accounts with Account Symbols ''A'' and ''B.'' For the month of December 2013, the Participant was billed $3,000 in Order Cancellation Fees. Specifically, Account Symbol A was assessed $1,000 in Order Cancellation Fees for activity in five different securities and had an ADV of 90,000 shares from qualified orders, whereas Account Symbol B was assessed $2,000 in Order Cancellation Fees for activity in three different securities and had an ADV of 110,000 shares from qualified orders.

Given that Account Symbol B had an ADV of 110,000 shares from qualified orders in December 2013, the entire $2,000 in Order Cancellation Fees assessed to Account Symbol B would be waived pursuant to proposed Section E.8(c). However, given that Account Symbol A had an ADV of 90,000 shares from qualified orders, the Trading Account would not qualify for the proposed exemption and would be billed $1,000 in Order Cancellation Fees. For the purposes of the proposed ADV exemption, the Order Cancellation Fee assessed to specific securities and ADV in specific securities is irrelevant.

The Exchange proposes to make these amendments to Section E.8 operative *February 3, 2014.* The Order Cancellation Fee shall continue to be calculated daily and billed after the end of the month. If an Account Symbol meets the requirements of proposed paragraph (c), the Account Symbol will not be billed an Order Cancellation Fee for that month.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Act [15] in general, and furthers the objectives of Section 6(b)(4) of the Act [16] in particular, in that it provides for the equitable allocation of reasonable dues, fees and other charges among members and other persons using its facilities. The Exchange believes that the proposed ADV exemption from the Order Cancellation Fee described herein promotes the equitable allocation of the Order Cancellation Fee as it will more fairly allocate costs among Participants according to their respective trading activity. A Participant with a Trading Account that has exceptionally high ADV provides additional revenue to the Exchange (*e.g.,* Liquidity Removing Fee under Section E.1 of the Fee Schedule and market data revenue), which may be used to recoup some of the costs of administering and processing cancelled orders. Thus, Participants with Trading Accounts that meet the proposed ADV threshold for a given month should not be billed Order Cancellation Fees assessed to such Trading Accounts for that month.

In addition, these changes to the Fee Schedule would equitably allocate reasonable fees among Participants in a non-discriminatory manner by assessing cancellation fees on all Trading Accounts that exceed a fixed Cancellation Ratio and by waiving cancellation fees on all Trading Accounts that satisfy the requirements of the proposed ADV exemption. Since all Participants are subject to the Order Cancellation Fee and given that the proposed ADV exemption is available to all Participants, the Exchange submits that the amended Order Cancellation Fee is non-discriminatory.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The Exchange does not believe that the proposed ADV exemption to the Order Cancellation Fee burdens competition, but instead, enhances competition, as it is intended to increase the competitiveness of, and draw additional volume to, the Exchange. The Exchange operates in a highly competitive market in which market participants can readily direct order flow to competing venues if they deem fee levels set by the Exchange to be excessive. The proposed ADV exemption provides relief from the Order Cancellation Fee to Participants that execute a requisite number of certain single-sided orders submitted to the Exchange, which is intended to increase revenue derived from trades and to draw additional liquidity to the Exchange. Thus, the proposed rule change is a competitive proposal that is intended to add additional liquidity and order executions to the Exchange, which will, in turn, benefit the Exchange and all Participants.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change is effective upon filing pursuant to Section 19(b)(3)(A)(ii) of the Act [17] and subparagraph(f)(2) of Rule 19b–4 thereunder [18] because it establishes or changes a due, fee or other charge imposed by the Exchange.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number SR-CHX–2014–01 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR- CHX–2014–01. This file number should be included on the

[13] Section E.8(a) provides, in pertinent part, that ''a cancellation fee shall apply for all cancellation messages relating to orders in each security priced at $1.00/share or more.''

[14] *See* Article 1, Rule 1(aa).

[15] 15 U.S.C. 78f.

[16] 15 U.S.C. 78f(b)(4).

[17] 15 U.S.C. 78s(b)(3)(A)(ii).

[18] 17 CFR 240.19b–4(f)(2).

subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal offices of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CHX–2014–01, and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[19]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01964 Filed 1–30–14; 8:45 am]

BILLING CODE 8011–01–P

[19] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71402; File No. SR–CBOE–2014–006]

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Bylaws of its Parent Company

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 17, 2014, Chicago Board Options Exchange, Incorporated (the ''Exchange'' or ''CBOE'') filed with the Securities and Exchange Commission (the ''Commission'') the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend the bylaws of its parent company, CBOE Holdings, Inc. (''CBOE Holdings''). The text of the proposed rule change is available on the Exchange's Web site (*http://www.cboe.com/AboutCBOE/CBOELegalRegulatoryHome.aspx*), at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing to make certain amendments to the Bylaws (the ''Bylaws'') of its parent company, CBOE Holdings, Inc. (''CBOE Holdings'') to make improvements in its governance. Currently, CBOE Holdings' Bylaws provide that ''when a quorum is present at any meeting, a plurality of the votes properly cast for the election of directors shall be sufficient to elect directors.'' This applies to both contested and uncontested elections. The Exchange proposes to change the manner in which uncontested elections occur. Specifically, the Exchange is proposing to move from a plurality voting standard to a majority voting standard for uncontested elections where ''each nominee for director shall be elected to the Board of Directors if a majority of the votes properly cast are in favor of such nominee's election (i.e., if the number of votes properly cast ''for'' a nominee's election exceeds the number of votes properly cast ''against'' that nominee's election); *provided, however,* that, if, as of the last date by which stockholders of the Corporation may submit notice to nominate a person for election as a director pursuant to *Section 2.11* of these Bylaws or pursuant to any rule or regulation of the Securities and Exchange Commission, the number of nominees for director exceeds the number of directors to be elected at any such meeting (a ''Contested Election''), a plurality of the votes properly cast for the election of directors shall be sufficient to elect directors.'' As such, there will be no change to the voting process for contested elections.

Under the majority voting standard that will apply to uncontested elections, a nominee who fails to receive the requisite vote would not be duly elected to the Board; however, because a director holds office until his or her successor is duly elected and qualified, any incumbent director-nominee who fails to receive the requisite vote does not automatically cease to be a director. Instead, such director continues as a ''holdover director'' until such director's death, resignation or removal, or until his or her successor is duly elected and qualified. For this reason, the majority voting standard under consideration requires that any incumbent nominee, as a condition to his or her nomination for election, must submit in writing an irrevocable resignation, the effectiveness of which is conditioned upon the director's failure to receive a majority of the votes properly cast in favor of such nominee's election and the Board's acceptance of the resignation.[3] The Exchange is proposing to amend the language in *Section 3.4* of the Bylaws to delete the statement that a resignation, unless specifically contingent upon its acceptance, will be effective as of its date or of the date specified therein, and replace that language with the statement that a resignation ''will be effective when delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events.'' This would allow Directors to submit resignations that are contingent upon both the Director not receiving majority vote in an uncontested election and the Board accepting such resignation (or some other event that could lead to the Director no longer intending to act as a Director at some point in the future due

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Pursuant to the ''Board Election Process'' section of CBOE Holdings' Corporate Governance Guidelines (available at *http://ir.cboe.com/documentdisplay.cfm?DocumentID=7090*).

to the occurrence of some future event). After a director's failure to receive the majority of properly cast votes, CBOE Holdings' Nominating & Governance Committee then considers the resignation offer and recommends to the CBOE Holdings Board of Directors regarding whether to accept it. Within 90 days after the certification of the election results, the Board of Directors will decide whether to accept or reject the resignation. Promptly thereafter, the Board will announce its decision by means of a press release.

Additionally, the Exchange is proposing some non-substantive changes to *Section 3.2* of the Bylaws for added clarity. For example, the term ''Board'' is being replaced with ''Board of Directors'' in two places to add clarity. Also, the phrase ''Directors will serve one-year terms ending on the annual meeting following the meeting at which such directors were elected or at such time as their successors are elected or appointed and qualified. . .'' is being replaced with ''Directors shall be elected annually and shall hold office until the next annual meeting and until such time as their successors are elected or appointed and qualified'' to avoid confusion regarding the term length and to clarify until when elected directors hold office. This change will clarify that terms are not necessarily for one year, but until the next annual meeting (which may not be exactly one year from the date of the previous meeting), and that there may be holdover directors until their successors are elected or appointed and qualified (except in the event of earlier death, resignation or removal).

As CBOE Holdings is listed on the NASDAQ Stock Market, these proposed changes are not inconsistent with the NASDAQ listing rules.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the Exchange and, in particular, the requirements of Section 6(b) of the Act.[4] Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)[5] requirements that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Additionally, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)[6] requirement that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

In particular, for purposes of an uncontested election, the proposed amendments adopt a majority vote standard for director elections for the Exchange's parent company, which would enable its directors to be elected in a manner that the Board of Directors believes is reflective of the desires of shareholders and provide a mechanism to protect against the election of directors by less than the majority vote of the shareholders.

The proposed rule change to amend CBOE Holdings' Bylaws to adopt a majority vote standard for uncontested elections is consistent with the Act because the proposed change is designed to allow the members of the Board of Directors to be elected in a manner that the Board of Directors believes closely reflects the desires of its shareholders (as well as a manner in which uncontested Board of Director elections are conducted for the majority of large public companies in the United States), while also providing a process for addressing the circumstance when a director fails to receive a majority of the votes in an uncontested election. The plurality standard would continue to apply in contested elections.

The proposed non-substantive changes to the Bylaws are intended to enhance clarity and prevent confusion, thereby removing impediments to and perfecting the mechanism of a free and open market and a national market system, and, in general, protecting investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed change does not impact either intermarket or intramarket competition, but instead is intended to enhance the governance of the Exchange's parent company.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange neither solicited nor received comments on the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The Exchange has filed the proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act[7] and Rule 19b–4(f)(6) thereunder.[8] Because the foregoing proposed rule change does not: (1) Significantly affect the protection of investors or the public interest; (2) impose any significant burden on competition; and (3) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act[9] and Rule 19b–4(f)(6)[10] thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission will institute proceedings to determine whether the proposed rule change should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml);* or
- Send an email to *rule-comments@sec.gov. Please include File Number* SR-CBOE-2014-0006 *on the subject line.*

Paper Comments

[4] 15 U.S.C. 78f(b).

[5] 15 U.S.C. 78f(b)(5).

[6] *Id.*

[7] 15 U.S.C. 78s(b)(3)(A)(iii).

[8] 17 CFR 240.19b–4(f)(6).

[9] 15 U.S.C. 78s(b)(3)(A).

[10] 17 CFR 240.19b–4(f)(6). In addition, Rule 19b–4(f)(6)(iii) requires the Exchange to give the Commission written notice of the Exchange's intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

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

All submissions should refer to File Number SR–CBOE–2014–006. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml).* Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Sreet NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2014-006 and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[11]

Kevin M. O'Neill,

Deputy Secretary,

[FR Doc. 2014–01962 Filed 1–30–14; 8:45 am]

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[11] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71408; File No. SR–NYSEMKT–2014–08]

Self-Regulatory Organizations; NYSE MKT LLC; Notice of Filing of Proposed Rule Change Amending Various Sections of Both the Limited Liability Company Agreement of NYSE Amex Options LLC Dated as of June 29, 2011 and the Members Agreement Dated as of June 29, 2011 By and Among the Company, NYSE MKT, NYSE Euronext, Banc of America Strategic Investments Corporation, Barclays Electronic Commerce Holdings Inc., Citadel Securities LLC, Citigroup Financial Strategies, Inc., Goldman, Sachs & Co., Datek Online Management Corp. and UBS Americas Inc. In Order To Make Certain Technical Changes Within the Aforementioned Agreements

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act'') [1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 14, 2014, NYSE MKT LLC (''NYSE MKT'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to various sections of both the Limited Liability Company Agreement of NYSE Amex Options LLC (the ''Company'') dated as of June 29, 2011 (as amended,[3] the ''LLC Agreement'') and the Members Agreement dated as of June 29, 2011 by and among the Company, NYSE MKT, NYSE Euronext, Banc of America Strategic Investments Corporation, Barclays Electronic Commerce Holdings Inc., Citadel Securities LLC, Citigroup Financial Strategies, Inc., Goldman, Sachs & Co., Datek Online Management Corp. and UBS Americas Inc. (collectively, excluding the Company, NYSE MKT and NYSE Euronext, the ''Founding Firms'') (as amended,[4] the ''Members Agreement'') in order to make certain technical changes within the aforementioned agreements (the ''Proposed Rule Change''). The text of the proposed rule change is available on the Exchange's Web site at *www.nyse.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below.

[1] 15 U.S.C.78s(b)(1).

[2] 17 CFR 240.19–4.

[3] *See* Securities Exchange Act Release No. 34–69388 (April 17, 2013), 78 FR 23963 (Notice of filing and immediate effectiveness of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company); Securities Exchange Act Release No. 34–67702 (August 21, 2012), 77 FR 51837 (Notice of filing and immediate effectiveness of a proposed rule change amending the NYSE Amex Options LLC Limited Liability Company Agreement to eliminate certain restrictions relating to the qualification of Founding Firm Advisory Committee Members); Securities Exchange Act Release No. 34–67902 (September 21, 2012), 77 FR 59423 (Order granting approval of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company); Securities Exchange Act Release No. 34–67569 (August 1, 2012), 77 FR 47138 (Notice of filing of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company).

[4] *See* Securities Exchange Act Release No. 34–69247 (March 27, 2013), 78 FR 19777 (Notice of filing and immediate effectiveness of a proposed rule change to modify the NYSE Amex Options LLC fee schedule to establish fees for mini-options contracts). Certain provisions of the Members Agreement related to the Volume-Based Equity Plan were duly amended by the Board on August 30, 2012. Changes to the Volume-Based Equity Plan do not constitute proposed rule changes within the meaning of Section 19(b)(1) of the Act and Rule 19b–4 thereunder. *See* Securities Exchange Act Release No. 34–64742 (June 24, 2011), 76 FR 38436, 38443.

The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

On June 29, 2011, the Exchange, its ultimate parent NYSE Euronext and the Founding Firms formed the Company. The Company operates an electronic trading facility (the ''Options Exchange'') that engages in the business of listing for trading options contracts permitted to be listed on a national securities exchange (or facility thereof) and related activities. The Company operates pursuant to the LLC Agreement and the Members Agreement. The Exchange proposes to make technical amendments to various sections of both the LLC Agreement and the Members Agreement as further described herein.[5]

Summary

The Exchange proposes to make certain technical modifications and clarifications to certain provisions of the LLC Agreement and the Members Agreement. Specifically, the Exchange proposes to make amendments that clarify:

(1) Differences between voting entitlements and economic entitlements associated with Common Interests, where appropriate;

(2) provisions of the LLC Agreement and the Members Agreement related to the capital structure of the Company;

(3) provisions of the LLC Agreement related to capital calls to provide greater specificity as to the matters to be decided by the board of directors of the Company (the ''Board'') in connection with a capital call and as to matters surrounding oversubscription and the issuance of Common Interests in connection with capital calls;

(4) provisions of the LLC Agreement related to ownership limitations to clarify the mechanism for maintaining compliance with applicable laws and regulations;

(5) provisions of the LLC Agreement related to royalty payments to clarify the effect of such payments on the Capital Account of NYSE MKT;

(6) provisions of the LLC Agreement related to distributions with respect to equity interests to clarify how the amounts of annual distributions to Members are determined;

(7) provisions of the LLC Agreement related to restricted member elections to clarify the circumstances under which a Member may become a Restricted Member;

(8) provisions of the LLC Agreement related to the composition of the Board to clarify the mechanism by which the Board may increase in size;

(9) provisions of the LLC Agreement related to the Founding Firm Advisory Committee to clarify the mechanism by which the Founding Firm Advisory Committee may increase in size;

(10) provisions of the LLC Agreement governing a Member's obligations with respect to the treatment of Confidential Information in order to clarify the scope of such policies and procedures;

(11) provisions of the LLC Agreement and Members Agreement related to transfers of Common Interests to clarify the mechanics by which Common Interests may be transferred, including the mechanics by which Common Interests may be converted into Non-voting Common Interests (and then converted back to Common Interests, when and as applicable) and applicable time periods for effecting transfers;

(12) provisions of the Members Agreement related to the Volume-Based Equity Plan to clarify (i) the mechanism by which the Volume Dispute Committee may increase in size and (ii) the calculation of Industry Volume and the determination whether a Founding Firm has achieved its Individual Target;[6] and

(13) provisions of the Members Agreement related to the determination of fair market value of a Member's Common Interests and of the Company to clarify how such fair market value is determined under various circumstances.

In addition, the Exchange proposes to make several typographical corrections.

The technical modifications described herein are not intended to substantively change the relevant provisions set forth in either the LLC Agreement or the Members Agreement, but only to ensure that, from a technical perspective, the LLC Agreement and Members Agreement clearly reflect the original intentions of the parties to those agreements.

Economic and Voting Common Interests

As a limited liability company, ownership of the Company is represented by limited liability company interests in the Company (''Interests''). The Interests represent equity interests in the Company and entitle the holders thereof to participate in the Company's allocations and distributions. The Interests are divided into preferred non-voting interests (''Preferred Interests''), Class A Common Interests and Class B Common Interests.

The holders of Interests are referred to as members of the Company (''Members''). The LLC Agreement designates Members as either Class A Members or Class B Members. Generally, Class A Members and Class B Members are distinguishable in that Class A Members hold Class A Common Interests and Class B Members hold Class B Common Interests.

Class A Common Interests and Class B Common Interests are not intended to be directly fungible (meaning that one Class A Common Interest does not represent the equivalent entitlements of one Class B Common Interest). This dissimilarity results from the operation of the Volume-Based Equity Plan, as set forth in Article II of the Members Agreement, pursuant to which, each year (until 2015, unless extended by the Board) the Company may issue additional Class B Common Interests as Incentive Shares without at the same time issuing new Class A Common Interests. These Incentive Shares would be allocated among the Class B Members based on each Class B Member's contribution to the volume of the Exchange relative to an Individual Target, which would have the effect of changing the relative economic and voting rights among the Class B Members. However, Incentive Shares have no effect on the relative economic and voting rights as between Class A Members (in the aggregate) and Class B Members (in the aggregate). As a result, the aggregate number of Class B Common Interests may increase while the relative economic or voting rights of Class B Members (in the aggregate) vis-à-vis Class A Members (in the aggregate) remain unchanged. The overall impact of the issuance of Incentive Shares, then, is to dilute the value of each Class B Common Interest relative to each Class A Common Interest.

[5] All capitalized terms used in this Proposed Rule Change that are not otherwise defined in this Proposed Rule Change shall have the meanings specified in the Amended LLC Agreement or Amended Members Agreement, as applicable.

[6] Changes to the Volume-Based Equity Plan do not constitute proposed rule changes within the meaning of Section 19(b)(1) of the Act and Rule 19b–4 thereunder. *See* Securities Exchange Act Release No. 34–64742 (June 24, 2011), 76 FR 38436, 38443. The changes to these provisions are being made simultaneously with the other changes described herein for convenience and are described here in the interest of completeness.

Certain provisions of the LLC Agreement prohibit Members from owning or voting Interests in excess of applicable regulatory thresholds (as discussed in Sections 4.9 and 7.5 of the LLC Agreement). If a Member exceeds such thresholds, it may be necessary to separate the economic and voting entitlements associated with such Member's Interests (in addition to limiting entitlements to the relevant thresholds). To account for such situations, a Member's Common Interests represent separate entitlements to net profits, net losses and distributions (an ''Economic Common Interest Percentage'' [7]) and entitlements to vote (a ''Voting Common Interest Percentage'' [8]).

By way of example, consider a Class B Member that is subject to a hypothetical regulatory restriction that prevents it from holding greater than a 15% voting interest in the Company. If such Class B Member earned Incentive Shares by operation of the Volume-Based Equity Plan that would bring its Economic Common Interest Percentage and Voting Common Interest Percentage to 18%, it would need to convert some of its Class B Common Interests into Non-voting Common Interests.[9] Following such a conversion, the Class B Member would hold Class B Common Interests (some of which would be Non-voting Common Interests) representing a Voting Common Interest Percentage of 15% and an Economic Common Interest Percentage of 18%.

As a result of this potential deviation between a Member's economic entitlement and its voting entitlement, it is appropriate, in certain circumstances, to refer to either a Member's Voting Common Interest Percentage or its Economic Common Interest Percentage. For example, a Member's participation in a capital call would be based on its Economic Common Interest Percentage rather than its Voting Common Interest Percentage. As further discussed below, however, the restriction on a Member's ability to own or vote Common Interests representing an Economic Common Interest Percentage or a Voting Common Interest Percentage in excess of nineteen and nine-tenths percent (19.9%) will continue to apply (other than to NYSE MKT alone, or, subject to appropriate SEC approval, together with its Permitted Transferees), so that no such Member's Economic Common Interest Percentage or Voting Common Interest Percentage will be permitted to exceed nineteen and nine-tenths percent (19.9%).

Under the existing agreements, various provisions refer to a Member's ''Common Interest Percentage'' to denote a Member's ownership interest in the Company. The term is meant to capture the percentage of economic or voting rights represented by the absolute number of Common Interests held by such Member. However, because (i) the term ''Common Interest Percentage'' does not, in all cases, properly convey the distinction between a Member's voting entitlement and its economic entitlement and (ii) various sections refer to an absolute number of Common Interests rather than a relative percentage, the Exchange proposes to amend the references to a Member's Common Interests or Common Interest Percentage in Sections 1.1, 4.3, 4.4, 4.5, 4.9, 5.1, 5.2, 5.3, 5.4, 6.1, 7.5, 8.1, 9.1, 9.2, 10.3, 11.2, 11.3, 11.5, 11.8, 12.2, 12.4, 12.5, 13.2, 16.10 and Schedule 8.1(i)(v) of the LLC Agreement and Sections 1.1, 2.1, 3.2, 3.3, 3.4, 4.1 and 5.10 of the Members Agreement to more directly specify when the entitlement being referred to is the Member's economic entitlement rather than its voting entitlement and vice versa.

Capital Structure

Sections 4.1 and 10.1 of the LLC Agreement describe the capital structure of the Company. Since the formation of the Company, the Company has entered into five transactions that have altered its capital structure: (i) The admission of NYSE Market, Inc. (''NYSE Market'') as a Member of the Company in conjunction with the transfer of Common Interests by the Founding Firms to NYSE Market on September 19, 2011 pursuant to Sections 10.4 and 11.1 of the LLC Agreement and Section 3.2 of the Members Agreement, (ii) the issuance of Annual Incentive Shares to the Founding Firms on February 29, 2012 pursuant to Section 2.1 of the Members Agreement (iii) the transfer of Common Interests by the Founding Firms to NYSE Market on October 1, 2012 pursuant to Article XI of the LLC Agreement and Section 3.1 of the Members Agreement, (iv) the issuance of Annual Incentive Shares to the Founding Firms on February 28, 2013 pursuant to Section 2.1 of the Members Agreement and (v) the transfer of Common Interests by the Founding Firms to NYSE Market on April 2, 2013 pursuant to Article XI of the LLC Agreement and Section 3.1 of the Members Agreement. All five transactions, along with the resultant changes to the Company's Members' Schedule, have been approved by the SEC.[10]

The Exchange proposes to amend the preamble, Sections 4.1, 10.1, 10.2 and

[7] ''Economic Common Interest Percentage'' is defined in the Amended LLC Agreement to mean, at any time, (A) with respect to the Common Interests owned by one or more Class A Member(s), the *product of* (w) the Aggregate Class A Economic Allocation *multiplied by* (x) a fraction, (1) the numerator of which shall be the number of Class A Common Interests then held by such Class A Member(s) (including any Class A Non-voting Common Interests) and (2) the denominator of which shall be the number of Class A Common Interests then owned by all Class A Members (including any Class A Non-voting Common Interests), and (B) with respect to the Common Interests owned by one or more Class B Member(s), the *product of* (y) the Aggregate Class B Economic Allocation *multiplied by* (z) a fraction, (1) the numerator of which shall be the number of Class B Common Interests then owned by such Class B Member(s) (including any Class B Non-voting Common Interests) and (2) the denominator of which shall be the number of Class B Common Interests then owned by all Class B Members (including any Class B Non-voting Common Interests).

[8] ''Voting Common Interest Percentage'' is defined in the Amended LLC Agreement to mean, at any time, (A) with respect to the Common Interests owned by one or more Class A Member(s), the *product of* (w) the Aggregate Class A Voting Allocation *multiplied by* (x) a fraction, (1) the numerator of which shall be the number of Class A Common Interests then owned by such Class A Member(s) excluding any Class A Non-voting Common Interests and (2) the denominator of which shall be the number of Class A Common Interests then owned by all Class A Members excluding all Class A Non-voting Common Interests, and (B) with respect to Common Interests owned by one or more Class B Member(s), the *product of* (y) the Aggregate Class B Voting Allocation *multiplied by* (z) a fraction, (1) the numerator of which shall be the number of Class B Common Interests then owned by such Class B Member(s) excluding any Class B Non-voting Common Interests and (2) the denominator of which shall be the number of Class B Common Interests then owned by all Class B Members excluding all Class B Non-voting Common Interests.

[9] The mechanics for how Common Interests may be converted into Non-voting Common Interests are included in proposed Section 11.2(c) of the Amended LLC Agreement and are discussed in greater detail under the heading ''Transfers of Interests—Converting Common Interests to Non-voting Common Interests.''

[10] *See* Securities Exchange Act Release No. 34–69388 (April 17, 2013), 78 FR 23963 (Notice of filing and immediate effectiveness of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company) (''Release No. 34–69388''); Securities Exchange Act Release No. 34–67902 (September 21, 2012), 77 FR 59423 (Order granting approval of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company); *see also* Securities Exchange Act Release No. 34–67569 (August 1, 2012), 77 FR 47138 (Notice of filing of a proposed rule change amending the Members' Schedule of NYSE Amex Options LLC in order to reflect changes to the capital structure of the Company).

The Commission notes that the transactions and corresponding changes to the Company's governing documents that were the subject of Release No. 34–69388 (April 17, 2013) were filed pursuant to Section 19(b)(3)(A)(iii) of the Exchange Act (15 U.S.C. 78s(b)(3)(A)(iii)) and Rule 19b–4(f)(6) thereunder (17 CFR 240.19b–4(f)(6)). As a result, that filing was not approved by the Commission; rather, it became immediately effective upon filing.

10.4 and Schedule A of the LLC Agreement to eliminate references to historical capital contributions and to provide, instead, a description of the Company's capitalization as it currently stands. The Exchange also proposes to amend the cover page and the preamble of the Members Agreement to provide context for the execution of the Amended Members Agreement.

In addition, the Exchange proposes to amend the definition of the term ''Effective Date'' in Section 1.1 of the LLC Agreement to provide that the LLC Agreement and Members Agreement are only effective with respect to a Person as of the time such Person becomes a Member of the Company. Relatedly, the Exchange proposes to replace the term ''Effective Date'' with the term ''Initial Effective Date'' in the preamble, Sections 1.1, 4.3, 4.4, 4.8, 8.1, 8.3, 8.6, 11.8, 14.1, 14.2, 16.2, 16.3 and Schedule 8.1(i)(v) of the Amended LLC Agreement and Sections 3.4, 5.3, 5.13 and Schedule 5.3 of the Amended Members Agreement in order to clarify that time periods in the Amended LLC Agreement and the Amended Members Agreement that are based on the date the LLC Agreement and Members Agreement were originally executed remain unchanged.

Because the admission of NYSE Market results in there now being more than one Class A Member, the Exchange proposes to amend Section 3.3 of the Members Agreement to clarify that it applies to transfers by NYSE MKT as well as any other Person that is or becomes a Class A Member. Similarly, to account for there being more than one Class A Member, the Exchange proposes to amend Section 10.2(b) of the LLC Agreement to clarify that Class A Common Interests will be owned only by NYSE MKT and its Permitted Transferees such as NYSE Market, its affiliate. Furthermore, to account for the possibility of more than one Person holding Preferred Interests, the Exchange proposes to amend the definition of ''Priority Claim'' in Section 1.1 of the LLC Agreement to clarify that distributions to owners of Preferred Interests shall be accomplished on a *pro rata* basis in accordance with the number of Preferred Interests owned by each such owner.[11]

In addition, as NYSE Market is an affiliate of NYSE MKT, the Exchange proposes to amend Sections 1.1, 8.1 and 11.2 of the LLC Agreement and Sections 3.3 and 3.4 of the Members Agreement to clarify that these provisions apply to NYSE MKT as well as NYSE MKT's Affiliates.

Finally, the Exchange proposes to amend the LLC Agreement and the Members Agreement in their entirety to change references to NYSE Amex to NYSE MKT.

Capital Calls

Pursuant to Sections 4.3, 4.4 and 4.5 of the LLC Agreement, Members may be subject to both regulatory and voluntary capital calls. Generally, capital calls may be issued by the Board from time to time subject to certain limitations. In connection with a voluntary capital call, participating Members are entitled to have their respective Economic Common Interest Percentages and Voting Common Interest Percentages increased in respect of their capital contributions, while the Economic Common Interest Percentages and Voting Common Interest Percentages of non-participating Members are accordingly reduced.

To further specify the mechanics of a capital call and related capital contributions, the Exchange proposes to amend Sections 4.3, 4.4 and 4.5 of the LLC Agreement. First, the Exchange proposes to amend Sections 4.3 and 4.4 to require the Board to specify certain items in connection with a capital call. Specifically, the Exchange proposes to require that the Board specify: the aggregate amount of the capital call, the date by which a capital contribution in respect of the capital call must be made, the fair market value of the Company with respect to such capital call (without giving effect to any capital contributions in respect of such capital call), the Per Common Interest FMV[12] with respect to such capital call (without giving effect to any capital contributions in respect of such capital call) and such other matters as the Board may determine.

The Exchange also proposes to amend Section 4.4 of the LLC Agreement in order to clarify that, should a participating Member (or class of Members) oversubscribe to a voluntary capital call, appropriate adjustments will be made to the Economic Common Interest Percentages and Voting Common Interest Percentages of the affected Members. To effect these adjustments, Section 4.4 of the Amended LLC Agreement provides that: (1) Appropriate adjustments shall be made to the Aggregate Class A Economic Allocation, Aggregate Class A Voting Allocation, Aggregate Class B Economic Allocation and Aggregate Class B Voting Allocation, (2) the Company shall issue Class A Common Interests or Class B Common Interests as necessary to the relevant Members, and (3) the Members' Schedule shall be adjusted accordingly. Any such adjustments will be subject to regulatory limitations including those contained in Section 4.9 of the Amended LLC Agreement. The Exchange proposes to further clarify that if each Member contributes its *pro rata* share of a voluntary capital call, such that no adjustments need be made to any Member's Economic Common Interest Percentage or Voting Common Interest Percentage, no new Common Interests shall be issued to any Member in connection with such voluntary capital call.

In addition, the Exchange proposes to amend Section 4.5(b) of the LLC Agreement to clarify the consequences of a Member failing to fund either (x) its *pro rata* portion of a regulatory capital call or (y) if the Member has committed to participate in a voluntary capital call, its portion of the voluntary capital call (such Member, a ''Non-Funding Member'' and the amount it fails to contribute, its ''Requested Amount''). Generally, the Board has the right to transfer the Common Interests a Non-Funding Member would have received had it participated in a regulatory or voluntary capital call (''Non-Funded Interests'') to the existing Members of the Company or, should the Members not purchase all of the Non-Funded Interests, to a Person who is not a Member.

The Exchange proposes to amend the proviso to Section 4.5(b) of the LLC Agreement by adding three provisions. First, clause (C) of the proviso to Section 4.5(b) of the Amended LLC Agreement provides that the aggregate number of Non-Funded Interests shall be equal to the quotient of (i) the Requested Amount divided by (ii) the relevant Per Common Interest FMV.

In addition, the Exchange proposes to add clause (D) of the proviso to Section 4.5(b) of the Amended LLC Agreement to clarify that, with respect to a

[11] Note that NYSE MKT is currently the only holder of Preferred Interests and it is not currently anticipated that any Preferred Interests will be issued to any other Person.

[12] ''Per Common Interest FMV'' is proposed to be defined in the Amended LLC Agreement to mean, with respect to any regulatory or voluntary capital call, (A) with respect to a Class A Common Interest, the *quotient* of (I) the *product of* (x) the FMV of the Company with respect to such Regulatory Capital Call or Voluntary Capital Call, as applicable, *multiplied by* (y) the Aggregate Class A Economic Allocation *divided by* (II) the total number of issued and outstanding Class A Common Interests at such time; (B) with respect to a Class B Common Interest, the *quotient* of (I) the *product of* (x) the FMV of the Company with respect to such Regulatory Capital Call or Voluntary Capital Call, as applicable, *multiplied by* (y) the Aggregate Class B Economic Allocation *divided by* (II) the total number of issued and outstanding Class B Common Interests at such time.

regulatory capital call, each Member that is not a Non-Funding Member shall be entitled to receive a number of new Class A Common Interests or Class B Common Interests, as applicable, equal to the quotient of (i) such Member's regulatory capital contribution divided by (ii) the applicable Per Common Interest FMV. In addition, the Capital Account of each such Member shall be increased by the sum of its regulatory capital contribution plus the amount of the regulatory capital contribution attributable to the Non-Funded Interests acquired by such Member. This provision is designed to mirror Section 4.4(e) of the Amended LLC Agreement. Thus, under the Amended LLC Agreement, a regulatory capital call in which not all Members fully participate (by making capital contributions on a *pro rata* basis) would be treated similarly to a voluntary capital call in which the Members do not all participate on a *pro rata* basis.

Finally, the Exchange proposes to add clause (E) of the proviso to Section 4.5(b) of the Amended LLC Agreement to provide that a Member that acquires Non-Funded Interests will be entitled to receive additional Class A Common Interests or Class B Common Interests, as applicable, to supplement those Common Interests that such Member was entitled to receive pursuant to either Section 4.4(e) of the Amended LLC Agreement (in the case of a voluntary capital call) or clause (D) described above (in the case of a regulatory capital call) by virtue of having made its initial contribution to the relevant capital call.

Example 4 in *Exhibit 5C* demonstrates the operation of these provisions.

Ownership Limitations

Section 4.9 of the LLC Agreement provides a mechanism by which Members who exceed certain regulatory thresholds with respect to ownership or voting entitlements may come into compliance with the applicable regulatory framework.

The Exchange proposes to clarify that a Member may be subject to the provisions of Section 4.9 (such a Member, an ''Exceeding Member'') either as a result of a regulatory threshold applicable directly to the Member's holdings of Common Interests or as a result of regulations applicable to the Company that operate to impose a regulatory threshold on each Member's holdings of Common Interests. Specifically, the Exchange proposes to clarify that a Member's ''Alternative Maximum Percentage'' is the lower of (1) the maximum Voting Common Interest Percentage or Economic Common Interest Percentage such Member (alone or together with its Affiliates) may own or vote under applicable Law or (2) the maximum Voting Common Interest Percentage or Economic Common Interest Percentage such Member (alone or together with its Affiliates) may own or vote without subjecting the Company to material regulatory obligations or material liabilities or a reasonable likelihood of material regulatory obligations or material liabilities arising as a result of the extent of such ownership or voting interest.

In addition, the Exchange proposes to amend Section 4.9 to clarify the mechanics by which ordinary Common Interests may be converted into Non-voting Common Interests pursuant to Section 11.2(c) of the Amended LLC Agreement, as described below under the heading ''Transfers of Interests''.

The proposed changes do not have any effect on the restrictions on a Member's ability to own or vote Common Interests representing an Economic Common Interest Percentage or a Voting Common Interest Percentage in excess of nineteen and nine-tenths percent (19.9%).

Royalty Payments

Pursuant to Section 4.10 of the LLC Agreement, NYSE MKT is required to make a capital contribution to the Company in the event that certain royalty fees are invoiced to the Company pursuant to the NYSE Euronext Agreement. The amount of this capital contribution is required to be equal to the amount of this royalty fee.

The Exchange proposes to amend Section 4.10 of the LLC Agreement to clarify that the amount of any such capital contribution shall increase the capital account of NYSE MKT and the amount of any such royalty fee shall decrease the capital account of NYSE MKT.

Distributions

Pursuant to Section 6.1 of the LLC Agreement, the Board is obligated to distribute annually the Company's Available Cash [13] to the holders of Preferred Interests and to the other Members.

The Exchange proposes to amend Section 6.1 of the LLC Agreement to clarify that the amounts of distributions of Available Cash to each Member shall be calculated on an ''accrual'' basis, which shall be measured on the basis of the calendar year period during which the Members actually own their respective Common Interests, in accordance with the Amended LLC Agreement or otherwise as the Members may agree.[14]

Restricted Members

Section 7.5 of the LLC Agreement provides a mechanism by which a Member who owns Interests in excess of such Member's Alternative Maximum Percentage or who owns an Interest entitling such Member to distributions in excess of such Member's maximum percentage of the distributions (a ''Capped Distribution Amount'') then being made to all Members may, from time to time, make an election (a ''Restricted Member Election''), by written notice to the Company, to be treated for purposes of the LLC Agreement as a ''Restricted Member,'' solely with respect to its Excess Interest Percentage or Capped Distribution Amount.

Any Class B Member, even one who does not own Interests in excess of such Member's Alternative Maximum Percentage, may make a Restricted Member Election. The Exchange proposes to amend Section 7.5(a) to clarify that the restricted member provisions only apply to Class B Members. The Exchange also proposes to amend Section 7.5(a) to clarify that, in those circumstances where a Restricted Member may reverse its election, it may do so in whole or in part.

The Exchange proposes to amend Section 7.5(b) of the LLC Agreement and delete Section 7.5(d) of the LLC Agreement in order to clarify the circumstances under which a Class B Member that has not exceeded its Alternative Maximum Percentage may become a Restricted Member. Specifically, the Exchange proposes to amend Section 7.5(b) of the LLC

[13] ''Available Cash'' is defined in the LLC Agreement to mean, with respect to a distribution pursuant to Section 6.1 of the LLC Agreement, cash (excluding cash in the redemption reserve) held by the Company at the time of such distribution that both (i) is not required for the operations of the Company based on the annual budget of the Company for such year, and (ii) the Board determines in good faith is not required for (A) the payment of liabilities or expenses of the Company or (B) the setting aside of reserves to meet the anticipated cash needs of the Company.

[14] By way of example, assume a Member holds Common Interests representing an Economic Common Interest Percentage of 10% on January 1, 2012. Assume further that this Member divests itself of 10% of its Common Interests on March 31, 2012, so that its Economic Common Interest Percentage is reduced to 9%. At the time of the distribution of Available Cash, the Member shall be entitled to more than 9% of such distribution, to reflect the fact that the Member held 10% for the period from January 1, 2012 through March 31, 2012.

Agreement to clarify that a Class B Member may make a Restricted Member Election with respect to any of its Class B Common Interests, even if such Class B Common Interests do not represent an Excess Interest Percentage; provided that (1) such Class B Member may only reverse such election under the circumstances described in Section 7.5(a)(iii)(C) of the Amended LLC Agreement and (2) the Voting Common Interest Percentage represented by such Class B Common Interests shall be deemed to be an ''Excess Interest Percentage'' (and such Class B Member shall be treated as a Converting Member with respect thereto) unless and until such Class B Member reverses the Restricted Member Election under the circumstances described in Section 7.5(a)(iii)(C) of the Amended LLC Agreement.

Composition of the Board

Pursuant to Section 8.1(d) of the LLC Agreement, subject to certain restrictions, each Member is entitled to appoint Directors to serve on the Board. Generally, each Founding Firm, subject to certain restrictions, is entitled to appoint one (1) Director and NYSE MKT is entitled to appoint up to seven (7) Directors. In addition, in the event that additional Founding Firms are entitled to appoint Directors to the Board resulting in an increase in the size of the Board, NYSE MKT is entitled to appoint additional Directors corresponding to the number of new Directors appointed by Founding Firms, so that NYSE MKT, subject to certain conditions, shall have the right to appoint a number of Directors to the Board that is equal to the number appointed by the Founding Firms plus one. NYSE MKT is further required to appoint a number of Directors (not to exceed the 7 Directors NYSE MKT is otherwise entitled to appoint) sufficient to ensure that no single Founding Firm's designees to the Board constitute twenty percent (20%) or a greater percentage of the Board.

The Exchange proposes to amend Section 8.1(d)(i) of the LLC Agreement to clarify that, in the event that the Board increases in size, NYSE MKT would be entitled and required to appoint a number of Directors in excess of the 7 Directors it is otherwise entitled to appoint to ensure that no single Founding Firm's designees constitute twenty percent (20%) or a greater percentage of the Board.

Founding Firm Advisory Committee

Pursuant to Section 8.3 of the LLC Agreement, the Board has established a Founding Firm Advisory Committee comprised of natural persons having the capacity to provide advice to the Board, which advice the Board will consider in good faith but shall not be bound by, with respect to subjects identified by the Board from time to time, including new products and market structure. Members of the Founding Firm Advisory Committee are appointed by the Members as follows: two (2) Advisory Committee Members are appointed by NYSE MKT and one (1) Advisory Committee Member is appointed by each Founding Firm.

The Exchange proposes to amend Section 8.3 of the LLC Agreement to clarify that, upon the admission to the Company of a new Member that is deemed to be a Founding Firm pursuant to Section 11.1(c) of the LLC Agreement, the authorized number of Advisory Committee Members shall automatically be increased by one.

Policies Related to Confidential Information

Section 7.4 of the LLC Agreement requires that each Member maintain commercially reasonable policies and procedures to prevent the disclosure of Confidential Information of the Company by any Director, alternate Director, observer to the Board or any committee of the Board or Advisory Committee Member to any other individual appointed by such Member to perform a similar role with respect to, or who is an officer or employee of, a Specified Entity.

The Exchange proposes to amend Section 7.4 of the LLC Agreement to provide that each Member maintain policies and procedures to prevent the disclosure of Confidential Information to a Specified Entity generally, rather than to individuals performing specified roles at a Specified Entity.

Transfers of Interests

Article XI of the LLC Agreement and Article III of the Members Agreement specify certain conditions under which Members may Transfer their Common Interests. Under the LLC Agreement, acquisitions of Class A Common Interests by Class B Members or Class B Common Interests by Class A Members require the recalculation of the Aggregate Class A Allocation and the Aggregate Class B Allocation.

The Exchange proposes to amend Section 11.2(a) of the LLC Agreement and Section 3.1 of the Members Agreement to clarify that the provisions of Section 11.2 of the LLC Agreement and Article III of the Members Agreement apply to transfers among the Members as well as to transfers to third parties. In addition, the Exchange proposes to amend Section 11.2 of the LLC Agreement to clarify the mechanics by which (1) Common Interests may be transferred among Members or redeemed, and (2) Common Interests may be converted into Non-voting Common Interests. These amendments are not intended to substantively change these mechanics, but rather to clarify, as a technical matter, the specific changes that are required to be made to the Members' Schedule to reflect such transactions. *Exhibit 5C* includes examples of how these mechanics may be implemented from time to time.

The Exchange also proposes to make certain conforming changes to the Members Agreement to clarify that the mechanics described below are applicable to transfers authorized thereunder.

In addition, the Exchange proposes to clarify that the call option granted to NYSE MKT pursuant to Section 3.4 of the Members Agreement is granted solely by the Class B Members.

Finally, the Exchange proposes to amend provisions in the Members Agreement to clarify the time periods during which Members may elect to transfer their Common Interests and relevant deadlines with respect to such transfers.

Transfers Among Members; Redemptions

The Exchange proposes to clarify that following any transfer or redemption of Class A Common Interests or Class B Common Interests, the Aggregate Class A Economic Allocation, the Aggregate Class A Voting Allocation, the Aggregate Class B Economic Allocation, the Aggregate Class B Voting Allocation and the number of Class A Common Interests and Class B Common Interests shall be adjusted, subject in each case to Section 4.9 of the Amended LLC Agreement, as follows, to reflect such transfers or redemptions:

(i) In the case of an acquisition of Class B Common Interests by a Class A Member or any of its Affiliates,

(A) the Aggregate Class A Economic Allocation shall be increased by the Economic Common Interest Percentage represented by the Class B Common Interests so acquired and the Aggregate Class B Economic Allocation shall be reduced by an equal percentage,

(B) the Aggregate Class A Voting Allocation shall be increased by a percentage equal to the Voting Common Interest Percentage represented by the Class B Common Interests so acquired and the Aggregate Class B Voting Allocation shall be reduced by an equal percentage, and

(C) the Class B Common Interests so acquired shall be converted into a

number of Class A Common Interests equal to the *product of* (w) a fraction, (1) the numerator of which shall be the Economic Common Interest Percentage represented by the Class B Common Interests so acquired and (2) the denominator of which shall be the Aggregate Class A Economic Allocation prior to such acquisition *multiplied by* (x) the aggregate number of Class A Common Interests issued and outstanding prior to such acquisition; *provided* that if any acquired Class B Common Interests are Class B Non-voting Common Interests, the number of such Class A Common Interests that shall be Class A Non-voting Common Interests shall be equal to the *difference* between (I) the total number of such Class A Common Interests *less* (II) the *product of* (y) a fraction, (1) the numerator of which shall be the Voting Common Interest Percentage represented by the Class B Common Interests so acquired and (2) the denominator of which shall be the Aggregate Class A Voting Allocation prior to such acquisition *multiplied by* (z) the total number of Class A Common Interests issued and outstanding prior to such acquisition that are not Class A Non-voting Common Interests.

(ii) In the case of a redemption of Class B Common Interests by the Company,

(A) the Aggregate Class A Economic Allocation shall be increased by a percentage equal to the *product of* (x) the Economic Common Interest Percentage represented by the Class B Common Interests so redeemed *multiplied by* (y) a fraction, (1) the numerator of which shall be equal to the Aggregate Class A Economic Allocation immediately prior to such redemption and (2) the denominator of which shall be equal to (I) one-hundred percent (100%) *minus* (II) the Economic Common Interest Percentage so redeemed, and the Aggregate Class B Economic Allocation shall be reduced by an equal percentage, and

(B) the Aggregate Class A Voting Allocation shall be increased by a percentage equal to (x) the total Voting Common Interest Percentage represented by the Class B Common Interests so redeemed *multiplied by* (y) a fraction, (1) the numerator of which shall be equal to the Aggregate Class A Voting Allocation immediately prior to such redemption and (2) the denominator of which shall be equal to (I) one-hundred percent (100%) *minus* (II) the Voting Common Interest Percentage so redeemed, and the Aggregate Class B Voting Allocation shall be reduced by an equal percentage.

(iii) In the case of an acquisition of Class A Common Interests by a Class B Member or any of its Affiliates,

(A) the Aggregate Class A Economic Allocation shall be reduced by the Economic Common Interest Percentage represented by the Class A Common Interests so acquired and the Aggregate Class B Economic Allocation shall be concomitantly increased,

(B) the Aggregate Class A Voting Allocation shall be reduced by the Voting Common Interest Percentage represented by the Class A Common Interests so acquired and the Aggregate Class B Voting Allocation shall be concomitantly increased, and

(C) the Class A Common Interests so acquired shall be converted into a number of Class B Common Interests equal to the *product of* (w) a fraction, (1) the numerator of which shall be the Economic Common Interest Percentage represented by the Class A Common Interests so acquired and (2) the denominator of which shall be the Aggregate Class B Economic Allocation prior to such acquisition *multiplied by* (x) the aggregate number of Class B Common Interests issued and outstanding prior to such acquisition; *provided* that if any acquired Class A Common Interests are Non-voting Common Interests, the number of such Class B Common Interests that shall be Class B Non-voting Common Interests shall be equal to the *difference* between (I) the total number of such Class B Common Interests *less* (II) the *product of* (y) a fraction, (1) the numerator of which shall be the Voting Common Interest Percentage represented by the Class A Common Interests so acquired and (2) the denominator of which shall be the Aggregate Class B Voting Allocation prior to such acquisition *multiplied by* (z) the total number of Class B Common Interests issued and outstanding prior to such acquisition that are not Class B Non-voting Common Interests.

(iv) In the case of a redemption of Class A Common Interests by the Company,

(A) the Aggregate Class A Economic Allocation shall be reduced by a percentage equal to (x) the Economic Common Interest Percentage represented by the Class A Common Interests so redeemed *multiplied by* (y) a fraction, (1) the numerator of which shall be equal to the Aggregate Class B Economic Allocation immediately prior to such redemption and (2) the denominator of which shall be equal to (I) one-hundred percent (100%) *minus* (II) the Economic Common Interest Percentage so redeemed, and the Aggregate Class B Economic Allocation shall be concomitantly increased, and

(B) the Aggregate Class A Voting Allocation shall be reduced by a percentage equal to (x) the total Voting Common Interest Percentage represented by the Class A Common Interests so redeemed *multiplied by* (y) a fraction, (1) the numerator of which shall be equal to the Aggregate Class B Voting Allocation immediately prior to such redemption and (2) the denominator of which shall be equal to (I) one-hundred percent (100%) *minus* (II) the Voting Common Interest Percentage so redeemed, and the Aggregate Class B Voting Allocation shall be concomitantly increased.

Examples 1, 2 and 3 in *Exhibit 5C* demonstrate the operation of these provisions.[15]

Converting Common Interests to Non-voting Common Interests

The Exchange proposes to add a Section 11.2(c) that clarifies that if a Member holds Common Interests representing an Excess Interest Percentage (such Member, solely to the extent that such Member holds Common Interests representing an Excess Interest Percentage or Common Interests converted into Non-voting Common Interests by operation of Section 11.2(c) of the Amended LLC Agreement, a ''*Converting Member*''), such Member's Voting Common Interest Percentage shall be reduced by converting a number of such Member's Common Interests into Non-voting Common Interests as follows:

(i) A number of such Member's Common Interests shall be converted into Non-voting Common Interests, which number shall be equal to the *product of:*

(A) In the case of Class A Common Interests, (x) such Member's Excess Interest Percentage *multiplied by* (y) a fraction, (1) the numerator of which shall be the total number of Class A Common Interests that are not Class A Non-voting Common Interests prior to such conversion and (2) the denominator of which shall be the Aggregate Class A Voting Allocation; or

(B) In the case of Class B Common Interests, (x) such Member's Excess Interest Percentage *multiplied by* (y) a fraction, (1) the numerator of which shall be the total number of Class B Common Interests that are not Class B Non-voting Common Interests prior to such conversion and (2) the

[15] Examples 1, 2 and 3 were the subject of discussions with the SEC staff at a meeting on August 23, 2012.

denominator of which shall be the Aggregate Class B Voting Allocation;

(ii) Each Member's (including the Converting Member's) Voting Common Interest Percentage shall be recalculated, taking into account the applicable calculation set forth in *clause (i)(A)* above; *provided* that with respect to all newly-converted Non-voting Common Interests, the Aggregate Class A Voting Allocation and Aggregate Class B Voting Allocation shall be adjusted to allocate the Voting Common Interest Percentage represented by the Common Interests that are subject to conversion pursuant to *clause (i)(A)* above proportionally between the Aggregate Class A Voting Allocation and Aggregate Class B Voting Allocation; and

(iii) If the calculations performed pursuant to *clause (ii)* result in any Member owning Common Interests representing an Excess Interest Percentage, the calculations required by Section 11.2(c)(i) of the Amended LLC Agreement shall be repeated until no Member owns Common Interests representing an Excess Interest Percentage.

By way of example, consider a Class B Member that holds 7 of 8 outstanding Class B Common Interests (none of which are Non-voting Common Interests), where the Aggregate Class B Voting Allocation is 25%. Such Class B Member's Voting Common Interest Percentage would be 21.875% (i.e., 7/8 of 25%) and it would, therefore, be an Exceeding Member with an Excess Interest Percentage of 1.875% (i.e., 21.875%—20%).[16] By operation of Section 4.9(c) of the Amended LLC Agreement, the Exceeding Member would be automatically deemed to be a Converting Member and would be subjected to the conversion mechanics of Section 11.2(c)(i) of the Amended LLC Agreement. First, a number of its Common Interests would be converted into Non-voting Common Interests. Pursuant to Section 11.2(c)(i)(A)(2) of the Amended LLC Agreement, this number would be equal to the *product of* (x) 1.875% (the Member's Excess Interest Percentage) *multiplied by* (y) a fraction, (1) the numerator of which would be 8 (the then-outstanding number of ordinary Class B Common Interests) and (2) the denominator of which would be 25% (the Aggregate Class B Voting Allocation), or 0.6 Class B Common Interests. Thus, by operation of Section 11.2(c)(i)(A)(2) of the Amended LLC Agreement, the Member would then hold 6.4 ordinary Class B Common Interests and 0.6 Non-voting Common Interests.

Next, pursuant to Section 11.2(c)(i)(B) of the Amended LLC Agreement, each Member's (including the Converting Member's) Voting Common Interest Percentage would be recalculated to reflect the conversion and the Aggregate Class A Voting Allocation and Aggregate Class B Voting Allocation would be adjusted to allocate the Voting Common Interest Percentage of the converted Common Interests proportionally between the Class A Members and the Class B Members. The Voting Common Interest Percentage represented by 0.6 Class B Common Interests is 1.875%. The proportional reallocation of this 1.875% is effected in the same way the Company would reallocate the Economic Common Interest Percentage of Common Interests that had been redeemed: the Aggregate Class A Voting Allocation is recalculated as 75%/98.125% (i.e., 100%—1.875%) and the Aggregate Class B Voting Allocation is recalculated as 23.125%/98.125% (i.e., 25%—1.875% and 100%—1.875%, respectively). Thus, the new Aggregate Class B Voting Allocation is 23.567%. As a result of this reallocation, the Converting Member's Voting Common Interest Percentage would be recalculated as 6.4 (ordinary Class B Common Interests held by it) divided by 7.4 (ordinary Class B Common Interests outstanding) *multiplied by* 23.567% (the new Aggregate Class B Voting Allocation), or 20.382%. Note that the Converting Member is still an Exceeding Member as a result of the proportional allocation of the Voting Common Interest Percentage represented by the converted Class B Common Interests. As a result, pursuant to Section 11.2(c)(i)(C) of the Amended LLC Agreement, the process described above will need to be repeated, iteratively, in respect of such Converting Member's ''new'' Excess Interest Percentage, until it is no longer an Exceeding Member. Ultimately, a total of 0.75 of such Member's Class B Common Interests will need to be converted into Non-voting Common Interests, resulting in: (1) Such Member holding 6.25 Class B Common Interests and 0.75 Non-voting Common Interests, (2) the Aggregate Class A Voting Allocation increasing to 76.8%, (3) the Aggregate Class B Voting Allocation falling to 23.2%, and (4) such Member's Voting Common Interest Percentage falling to 20%.[17]

Conversion of Non-Voting Common Interests to Common Interests

In certain circumstances (including, for example, where an Exceeding Member holds Non-voting Common Interests while it divests itself of the Common Interests representing its Excess Interest Percentage in accordance with Section 4.9 of the Amended LLC Agreement), a Member's Common Interests that were required to be converted to Non-voting Common Interests may be converted back into ordinary Common Interests upon their transfer to another Member. To effect this reconversion, the Exchange proposes to provide in Section 11.2(c) of the Amended LLC Agreement that, subject to Section 7.5 of the Amended LLC Agreement, in the event of (x) a Transfer by a Converting Member of any Common Interests or (y) a redemption by the Company of any Common Interests owned by a Converting Member:

(i) Simultaneously with such Transfer or redemption, as applicable, (A) all Non-voting Common Interests created by application of Section 11.2(c) of the Amended LLC Agreement (other than those held or transferred by a Restricted Member) shall be converted back into Common Interests (with applicable voting and consent rights as set forth in the Amended LLC Agreement) and shall represent the same Voting Common Interest Percentage they represented prior to their conversion, (B) the Aggregate Class A Voting Allocation and Aggregate Class B Voting Allocation shall be adjusted to reverse the adjustments required by Section 11.2(c)(i) of the Amended LLC Agreement with respect to such converted Common Interests and (C) each Member's (including the Converting Member's) Voting Common Interest Percentage shall be recalculated accordingly; and

(ii) Upon giving effect to such Transfer or redemption, as applicable (including giving effect to *clause (i)* hereof) any Member (including any Transferee or Transferor Member) that is or becomes an Exceeding Member shall be subject to the provisions of Section 4.9 of the Amended LLC Agreement and shall be required to be a Converting Member with respect to the resulting Excess Interest Percentage.

By way of example, consider the Exceeding Member described above (the ''Transferring Member'') desiring to transfer the Common Interests representing its Excess Interest

[16] In the interests of simplicity, for this example, we round up the 19.9% Maximum Percentage to 20%.

[17] Note that as a consequence of the changes to the Aggregate Class A Voting Allocation and Aggregate Class B Voting Allocation, each Member's Voting Common Interest Percentage will also be proportionally increased. If, as a result, such a Member becomes an Exceeding Member, it would also be subjected to the provisions of amended Section 4.9 and, if applicable, proposed Section 11.2(c) of the Amended LLC Agreement.

Percentage. Prior to the application of the conversion mechanics described in Section 11.2(c)(i) of the Amended LLC Agreement, its Excess Interest Percentage was 1.875%.[18] Assume there is only one other Class B Member (the ''Acquiring Member''), holding 1 Class B Common Interest (of the 8 total Interests outstanding). The Acquiring Member's Voting Common Interest Percentage is only 3.125% and it is not at risk of becoming an Exceeding Member. It, therefore, wishes to acquire Common Interests from the Transferring Member representing the entirety of the Transferring Member's Excess Interest Percentage. In the hands of the Acquiring Member, such Common Interests will no longer need to be Non-voting Common Interests, so they will need to be converted back into ordinary Class B Common Interests.

To effect this transfer, pursuant to Section 11.2(c)(ii)(A) of the Amended LLC Agreement, all Non-voting Common Interests that had been previously created by operation of Section 11.2(c)(i) of the Amended LLC Agreement (other than those held or transferred by Restricted Members) will be temporarily converted back to ordinary Common Interests and the conversion described above will be temporarily reversed, so that (1) the Transferring Member will be deemed to hold 7 (and not 6.25) ordinary Class B Common Interests and no Non-voting Common Interests, (2) the Aggregate Class A Voting Allocation will be deemed to be 75% and the Aggregate Class B Voting Allocation will be deemed to be 25%, and (3) the Voting Common Interest Percentages of all other Members will be deemed to have returned to their values prior to the conversion. The Acquiring Member, then, will acquire Class B Common Interests representing a Voting Common Interest Percentage (and an Economic Common Interest Percentage) of 1.875%, or 0.6 Class B Common Interests.

Upon giving effect to this Transfer, (1) the Transferring Member will hold 6.4 (i.e., 7—0.6) Class B Common Interests, representing a Voting Common Interest Percentage (and Economic Common Interest Percentage) of 20% and (2) the Acquiring Member will hold 1.6 (i.e., 1 + 0.6) Class B Common Interests, representing a Voting Common Interest Percentage (and Economic Common Interest Percentage) of 5%.[19] Neither will hold any Non-voting Common Interests and neither will be an Exceeding Member.

Conforming Changes

The Exchange further proposes to amend Sections 3.2(i) and 3.3(e) of the Members Agreement to clarify that (A) any redemption of Class B Common Interests pursuant to Section 3.2(b)(iii) or Section 3.2(c)(ii) of the Members Agreement and (B) any acquisition of Class A Common Interests by Class B Members pursuant to Section 3.3 of the Members Agreement or redemption of Class A Common Interests shall be, in all cases, subject to the mechanics described above and shall result in appropriate adjustments to the Aggregate Class A Economic Allocation, the Aggregate Class B Economic Allocation, Aggregate Class A Voting Allocation, the Aggregate Class B Voting Allocation, and the number of Class A Common Interests and Class B Common Interests, in each case, resulting from such transfer or redemption pursuant to Section 11.2(b) of the Amended LLC Agreement, and resulting adjustments, if any, to each Member's Economic Common Interest Percentage and Voting Common Interest Percentage.

Call Option of NYSE MKT

Section 3.4 of the Members Agreement provides for a ''call option'' that is exercisable by NYSE MKT under certain circumstances. The Exchange proposes to amend Section 3.4 of the Members Agreement to clarify that the call option described therein is granted by the Class B Members rather than the Members (other than NYSE MKT) and gives NYSE MKT the right and the option to require the Class B Members (and any transferee of a Class B Member or transferee of a transferee) collectively to transfer to NYSE MKT any or all of the aggregate Class B Common Interests held by all Class B Members.

Sale and Transfer Periods

The Exchange proposes to amend the definition of ''Sale Period'' in Section 1.1 of the Members Agreement in order to clarify that the period of time during which a Founding Firm may elect to transfer its Common Interests pursuant to Section 3.2 of the Amended Members Agreement is, in all cases, the 21 day period beginning on the first Business Day after the later of (x) the deadline for NYSE Euronext to file its Form 10–K with the SEC and (y) the date NYSE Euronext actually files such Form 10–K. The Exchange also proposes to add the term ''Transfer Period'' in Section 1.1 of the Members Agreement, to mean, with respect to a Sale Period, the period of time starting on the first day of such Sale Period and ending on the earlier of (x) the day immediately preceding the first day of the following Sale Period and (y) with respect to a Member, if applicable, the date on which a transfer by such Member pursuant to Section 3.2 of the Amended Members Agreement is actually consummated. Relatedly, the Exchange proposes to amend Section 3.2 and Schedule 3.2(a) of the Members Agreement to clarify that transfers pursuant to Section 3.2 of the Amended Members Agreement must be consummated during the applicable Transfer Period rather than the applicable Sale Period.

In addition, the Exchange proposes to delete Section 3.2(j) of the Members Agreement related to the determination of the first Sale Period, as that provision is no longer applicable by its terms.

Volume-Based Equity Plan

Volume Dispute Committee

Section 2.4 of the Members Agreement establishes a Volume Dispute Committee empowered to take certain actions related to the Volume-Based Equity Plan. The Volume Dispute Committee is composed of fifteen natural persons, one of whom is appointed by each Founding Firm and the remainder of whom are appointed by NYSE MKT.

Under the Amended Members Agreement, Section 2.4 is clarified to provide that upon the admission to the Company of a new Member that is deemed a Founding Firm pursuant to Section 11.1(c) of the Amended LLC Agreement, the number of representatives on the Volume Dispute Committee shall automatically be increased by two (2), one of whom shall be appointed by such new Member and one of whom shall be appointed by NYSE MKT.

Volume Calculations

The definition of ''Industry Volume'' in the Members Agreement provides a mechanism for determining the aggregate industry-wide volume in certain products for purposes of determining a Founding Firm's Individual Target. Section 2.3 of the Members Agreement provides a mechanism for the determination of whether a Founding Firm has achieved its Individual Target.

The Exchange proposes to amend the definition of ''Industry Volume'' to specify that Industry Volume shall include one-tenth of the volume in certain mini-options contracts that may be listed on the Exchange pursuant to NYSE MKT Rule 903. The Exchange also proposes to amend Section 2.3 of

[18] In the interests of simplicity, for this example, we again round up the 19.9% Maximum Percentage to 20%.

[19] Because the transfer is between Class B Members, no aggregate allocations would need to be adjusted.

the Members Agreement to provide that for purposes of determining whether a Founding Firm has achieved its Individual Target, a Founding Firm will receive one-tenth of a credit for each transaction in any such mini-options contract.

Fair Market Value

The Exchange proposes to amend various provisions of the LLC Agreement and the Members Agreement to provide greater specificity with respect to the determination of fair market value. In addition, the Exchange proposes to amend certain provisions of the Members Agreement to remove references to provisions that are no longer applicable by their terms. Specifically, the Exchange proposes to amend:

- Section 4.9(c) of the LLC Agreement to provide that, in connection with a transfer of Common Interests representing an Excess Interest Percentage, the fair market value of such Common Interests will be determined as the *product of* (x) the fair market value of the Company, determined as of the date such Member is determined to be an Exceeding Member, *multiplied by* (y) the Excess Interest Percentage represented by such Common Interests;
- Section 11.5(b) of the LLC Agreement to provide that, in connection with certain redemptions of a Member's Common Interests, the fair market value of the redeemed Common Interests will be determined as the *product of* (x) the fair market value of the Company, determined as of the end of the calendar month immediately preceding the date the Company determines to redeem such Common Interests, *multiplied by* (y) the Economic Common Interest Percentage represented by such Common Interests;
- Section 11.5(c) of the LLC Agreement to provide that, in connection with certain redemptions of a Member's Common Interests, the fair market value of the redeemed Common Interests will be determined as the *product of* (x) the fair market value of the Company, determined as of the date the Company determines to redeem such Common Interests, *multiplied by* (y) the Economic Common Interest Percentage represented by such Common Interests;
- Section 11.5(g) of the LLC Agreement to provide that, in connection with a transfer of Class B Common Interests to NYSE MKT pursuant to Section 11.5(g) of the LLC Agreement, the fair market value of such transferred Class B Common Interests will be determined as the *product of* (x) the fair market value of the Company, determined as of the end of the calendar month immediately preceding the date NYSE MKT determines to exercise its right to require a Founding Firm to transfer its Class B Common Interests to NYSE MKT *multiplied by* (y) the Economic Common Interest Percentage represented by such Class B Common Interests;
- the definition of ''EBITDA'' in Section 1.1 of the Members Agreement to remove provisions regarding the calculation of fair market value that are no longer applicable;
- Section 2.1(i) of the Members Agreement (proposed to be renumbered as Section 2.1(h) in the Amended Members Agreement) to provide that, in connection with the redemption of a Founding Firm's Class B Common Interests pursuant to Section 2.1(i) of the Members Agreement, fair market value of the Company will be determined as of the final day of the calendar month immediately preceding the relevant quarterly determination date; and
- Section 3.4 of the Members Agreement to provide that, in connection with NYSE MKT's call option, fair market value of the Company will be determined as of the final day of the calendar month immediately preceding the exercise by NYSE MKT of its call option.

Typographical and Other Technical Corrections

The Exchange proposes to amend various provisions of the LLC Agreement and the Members Agreement in order to make certain typographical corrections. Specifically, the Exchange proposes to:

- Replace the term ''and'' with ''or'' in the definition of ''Initial Member'' in Section 1.1 of the LLC Agreement;
- Replace the term ''hold(s)'' with ''own(s)'' in Sections 1.1 and 11.8 of the LLC Agreement;
- Replace the term ''held'' with ''owned'' in Sections 8.1, 10.1, 11.3, 11.4 and 11.8 of the LLC Agreement;
- Replace the term ''holding'' with ''owning'' in Sections 1.1, 9.1 and 13.2 of the LLC Agreement;
- Replace the term ''holder(s)'' with ''owner(s)'' in Sections 6.1, 9.1, 11.3 and 12.2 of the LLC Agreement;
- Delete the phrase ''or hold'' in Section 9.5 of the LLC Agreement;
- Replace the term ''Shares'' with ''Common Interests or Preferred Interests'' in Sections 1.1 and 11.1 of the LLC Agreement;
- Replace the term ''subsection'' with ''clause'' in Section 11.8 of the LLC Agreement;
- Delete the term ''ownership'' in describing certain regulatory thresholds in Section 11.8 of the LLC Agreement;
- Replace the term ''for'' with the phrase ''with respect to'' in the definition of ''EBITDA'' in Section 1.1 of the Members Agreement; and
- Add the terms ''Agreement'', ''Company'' and ''NYSE Euronext'' to Section 1.1 of the Members Agreement.

Redactions to the Members Agreement

Certain provisions in the Members Agreement have been redacted in order to preserve the confidentiality of commercially sensitive information. The redacted provisions are limited to (i) numerical dollar amounts and percentage thresholds, (ii) commercially sensitive terms and provisions related to the calculation of ''fair market value'' and (iii) certain competitive information. In connection with the revisions described herein, the Exchange proposes to amend certain of the redacted provisions in the Members Agreement related to the calculation of fair market value.

2. Statutory Basis

The Proposed Rule Change is consistent with Section 6(b) [20] of the Act,[21] in general, and, in particular, furthers the objectives of Sections 6(b)(1) [22], 6(b)(5) [23] and 6(b)(8) [24] of the Act.

The Proposed Rule Change is consistent with, and furthers the objectives of, Section 6(b)(1) of the Act because it enforces compliance by its members and persons associated with its members, with the provisions of the Act, the rules and regulations promulgated thereunder and the rules of the Exchange. It is also consistent with, and furthers the objectives of, Section 6(b)(5) of the Act in that it preserves all of NYSE MKT's existing rules and mechanisms to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in facilitating transactions in securities, to remove impediments to and perfect the mechanisms of a free and open market and a national market system and, in general, to protect investors and the public interest. The Proposed Rule Change does not modify, in any material respect, any of the provisions of the LLC Agreement or Members Agreement, that the SEC has found to be consistent with

[20] 15 U.S.C. 78f(b).
[21] 15 U.S.C. 78.
[22] 15 U.S.C. 78f(b)(1).
[23] 15 U.S.C. 78f(b)(5).
[24] 15 U.S.C. 78f(b)(8).

Section 6(b) of the Act. Finally, the Proposed Rule Change is consistent with Section 6(b)(8) of the Act because it will not impose any burden on competition, as discussed in Section 4 below.

The Proposed Rule Change does not modify the Options Exchange's trading or compliance rules and preserves the existing mechanisms for ensuring the Exchange's compliance with the Act, the rules and regulations promulgated thereunder and the rules of the Exchange. Furthermore, the proposed amendments to the provisions of the LLC Agreement related to ownership limitations in the Proposed Rule Change clarify the mechanisms by which Members may maintain compliance with applicable laws and regulations, enabling and ensuring continued compliance with such laws and regulations by both the Exchange and its Members. Finally, the proposed amendments do not change the structure of the joint venture which retains NYSE MKT's regulatory control over the Options Exchange or the provisions specifically designed to ensure the independence of its self-regulatory function and to ensure that any regulatory determinations by NYSE MKT, as the self-regulatory organization for the Options Exchange, are controlling with respect to the actions and decisions of the Options Exchange.

Additionally, the Amended LLC Agreement continues to require the Company, its Members and its directors to comply with the federal securities laws and the rules and regulations promulgated thereunder and to engage in conduct that fosters and does not interfere with the Exchange's or the Company's ability to carry out its respective responsibilities under the Act.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the Proposed Rule Change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The Proposed Rule Change does not substantively change the LLC Agreement and Members Agreement, and instead provides clarifications to address certain ambiguities in those documents. Furthermore, the proposed amendments to the provisions of the LLC Agreement related to ownership limitations in the Proposed Rule Change clarify the mechanisms by which Members may maintain compliance with applicable laws and regulations, including the Commission's policies with respect to permissible equity ownership limitations, enabling and ensuring continued compliance with applicable equity ownership limits by Members of the Exchange. In addition, the Proposed Rule Change does not affect the availability or pricing of any goods or services and, as a result, will not affect competition either between the Exchange and others that provide the same goods and services as the Exchange or among market participants.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve or disapprove the proposed rule change, or

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number SR–NYSEMKT–2014–08 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–NYSEMKT–2014–08. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available. All submissions should refer to File Number SR-NYSEMKT–2014–08 and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[25]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01969 Filed 1–30–14; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71405; File No. SR–Topaz–2014–05]

Self-Regulatory Organizations; Topaz Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Regarding System Protections

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that, on January 17, 2014, the Topaz Exchange, LLC (d/b/a ISE Gemini) (the ''Exchange'' or ''Topaz'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which items

[25] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to specify in its rules certain system protections contained in the trading system.

The text of the proposed rule change is available on the Exchange's Internet Web site at *http://www.ise.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposal is to specify in the Exchange's rules certain existing trading system protections that prevent the entry and/or execution of orders in certain circumstances. These protections are in addition to the system protection currently described in Rule 714 that prevents orders from being automatically executed at prices that are inferior to a protected bid or offer on another exchange (''trade through protection'') pursuant to the requirements of the Intermarket Linkage Plan (the ''Plan'') and rules adopted by the Exchange to implement the Plan (the ''Linkage Rules'').[3]

Specifically, Topaz Rule 714 provides that incoming orders will not be automatically executed at prices that are inferior to the national best bid or offer (''NBBO''). Thus, the language currently contained in Rule 714 reflects how the trading system assures compliance with the prohibition on trading through the NBBO contained in Topaz Rule 1901. Rule 714 also indicates that the prohibition on trade-throughs does not apply with respect to non-firm quotations as provided in Topaz Rule 1900(k). The Exchange proposes to make several non-substantive changes to the text and format of Topaz Rule 714 with respect to these linkage-related provisions for clarity,[4] and to add a reference to intermarket sweep orders (''ISOs''). Pursuant to Topaz Rule 1901, ISOs are eligible to be executed at a price that is inferior to the NBBO. For clarity, the Exchange believes it is appropriate to specify in Rule 714 that the system does not prevent the automatic execution of an ISO at a price that is inferior to the NBBO.

The Exchange also is proposing to amend Rule 714 to add additional circumstances in which the trading system does not provide automatic executions as follows:

- *Price Level Protection.* There is a limit on the number of price levels at which an incoming order to sell (buy) will be executed automatically when there are no bids (offers) from other exchanges at any price for the options series. In such a circumstance, incoming orders are automatically executed at each successive price level until the maximum number of price levels is reached,[5] and any balance is either handled by the primary market maker (''PMM'') (in the case of Priority Customer Orders)[6] or canceled (in the case of Professional Orders).[7] The number of price levels, which may be between 1 and 10, is determined by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to three price levels.[8]
- *Limit Order Price Protection.* There is a limit on the amount by which incoming limit orders to buy may be priced above the Exchange's best offer and by which incoming limit orders to sell may be priced below the Exchange's best bid. Limit orders that exceed the pricing limit are rejected upon entry. The limit is established by the Exchange from time-to-time, on a class-by-class basis, as the greater of: (i) an absolute amount not to exceed $2.00, or (ii) a percentage of the Exchange's best bid/offer not to exceed 10 percent.[9] The Exchange currently has these limits set to $1.00 and 1 percent respectively.[10]
- *Size Limitation.* There is a limit on the number of contracts an incoming order may specify. Orders or quotes that exceed the maximum number of contracts are rejected upon entry.[11] The maximum number of contracts, which shall not be less than 10,000, is established by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to 999,999 contracts.[12]

The Exchange further proposes that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the order protections are triggered as necessary and appropriate.

When the PMM handles Priority Customer orders that are not automatically executed or canceled pursuant to the price level protection described above, they must do so pursuant to their obligations under Topaz Rule 803 and consistent with Rule 400 (Just and Equitable Principles

[3] Linkage Rules of the International Securities Exchange, LLC (''ISE'') are incorporated by reference into the Topaz rulebook. The ISE Linkage Rules are provided in Chapter 19 of the ISE rulebook.

[4] The current text of Rule 714 references non-firm quotations on the Exchange. This language preceded the adoption of the Linkage Rules and is no longer applicable. Accordingly, the Exchange proposes to delete this language.

[5] For example, assume the parameter is set to three tick levels, the best bid on Topaz in an options series that is traded in penny increments is $1.50, and there are no bids in the series from any other exchanges. If a Priority Customer market order to sell is received, the system will not automatically execute the incoming order at a price below $1.48. Therefore, such an order will execute the full size available at $1.50, $1.49 and $1.48, and any unexecuted balance will be handled by the PMM. In this respect, the PMM has the obligation under existing Exchange rules to engage in dealings for his own account when, among other things, there is a temporary disparity between the supply of and demand for a particular options contract, and to act with due diligence in handling orders. *See infra,* notes 13 and 14 and accompanying text.

[6] Pursuant to Topaz Rule 100(a)(37A) and (37B), a Priority Customer Order is an order for the account of a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s).

[7] Pursuant to Topaz Rule 100(a)(37C), a Professional Order is an order that is for the account of a person or entity that is not a Priority Customer.

[8] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the price level limit to allow members the opportunity to perform any system changes. Any change to the price level limit would be subject to consultations with members.

[9] For example, if the Topaz best bid is $3.00 and the limits are set to the greater of $1.00 or 1% (which equals $0.03 in this example), a limit order to sell that is entered with a limit price below $2.00 will be rejected.

[10] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the limit order price check to allow members the opportunity to perform any system changes. Any change to the limit order price check would be subject to consultations with members.

[11] For example, if the limit is set to 800,000 contracts, an order with a size of 800,001 or greater would be rejected by the system.

[12] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the size limit to allow members the opportunity to perform any system changes. Any change to the size limit would be subject to consultations with members.

of Trade). Rule 803 states, among other things, that market makers have a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class.[13] The Rule also specifies that a PMM must act with due diligence in handling orders and must accord priority to such orders over the PMM's principal orders.[14] In addition to these existing provisions, the Exchange proposes to specify in Rule 803(c) that PMMs are required to address orders they handle as soon as practical by either (i) executing all or a portion of the orders at a price that at least matches the NBBO and that improves upon the Exchange's best bid (in the case of a sell order) or the Exchange's best offer (in the case of a buy order); [15] or (ii) releasing all or a portion of the order for execution against bids and offers on the Exchange.

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the ''Act'') [16] in general, and furthers the objectives of Section 6(b)(5) of the Act [17] in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The system protections described above were implemented in the interest of protecting investors and to assure fair and orderly markets on the Exchange.

Specifically, the Exchange operates an electronic marketplace in which orders are processed and executed in less than one second. Without any safeguards, orders that outsize the liquidity available at the displayed best bid or offer on the Exchange could potentially trade at prices far below the best bid and far above the best offer, creating extreme volatility in the marketplace and poor executions for investors. The primary safeguard in the national market system that protects against such occurrences is the prohibition against trading through protected bids and offers on other options exchanges, as this links the liquidity available across markets and in most circumstances, provides a stop-gap on each individual exchange. However, not all products are multiply traded, and even in multiply-traded options series, it is possible that Topaz could be the only exchange disseminating a protected bid and/or offer in a particular options series at any given sub-second during the trading day.

Accordingly, the Exchange designed its system to provide the price level protection described above when there are no other protected bids and offers in the national market system. The Exchange believes that limiting the number of price levels at which an incoming order will execute in these circumstances appropriately balances the interests of investors seeking execution of their orders and the Exchange's obligations to provide a fair and orderly market. While Professional Orders are canceled in these circumstances, the Exchange seeks to provide a higher level of service for Priority Customer orders by having them handled by the PMM, which has an affirmative obligation to provide liquidity and price continuity. This procedure also provides an opportunity for liquidity to refresh in the market, further providing better execution potential for Priority Customer orders. The Exchange believes that providing this service for Priority Customer orders is appropriate and consistent with feedback from members that enter Priority Customer orders on the Exchange, who prefer that Priority Customer orders not be canceled in this circumstance.

Similarly, the Exchange's experience and member feedback indicates that the current limit of three price levels has worked well to balance the interests of investors receiving execution of their orders while protecting them from being executed at unreasonable prices. Nevertheless, the Exchange believes it is appropriate to maintain some flexibility to adjust the number of price level so that it can continually evaluate market conditions and investor needs. In this respect, under the proposal, the Exchange has the flexibility to adjust the number of price levels up to ten. The Exchange believes this limit is sufficient to give it the ability to make appropriate adjustments as necessary and appropriate to maintain fair and orderly markets.

The Exchange also represents that the proposal merely clarifies the existing PMM obligations by specifying that the PMM must address orders it handles by either providing an execution or releasing orders for execution against bids and offers on the Exchange. The proposal further specifies that the price at which a PMM may execute an order must be at least equal to the NBBO and improve upon the best bid (offer) on the Exchange.[18] While this was not previously stated explicitly in the Rules for this specific circumstance, the Exchange has always applied the obligations contained in Topaz Rule 803(b) and Supplementary Material .01 thereto, as well as Rule 400 and Rule 713, consistent with the additional proposed language and has enforced compliance accordingly.[19] Moreover, the Exchange believes the specified order handling provisions are appropriate to assure compliance with all applicable Exchange Rules with respect to the handling of orders by the PMM.[20]

The limit order price protection and size limitation for regular orders were designed to reject orders upon entry that were likely submitted in error. Limit orders that are entered with prices that cross the market by a large amount are likely to have been entered in the wrong options series, on the wrong side of the market, or with an erroneous price (*e.g.,* a bid of $15 rather than $1.50). Similarly, orders entered with an unreasonably large size (*e.g.,* 1 million contracts or more) are likely to have been entered in error. The Exchange believes that it is in the interest of fair and orderly markets and the protection of investors to reject these orders upon entry, and thereby prevent erroneous transactions from occurring.

The Exchange further believes that the Exchange's experience and member feedback indicates that the current limits of $1.00 and 1 percent for the limit order price protection, and 999,999 contracts for the size limitation, has worked well to provide the protection of rejecting orders that have been entered in error while assuring that valid orders are not rejected. In this

[13] Rule 803(b).

[14] Rule 803, Supplementary Material .01. The Exchange currently conducts surveillance of PMMs to assure that orders are handled timely, that such orders are executed at appropriate prices, and that such orders are afforded priority over the PMM's principal orders. This surveillance includes all orders handled by the PMM regardless of whether they are handling them via operation of the NBBO trade through protection and price level protection.

[15] A PMM cannot provide an execution at the same price as the Exchange's best bid or offer (as applicable) because that would allow the PMM to by-pass the execution priority rules contained in Rule 713. The Exchange conducts surveillance to detect instances when the PMM executes an order it is handling at the same price as the Topaz best bid or offer (as applicable). It is not a violation for the PMM to execute an order at the same price as the Topaz best bid or offer when the PMM is the only market participant at that price.

[16] 15 U.S.C. 78f(b).

[17] 15 U.S.C. 78f(b)(5).

[18] *See supra,* note 15.

[19] *See supra,* notes 14 and 15.

[20] *Id.*

respect, the Exchange notes that orders below the established limits may well have been entered in error, but that it is highly unlikely that orders entered above the current limits were not entered in error. The Exchange believes it is appropriate to maintain some flexibility to adjust the limits so that it can continually evaluate the extent to which such limits could be reduced to prevent the entry of additional erroneous orders without rejecting legitimate orders. In this respect, under the proposal, the Exchange has specified that the limit order price protection limits shall not exceed $2.00 and 10 percent respectively. The Exchange believes that these limits provide sufficient flexibility for the Exchange to make appropriate adjustments in the interest of maintaining fair and orderly markets. The Exchange also notes that it has specified that the order size limitation shall not be less than 10,000 contracts. The Exchange notes in this respect that a block-size options order is defined as an order of at least 50 contracts,[21] and that an order of 500 contracts is considered a very large institutional-size order (a block-size order in the equities market is an order of at least 10,000 shares).[22] Accordingly, the Exchange believes that it would not be unreasonable to set a size limit as low as 10,000 contracts should the Exchange determine that it was necessary to maintain fair and orderly markets and to protect investors from executing orders entered with an erroneously large size.

Finally, the Exchange notes that it will give members at least a two week notice prior to changing the level at which the system protections are triggered to allow members to perform any system changes, and that the Exchange provides these protections for the benefit of, and in consultation with, its members. Notwithstanding, the Exchange also recognizes that the applicable protections may not be appropriate in unusual market conditions. In this respect, the Exchange has included in the proposal a provision providing that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the system protections are triggered that are beyond those specified in the rule. The Exchange believes this is consistent with its obligation to assure a fair and orderly market, and that the need for such flexibility is recognized in other Exchange rules, such as those related to position limits, quote-width differentials and market maker risk parameters.[23] In the event that the Exchange temporarily revises the levels at which the protections are triggered, it will immediately notify all members.

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change specifies circumstances in which the trading system does not provide an automatic execution in the interest of protecting investors against the execution of erroneous orders or the execution of orders at erroneous prices. As such, the proposal does not impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The Exchange believes that the foregoing proposed rule change may take effect upon filing with the Commission pursuant to Section19(b)(3)(A)[24] of the Act and Rule 19b–4(f)(6) thereunder[25] because the foregoing proposed rule change does not (i) significantly affect the protection of investors or the public interest, (ii) impose any significant burden on competition, and (iii) become operative for 30 days after its filing date, or such shorter time as the Commission may designate.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is: (i) necessary or appropriate in the public interest; (ii) for the protection of investors; or (iii) otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov*. Please include File Number SR–Topaz–2014–05 on the subject line.

Paper Comments

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

All submissions should refer to File Number *SR-Topaz-2014–05*. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-Topaz-2014–05 and should be submitted on or before February 21, 2014.

[21] Rule 716(a).

[22] *See, e.g.,* Rule 716(e) (providing that the minimum size of an order entered into the Solicited Order Mechanism is 500 contracts); and Rule 715(j) (providing that a qualified Contingent Cross Order must be for at least 1,000 contracts).

[23] *See* Rule 412 (regarding position limits), Rule 803 (regarding maximum quotation spreads) and Rule 804 (regarding market maker risk parameters).

[24] 15 U.S.C. 78s(b)(3)(A).

[25] 17 CFR 240.19b–4(f)(6).

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[26]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01965 Filed 1–30–14; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71406; File No. SR–ISE–2014–05]

Self-Regulatory Organizations; International Securities Exchange, LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Regarding System Protections

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that, on January 17, 2014, the International Securities Exchange, LLC (the ''Exchange'' or the ''ISE'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend its rules to specify in its rules certain system protections contained in the trading system. The text of the proposed rule change is available on the Exchange's Web site *www.ise.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B and C below, of the most significant aspects of such statements.

[26] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposal is to specify in the Exchange's rules certain existing trading system protections that prevent the entry and/or execution of orders in certain circumstances. These protections are in addition to the system protection currently described in Rule 714 that prevents orders from being automatically executed at prices that are inferior to a protected bid or offer on another exchange (''trade through protection'') pursuant to the requirements of the Intermarket Linkage Plan (the ''Plan'') and ISE Rules adopted to implement the Plan (the ''Linkage Rules'').[3]

Specifically, ISE Rule 714 provides that incoming orders will not be automatically executed at prices that are inferior to the national best bid or offer (''NBBO''). Thus, the language currently contained in Rule 714 reflects how the trading system assures compliance with the prohibition on trading through the NBBO contained in ISE Rule 1901. Rule 714 also indicates that the prohibition on trade-throughs does not apply with respect to non-firm quotations as provided in ISE Rule 1900(k). The Exchange proposes to make several non-substantive changes to the text and format of ISE Rule 714 with respect to these linkage-related provisions for clarity,[4] and to add a reference to intermarket sweep orders (''ISOs''). Pursuant to ISE Rule 1901, ISOs are eligible to be executed at a price that is inferior to the NBBO. For clarity, the Exchange believes it is appropriate to specify in Rule 714 that the system does not prevent the automatic execution of an ISO at a price that is inferior to the NBBO.

The Exchange also is proposing to amend Rule 714 to add additional circumstances in which the trading system does not provide automatic executions as follows:

• *Price Level Protection.* There is a limit on the number of price levels at which an incoming order to sell (buy) will be executed automatically when there are no bids (offers) from other exchanges at any price for the options series. In such a circumstance, incoming orders are automatically executed at each successive price level until the maximum number of price levels is reached,[5] and any balance is either handled by the primary market maker (''PMM'') (in the case of Priority Customer Orders)[6] or canceled (in the case of Professional Orders).[7] The number of price levels, which may be between 1 and 10, is determined by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to three price levels.[8]

• *Limit Order Price Protection.* There is a limit on the amount by which incoming limit orders to buy may be priced above the Exchange's best offer and by which incoming limit orders to sell may be priced below the Exchange's best bid. Limit orders that exceed the pricing limit are rejected upon entry. The limit is established by the Exchange from time-to-time, on a class-by-class basis, as the greater of: (i) An absolute amount not to exceed $2.00, or (ii) a percentage of the Exchange's best bid/offer not to exceed 10 percent.[9] The Exchange currently has these limits set to $1.00 and 1 percent respectively.[10]

• *Size Limitation.* There is a limit on the number of contracts an incoming order may specify. Orders or quotes that exceed the maximum number of

[3] ISE Rules 1900 through 1902 (Linkage Rules).

[4] The current text of ISE Rule 714 references non-firm quotations on the Exchange. This language preceded the adoption of the Linkage Rules and is no longer applicable. Accordingly, the Exchange proposes to delete this language.

[5] For example, assume the parameter is set to three tick levels, the best bid on the ISE in an options series that is traded in penny increments is $1.50, and there are no bids in the series from any other exchanges. If a Priority Customer market order to sell is received, the system will not automatically execute the incoming order at a price below $1.48. Therefore, such an order will execute the full size available at $1.50, $1.49 and $1.48, and any unexecuted balance will be handled by the PMM. In this respect, the PMM has the obligation under existing Exchange rules to engage in dealings for his own account when, among other things, there is a temporary disparity between the supply of and demand for a particular options contract, and to act with due diligence in handling orders. *See infra,* notes 13 and 14 and accompanying text.

[6] Pursuant to ISE Rule 100(a)(37A) and (37B), a Priority Customer Order is an order for the account of a person or entity that (i) is not a broker or dealer in securities, and (ii) does not place more than 390 orders in listed options per day on average during a calendar month for its own beneficial account(s).

[7] Pursuant to ISE Rule 100(a)(37C), a Professional Order is an order that is for the account of a person or entity that is not a Priority Customer.

[8] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the price level limit to allow members the opportunity to perform any system changes. Any change to the price level limit would be subject to consultations with members.

[9] For example, if the ISE best bid is $3.00 and the limits are set to the greater of $1.00 or 1% (which equals $0.03 in this example), a limit order to sell that is entered with a limit price below $2.00 will be rejected.

[10] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the limit order price check to allow members the opportunity to perform any system changes. Any change to the limit order price check would be subject to consultations with members.

contracts are rejected upon entry.[11] The maximum number of contracts, which shall not be less than 10,000, is established by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to 999,999 contracts.[12]

The Exchange further proposes that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the order protections are triggered as necessary and appropriate.

When the PMM handles Priority Customer orders that are not automatically executed or canceled pursuant to the price level protection described above, they must do so pursuant to their obligations under ISE Rule 803 and consistent with Rule 400 (Just and Equitable Principles of Trade). Rule 803 states, among other things, that market makers have a continuous obligation to engage, to a reasonable degree under the existing circumstances, in dealings for his own account when there exists, or it is reasonably anticipated that there will exist, a lack of price continuity, a temporary disparity between the supply of and demand for a particular options contract, or a temporary distortion of the price relationships between options contracts of the same class.[13] The Rule also specifies that a PMM must act with due diligence in handling orders and must accord priority to such orders over the PMM's principal orders.[14] In addition to these existing provisions, the Exchange proposes to specify in Rule 803(c) that PMMs are required to address orders they handle as soon as practical by either (i) executing all or a portion of the orders at a price that at least matches the NBBO and that improves upon the Exchange's best bid (in the case of a sell order) or the Exchange's best offer (in the case of a buy order);[15] or (ii) releasing all or a portion of the order for execution against bids and offers on the Exchange.

The Exchange also proposes to specify in Rule 722 (Complex Orders) the following pricing limits for complex orders and quotes:

- *Trade-through limit:* Rule 722 permits the legs of a complex order to be executed at prices that are inferior to the prices available on other exchanges trading the same options series.[16] Notwithstanding, the system will not permit the legs of a complex order to trade through the best bids and offers from other exchanges by more than a configurable amount calculated as the lessor of: (i) An absolute amount not to exceed $0.10; and (ii) a percentage of the NBBO not to exceed 500 percent, as determined by the Exchange on a class or series basis. Effectively, the limit currently is an absolute amount of $0.05,[17] as the parameters are set to $0.05 and 500 percent respectively.[18] A member can also include an instruction on a complex order entered on the complex order book that the legs of the order are to be executed only at prices that are equal to or better than the national best bid or offer for the options series and any stock component.[19]
- *Minimum net price:* The system will reject any complex order strategy where all legs are to buy if it is entered at a price that is less than the minimum price, which is calculated as the sum of the ratio times $0.01 per leg.[20]
- *Vertical spread price:* The system will reject a vertical spread order (*i.e.,* an order to buy a call (put) option and to sell another call (put) option in the same security with the same expiration but a higher (lower) strike price) when entered with a net price of less than zero, and will prevent the execution of a vertical spread order at a price that is less than zero when entered as a market order to sell.[21]
- *Complex Limit Order Price Protection:* There is a limit on the amount by which the net price of an incoming complex limit order to buy may exceed the net price available from the individual options series on the Exchange and by which the net price of an incoming complex limit order to sell may be below the net price available from the individual options series on the Exchange.[22] Limit orders that exceed the pricing limit are rejected. The limit is established by the Exchange from

[11] For example, if the limit is set to 800,000 contracts, an order with a size of 800,001 or greater would be rejected by the system.

[12] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the size limit to allow members the opportunity to perform any system changes. Any change to the size limit would be subject to consultations with members.

[13] Rule 803(b).

[14] Rule 803, Supplementary Material .01. The Exchange currently conducts surveillance of PMMs to assure that orders are handled timely, that such orders are executed at appropriate prices, and that such orders are afforded priority over the PMM's principal orders. This surveillance includes all orders handled by the PMM regardless of whether they are handling them via operation of the NBBO trade through protection or price level protection.

[15] A PMM cannot provide an execution at the same price as the Exchange's best bid or offer (as applicable) because that would allow the PMM to by-pass the execution priority rules contained in Rule 713. The Exchange conducts surveillance to detect instances when the PMM executes an order it is handling at the same price as the ISE best bid or offer (as applicable). It is not a violation for the PMM to execute an order at the same price as the ISE best bid or offer when the PMM is the only market participant at that price.

[16] ISE Rule 722(b)(3). Under ISE Rule 722, the legs of a complex order may not be executed at worse prices than are available on the Exchange for the individual series, but may be executed at the same price as bids and offers on the Exchange for the individual series so long as there are no Priority Customer orders on the Exchange at those prices (provided however that for complex order with multiple options legs, if one of the options legs improves upon the best price available on the Exchange then the other leg is permitted to trade at the same price as a Priority Customer).

[17] Since the lowest possible price is $0.01, and 500% of $0.01 equals $0.05, the lessor of the two limits will always equal $0.05 under the current settings (*e.g.,* if the price were $0.02, it would be the lessor of $0.05 or $0.10, which is $0.05).

[18] For example, assume that the national best offer for series A is $1.00 (ISE offer $1.15) and the national best offer for series B is $0.95 (ISE offer $1.10). Under ISE Rule 722, away market prices are not considered, and the highest net price at which a complex order to buy series A and to buy series B could be executed would be $2.25 ($1.15 + $1.10) (assuming there are no Priority Customer orders at the ISE best offer for series A or series B). However, when the trade through limit is applied, the highest price at which series A could be executed is $1.05 ($1.00 + $0.05) and the highest price at which series B could be executed would be $1.00 ($0.95 + $0.05). As a result, the maximum net price that a complex order to buy series A and to buy series B can be executed is $2.05 ($1.05 + $1.00). The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the trade-through limit for complex orders to allow members the opportunity to perform any system changes. Any change to the trade-through limit for complex orders would be subject to consultations with members.

[19] For example, assume that the national best offer for series A is $1.00 (ISE offer $1.15) and the national best offer for series B is $0.95 (ISE offer $1.10). If a complex order to buy series A and to buy series B contains an instruction not to trade through the NBBO, the highest price at which series A could be executed is $1.00 and the highest price at which series B could be executed would be $0.95. As a result, the maximum net price at which the complex order can be executed is $1.95 ($1.00 + $0.95). It is anticipated that this functionality will be available early next year. The Exchange will notify members via an exchange circular prior to implementing this optional functionality.

[20] For example, an order to buy 2 calls and buy 1 put would have a minimum price of $0.03. If such an option were entered at a price of $0.02, it would not be executable, as a price of zero would have to be assigned to one of the legs of the order.

[21] For example, a market order to sell a complex strategy *buy a Dec 50 call and Sell a Dec 55 call* will not leg into the market if the best bid for the December 50 call is less than the offer for the Dec 55 call, as the seller would be paying to execute the sell transaction: the investor who sells a Dec 50 call @ $1.00 and buys a Dec 55 call @ $1.20, would pay $0.20 to sell the strategy. The vertical spread price check does not apply to complex orders executed in the Facilitation Mechanism, Solicited Order Mechanism and Price Improvement Mechanism. Complex orders executed in these mechanisms are two-sided orders where the contra-side order is willing to trade with the agency order at an agreed upon price thus removing the risk that the order was executed erroneously or at an erroneous price.

[22] For example, assume the ISE best offer for series A is $2.00 and the ISE best offer for series B is $0.50, and that the limits are set to the greater of $1.00 or 1%. A complex limit order to buy series A and buy series B that is entered with a net limit price above $3.50 will be rejected (*i.e.,* $2.00 for series A + $0.50 for series B = net price of $2.50; $2.50 + $1.00 = $3.50).

time-to-time, on a class-by-class basis, as the greater of: (i) An absolute amount not to exceed $2.00, or (ii) a percentage of the Exchange's best bid/offer not to exceed 10%. The Exchange currently has these limits set to $1.00 and 1 percent respectively.[23] This limit order price protection applies only to orders and does not apply to quotes.

• *Complex Order Size Limitation:* There is a limit on the number of contracts (and shares in the case of a stock-option order) any single leg of an incoming complex order may specify. Orders that exceed the maximum number of contracts (or shares as applicable) are rejected.[24] The maximum number of contracts (or shares), which shall not be less than 10,000 contracts (or 100,000 shares), is established by the Exchange from time-to-time on a class-by-class basis. Currently, this limit is set to the maximum value of 999,999 contracts and 9,999,999 shares.[25]

2. Statutory Basis

The Exchange believes that its proposal is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the ''Act'')[26] in general, and furthers the objectives of Section 6(b)(5) of the Act[27] in particular, in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism for a free and open market and a national market system, and, in general, to protect investors and the public interest. The system protections described above were implemented in the interest of protecting investors and to assure fair and orderly markets on the Exchange.

Specifically, the Exchange operates an electronic marketplace in which orders are processed and executed in less than one second. Without any safeguards, orders that outsize the liquidity available at the displayed best bid or offer on the Exchange could potentially trade at prices far below the best bid and far above the best offer, creating extreme volatility in the marketplace and poor executions for investors. The primary safeguard in the national market system that protects against such occurrences is the prohibition against trading through protected bids and offers on other options exchanges, as this links the liquidity available across markets and in most circumstances, provides a stop-gap on each individual exchange. However, not all products are multiply traded, and even in multiply-traded options series, it is possible that ISE could be the only exchange disseminating a protected bid and/or offer in a particular options series at any given sub-second during the trading day.

Accordingly, the Exchange designed its system to provide the price level protection described above when there are no other protected bids and offers in the national market system. The Exchange believes that limiting the number of price levels at which an incoming order will execute in these circumstances appropriately balances the interests of investors seeking execution of their orders and the Exchange's obligations to provide a fair and orderly market. While Professional Orders are canceled in these circumstances, the Exchange seeks to provide a higher level of service for Priority Customer orders by having them handled by the PMM, which has an affirmative obligation to provide liquidity and price continuity. This procedure also provides an opportunity for liquidity to refresh in the market, further providing better execution potential for Priority Customer orders. The Exchange believes that providing this service for Priority Customer orders is appropriate and consistent with feedback from members that enter Priority Customer orders on the Exchange, who prefer that Priority Customer orders not be canceled in this circumstance.

Similarly, the Exchange's experience and member feedback indicates that the current limit of three price levels has worked well to balance the interests of investors receiving execution of their orders while protecting them from being executed at unreasonable prices. Nevertheless, the Exchange believes it is appropriate to maintain some flexibility to adjust the number of price level so that it can continually evaluate market conditions and investor needs. In this respect, under the proposal, the Exchange has the flexibility to adjust the number of price levels up to ten. The Exchange believes this limit is sufficient to give it the ability to make appropriate adjustments as necessary and appropriate to maintain fair and orderly markets.

The Exchange also represents that the proposal merely clarifies the existing PMM obligations by specifying that the PMM must address orders it handles by either providing an execution or releasing orders for execution against bids and offers on the Exchange. The proposal further specifies that the price at which a PMM may execute an order must be at least equal to the NBBO and improve upon the best bid (offer) on the Exchange.[28] While this was not previously stated explicitly in the Rules for this specific circumstance, the Exchange has always applied the obligations contained in ISE Rule 803(b) and Supplementary Material .01 thereto, as well as Rule 400 and Rule 713, consistent with the additional proposed language and has enforced compliance accordingly.[29] Moreover, the Exchange believes the specified order handling provisions are appropriate to assure compliance with all applicable Exchange Rules with respect to the handling of orders by the PMM.[30]

With respect to the trade through limit for complex orders, the Exchange believes it is consistent with the protection of investors to limit the amount by which the legs of a complex order are allowed to trade through the NBBO for the series. Pursuant to ISE Rule 722(b), the legs of a complex order are not permitted to trade at prices that are inferior to the ISE best bid or offer.[31] It is possible, however, that the ISE best bid and/or offer are not at or near the NBBO for the options series.[32] Investors understand that there is a benefit to executing certain trading strategies using complex orders, which assures that all parts of the strategy are executed and if applicable, at a specified net price. They also understand that the benefit of using a complex order may come at a ''cost'' because complex orders may be executed at prices that are inferior to the net price that might have been achieved if the individual legs of the complex order were executed at the NBBO.[33] However, the Exchange believes it is necessary to protect investors from executing complex orders when such ''cost'' becomes

[23] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the complex limit order price check to allow members the opportunity to perform any system changes. Any change to the complex limit order price check would be subject to consultations with members.

[24] For example, if the limit is set to 800,000 contracts, a complex order with a size of 800,001 or greater for any single options leg would be rejected by the system.

[25] The Exchange will provide at least a two week notice to members via an exchange circular prior to changing the complex order size limit to allow members the opportunity to perform any system changes. Any change to the complex order size limit would be subject to consultations with members.

[26] 15 U.S.C. 78f(b).

[27] 15 U.S.C. 78f(b)(5).

[28] *See supra,* note 15.

[29] *See supra,* notes 14 and 15.

[30] *Id.*

[31] *See supra,* note 16.

[32] See example *supra,* note 18 (demonstrating that a net price of $2.25 would be unreasonable given that the national best offers for series A and series B indicate a net price closer to $1.95 ($1.00 + $0.95)).

[33] Executing strategies through separate, non-contingent transactions, carries the risk that an investor will not be able to execute all of the components at the desired prices and/or sizes.

economically irrational. Indeed, such pricing discrepancies indicate that there likely is an error, such as the wrong symbol, series or price was entered on the order.

The Exchange believes that providing the trade-through limit protection to complex orders is appropriate and consistent with feedback from members that enter complex orders on the Exchange, who prefer that their complex orders not be executed in this circumstance. In this respect, the Exchange's experience and member feedback indicates that the current limit of $0.05 is appropriate to balance the interests of investors receiving execution of their complex orders while protecting them from being executed at unreasonable prices.[34] Nevertheless, the Exchange believes it is appropriate to maintain some flexibility to adjust the amount by which a complex order may trade through the NBBO, so that it can continually evaluate market conditions and investor needs. In this respect, under the proposal, the Exchange has the flexibility to adjust the absolute value up to $0.10 and the percentage up to 500 percent.[35] The Exchange believes this will be sufficient to give it the ability to make appropriate adjustments should market conditions so require.

As discussed, the complex order trade-through limit is designed to prevent investors from erroneously executing complex orders at unreasonable prices while not unreasonably restricting the ability for investors to price complex orders. In some instances, however, investors may prefer that the Exchange further restrict the execution of complex orders by not allowing them to trade through the NBBO at all. Accordingly, the Exchange proposes to offer the optional ability for investors to instruct the Exchange not to execute the legs of a complex orders through the NBBO for the individual series. While the Exchange does not believe it would be appropriate to impose such a restriction on all investors, it believes that offering this optional limitation on complex orders is reasonable and appropriate for investors that prefer only to execute complex orders at net prices that equal or better the NBBO for the component series.

The limit order price protection and size limitation for both regular and complex orders were designed to reject orders upon entry that were likely submitted in error. Limit orders that are entered with prices that cross the market by a large amount are likely to have been entered in the wrong options series, on the wrong side of the market, or with an erroneous price (*e.g.,* a bid of $15 rather than $1.50). Similarly, orders entered with an unreasonably large size (*e.g.,* 1 million contracts or more) are likely to have been entered in error. The Exchange believes that it is in the interest of fair and orderly markets and the protection of investors to reject these orders upon entry, and thereby prevent erroneous transactions from occurring.

The Exchange further believes that the Exchange's experience and member feedback indicates that the current limits of $1.00 and 1 percent for the limit order price protection, and 999,999 contracts (and 9,999,999 shares in the case of a stock-option order) for the size limitation, has worked well to provide the protection of rejecting orders that have been entered in error while assuring that valid orders are not rejected. In this respect, the Exchange notes that orders below the established limits may well have been entered in error, but that it is highly unlikely that orders entered above the current limits were not entered in error. The Exchange believes it is appropriate to maintain some flexibility to adjust the limits so that it can continually evaluate the extent to which such limits could be reduced to prevent the entry of additional erroneous orders without rejecting legitimate orders. In this respect, under the proposal, the Exchange has specified that the limit order price protection limits shall not exceed $2.00 and 10 percent respectively. The Exchange believes that these limits provide sufficient flexibility for the Exchange to make appropriate adjustments in the interest of maintaining fair and orderly markets. The Exchange also notes that it has specified that the order size limitation shall not be less than 10,000 contracts (and 100,000 shares in the case of a stock-option order). The Exchange notes in this respect that a block-size options order is defined as an order of at least 50 contracts,[36] and that an order of 500 contracts is considered a very large institutional-size order (a block-size order in the equities market is an order of at least 10,000 shares).[37] Accordingly, the Exchange believes that it would not be unreasonable to set a size limit as low as 10,000 contracts (and 100,000 shares in the case of a stock-option order) should the Exchange determine that it was necessary to maintain fair and orderly markets and to protect investors from executing orders entered with an erroneously large size.

As discussed above, a complex order strategy where all legs are to buy will be rejected if it is entered at a price that is less than the minimum price. The Exchange believes it is reasonable to reject such orders upon entry as they are not executable.[38] Allowing such orders to be entered would create investor confusion; as such orders would not receive an execution and would remain pending until canceled. Similarly, the Exchange believes that rejecting vertical spread orders that are entered at a negative price protects investors from executing orders that were entered in error, and that preventing the execution of single-sided vertical spread orders at negative prices when they are entered as a sell market order, protects investors from paying to sell a strategy when they expected to receive payment for selling the strategy. These restrictions help the Exchange to maintain a fair and orderly market, and provide a valuable service to investors.

Finally, the Exchange notes that it will give members at least a two week notice prior to changing the level at which the system protections are triggered to allow members to perform any system changes, and that the Exchange provides these protections for the benefit of, and in consultation with, its members. Notwithstanding, the Exchange also recognizes that the applicable protections may not be appropriate in unusual market conditions. In this respect, the Exchange has included in the proposal a provision providing that, in the event of unusual market conditions and in the interest of a fair and orderly market, the Exchange may temporarily establish the levels at which the system protections are triggered that are beyond those specified in the rule. The Exchange believes this is consistent with its obligation to assure a fair and orderly market, and that the need for such flexibility is recognized in other Exchange rules, such as those related to position limits, quote-width differentials and market maker risk parameters.[39] In the event that the Exchange temporarily revises the levels at which the protections are triggered, it will immediately notify all members.

[34] *See supra,* note 18 and accompanying text.

[35] *Id.*

[36] ISE Rule 716(a).

[37] *See, e.g.,* ISE Rule 716(e) (providing that the minimum size of an order entered into the Solicited Order Mechanism is 500 contracts); and ISE Rule 715(j) (providing that a qualified Contingent Cross Order must be for at least 1,000 contracts).

[38] *See supra,* note 20.

[39] *See* ISE Rule 412 (regarding position limits), ISE Rule 803 (regarding maximum quotation spreads), ISE Rule 804 (regarding market maker risk parameters) and ISE Rule 722 (regarding market maker risk parameters for complex orders).

B. Self-Regulatory Organization's Statement on Burden on Competition

The proposed rule change specifies circumstances in which the trading system does not provide an automatic execution in the interest of protecting investors against the execution of erroneous orders or the execution of orders at erroneous prices. As such, the proposal does not impose any burden on competition.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not significantly affect the protection of investors or the public interest, does not impose any significant burden on competition, and, by its terms, does not become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) [40] of the Act and Rule 19b–4(f)(6) [41] thereunder. The Exchange provided the Commission with written notice of its intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing the proposed rule change.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number SR–ISE–2014–05 on the subject line.

Paper Comments

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

All submissions should refer to File Number *SR–ISE–2014–05.* This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–ISE–2014–05 and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[42]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01966 Filed 1–30–14; 8:45 am]

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[40] 15 U.S.C. 78s(b)(3)(A).

[41] 17 C.F.R. 240.19b–4(f)(6).

[42] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71409; File No. SR–NYSEArca–2014–06]

Self-Regulatory Organizations; NYSE Arca, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Increase Its Options Regulatory Fee

January 27, 2014.

Pursuant to Section 19(b)(1) [1] of the Securities Exchange Act of 1934 (the ''Act'') [2] and Rule 19b–4 thereunder,[3] notice is hereby given that, on January 22, 2014, NYSE Arca, Inc. (the ''Exchange'' or ''NYSE Arca'') filed with the Securities and Exchange Commission (the ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange proposes to increase its Options Regulatory Fee. The Exchange proposes to implement this change on February 3, 2014. The text of the proposed rule change is available on the Exchange's Web site at *www.nyse.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

[1] 15 U.S.C.78s(b)(1).

[2] 15 U.S.C. 78a.

[3] 17 CFR 240.19b–4.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to increase its Options Regulatory Fee (''ORF''), effective February 3, 2014.

Background

The ORF, which is currently $0.005 per contract, is assessed by the Exchange on each OTP Holder or OTP Firm for all options transactions executed or cleared by the OTP Holder or OTP Firm that are cleared by The Options Clearing Corporations (''OCC'') in the customer range, i.e., transactions that clear in the customer account of the OTP Holder's or OTP Firm's clearing firm at OCC, regardless of the marketplace of execution.[4] In other words, the Exchange imposes the ORF on all customer-range transactions executed by an OTP Holder or OTP Firm even if the transactions do not take place on the Exchange. In the case where an OTP Holder or OTP Firm executes a transaction and a different OTP Holder or OTP Firm clears the transaction, the ORF would be assessed to the OTP Holder or OTP Firm that executes the transaction. In the case where a non-OTP Holder or non-OTP Firm executes a transaction and an OTP Holder or OTP Firm clears the transaction, the ORF would be assessed to the OTP Holder or OTP Firm that clears the transaction.

The dues and fees paid by OTP Holders or OTP Firms go into the general funds of the Exchange, a portion of which is used to help pay the costs of regulation. In particular, the ORF is designed to recover a material portion of the costs to the Exchange of the supervision and regulation of OTP Holders or OTP Firms, including performing routine surveillances and investigations, as well as policy, rulemaking, interpretive, and enforcement activities. The Exchange monitors the amount of revenue collected from the ORF to ensure that this revenue, in combination with other regulatory fees and fines, does not exceed regulatory costs. The ORF is collected indirectly from OTP Holders or OTP Firms through their clearing firms by OCC on behalf of the Exchange.

Proposed Change

The Exchange proposes to increase the ORF from $0.005 per contract to $0.0055 per contract in order to recoup increased regulatory expenses while also ensuring that the ORF will not exceed such expenses. Transaction volumes across the industry have increased moderately since the ORF was last changed in December 2012, but the Exchange's regulatory expenses have increased at a faster rate. The Exchange believes that revenue generated from the proposed ORF, when combined with all of the Exchange's other regulatory fees, will cover a material portion but not all of the Exchange's regulatory costs. The Exchange will continue to monitor the amount of revenue collected from the ORF to ensure that it, in combination with its other regulatory fees and fines, does not exceed regulatory costs. If the Exchange determines that regulatory revenues exceed regulatory costs, the Exchange will adjust the ORF by submitting a fee filing change to the Commission.[5] The Exchange proposes to implement this fee change on February 3, 2014.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the ''Act''),[6] in general, and furthers the objectives of Section 6(b)(4) and (5) of the Act,[7] in particular, because it provides for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities and does not unfairly discriminate between customers, issuers, brokers, or dealers.

The Exchange believes that the proposed fee change is reasonable because the Exchange's revenue from the collection of the ORF has not kept pace with Exchange's regulatory expenses. As described above, the ORF seeks to recover the costs of supervising and regulating members, including performing routine surveillances and investigations, as well as policy, rulemaking, interpretive and enforcement activities. The proposed ORF increase will help to offset these regulatory expenses, but would not result in total regulatory revenue exceeding total regulatory costs. The Exchange further notes that another options exchange has raised its options regulatory fee to $0.0095 per contract and thus the Exchange's ORF of $0.0055 per contract will still be below that level.[8]

The Exchange believes that the proposed ORF increase is equitable and not unfairly discriminatory because it is objectively allocated to all OTP Holders or OTP Firms on all of their transactions that clear in the customer range at OCC. Moreover, the Exchange believes the ORF ensures fairness by assessing higher fees to those member firms that require more Exchange regulatory services based on the amount of customer options business they conduct. Regulating customer trading activity is more labor intensive and requires greater expenditure of human and technical resources than regulating non-customer trading activity. Surveillance and regulation of non-customer trading activity generally tends to be more automated and less labor intensive. As a result, the costs associated with administering the customer component of the Exchange's overall regulatory program are anticipated to be higher than the costs associated with administering the non-customer component of its regulatory program. As such, the Exchange proposes assessing higher fees to those firms that will require more Exchange regulatory services based on the amount of customer options business they conduct.[9]

The Exchange believes that the ORF will continue to be equitable and not unfairly discriminatory because the fee increase is objectively allocated to all OTP Holders or OTP Firms. As noted above, the Exchange will continue to monitor the amount of revenue collected from the ORF to ensure that it, in combination with its other regulatory fees and fines, does not exceed regulatory costs. If the Exchange determines that regulatory revenues exceed regulatory costs, the Exchange will adjust the ORF by submitting a fee filing change to the Commission.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance

[4] *See* Securities Exchange Act Release No. 34–68174 (November 7, 2012), 77 FR 67845 (November 14, 2012) (SR–NYSEArca–2012–118).

[5] The Exchange notes that its regulatory responsibilities with respect to member compliance with options sales practice rules have been allocated to FINRA under an SEC Rule 17d–2 agreement; the ORF is not designed to cover the cost of options sales practice regulation. *See* Securities Exchange Act Release No. 64399 (May 4, 2011), 76 FR 27114 (May 10, 2011) (SR–NYSEArca-2011–20).

[6] 15 U.S.C. 78f(b).

[7] 15 U.S.C. 78f(b)(4) and (5).

[8] *See* Securities Exchange Act Release No. 34–71007 (December 6, 2013), 78 FR 75653 (December 12, 2013) (SR–CBOE–2013–117).

[9] The ORF is not charged for orders that clear in categories other than the customer range (e.g., market maker orders) because members incur the costs of owning memberships and through their memberships are charged transaction fees, dues and other fees that go into the general funds of the Exchange, a portion of which is used to help pay the costs of regulation. *See supra* note 4.

of the purposes of the Act. The proposed fee change is not designed to address any competitive issues. Rather, the proposed change is designed to help the Exchange adequately fund its regulatory activities while seeking to ensure that total regulatory revenues do not exceed total regulatory costs.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change is effective upon filing pursuant to Section 19(b)(3)(A) [10] of the Act and subparagraph (f)(2) of Rule 19b–4 [11] thereunder, because it establishes a due, fee, or other charge imposed by the Exchange.

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings under Section 19(b)(2)(B) [12] of the Act to determine whether the proposed rule change should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number SR–NYSEArca–2014–06 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–NYSEArca–2014–06. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–NYSEArca–2014–06, and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[13]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01968 Filed 1–30–14; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71403; File No. SR–CME–2014–03]

Self-Regulatory Organizations; Chicago Mercantile Exchange Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Amend the Fee Schedule Applicable to its OTC Credit Default Swap Clearing Offering

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'' or ''Exchange Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 17, 2014, Chicago Mercantile Exchange Inc. (''CME'' or the ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change described in Items I, II and III below, which Items have been prepared primarily by CME. CME filed the proposal pursuant to Section 19(b)(3)(A) of the Act,[3] and Rule 19b–4(f)(2) [4] thereunder so that the proposal was effective upon filing with the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CME is proposing to amend the fee schedule that currently applies to its OTC Credit Default Swap index clearing offering. The text of the proposed rule change is available on the Exchange's Web site at *http://www.cmegroup.com*, at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, CME included statements concerning the purpose and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. CME has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

CME is registered as a derivatives clearing organization with the Commodity Futures Trading Commission and currently offers clearing services for many different futures and swaps products. With this filing, CME proposes to make certain amendments to the current fee schedule that applies to CDX North American Index Credit Default Swaps cleared at CME. The proposed modifications would extend the current twenty-five percent (25%) discount off of base clearing fees for all market participants

[10] 15 U.S.C. 78s(b)(3)(A).

[11] 17 CFR 240.19b–4(f)(2).

[12] 15 U.S.C. 78s(b)(2)(B).

[13] 17 CFR 200.30–3(a)(12).

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] 15 U.S.C. 78s(b)(3)(A).

[4] 17 CFR 240.19b–4(f)(2).

that clear OTC North American Index CDS products at CME. The proposed changes also make one additional adjustment to the pricing in the current ''Fee Schedule B'' by amending a base fee from $2.90 to $2.00.

The changes that are described in this filing are limited to fee changes for OTC CDS index products. The proposed changes therefore will become effective immediately. It should also be noted that these proposed fee changes are limited to CME's business as a derivatives clearing organization clearing products under the exclusive jurisdiction of the Commodity Futures Trading Commission (''CFTC'') and do not materially impact CME's security-based swap clearing business in any way. CME has also certified the proposed rule changes that are the subject of this filing to the Commodity Futures Trading Commission (''CFTC'') in CFTC Submission 14–010.

CME believes the proposed rule changes are consistent with the requirements of the Exchange Act including Section 17A of the Exchange Act.[5] More specifically, the proposed rule changes establish or change a member due, fee or other charge imposed by CME under Section 19(b)(3)(A)(ii)[6] of the Securities Exchange Act of 1934 and Rule 19b–4(f)(2)[7] thereunder. CME believes that the proposed fee change is consistent with the requirements of the Securities Exchange Act of 1934 and the rules and regulations thereunder and, in particular, to 17A(b)(3)(D)[8], because the proposed fee changes apply equally to all market participants clearing covered products and therefore the proposed changes provide for the equitable allocation of reasonable dues, fees and other charges among participants. CME also notes that it operates in a highly competitive market in which market participants can readily direct business to competing venues. As such, the proposed changes are appropriately filed pursuant to Section 19(b)(3)(A)[9] of the Act and paragraph (f)(2) of Rule 19b–4 thereunder.

B. Self-Regulatory Organization's Statement on Burden on Competition

CME does not believe that the proposed rule change will have any impact, or impose any burden, on competition. The proposed modifications have the effect of extending current CDS index swap clearing pricing. These products are swaps under the exclusive jurisdiction of the CFTC, and, as such, these proposed changes do not affect the security-based swap clearing activities of CME in any way and therefore do not impose any burden on competition that is inappropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

CME has not solicited, and does not intend to solicit, comments regarding this proposed rule change. CME has not received any unsolicited written comments from interested parties.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A)[10] of the Act and paragraph (f)(2) of Rule 19b–4 thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.[11]

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*), or
- Send an email to *rule-comments@sec.gov.* Please include File No. SR–CME–2014–03 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–CME–2014–03. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours or 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of CME and on CME's Web site at *http://www.cmegroup.com/market-regulation/rule-filings.html.*

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–CME–2014–03 and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[12]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01963 Filed 1–30–14; 8:45 am]

BILLING CODE 8011–01–P

[5] 15 U.S.C. 78q–1.

[6] 15 U.S.C. 78s(b)(3)(A)(ii).

[7] 17 CFR 240.19b–4(f)(2).

[8] 15 U.S.C. 78q–1(b)(3)(D).

[9] 15 U.S.C. 78s(b)(3)(A).

[10] 15 U.S.C. 78s(b)(3)(A).

[11] 15 U.S.C. 78s(b)(3)(C).

[12] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71400; File No. SR–CHX–2014–02]

Self-Regulatory Organizations; Chicago Stock Exchange, Inc.; Notice of Filing and Immediate Effectiveness of Proposed Rule Change To Offer Risk Management Tools Designed To Allow Participants To Monitor and Address Exposure to Risk

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act'')[1] and Rule 19b–4[2] thereunder, notice is hereby given that on January 17, 2014, the Chicago Stock Exchange, Inc. (''CHX'' or the ''Exchange'') filed

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

CHX proposes to offer risk management tools designed to allow Participants to monitor and address exposure to risk. The Exchange has designated this proposal as non-controversial and provided the Commission with the notice required by Rule 19b–4(f)(6)(iii) under the Act.[3] The text of this proposed rule change is available on the Exchange's Web site at (www.chx.com) and in the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the CHX included statements concerning the purpose of and basis for the proposed rule changes and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The CHX has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory

Basis for, the Proposed Rule Change

1. Purpose

In order to assist Participants' efforts to manage their risk level, the Exchange proposes to offer risk management tools designed to allow Participants to monitor and address exposure to risk.

On October 2, 2012, the Commission conducted a roundtable entitled ''Technology and Trading: Promoting Stability in Today's Markets'' (the ''Roundtable'').[4] While a number of issues were discussed at the Roundtable, a large amount of time was devoted to discussing ''kill-switches,'' a mechanism that would deactivate trading when certain thresholds were met. Panelists and commentators on the Roundtable's topics generally supported a kill-switch mechanism that would permit market centers to terminate a firm's trading activity if such activity was posing a threat to market integrity. But there was concern that firms would ''be reluctant to systematically cut themselves off from the market'' [5] and therefore, any kill-switch-triggering threshold would be set by the firm at a conservative level such that the automated disconnect would not occur when actually needed. At the same time though, the ability to detect unusual behavior would be invaluable to a firm in assessing whether an error was causing an unwanted buildup in risk.

To address the concerns raised during the Roundtable, the Exchange proposes to offer optional risk management tools for its Participants that would facilitate, among other things, blocking of a Participant's orders if certain thresholds were met. As proposed, the risk management tools seek to balance the conflicting viewpoints raised during the Roundtable by providing risk monitoring services that grant discretion to the Participant to define pre-set risk thresholds. The tools are designed to act as backstop for Participants' risk controls by providing them with the ability to take action to more effectively manage their risk levels with respect to orders at the Exchange.

The risk management tools will provide Participants with the ability to segment activity into risk groups and to monitor exposure in real time as trades execute. Participants may also take certain actions in response to an unwanted buildup in risk levels, such as bulk blocking or bulk cancelling orders by risk group. Additionally, Participants may define risk limits that may be adjusted intraday and elect to have the Exchange take action based on these pre-set limits, such as sending alerts as exposure limits are approached and breached or automatically blocking orders upon a breach. The tools are meant to be supplemental, acting as a backstop for a Participant's internal monitoring and procedures related to risk management. The Exchange does not guarantee that the tools will be sufficiently comprehensive to meet all of a Participant's needs, and the tools are not designed to be the sole means of risk control. Moreover, the use of the Exchange's risk management tools will not automatically constitute compliance with Exchange or federal rules.

As noted above, the proposed risk management tools will be optional for Participants. The Exchange will not provide preferential treatment to Participants using Exchange-offered risk management tools and will not charge a fee for use of the risk management tools. Should the Exchange determine to charge a fee for use of the risk management tools, such fee will be proposed through a subsequent rule filing.

The Exchange will be phasing in its risk management tools as the technology supporting the functionality is being implemented and will announce by Regulatory Notice when specific risk management tools will be available. The Exchange intends to make available the ability to segment activity into risk groups, define risk limits, and enter bulk block and bulk cancel messages during the first roll out.[6] Additional functionality, such as allowing Participants to elect to have the Exchange take automated action based on pre-set limits, will be phased in over subsequent months.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the requirements of Section 6(b) of the Act,[7] in general, and Section 6(b)(5) of the Act,[8] in particular, in that it is designed to foster cooperation and coordination with persons facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest and not to permit unfair discrimination between customers, issuers, brokers, or dealers.

The Exchange believes that the proposed rule change will foster cooperation and coordination with persons facilitating transactions in securities because the Exchange will provide alerts to Participants when their trading reaches certain thresholds. As such, the Exchange will help Participants monitor their risk levels and provide tools for the firms to take action. Additionally, the Exchange believes that the proposed rule change will remove impediments to and perfect the mechanism of a free and open market and a national market system because the tools will provide Participants with the ability to self-manage their levels of risk while providing an alert system that will help to ensure that Participants are aware of

[3] 17 CFR 240.19b–4(f)(6)(iii).

[4] *See* Securities Exchange Act Release No. 67802 (Sept. 7, 2012), 77 FR 56697 (Sept. 13, 2012) (File No. 4–652). A webcast of the Roundtable is available at *www.sec.gov/news/otherwebcasts/2012/ttr100212.shtml.*

[5] *See* Transcript of Roundtable, Sections 0151–0152 (October 2, 2012) (remarks of Lou Steinberg, TD Ameritrade).

[6] The Exchange expects the first rollout to begin the first quarter of 2014.

[7] 15 U.S.C. 78f(b).

[8] 15 U.S.C. 78f(b)(5).

developing issues. As such, the Exchange believes that the tools will provide a means to address potentially market-impacting events, helping to ensure the proper functioning of the market.

Further, the Exchange believes that the proposed rule change is designed to protect investors and the public interest because the tools are a form of impact mitigation that will aid Participants in minimizing their risk exposure and reduce the potential for disruptive, market-wide events. The Exchange understands that firms test their trading systems in order to identify and mitigate latent defects. The proposed tools will serve as a back stop for Participants to assist them in identifying any such issues. The Exchange believes the risk management tools will assist Participants in managing their financial exposure which, in turn, could enhance the integrity of trading on the securities markets and help to assure the stability of the financial system.

Finally, the Exchange believes that the proposed rule change does not unfairly discriminate among the Exchange's Participants because use of the risk management tools is optional and is not a prerequisite for participation on the Exchange.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. In fact, the Exchange believes that the proposal will have a positive effect on competition because, by providing Participants with additional means to monitor and control risk, the proposal will increase confidence in the proper functioning of the markets. The Exchange believes the risk management tools will assist Participants in managing their financial exposure which, in turn, could enhance the integrity of trading on the securities markets and help to assure the stability of the financial system. As a result, the level of competition should increase as public confidence in the markets is solidified.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were either solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not: (i) Significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days after the date of the filing, or such shorter time as the Commission may designate, it has become effective pursuant to 19(b)(3)(A) of the Act [9] and Rule 19b–4(f)(6) [10] thereunder.

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml);* or
- Send an email to rule-comments@sec.gov. *Please include File Number SR–CHX–2014–02 on the subject line.*

Paper Comments

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

All submissions should refer to File Number SR–CHX–2014–02. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–CHX–2014–02 and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[11]

Kevin M. O'Neill,

Deputy Secretary.

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[9] 15 U.S.C. 78s(b)(3)(A).

[10] 17 CFR 240.19b–4(f)(6). In addition, Rule 19b–4(f)(6) requires a self-regulatory organization to give the Commission written notice of its intent to file the proposed rule change at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

[11] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71401; File No. XZSR–C2–2014–001]

Self-Regulatory Organizations; C2 Options Exchange, Incorporated; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend the Bylaws of its Parent Company

January 27, 2014.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (the ''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on January 17, 2014, C2 Options Exchange, Incorporated (the ''Exchange'' or ''C2'') filed with the Securities and Exchange Commission (the ''Commission'') the proposed rule change as described in Items I and II below, which Items have been prepared by the Exchange. The Commission is publishing this notice to

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Exchange proposes to amend the Bylaws of its parent company, CBOE Holdings, Inc. (''CBOE Holdings''). The text of the proposed rule change is available on the Exchange's Web site (*http://www.cboe.com/AboutCBOE/CBOELegalRegulatoryHome.aspx*), at the Exchange's Office of the Secretary, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange is proposing to make certain amendments to the Bylaws (the ''Bylaws'') of its parent company, CBOE Holdings, Inc. (''CBOE Holdings'') to make improvements in its governance. Currently, CBOE Holdings' Bylaws provide that ''when a quorum is present at any meeting, a plurality of the votes properly cast for the election of directors shall be sufficient to elect directors.'' This applies to both contested and uncontested elections. The Exchange proposes to change the manner in which uncontested elections occur. Specifically, the Exchange is proposing to move from a plurality voting standard to a majority voting standard for uncontested elections where ''each nominee for director shall be elected to the Board of Directors if a majority of the votes properly cast are in favor of such nominee's election (i.e., if the number of votes properly cast ''for'' a nominee's election exceeds the number of votes properly cast ''against'' that nominee's election); *provided, however,* that, if, as of the last date by which stockholders of the Corporation may submit notice to nominate a person for election as a director pursuant to *Section 2.11* of these Bylaws or pursuant to any rule or regulation of the Securities and Exchange Commission, the number of nominees for director exceeds the number of directors to be elected at any such meeting (a ''Contested Election''), a plurality of the votes properly cast for the election of directors shall be sufficient to elect directors.'' As such, there will be no change to the voting process for contested elections.

Under the majority voting standard that will apply to uncontested elections, a nominee who fails to receive the requisite vote would not be duly elected to the Board; however, because a director holds office until his or her successor is duly elected and qualified, any incumbent director-nominee who fails to receive the requisite vote does not automatically cease to be a director. Instead, such director continues as a ''holdover director'' until such director's death, resignation or removal, or until his or her successor is duly elected and qualified. For this reason, the majority voting standard under consideration requires that any incumbent nominee, as a condition to his or her nomination for election, must submit in writing an irrevocable resignation, the effectiveness of which is conditioned upon the director's failure to receive a majority of the votes properly cast in favor of such nominee's election and the Board's acceptance of the resignation.[3] The Exchange is proposing to amend the language in *Section 3.4* of the Bylaws to delete the statement that a resignation, unless specifically contingent upon its acceptance, will be effective as of its date or of the date specified therein, and replace that language with the statement that a resignation ''will be effective when delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events.'' This would allow Directors to submit resignations that are contingent upon both the Director not receiving majority vote in an uncontested election and the Board accepting such resignation (or some other event that could lead to the Director no longer intending to act as a Director at some point in the future due to the occurrence of some future event). After a director's failure to receive the majority of properly cast votes, CBOE Holdings' Nominating & Governance Committee then considers the resignation offer and recommends to the CBOE Holdings Board of Directors regarding whether to accept it. Within 90 days after the certification of the election results, the Board of Directors will decide whether to accept or reject the resignation. Promptly thereafter, the Board will announce its decision by means of a press release.

Additionally, the Exchange is proposing some non-substantive changes to *Section 3.2* of the Bylaws for added clarity. For example, the term ''Board'' is being replaced with ''Board of Directors'' in two places to add clarity. Also, the phrase ''Directors will serve one-year terms ending on the annual meeting following the meeting at which such directors were elected or at such time as their successors are elected or appointed and qualified. . .'' is being replaced with ''Directors shall be elected annually and shall hold office until the next annual meeting and until such time as their successors are elected or appointed and qualified'' to avoid confusion regarding the term length and to clarify until when elected directors hold office. This change will clarify that terms are not necessarily for one year, but until the next annual meeting (which may not be exactly one year from the date of the previous meeting), and that there may be holdover directors until their successors are elected or appointed and qualified (except in the event of earlier death, resignation or removal).

As CBOE Holdings is listed on the NASDAQ Stock Market, these proposed changes are not inconsistent with the NASDAQ listing rules.

2. Statutory Basis

The Exchange believes the proposed rule change is consistent with the Act and the rules and regulations thereunder applicable to the Exchange and, in particular, the requirements of Section 6(b) of the Act.[4] Specifically, the Exchange believes the proposed rule change is consistent with the Section 6(b)(5)[5] requirements that the rules of an exchange be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest. Additionally, the Exchange believes the

[3] Pursuant to the ''Board Election Process'' section of CBOE Holdings' Corporate Governance Guidelines (available at *http://ir.cboe.com/documentdisplay.cfm?DocumentID=7090).*

[4] 15 U.S.C. 78f(b).

[5] 15 U.S.C. 78f(b)(5).

proposed rule change is consistent with the Section 6(b)(5)[6] requirement that the rules of an exchange not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers.

In particular, for purposes of an uncontested election, the proposed amendments adopt a majority vote standard for director elections for the Exchange's parent company, which would enable its directors to be elected in a manner that the Board of Directors believes is reflective of the desires of shareholders and provide a mechanism to protect against the election of directors by less than the majority vote of the shareholders.

The proposed rule change to amend CBOE Holdings' Bylaws to adopt a majority vote standard for uncontested elections is consistent with the Act because the proposed change is designed to allow the members of the Board of Directors to be elected in a manner that the Board of Directors believes closely reflects the desires of its shareholders (as well as a manner in which uncontested Board of Director elections are conducted for the majority of large public companies in the United States), while also providing a process for addressing the circumstance when a director fails to receive a majority of the votes in an uncontested election. The plurality standard would continue to apply in contested elections.

The proposed non-substantive changes to the Bylaws are intended to enhance clarity and prevent confusion, thereby removing impediments to and perfecting the mechanism of a free and open market and a national market system, and, in general, protecting investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed change does not impact either intermarket or intramarket competition, but instead is intended to enhance the governance of the Exchange's parent company.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange neither solicited nor received comments on the proposed rule change.

[6] *Id.*

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The Exchange has filed the proposed rule change pursuant to Section 19(b)(3)(A)(iii) of the Act[7] and Rule 19b–4(f)(6) thereunder.[8] Because the foregoing proposed rule change does not: (1) Significantly affect the protection of investors or the public interest; (2) impose any significant burden on competition; and (3) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective

pursuant to Section 19(b)(3)(A) of the Act[9] and Rule 19b–4(f)(6)[10] thereunder. At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission will institute proceedings to determine whether the proposed rule change should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml);* or
- Send an email to *rule-comments@sec.gov. Please include File Number* SR-C2-2014-0001 *on the subject line.*

Paper comments

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

All submissions should refer to File Number SR–C2–2014–001. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml).* Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–C2–2014-*001* and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[11]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01961 Filed 1–30–14; 8:45 am]

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[7] 15 U.S.C. 78s(b)(3)(A)(iii).

[8] 17 CFR 240.19b–4(f)(6).

[9] 15 U.S.C. 78s(b)(3)(A).

[10] 17 CFR 240.19b–4(f)(6). In addition, Rule 19b–4(f)(6)(iii) requires the Exchange to give the Commission written notice of the Exchange's intent to file the proposed rule change, along with a brief description and text of the proposed rule change, at least five business days prior to the date of filing of the proposed rule change, or such shorter time as designated by the Commission. The Exchange has satisfied this requirement.

[11] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–71410; File No. SR–NYSEMKT–2014–09]

Self-Regulatory Organizations; NYSE MKT LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Increase Its Options Regulatory Fee

January 27, 2014.

Pursuant to Section 19(b)(1)[1] of the Securities Exchange Act of 1934 (the ''Act'')[2] and Rule 19b–4 thereunder,[3] notice is hereby given that, on January 22, 2014, NYSE MKT LLC (the ''Exchange'' or ''NYSE MKT'') filed with the Securities and Exchange

[1] 15 U.S.C.78s(b)(1).

[2] 15 U.S.C. 78a.

[3] 17 CFR 240.19b–4.

Commission (the ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of the Substance of the Proposed Rule Change

The Exchange proposes to increase its Options Regulatory Fee. The Exchange proposes to implement this change on February 3, 2014. The text of the proposed rule change is available on the Exchange's Web site at *www.nyse.com,* at the principal office of the Exchange, and at the Commission's Public Reference Room.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of those statements may be examined at the places specified in Item IV below. The Exchange has prepared summaries, set forth in sections A, B, and C below, of the most significant parts of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The Exchange proposes to increase its Options Regulatory Fee (''ORF''), effective February 3, 2014.

Background

The ORF, which is currently $0.005 per contract, is assessed by the Exchange on each ATP Holder for all options transactions executed or cleared by the ATP Holder that are cleared by The Options Clearing Corporations (''OCC'') in the customer range, i.e., transactions that clear in the customer account of the ATP Holder's clearing firm at OCC, regardless of the marketplace of execution.[4] In other words, the Exchange imposes the ORF on all customer-range transactions executed by an ATP Holder even if the transactions do not take place on the Exchange. In the case where an ATP Holder executes a transaction and a different ATP Holder clears the transaction, the ORF would be assessed to the ATP Holder that executes the transaction. In the case where a non-ATP Holder executes a transaction and an ATP Holder clears the transaction, the ORF would be assessed to the ATP Holder that clears the transaction.

The dues and fees paid by ATP Holders go into the general funds of the Exchange, a portion of which is used to help pay the costs of regulation. In particular, the ORF is designed to recover a material portion of the costs to the Exchange of the supervision and regulation of ATP Holders, including performing routine surveillances and investigations, as well as policy, rulemaking, interpretive, and enforcement activities. The Exchange monitors the amount of revenue collected from the ORF to ensure that this revenue, in combination with other regulatory fees and fines, does not exceed regulatory costs. The ORF is collected indirectly from ATP Holders through their clearing firms by OCC on behalf of the Exchange.

Proposed Change

The Exchange proposes to increase the ORF from $0.005 per contract to $0.0055 per contract in order to recoup increased regulatory expenses while also ensuring that the ORF will not exceed such expenses. Transaction volumes across the industry have increased moderately since the ORF was last changed in December 2012, but the Exchange's regulatory expenses have increased at a faster rate. The Exchange believes that revenue generated from the proposed ORF, when combined with all of the Exchange's other regulatory fees, will cover a material portion but not all of the Exchange's regulatory costs. The Exchange will continue to monitor the amount of revenue collected from the ORF to ensure that it, in combination with its other regulatory fees and fines, does not exceed regulatory costs. If the Exchange determines that regulatory revenues exceed regulatory costs, the Exchange will adjust the ORF by submitting a fee filing change to the Commission.[5] The Exchange proposes to implement this fee change on February 3, 2014.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with Section 6(b) of the Securities Exchange Act of 1934 (the ''Act''),[6] in general, and furthers the objectives of Section 6(b)(4) and (5) of the Act,[7] in particular, because it provides for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities and does not unfairly discriminate between customers, issuers, brokers, or dealers.

The Exchange believes that the proposed fee change is reasonable because the Exchange's revenue from the collection of the ORF has not kept pace with Exchange's regulatory expenses. As described above, the ORF seeks to recover the costs of supervising and regulating members, including performing routine surveillances and investigations, as well as policy, rulemaking, interpretive and enforcement activities. The proposed ORF increase will help to offset these regulatory expenses, but would not result in total regulatory revenue exceeding total regulatory costs. The Exchange further notes that another options exchange has raised its options regulatory fee to $0.0095 per contract and thus the Exchange's ORF of $0.0055 per contract will still be below that level.[8]

The Exchange believes that the proposed ORF increase is equitable and not unfairly discriminatory because it is objectively allocated to all ATP Holders on all of their transactions that clear in the customer range at OCC. Moreover, the Exchange believes the ORF ensures fairness by assessing higher fees to those member firms that require more Exchange regulatory services based on the amount of customer options business they conduct. Regulating customer trading activity is more labor intensive and requires greater expenditure of human and technical resources than regulating non-customer trading activity. Surveillance and regulation of non-customer trading activity generally tends to be more automated and less labor intensive. As a result, the costs associated with administering the customer component of the Exchange's overall regulatory program are anticipated to be higher than the costs associated with administering the non-customer

[4] *See* Securities Exchange Act Release No. 34–68183 (November 8, 2012), 77 FR 68186 (November 15, 2012) (SR–NYSEMKT–2012–54).

[5] The Exchange notes that its regulatory responsibilities with respect to member compliance with options sales practice rules have been allocated to FINRA under an SEC Rule 17d–2 agreement; the ORF is not designed to cover the cost of options sales practice regulation. *See* Securities Exchange Act Release No. 34–64400 (May 4, 2011), 76 FR 27118 (May 10, 2011) (SR–NYSEAmex–2011–27).

[6] 15 U.S.C. 78f(b).

[7] 15 U.S.C. 78f(b)(4) and (5).

[8] *See* Securities Exchange Act Release No. 34–71007 (December 6, 2013), 78 FR 75653 (December 12, 2013) (SR–CBOE–2013–117).

component of its regulatory program. As such, the Exchange proposes assessing higher fees to those firms that will require more Exchange regulatory services based on the amount of customer options business they conduct.[9]

The Exchange believes that the ORF will continue to be equitable and not unfairly discriminatory because the fee increase is objectively allocated to all ATP Holders. As noted above, the Exchange will continue to monitor the amount of revenue collected from the ORF to ensure that it, in combination with its other regulatory fees and fines, does not exceed regulatory costs. If the Exchange determines that regulatory revenues exceed regulatory costs, the Exchange will adjust the ORF by submitting a fee filing change to the Commission.

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed fee change is not designed to address any competitive issues. Rather, the proposed change is designed to help the Exchange adequately fund its regulatory activities while seeking to ensure that total regulatory revenues do not exceed total regulatory costs.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

No written comments were solicited or received with respect to the proposed rule change.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The foregoing rule change is effective upon filing pursuant to Section 19(b)(3)(A)[10] of the Act and subparagraph (f)(2) of Rule 19b–4[11] thereunder, because it establishes a due, fee, or other charge imposed by the Exchange.

At any time within 60 days of the filing of such proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings under Section 19(b)(2)(B)[12] of the Act to determine whether the proposed rule change should be approved or disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/sro.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number SR–NYSEMKT–2014–09 on the subject line.

Paper Comments

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

All submissions should refer to File Number SR–NYSEMKT–2014–09. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/sro.shtml*). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR–NYSEMKT–2014–09, and should be submitted on or before February 21, 2014.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.[13]

Kevin M. O'Neill,

Deputy Secretary.

[FR Doc. 2014–01970 Filed 1–30–14; 8:45 am]

BILLING CODE 8011–01–P

[9] The ORF is not charged for orders that clear in categories other than the customer range (e.g., market maker orders) because members incur the costs of owning memberships and through their memberships are charged transaction fees, dues and other fees that go into the general funds of the Exchange, a portion of which is used to help pay the costs of regulation. *See supra* note 4.

[10] 15 U.S.C. 78s(b)(3)(A).

[11] 17 CFR 240.19b–4(f)(2).

[12] 15 U.S.C. 78s(b)(2)(B).

[13] 17 CFR 200.30–3(a)(12).

SMALL BUSINESS ADMINISTRATION

[Disaster Declaration #13865 and #13866]

Alaska Disaster #AK–00030

AGENCY: U.S. Small Business Administration.

ACTION: Notice.

SUMMARY: This is a Notice of the Presidential declaration of a major disaster for Public Assistance Only for the State of Alaska (FEMA—4161—DR), dated 01/16/2014.

Incident: Flooding.

Incident Period: 10/27/2013 through 10/28/2013.

DATES: *Effective Date:* 01/16/2014.

Physical Loan Application Deadline Date: 03/17/2014.

Economic Injury (EIDL) Loan Application Deadline Date: 10/16/2014.

ADDRESSES: Submit completed loan applications to: U.S. Small Business Administration, Processing And Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

FOR FURTHER INFORMATION CONTACT: A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street SW., Suite 6050, Washington, DC 20416.

SUPPLEMENTARY INFORMATION: Notice is hereby given that as a result of the President's major disaster declaration on 01/16/2014, Private Non-Profit organizations that provide essential services of governmental nature may file disaster loan applications at the address listed above or other locally announced locations.

The following areas have been determined to be adversely affected by the disaster:

Primary Counties: Kenai Peninsula Borough.

The Interest Rates are:

	Percent
For Physical Damage:.	
Non-Profit Organizations with Credit Available Elsewhere	2.625
Non-Profit Organizations without Credit Available Elsewhere	2.625
For Economic Injury:.	
Non-Profit Organizations without Credit Available Elsewhere.	
2.625.	

The number assigned to this disaster for physical damage is 138656 and for economic injury is 138666.

(Catalog of Federal Domestic Assistance Numbers 59002 and 59008)

Joseph P. Loddo,

Acting Associate Administrator for Disaster Assistance.

[FR Doc. 2014–01991 Filed 1–30–14; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Disaster Declaration # 13841 and # 13842]

ARKANSAS Disaster Number AR–00066

AGENCY: U.S. Small Business Administration.

ACTION: Amendment 1

SUMMARY: This is an amendment of the Presidential declaration of a major disaster for Public Assistance Only for the State of ARKANSAS (FEMA—4160—DR), dated 01/06/2014.

Incident: Severe Winter Storm

Incident Period: 12/05/2013 through 12/06/2013

Effective Date: 01/22/2014

Physical Loan Application Deadline Date: 03/07/2014

Economic Injury (EIDL) Loan Application Deadline Date: 10/06/2014

ADDRESSES: Submit completed loan applications to: U.S. Small Business Administration, Processing and Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

FOR FURTHER INFORMATION CONTACT: A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street, SW., Suite 6050, Washington, DC 20416

SUPPLEMENTARY INFORMATION: The notice of the President's major disaster declaration for Private Non-Profit organizations in the State of ARKANSAS, dated 01/06/2014, is hereby amended to include the following areas as adversely affected by the disaster.

Primary Counties: Fulton.

All other information in the original declaration remains unchanged.

of Federal Domestic Assistance Numbers 59002 and 59008)

James E. Rivera,

Associate Administrator for Disaster Assistance.

[FR Doc. 2014–01990 Filed 1–30–14; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Disaster Declaration #13839 and #13840]

Texas Disaster Number TX–00418

AGENCY: U.S. Small Business Administration.

ACTION: Amendment 1.

SUMMARY: This is an amendment of the Presidential declaration of a major disaster for Public Assistance Only for the State of Texas (FEMA–4159–DR), dated 12/20/2013.

Incident: Severe Storms and Flooding.

Incident Period: 10/30/2013 through 10/31/2013.

Effective Date: 01/17/2014.

Physical Loan Application Deadline Date: 02/18/2014.

Economic Injury (EIDL) Loan Application Deadline Date: 09/22/2014.

ADDRESSES: Submit completed loan applications to: U.S. Small Business Administration Processing and Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

FOR FURTHER INFORMATION CONTACT: A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street SW., Suite 6050, Washington, DC 20416.

SUPPLEMENTARY INFORMATION: The notice of the President's major disaster declaration for Private Non-Profit organizations in the State of TEXAS, dated 12/20/2013, is hereby amended to include the following areas as adversely affected by the disaster.

Primary Counties: Freestone.

All other information in the original declaration remains unchanged.

(Catalog of Federal Domestic Assistance Numbers 59002 and 59008)

James E. Rivera,

Associate Administrator for Disaster Assistance.

[FR Doc. 2014–01995 Filed 1–30–14; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Disaster Declaration # 13867 and # 13868]

California Disaster # CA–00215

AGENCY: U.S. Small Business Administration.

ACTION: Notice.

SUMMARY: This is a notice of an Administrative declaration of a disaster for the State of California dated 01/23/2014.

Incident: Pfeiffer Fire.

Incident Period: 12/16/2013 through 12/20/2013.

Effective Date: 01/23/2014.

Physical Loan Application Deadline Date: 03/24/2014.

Economic Injury (EIDL) Loan Application Deadline Date: 10/23/2014.

ADDRESSES: Submit completed loan applications to: U.S. Small Business Administration, Processing And Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

FOR FURTHER INFORMATION CONTACT: A. Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street SW., Suite 6050, Washington, DC 20416.

SUPPLEMENTARY INFORMATION: Notice is hereby given that as a result of the Administrator's disaster declaration, applications for disaster loans may be filed at the address listed above or other locally announced locations.

The following areas have been determined to be adversely affected by the disaster:

Primary Counties: Monterey.

Contiguous Counties:

California: Fresno, Kings, San Benito San, Luis Obispo, Santa Cruz.

The Interest Rates are:

	Percent
For Physical Damage:	
Homeowners With Credit Available Elsewhere	4.500
Homeowners Without Credit Available Elsewhere	2.250
Businesses With Credit Available Elsewhere	6.000
Businesses Without Credit Available Elsewhere	4.000
Non-Profit Organizations With Credit Available Elsewhere	2.625
Non-Profit Organizations Without Credit Available Elsewhere	2.625
For Economic Injury:	
Businesses & Small Agricultural Cooperatives Without Credit Available Elsewhere	4.000
Non-Profit Organizations Without Credit Available Elsewhere	2.625

The number assigned to this disaster for physical damage is 13867 5 and for economic injury is 13868 0.

The State which received an EIDL Declaration # is California.

(Catalog of Federal Domestic Assistance Numbers 59002 and 59008)

Dated: January 23, 2014.

Jeanne Hulit,

Acting Administrator.

[FR Doc. 2014–01996 Filed 1–30–14; 8:45 am]

BILLING CODE 8025–01–P

SMALL BUSINESS ADMINISTRATION

[Disaster Declaration # 13869 and # 13870]

Connecticut Disaster # CT–00032

AGENCY: U.S. Small Business Administration.

ACTION: Notice.

SUMMARY: This is a notice of an Administrative declaration of a disaster for the State of Connecticut dated 01/24/2014.

Incident: Shelton Apartment Fire

Incident Period: 01/06/2014.

Effective Date: 01/24/2014.

Physical Loan Application Deadline Date: 03/25/2014

Economic Injury (EIDL) Loan Application Deadline Date: 10/24/2014

ADDRESSES: Submit completed loan applications to:

U.S. Small Business Administration, Processing and Disbursement Center, 14925 Kingsport Road, Fort Worth, TX 76155.

FOR FURTHER INFORMATION CONTACT: A Escobar, Office of Disaster Assistance, U.S. Small Business Administration, 409 3rd Street SW., Suite 6050, Washington, DC 20416.

SUPPLEMENTARY INFORMATION: Notice is hereby given that as a result of the Administrator's disaster declaration, applications for disaster loans may be filed at the address listed above or other locally announced locations.

The following areas have been determined to be adversely affected by the disaster:

Primary Counties: Fairfield.

Contiguous Counties:

Connecticut: Litchfield, New Haven.

New York: Dutchess, Putnam, Westchester.

The Interest Rates are:

	Percent
For Physical Damage:	
Homeowners With Credit Available Elsewhere	4.500
Homeowners Without Credit Available Elsewhere	2.250
Businesses With Credit Available Elsewhere	6.000
Businesses Without Credit Available Elsewhere	4.000
Non-Profit Organizations With Credit Available Elsewhere	2.625
Non-Profit Organizations Without Credit Available Elsewhere	2.625
For Economic Injury:	
Businesses & Small Agricultural Cooperatives Without Credit Available Elsewhere	4.000
Non-Profit Organizations Without Credit Available Elsewhere	2.625

The number assigned to this disaster for physical damage is 13869 5 and for economic injury is 13870 0.

The States which received an EIDL Declaration # are Connecticut, New York.

(Catalog of Federal Domestic Assistance Numbers 59002 and 59008)

Dated: January 24, 2014.

Jeanne Hulit,

Acting Administrator.

[FR Doc. 2014–02001 Filed 1–30–14; 8:45 am]

BILLING CODE 8025–01–P

DEPARTMENT OF STATE

[Public Notice 8617]

Culturally Significant Objects Imported for Exhibition Determinations: ''Bodies in Balance: The Art of Tibetan Medicine''

SUMMARY: Notice is hereby given of the following determinations: Pursuant to the authority vested in me by the Act of October 19, 1965 (79 Stat. 985; 22 U.S.C. 2459), Executive Order 12047 of March 27, 1978, the Foreign Affairs Reform and Restructuring Act of 1998 (112 Stat. 2681, *et seq.;* 22 U.S.C. 6501 note, *et seq.*), Delegation of Authority No. 234 of October 1, 1999, and Delegation of Authority No. 236–3 of August 28, 2000 (and, as appropriate, Delegation of Authority No. 257 of April 15, 2003), I hereby determine that the objects to be included in the exhibition ''Bodies in Balance: The Art of Tibetan Medicine,'' imported from abroad for temporary exhibition within the United States, are of cultural significance. The objects are imported pursuant to loan agreements with the foreign owners or custodians. I also determine that the exhibition or display of the exhibit objects at the Rubin Museum of Art, New York, New York, from on or about March 15, 2014, until on or about September 8, 2014, and at possible additional exhibitions or venues yet to be determined, is in the national interest. I have ordered that Public Notice of these Determinations be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: For further information, including a list of the exhibit objects, contact Paul W. Manning, Attorney-Adviser, Office of the Legal Adviser, U.S. Department of State (telephone: 202–632–6469). The mailing address is U.S. Department of State, SA–5, L/PD, Fifth Floor (Suite 5H03), Washington, DC 20522–0505.

Dated: January 24, 2014.

Kelly Keiderling,

Principal Deputy Assistant Secretary, Bureau of Educational and Cultural Affairs, Department of State.

[FR Doc. 2014–02077 Filed 1–30–14; 8:45 am]

BILLING CODE 4710–05–P

DEPARTMENT OF STATE

[Public Notice 8616]

Meeting of the International Maritime Organization Sub-Committee on Pollution Prevention and Response; Notice of Request for Comments

The planned open meeting of the Shipping Coordinating Committee (SHC), a Department of State advisory committee, on Tuesday, January 21, 2014, was cancelled due to the weather-related closure of Washington, DC, Federal offices. The Department of State is now soliciting comment from any interested individuals to prepare for the first Session of the International Maritime Organization's (IMO) Sub-Committee on Pollution Prevention and Response (PPR) to be held at the IMO Headquarters, United Kingdom, February 3–7, 2014.

The agenda items to be considered include:

—Adoption of the agenda

—Decisions of other IMO bodies

—Evaluation of safety and pollution hazards of liquid chemicals and preparation of consequential amendments to the IBC Code

—Development of a code for the transport and handling of limited amounts of hazardous and noxious liquid substances in bulk on offshore support vessels

—Additional guidelines for implementation of the BWM Convention

—Production of a manual entitled ''Ballast Water Management—How to do it''

—Improved and new technologies approved for ballast water

management systems and reduction of atmospheric pollution
—Consideration of the impact on the Arctic of emissions of Black Carbon from international shipping
—Review of relevant non-mandatory instruments as a consequence of the amended MARPOL Annex VI and the NOx Technical Code
—Implementation of the OPRC Convention and the OPRC–HNS Protocol and relevant Conference resolutions
—Consideration of IACS unified interpretations
—Casualty analysis
—Biennial agenda and provisional agenda for PPR 2
—Election of Chairman and Vice-Chairman for 2015
—Any other business
—Report to the Marine Environment Protection Committee

DATES: Comments and related material must either be submitted on or before February 7, 2014.

ADDRESSES: You may submit comments using the following methods (please use only one of the following methods):

(1) Submit comments to Docket No. DOS–2014–002 at *www.regulations.gov.*

(2) Email comments to Mr. Timothy Brown at the following address: *timothy.m.brown@uscg.mil.*

(3) Fax to: 202–493–2251.

(4) Mail delivery: Room PL–401 on the Plaza level of the Nassif Building, 400 Seventh Street SW., Washington, DC, between 9 a.m. and 5 p.m., Monday through Friday, except Federal holidays. The telephone number is 202–366–9329.

FOR FURTHER INFORMATION CONTACT: If you have questions on this notice, please contact Mr. Timothy Brown, by email: *timothy.m.brown@uscg.mil,* by phone at 202–372–2358 or by fax at (202) 372–8383. Additional information regarding this and other IMO SHC public meetings may be found at: *www.uscg.mil/imo.*

Dated: January 27, 2014.

Marc Zlomek,

Oceans Policy Advisor, Bureau of Oceans and International, Environmental and Scientific Affairs, Department of State.

[FR Doc. 2014–02075 Filed 1–30–14; 8:45 am]

BILLING CODE 4710–09–P

SUSQUEHANNA RIVER BASIN COMMISSION

Actions Taken at December 12, 2013, Meeting

AGENCY: Susquehanna River Basin Commission.

ACTION: Notice.

SUMMARY: As part of its regular business meeting held on December 12, 2013, in Annapolis, Maryland, the Commission took the following actions: (1) approved or tabled the applications of certain water resources projects (one involving an into-basin diversion and one involving an out-of-basin diversion); and (2) took additional actions, as set forth in the Supplementary Information below.

DATES: December 12, 2013.

ADDRESSES: Susquehanna River Basin Commission, 4423 N. Front Street, Harrisburg, PA 17110–1788.

FOR FURTHER INFORMATION CONTACT: Richard A. Cairo, General Counsel, telephone: (717) 238–0423, ext. 1306; fax: (717) 238–2436; email: *rcairo@srbc.net.* Regular mail inquiries may be sent to the above address. See also Commission Web site at *www.srbc.net.*

SUPPLEMENTARY INFORMATION: In addition to the actions taken on projects identified in the summary above and the listings below, the following items were also presented or acted upon at the business meeting: (1) Heard a presentation from the Maryland Department of Natural Resources director Bruce Michael on the Federal Energy Regulatory Commission licensing for Conowingo; (2) adopted a resolution urging the President and Congress to provide full funding for the National Streamflow Information Program, thereby supporting the Susquehanna Flood Forecast & Warning System; (3) adopted the five-year update of the 2008 *Comprehensive Plan for the Water Resources of the Susquehanna River Basin;* (4) adopted a resolution on the sale of the former headquarters property at 1721 North Front Street, Harrisburg, Pa.; and 5) ratified one grant and one agreement.

Project Applications Approved

The Commission approved the following project applications:

1. Project Sponsor: Aqua Pennsylvania, Inc. Project Facility: Mifflin Township Water System, Mifflin Township, Columbia County, Pa. Renewal of groundwater withdrawal of up to 0.432 mgd (30-day average) from Mifflinville Well 3 (Docket No. 19960902).

2. Project Sponsor and Facility: Chesapeake Appalachia, LLC (Susquehanna River), Athens Township, Bradford County, Pa. Renewal of surface water withdrawal of up to 0.750 mgd (peak day) (Docket No. 20080906).

3. Project Sponsor and Facility: Energy Corporation of America (West Branch Susquehanna River), Goshen Township, Clearfield County, Pa. Renewal of surface water withdrawal of up to 2.000 mgd (peak day) (Docket No. 20091203).

4. Project Sponsor and Facility: LHP Management, LLC (Fishing Creek—Clinton Country Club), Bald Eagle Township, Clinton County, Pa. Renewal of surface water withdrawal of up to 0.999 mgd (peak day) (Docket No. 20090906).

5. Project Sponsor and Facility: Millersburg Area Authority, Upper Paxton Township, Dauphin County, Pa. Renewal of groundwater withdrawal of up to 0.173 mgd (30-day average) from Well 10 and groundwater withdrawal of up to 0.102 mgd (30-day average) from Well 11 (Docket No. 19830309).

6. Project Sponsor and Facility: New Holland Borough Authority, New Holland Borough, Lancaster County, Pa. Renewal of groundwater withdrawal of up to 0.400 mgd (30-day average) from Well 2 (Docket No. 19830501).

7. Project Sponsor and Facility: Southwestern Energy Production Company (Lycoming Creek—Bodines), Lewis Township, Lycoming County, Pa. Renewal of surface water withdrawal of up to 0.500 mgd (peak day) (Docket No. 20091207).

8. Project Sponsor and Facility: Southwestern Energy Production Company (Lycoming Creek—Ralston), McIntyre Township, Lycoming County, Pa. Renewal of surface water withdrawal of up to 0.500 mgd (peak day) (Docket No. 20091210).

9. Project Sponsor and Facility: Talisman Energy USA Inc. (Choconut Creek), Choconut Township, Susquehanna County, Pa. Surface water withdrawal of up to 0.999 mgd (peak day).

Project Application Approved Involving a Diversion:

The Commission approved the following project application:

1. Project Sponsor: Gettysburg Municipal Authority. Project Facility: Hunterstown Wastewater Treatment Plant, Straban Township, Adams County, Pa. Modification to increase authorized diversion to accommodate occasional power plant surge (Docket No. 20100916).

Project Applications Tabled:

The Commission tabled the following project applications:

1. Project Sponsor and Facility: Aqua Infrastructure, LLC (Tioga River), Hamilton Township, Tioga County, Pa. Application for surface water withdrawal of up to 2.500 mgd (peak day).

2. Project Sponsor and Facility: DS Waters of America, Inc., Clay Township,

Lancaster County, Pa. Application for renewal of groundwater withdrawal of up to 0.115 mgd (30-day average) from Well 6 (Docket No. 20000203).

3. Project Sponsor: Gettysburg Municipal Authority. Project Facility: York Water Company Interconnection, Straban Township, Adams County, Pa. Application for consumptive water use of up to 3.000 mgd (peak day).

4. Project Sponsor and Facility: Houtzdale Municipal Authority, Gulich Township, Clearfield County, Pa. Application for groundwater withdrawal of up to 0.537 mgd (30-day average) from Well 14R.

5. Project Sponsor and Facility: Keystone Clearwater Solutions, LLC (Lycoming Creek), Lewis Township, Lycoming County, Pa. Modification to low flow protection requirements and authorization of additional water uses of the surface water withdrawal approval (Docket No. 20110616).

6. Project Sponsor: New Oxford Municipal Authority. Project Facility: Oxen Country Meadows, Oxford Township, Adams County, Pa. Application for groundwater withdrawal of up to 0.144 mgd (30-day average) from Oxen Country Meadows (OCM) Well 1.

7. Project Sponsor: Old Dominion Electric Cooperative. Project Facility: Rock Springs Expansion, Rising Sun District, Cecil County, Md. Application for consumptive water use of up to 7.900 mgd (peak day).

8. Project Sponsor and Facility: Old Dominion Electric Cooperative (Susquehanna River), Fulton Township, Lancaster County, Pa. Application for surface water withdrawal of up to 8.700 mgd (peak day).

9. Project Sponsor and Facility: Seneca Resources Corporation (Arnot No. 5 Mine Discharge), Bloss Township, Tioga County, Pa. Application for renewal of surface water withdrawal of up to 0.499 mgd (peak day) (Docket No. 20090908).

10. Project Sponsor and Facility: Talisman Energy USA Inc. (Fall Brook—C.O.P. Tioga State Forest), Ward Township, Tioga County, Pa. Application for renewal of surface water withdrawal of up to 0.999 mgd (peak day) (Docket No. 20091204).

11. Project Sponsor and Facility: Talisman Energy USA Inc. (Fellows Creek—C.O.P. Tioga State Forest), Ward Township, Tioga County, Pa. Application for renewal of surface water withdrawal of up to 0.999 mgd (peak day) (Docket No. 20091205).

12. Project Sponsor and Facility: York Water Company (Susquehanna River and South Branch Codorus Creek), Lower Windsor and Spring Garden Townships, York County, Pa. Modification to authorize supply of water to Gettysburg Municipal Authority through an interconnection, subject to receipt by Gettysburg Municipal Authority of an interbasin diversion approval (Docket No. 20021023).

Project Application Tabled Involving a Diversion:

The Commission tabled the following project application:

1. Project Sponsor: Gettysburg Municipal Authority. Project Facility: York Water Company Interconnection, Straban Township, Adams County, Pa. Application for an out-of-basin diversion of up to 3.000 mgd (peak day) to the Potomac River Basin.

Project Applications Withdrawn

The following project applications were withdrawn by the project sponsors:

1. Project Sponsor and Facility: WPX Energy Appalachia, LLC (Turner Lake), Liberty Township, Susquehanna County, Pa. Application for renewal of surface water withdrawal of up to 0.393 mgd (peak day) (Docket No. 20090601).

2. Project Sponsor and Facility: Winner Water Services, Inc. (Manor #44 Deep Mine), Girard Township, Clearfield County, Pa. Application for surface water withdrawal of up to 0.144 mgd (peak day).

Authority: Pub. L. 91–575, 84 Stat. 1509 et seq., 18 CFR Parts 806, 807, and 808.

Dated: January 24, 2014.

Stephanie L. Richardson,

Secretary to the Commission.

[FR Doc. 2014–01923 Filed 1–30–14; 8:45 am]

BILLING CODE 7040–01–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

Agency Information Collection Activities: Requests for Comments; Clearance of Renewed Approval of Information Collection: NAS Data Release Request

AGENCY: Federal Aviation Administration (FAA), DOT

ACTION: Notice and request for comments.

SUMMARY: In accordance with the Paperwork Reduction Act of 1995, FAA invites public comments about our intention to request the Office of Management and Budget (OMB) approval to renew an information collection. The information enables the FAA to evaluate the validity of the user's request for National Airspace (NAS) data from FAA systems and equipment.

DATES: Written comments should be submitted by April 1, 2014.

FOR FURTHER INFORMATION CONTACT: Kathy DePaepe at (405) 954–9362, or by email at: *Kathy.DePaepe@faa.gov*.

ADDRESSES: Send comments to the FAA at the following address: Ms. Kathy DePaepe, Room 126B, Federal Aviation Administration, ASP–110, 6500 S. MacArthur Blvd., Oklahoma City, OK 73169.

SUPPLEMENTARY INFORMATION:

OMB Control Number: 2120–0668.

Title: NAS Data Release Request.

Form Numbers: FAA Form 1200–5.

Type of Review: Renewal of an information collection.

Background: This data collection is the genesis for granting approval to release filtered NAS data. The information provided sets the criteria for the FAA Data Release Request Committee (DRRC) to approve or disapprove individual requests for NAS data. The information submitted by the requestor determines the requestor's eligibility to use FAA NAS data. The agency currently uses the collected information to determine suitability for procuring NAS data for use in various evaluations.

Respondents: Approximately 9 data requestors annually.

Frequency: Information is collected on occasion.

Estimated Average Burden per Response: 3 hours.

Estimated Total Annual Burden: 27 hours.

Public Comments Invited: You are asked to comment on any aspect of this information collection, including (a) Whether the proposed collection of information is necessary for FAA's performance; (b) the accuracy of the estimated burden; (c) ways for FAA to enhance the quality, utility and clarity of the information collection; and (d) ways that the burden could be minimized without reducing the quality of the collected information. The agency will summarize and/or include your comments in the request for OMB's clearance of this information collection.

Issued in Washington, DC, on January 27, 2014.

Albert R. Spence,

FAA Assistant Information Collection Clearance Officer, IT Enterprises Business Services Division, ASP–110.

[FR Doc. 2014–02063 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

Eleventh Meeting: RTCA Tactical Operations Committee (TOC)

AGENCY: Federal Aviation Administration (FAA), U.S. Department of Transportation (DOT).

ACTION: Eleventh Meeting Notice of RTCA NextGen Advisory Committee.

SUMMARY: The FAA is issuing this notice to advise the public of the eleventh meeting of the RTCA NextGen Advisory Committee.

DATES: The meeting will be held February 20, 2014 from 9:30 a.m.—3:00 p.m.

ADDRESSES: The meeting will be held at Honeywell Deer Valley, 21111 N. 19th Ave, Conference Room PRN A, B & C, Phoenix, AZ 85027.

FOR FURTHER INFORMATION CONTACT: The RTCA Secretariat, 1150 18th Street NW., Suite 910, Washington, DC, 20036, or by telephone at (202) 833–9339, fax at (202) 833–9434, or Web site at *http://www.rtca.org.* Andy Cebula, NAC Secretary can also be contacted at *acebula@rtca.org* or 202–330–0652.

SUPPLEMENTARY INFORMATION: Pursuant to section 10(a) (2) of the Federal Advisory Committee Act (Pub. L. 92–463, 5 U.S.C., App.), notice is hereby given for a meeting of Special Committee 224. The agenda will include the following:

The meeting is being held at the secured facilities of Honeywell Aerospace. All members of the public are required to register no later than February 12, 2014, by contacting Kathy Phoenix via email *Kathy.phoenix@honeywell.com* and provide the following information:

U.S. Citizens

—Last name, First name (as it appears on State Drivers License or State ID)
—Employer and Address
—Phone Number
—Statement of U.S. Citizenship

Non-U.S. Citizens

—Full Name as it appears on Passport
—Country of Citizenship
—Passport and Visa Numbers, I–94 Stamp and Expiration Date
—Employer and Address—Identify whether U.S. or foreign-owned
—Phone number contact

February 20

- Opening of Meeting/Introduction of NAC Members—Chairman Bill Ayer
- Official Statement of Designated Federal Official—The Honorable Mike Whitaker, FAA Deputy Administrator
- Review and Approval of September 2013 Meeting Summary
- Chairman's Report—Chairman Ayer
- FAA Report—Mr. Whitaker
- Report on current topics related to NextGen implementation
- DataComm—Update and Status
- Previous NAC Recommendations
  - FAA Response and Next Steps to previous NAC recommendations
  - NextGen Capabilities Prioritization
  - CatEx 2
  - Fuel Data Sources
  - PBN Implementation
- Review and Approve Recommendation for Submission to FAA—Industry Barriers to NextGen Utilization
- Report to identify and mitigate industry barriers to implementing PBN
- Blueprint for Performance-Based Navigation Procedures Implementation
- Overview of Tasking
- Soliciting Committee Perspectives on Blueprint for Performance-Based Navigation Procedures Implementation
- Committee Breakouts and Discussion of Tasking Questions
- Recap of Meeting and Anticipated Issues for NAC consideration and action at the next meeting, June 4, 2014, Washington DC
- Other business
- Adjourn

Attendance is open to the interested public but limited to space availability. With the approval of the chairman, members of the public may present oral statements at the meeting. Persons wishing to present statements or obtain information should contact the person listed in the **FOR FURTHER INFORMATION CONTACT** section. Members of the public may present a written statement to the committee at any time.

Issued in Washington, DC, on January 27, 2014.

Paige Williams,

Management Analyst, NextGen, Business Operations Group, Federal Aviation Administration.

[FR Doc. 2014–02029 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF TRANSPORTATION

Federal Highway Administration

Notice of Final Federal Agency Actions on Transportation Project in Nevada

AGENCY: Federal Highway Administration (FHWA), DOT.

ACTION: Notice of Limitation on Claims for Judicial Review of Actions by FHWA and Other Federal Agencies.

SUMMARY: This notice announces actions taken by the FHWA and other Federal agencies that are final within the meaning of 23 U.S.C. 139(l)(1). The actions relate to the Pyramid Way and McCarran Boulevard Intersection Improvement Project located in Sparks, Washoe County, Nevada. These actions grant licenses, permits, and approval of the project.

DATES: By this notice, FHWA is advising the public of final agency actions subject to 23 U.S.C. 139(l)(1). A claim seeking judicial review of the Federal agency actions on the listed highway project will be barred unless the claim is filed on or before June 30, 2014. If this date falls on a Saturday, Sunday, or legal holiday, parties are advised to file their claim no later than the business day preceding this date. If the Federal law that authorizes judicial review of a claim provides a time period of less than 150 days for filing such claim, then that shorter time period still applies.

FOR FURTHER INFORMATION CONTACT: For FHWA: Mr. Abdelmoez Abdalla, Environmental Program Manager, Federal Highway Administration, 705 North Plaza Street, Carson City, Nevada 89701–0602; telephone: (775) 687–1231; email: *abdelmoez.abdalla@dot.gov.* The FHWA Nevada Division Office's regular business hours are 7:30 a.m. to 4 p.m. (Pacific Standard Time). For the Nevada Department of Transportation (NDOT): Mr. Steve M. Cooke, P.E., Chief, Environmental Services Division, Nevada Department of Transportation, 1263 South Stewart Street, Carson City, Nevada 89712; telephone: (775) 888–7013; email: *scooke@dot.state.nv.us.* The NDOT office's regular business hours are 8 a.m. to 5 p.m.(Pacific Standard Time).

SUPPLEMENTARY INFORMATION: Notice is hereby given that the FHWA and other Federal agencies have taken final agency actions related to the Pyramid Way and McCarran Boulevard Intersection Improvement Project located in Sparks, Washoe County, Nevada. FHWA, in cooperation with the Nevada Department of Transportation (NDOT), prepared a Draft Environmental Impact Statement (EIS) (FHWA–NV–EIS–13–01–D) and Final EIS (FHWA–NV–EIS–13–01–F) for proposed improvements to the Pyramid Way and McCarran Boulevard Intersection in Sparks, Nevada. The improvements include widening Pyramid Way from two lanes to three lanes in each direction (north-south) from a reconfigured Queen Way on the north to Tyler Way on the south. McCarran Boulevard would remain two lanes in each direction (east-west) but with additional turning lanes.

The actions by the Federal agencies, and the laws under which such actions were taken, are described in the

combined Final EIS (FHWA–NV–EIS–13–01–F) and Record of Decision (ROD) issued on November 26, 2013, and in other documents in the FHWA and NDOT project record. These documents are available by contacting FHWA or NDOT at the addresses provided above. The combined Final EIS and ROD can also be downloaded electronically from the project Web site at *http://www.pyramidmccarran.com/,* or viewed at area public libraries. This notice applies to all Federal agency decisions on the project as of the issuance date of this notice and all laws under which such actions were taken, including but not limited to: General: National Environmental Policy Act (NEPA) [42 U.S.C. 4321–4351]; Federal-Aid Highway Act (FAHA) [23 U.S.C. 109 and 23 U.S.C. 128]; Public Hearing [23 U.S.C. 128].

1. Air: Clean Air Act [42 U.S.C. 7401–7671(q)] (Transportation Conformity).

2. Noise: Procedures for Abatement of Highway Traffic Noise and Construction Noise [23 U.S.C. 109(h), 109(i); 42 U.S.C. 4331, 4332; sec. 339(b), Pub. L. 104–59, 109 Stat. 568, 605; 49 CFR 1.48(b)].

3. Land: Section 4(f) of the Department of Transportation Act of 1966 [23 U.S.C. 138 and 49 U.S.C. 303] and Section 6(f) of the Land and Water Conservation Act as amended [16 U.S.C. 4601].

4. Historic and Cultural Resources: Section 106 of the National Historic Preservation Act of 1966, as amended [16 U.S.C. 470f]; Archeological and Historic Preservation Act [16 U.S.C. 469–469(c)].

5. Wildlife: Endangered Species Act [16 U.S.C. 1531–1544 and Section 1536]; Fish and Wildlife Coordination Act [16 U.S.C. 661–667 (d)]; Migratory Bird Treaty Act [16 U.S.C. 703–712].

6. Social and Economic: Civil Rights Act of 1964 [42 U.S.C. 2000 (d)–2000 (d)(1)].

7. Executive Orders: E.O. 11990, Protection of Wetlands; E.O. 11988, Floodplain Management; E.O. 12898, Federal Actions to Address Environmental Justice in Minority Populations and Low Income Populations; E.O. 11593, Protection and Enhancement of Cultural Resources; E.O. 13287, Preserve America; E.O. 11514, Protection and Enhancement of Environmental Quality; E. 0. 13112, Invasive Species.

(Catalog of Federal Domestic Assistance Program No. 20.205, Highway Research, Planning and Construction. The regulations implementing Executive Order 12372 regarding intergovernmental consultation on Federal programs and activities apply to this program.)

Authority: 23 U.S.C. 139(l)(1), as amended by the Moving Ahead for Progress Act, Pub. L. 112–141, section 1308, 126 Stat. 405 (2012).

Issued on: January 15, 2014.

Susan Klekar,

Division Administrator, Carson City, Nevada.

[FR Doc. 2014–01986 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–RY–P

DEPARTMENT OF TRANSPORTATION

Federal Transit Administration

[Docket FTA–2014–0001]

Notice of Establishment of Emergency Relief Docket for Calendar Year 2014

AGENCY: Federal Transit Administration (FTA), DOT.

ACTION: Notice.

SUMMARY: The Federal Transit Administration (FTA) is establishing an Emergency Relief Docket for calendar year 2014 so that grantees and subgrantees affected by national or regional emergencies may request relief from FTA administrative and statutory requirements. By this notice, FTA is establishing an Emergency Relief Docket for calendar year 2014.

FOR FURTHER INFORMATION CONTACT: Bonnie L. Graves, Acting Assistant Chief Counsel for Legislation and Regulations, Office of Chief Counsel, Federal Transit Administration, 1200 New Jersey Ave. SE., Room E56–306, Washington, DC, 20590, phone: (202) 366–4011, fax: (202) 366–3809, or email, *Bonnie.Graves@dot.gov*.

SUPPLEMENTARY INFORMATION: Pursuant to title 49 CFR part 601, subpart D, FTA is establishing the Emergency Relief Docket for calendar year 2014, and also opening the docket for Hurricane Sandy requests made in calendar year 2014. Grantees and subgrantees impacted by Hurricane Sandy and requesting relief from FTA administrative or statutory requirements should use the calendar year 2014 docket for any requests made after January 31, 2014. The docket may be opened at the request of a grantee or subgrantee, or on the Administrator's own initiative.

In the event a grantee or subgrantee believes the Emergency Relief Docket should be opened and it has not been opened, that grantee or subgrantee may submit a petition in duplicate to the Administrator, via U.S. mail, to: Federal Transit Administration, 1200 New Jersey Ave. SE., Washington, DC 20590; via telephone, at: (202) 366–4011; via fax, at (202) 366–3472, or via email, to *bonnie.graves@dot.gov,* requesting opening of the Docket for that emergency and including the information set forth below.

Section 5324(d) of title 49, U.S.C. provides that a grant awarded under section 5324 or under 49 U.S.C. 5307 or 49 U.S.C. 5311 that is made to address an emergency shall be subject to the terms and conditions the Secretary determines are necessary. This language allows FTA to waive statutory, as well as administrative, requirements. Therefore, grantees affected by an emergency or major disaster may request waivers of provisions of chapter 53 of title 49, U.S.C. when the requirement(s) will limit a grantee's or subgrantee's ability to respond to an emergency. Grantees must follow the procedures set forth below when requesting a waiver of statutory or administrative requirements.

All petitions for relief from a provision of chapter 53 of title 49, U.S.C. or FTA administrative requirements must be posted in the docket in order to receive consideration by FTA. The docket is publicly available and can be accessed 24 hours a day, seven days a week, via the Internet at *www.regulations.gov*. Petitions may also be submitted by U.S. mail or by hand delivery to the DOT Docket Management Facility, 1200 New Jersey Ave. SE., Room W12–140, Washington, DC 20590. Any grantee or subgrantee submitting petitions for relief or comments to the docket must include the agency name (Federal Transit Administration) and docket number FTA–2014–0001. Grantees and subgrantees making submissions to the docket by mail or hand delivery should submit two copies. Grantees and subgrantees are strongly encouraged to contact their FTA regional office and notify FTA of the intent to submit a petition to the docket.

In the event a grantee or subgrantee needs to request immediate relief and does not have access to electronic means to request that relief, the grantee or subgrantee may contact any FTA regional office or FTA headquarters and request that FTA staff submit the petition on its behalf.

A petition for relief shall:

(a) Identify the grantee or subgrantee and its geographic location;

(b) Identify the section of chapter 53 of title 49, U.S.C., or the FTA policy statement, circular, guidance document and/or rule from which the grantee or subgrantee seeks relief;

(c) Specifically address how a requirement in chapter 53 of title 49 U.S.C., or an FTA requirement in a policy statement, circular, agency guidance or rule will limit a grantee's or

subgrantee's ability to respond to an emergency or disaster; and

(d) Specify if the petition for relief is one-time or ongoing, and if ongoing identify the time period for which the relief is requested. The time period may not exceed three months; however, additional time may be requested through a second petition for relief.

A petition for relief from administrative requirements will be conditionally granted for a period of three (3) business days from the date it is submitted to the Emergency Relief Docket. FTA will review the petition after the expiration of the three business days and review any comments submitted thereto. FTA may contact the grantee or subgrantee that submitted the request for relief, or any party that submits comments to the docket, to obtain more information prior to making a decision. FTA shall then post a decision to the Emergency Relief Docket. FTA's decision will be based on whether the petition meets the criteria for use of these emergency procedures, the substance of the request, and the comments submitted regarding the petition. If FTA does not respond to the request for relief to the docket within three business days, the grantee or subgrantee may assume its petition is granted for a period not to exceed three months until and unless FTA states otherwise.

A petition for relief from statutory requirements will not be conditionally granted and requires a written decision from the FTA Administrator.

Pursuant to section 604.2(f) of FTA's charter rule (73 FR 2325, Jan. 14, 2008), grantees and subgrantees may assist with evacuations or other movement of people that might otherwise be considered charter transportation when that transportation is in response to an emergency declared by the President, governor, or mayor, or in an emergency requiring immediate action prior to a formal declaration, even if a formal declaration of an emergency is not eventually made by the President, governor or mayor. Therefore, a request for relief is not necessary in order to provide this service. However, if the emergency lasts more than 45 calendar days, the grantee or subgrantee shall follow the procedures set out in this notice.

FTA reserves the right to reopen any docket and reconsider any decision made pursuant to these emergency procedures based upon its own initiative, based upon information or comments received subsequent to the three business day comment period, or at the request of a grantee or subgrantee upon denial of a request for relief. FTA shall notify the grantee or subgrantee if it plans to reconsider a decision. FTA decision letters, either granting or denying a petition, shall be posted in the Emergency Relief Docket and shall reference the document number of the petition to which it relates.

Issued in Washington, DC, this 23 day of January 2014.

Therese W. McMillan,

Deputy Administrator.

[FR Doc. 2014–02002 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–57–P

DEPARTMENT OF TRANSPORTATION[REMOVED PRIVATE FIELD]

Federal Transit Administration

Federal Fiscal Year 2014 Annual List of Certifications and Assurances for Federal Transit Administration Grants and Cooperative Agreements

AGENCY: Federal Transit Administration, DOT.

ACTION: Notice of availability.

SUMMARY: This notice announces the availability of the Federal Transportation Administration's (FTA) Fiscal Year (FY) 2014 Annual List of Certifications and Assurances for FTA Grants and Cooperative Agreements. *See* FTA Web site, *http://www.fta.dot.gov.* In this notice, FTA provides a consolidated list of the various pre-award Certifications and Assurances that may apply to an Applicant for FTA funding and its Project. Each Applicant for FTA funding must submit the Certifications and Assurances that apply to itself and the Project(s) for which it seeks funding during the fiscal year in which it requests that funding. An Applicant typically acts through its certified or authorized representative (You). You, as the Authorized Representative, must have the authority to, among other things, sign the Applicant's Certifications and Assurances and bind the Applicant's compliance. This Notice also describes both FTA's and the Applicant's responsibilities with respect to the Certifications and Assurances and highlights the differences between the FY 2014 Certifications and Assurances and those published for FY 2013. In addition, this Notice also provides instructions on how and when to submit Certifications and Assurances for FY 2014.

DATES: *Effective Date:* These FY 2014 Certifications and Assurances are effective October 1, 2013, the first day of FY 2014.

FOR FURTHER INFORMATION CONTACT: The appropriate Regional or Metropolitan Office listed in this Notice. For copies of related documents and information, see our Web site at *http://www.fta.dot.gov* or contact our Office of Administration at 202–366–4007.

Region 1: Boston

States served: Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island and Vermont
Telephone # 617–494–2055

Region 2: New York

States served: New York, and New Jersey
Telephone # 212–668–2170

Region 3: Philadelphia

States served: Delaware, Maryland, Pennsylvania, Virginia, and West Virginia
Telephone # 215–656–7100

Region 4: Atlanta

States served: Alabama, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Tennessee,
Territories served: Puerto Rico and the U.S. Virgin Islands
Telephone # 404–865–5600

Region 5: Chicago

States served: Illinois, Indiana, Michigan, Minnesota, Ohio, and Wisconsin
Telephone # 312–353–2789

Region 6: Dallas/Ft. Worth

States served: Arkansas, Louisiana, New Mexico, Oklahoma, and Texas
Telephone # 817–978–0550

Region 7: Kansas City

States served: Iowa, Kansas, Missouri, and Nebraska
Telephone # 816–329–3920

Region 8: Denver

States served: Colorado, Montana North Dakota, South Dakota, Utah, and Wyoming
Telephone # 720–963–3300

Region 9: San Francisco

States served: Arizona, California, Hawaii, Nevada,
Territories served: Guam, American Samoa
and the Northern Mariana Islands
Telephone # 415–744–3133

Region 10: Seattle

States served: Alaska, Idaho,

Oregon, and Washington
Telephone # 206–220–7954

Chicago Metropolitan Office

Area served: Chicago Metropolitan Area
Telephone # 312–886–1616

Los Angeles Metropolitan Office

Area served: Los Angeles Metropolitan Area
Telephone # 213–202–3950

Lower Manhattan Recovery Office

Area served: Lower Manhattan
Telephone # 212–668–1770

New York Metropolitan Office

Area served: New York Metropolitan Area
Telephone # 212–668–2201

Philadelphia Metropolitan Office

Area served: Philadelphia Metropolitan Area
Telephone # 215–656–7070

Washington DC Metropolitan Office

Area served: Washington DC Metropolitan Area
Telephone # 202–219–3562/202–219–3565

SUPPLEMENTARY INFORMATION:

1. What Are FTA's Responsibilities?

The second sentence of 49 U.S.C. 5323(n) states in pertinent part that, ''[t]he Secretary [of Transportation] shall publish annually a list of all certifications required under this chapter [49 U.S.C. chapter 53] . . . .'' The first sentence of 49 U.S.C. 5323(n) states that, ''[a] certification required under this chapter [53] and any additional certification or assurance required by law or regulation to be submitted to the Secretary [who delegated that authority to the Federal Transit Administrator] may be consolidated into a single document to be submitted annually as part of a grant application under this chapter [53].'' Therefore, FTA has grouped those certifications and assurances into the following twenty-four (24) groups:

Group 01. Required Certifications and Assurances for Each Applicant.
Group 02. Lobbying.
Group 03. Procurement and Procurement Systems.
Group 04. Private Sector Protections.
Group 05. Rolling Stock Reviews and Bus Testing.
Group 06. Demand Responsive Service.
Group 07. Intelligent Transportation Systems.
Group 08. Interest and Financing Costs and Acquisition of Capital Assets by Lease.
Group 09. Transit Asset Management Plan and Public Transportation Agency Safety Plan.
Group 10. Alcohol and Controlled Substances Testing.
Group 11. Fixed Guideway Capital Investment Grants Program (New Starts, Small Starts, and Core Capacity) and Capital Investment Program in Effect before MAP–21.
Group 12. State of Good Repair Program.
Group 13. Fixed Guideway Modernization Grant Program.
Group 14. Bus and Bus Facilities Formula Grants Program and Bus and Bus Related Equipment and Facilities Grant Program (Discretionary).
Group 15. Urbanized Area Formula Grants Programs, Passenger Ferry GrantsProgram, and Job Access and Reverse Commute (JARC) Program.
Group 16. Seniors/Elderly/Individuals with Disabilities Programs and New Freedom Program.
Group 17. Rural/Other Than Urbanized Areas/Appalachian Development/Over-the-Road Bus Accessibility Programs.
Group 18. Public Transportation on Indian Reservations Programs (also known as the Tribal Transit Programs).
Group 19. Low or No Emission/Clean Fuels Grant Programs.
Group 20. Paul S. Sarbanes Transit in Parks Program.
Group 21. State Safety Oversight Program.
Group 22. Public Transportation Emergency Relief Program.
Group 23. Expedited Project Delivery Pilot Program.
Group 24. Infrastructure Finance Programs.

Since 1995, FTA has consolidated the Certifications and Assurances required by law or regulation into a single document for publication in the **Federal Register**. To receive Federal funding appropriated or made available for the grant and cooperative agreement programs FTA administers, your Applicant must submit the annual Certifications and Assurances required for the type of funding it seeks.

U.S. DOT's annual appropriations for FY 2014 have been included in the Consolidated Appropriations Act, 2014.[1] As such, FTA is publishing its FY 2014 Certifications and Assurances now. These FY 2014 Certifications and Assurances supersede any Certifications and Assurances published in an earlier fiscal year or that may have appeared as illustrations in any discontinued FTA circular. After publication in the **Federal Register**, each Applicant must submit adequate FY 2014 Certifications and Assurances before FTA may award funding to support that Applicant's request for funding for its Project.

2. What Is the Legal Effect of the Certifications and Assurances?

a. Pre-Award Representations. Certifications and Assurances are pre-award representations typically required by Federal law or regulation that your Applicant must submit before FTA may provide Federal funding for its Project. In general, these FY 2014 Certifications and Assurances are effective October 1, 2013, except as FTA determines otherwise in writing. For FY 2014, however, certain Certifications and Assurances in effect prior to MAP–21 continue to apply to certain Projects and Project activities that are financed with funds appropriated or made available for FY 2012 or a previous fiscal year. Conversely, some Certifications and Assurances apply to both Programs funded by MAP–21 and Programs financed with funds appropriated or made available for FY 2012 or a previous fiscal year. Therefore, it is critically important that you know the fiscal year in which the funding awarded for your Applicant's Project was appropriated.

Upon publication in the **Federal Register**, FTA may not award funding for your Applicant's Project until it submits sufficient FY 2014 Certifications and Assurances.

b. Binding Commitment. Your Applicant must comply with any Certifications or Assurances you make on its behalf, irrespective of whether you remain your Applicant's authorized representative. When you submit its Certifications and Assurances to FTA, both you and your Applicant are agreeing to comply with those terms. For programs that require specific certifications, when the Certifications and Assurances that would apply under MAP–21 differ from the Certifications and Assurances that would apply in FY 2012 or a previous fiscal year, FTA continues to include both types in the single Group used to facilitate funding your Applicant's request(s).

c. Length of Commitment. Your Applicant's FY 2014 Certifications and Assurances remain in effect until its Project is closed or the useful life of its Project property has expired, whichever is later. If your Applicant provides different Certifications and Assurances in a later fiscal year, the later Certifications and Assurances will usually apply to its Project, except as FTA determines otherwise in writing.

[1] A Public Law Number has not been assigned to the Consolidated Appropriations Act, 2014, as of the date of this notice's issuance.

d. Duration. You and your Applicant may use the FY 2014 Certifications and Assurances in Appendix A to support applications for FTA funding until FTA issues its FY 2015 Certifications and Assurances.

e. The FY 2014 Certifications and Assurances are Not a Complete List of Federal Requirements. FTA cautions that the FY 2014 Certifications and Assurances focus mainly on those representations your Applicant is required to submit to FTA before FTA may award Federal funds for its Project. Consequently, these Certifications and Assurances do not include many other Federal requirements that will apply to your Applicant and its Project.

f. Federal Requirements. In addition to the information in this Notice and FTA's FY 2014 Apportionments Notice, FTA also strongly encourages you and your Applicant's staff and prospective and current Third Party Participants to review all Federal legislation, regulations, and guidance that apply to your Applicant's proposed Project and to them. The FY 2014 Master Agreement identifies many of those requirements and applicable guidance, which can be accessed at http://www.fta.dot.gov.

g. Penalties for False or Fraudulent Statements. If you provide any false or fraudulent statement to the Federal Government on behalf of your Applicant or yourself, you may incur both Federal civil and criminal penalties. *See:*

(1) The Program Fraud Civil Remedies Act of 1986, as amended, 31 U.S.C. 3801 *et seq.,*

(2) U.S. Department of Transportation (U.S. DOT) regulations, ''Program Fraud Civil Remedies,'' 49 CFR part 31, and

(3) Section 5323(l)(1) of title 49, United States Code, which provides for Federal criminal penalties and termination of Federal funding should you provide, on behalf of your Applicant or yourself, a false or fraudulent certificate, submission, or statement in connection with the Federal transit program authorized by 49 U.S.C. chapter 53.

3. What are Your Responsibilities?

a. Make Sure All Involved With Your Applicant's Project Understand the Federal Requirements That Will Apply to Your Applicant and Its Project

As your Applicant's authorized representative, FTA strongly advises you to read this Notice and the Certifications and Assurances in its Appendix A before selecting Certifications and Assurances on behalf of your Applicant. In addition to reading the information in this Notice and its Appendix A (located at our Web site, *http://www.fta.dot.gov*), FTA also advises you to read the information accompanying the apportionment tables when FTA publishes its FY 2014 Apportionments Notice.

Your Applicant is responsible for compliance with all Federal requirements that apply to itself and its Project. Nevertheless, people and organizations participating in its Project, including Subrecipients, Third Party Contractors, and Third Party Sub-contractors (Third Party Participants) can seriously affect its ability to comply with those Federal requirements. Therefore, all Third Party Participants involved in its Project need to know and agree to comply with the Federal requirements that affect the Applicant's Project related activities and themselves.

b. Subrecipient and Other Third Party Participation

Except in limited circumstances when FTA has determined otherwise, your Applicant is ultimately responsible for compliance with all Certifications and Assurances that you select on its behalf, even though much of its Project will be carried out by Subrecipients or other Third Party Participants. Therefore, FTA strongly recommends that you take appropriate measures to ensure that Subrecipients and other Third Party Participants in your Applicant's Project do not take actions that will cause your Applicant to violate the representations made in its Certifications and Assurances.

c. Submit Your Applicant's Certifications and Assurances

You must submit all Groups of the FY 2014 Certifications and Assurances that apply to your Applicant and the Projects for which it seeks FTA funding in FY 2014. For your convenience, FTA recommends that you submit all 24 Groups of Certifications and Assurances. Those provisions of the various Certifications and Assurances that do not apply to your Applicant or its Project will not be enforced.

d. Obtain the Affirmation of Your Applicant's Attorney

You must obtain an affirmation of your Applicant's Attorney, signed in FY 2014, stating that your Applicant has sufficient authority under its State and local law to certify its compliance with the FY 2014 Certifications and Assurances that you have selected on its behalf. Your Applicant's Attorney must sign this affirmation during FY 2014. An Affirmation of its Attorney dated in a previous fiscal year is insufficient, unless FTA expressly determines otherwise in writing.

e. When To Submit

(1) If your Applicant is applying for funding under any of the discretionary capital programs (*e.g.,* New Starts, Small Starts, or Core Capacity Improvement), FTA expects to receive your Applicant's FY 2014 Certifications and Assurances within ninety (90) days from the date of this publication or soon after the submittal of your Applicant's request for FY 2014 funding. Likewise, if your Applicant is a current FTA recipient with an active Project funded with FTA capital or formula funds, FTA expects to receive your Applicant's FY 2014 Certifications and Assurances within ninety (90) days from the date of this publication or soon after the submittal of your Applicant's request for FY 2014 funding.

(2) If your Applicant seeks funding from an FTA program other than a formula program or a discretionary capital program, *e.g.,* for a Research, Development, Demonstration, and Deployment Project, FTA expects to receive your Applicant's FY 2014 Certifications and Assurances with the submission of its Application for FTA funding or soon thereafter.

4. Where are FTA's FY 2014 certifications and assurances?

a. Appendix A of this Notice, which is available at FTA's Web site, *http://www.fta.dot.gov*, and

b. TEAM-Web, FTA's electronic award and management system, *http://ftateamweb.fta.dot.gov*, at the ''Cert's & Assurances'' tab of the ''View/Modify Recipients'' page in the ''Recipients'' option.

5. What changes have been made since FY 2013?

FTA has made the following changes:

a. Transferred Group 03, ''Procurement and Procurement Systems,'' and Transferred Group 04, Private Sector Protections,'' FTA reversed the positions of these two groups, consistent with the customary placement in effect before FY 2013,

b. Transferred Group 04, ''Private Sector Protections,'' Subgroup 04.C, ''School Bus Agreement.'' FTA amended subgroup 04.C to add that, as a remedy, FTA may require an Applicant or Third Party Participant that violates FTA's School Bus regulations to take such remedial measures as FTA considers appropriate,

c. Group 10, ''Alcohol and Controlled Substance Testing.'' To comply with 49 U.S.C. 5331, as amended by MAP–21, FTA amended its ''Prevention of

Alcohol Misuse and Prohibited Drug Use in Transit Operations'' regulations, 49 CFR part 655, subpart I, specifically 49 CFR 655.83, to require your Applicant to certify that its Subrecipients and Third Party Contractors will comply with the regulation,

d. Group 15, ''Urbanized Area Formula Programs, Passenger Ferry Grants Program, and Job Access and Reverse Commute (JARC) Program.'' FTA added a new subgroup 15.C to provide Certifications and Assurances for the Passenger Ferry Grants Program, 49 U.S.C. 5307(h), as amended by MAP–21,

e. Group 18, ''Public Transportation on Indian Reservations Programs (also known as the Tribal Transit Programs.).'' FTA added the requirements to both the Program as amended by MAP–21, and the former Program in effect in FY 2012 or a previous fiscal year, that FTA's Buy America requirements under 49 U.S.C. 5323(j), as amended by MAP–21, would apply to Tribal Transit Projects; consequently, FTA consolidated both sets of Certifications and Assurances into a single program, and

f. Group 21, ''State Safety Oversight Grant Program.'' FTA adopted appropriate certifications for this program.

6. How do you submit the certifications and assurances?

a. Electronic Submission. Except in rare circumstances and if permitted by FTA, you must submit your Applicant's FY 2014 Certifications and Assurances in TEAM-Web. To submit the Certifications and Assurances, you must be registered in TEAM-Web.

The TEAM-Web ''Recipients'' option at the ''Cert's & Assurances'' tab of the ''View/Modify Recipients'' page contains fields for individually selecting among the 24 Groups of Certifications and Assurances that apply to your Applicant and also a designated field for selecting all 24 Groups, of which only the requirements that apply to you or your Applicant will be enforced.

The ''Cert's & Assurances'' tab has a field for you to enter your personal identification number (PIN), which is your electronic signature. There is also a field for the Attorney's PIN, affirming your Applicant's legal authority to make and comply with the Certifications and Assurances you have selected on its behalf. You may enter your PIN in place of the Attorney's PIN, provided that your Applicant has on file a similar affirmation that has been written, dated, and signed by its Attorney in FY 2014.

b. Paper Submission. You may submit your Applicant's FY 2014 Certifications and Assurances on paper only if you cannot submit them electronically in TEAM-Web and FTA agrees to accept hard copy submissions. In that case, you must submit the Signature Page(s) in Appendix A of the Certifications and Assurances indicating the Groups of Certifications and Assurances your Applicant is providing if you cannot submit them electronically. You may place a single mark in the designated space to signify your Applicant's agreement to comply with all Groups of Certifications and Assurances to the extent that they apply to it, or select the specific Groups of Certifications and Assurances that apply to it and its Projects.

You must enter your signature on the Signature Page(s) and provide an Affirmation by your Applicant's Attorney concerning your Applicant's legal capacity to make and comply with the FY 2014 Certifications and Assurances selected on its behalf. You may enter your signature in place of the Attorney's signature in the Affirmation by Applicant's Attorney part of the Signature Page, provided that your Applicant has on file a similar affirmation, written, dated, and signed by its Attorney in FY 2014.

For more information, you may contact the appropriate FTA Regional or Metropolitan Office.

Authority: 49 U.S.C. chapter 53; the Moving Ahead for Progress in the 21st Century Act (MAP–21) Pub. L. 112–141, June 6, 2012; other Federal laws administered by FTA; U.S. DOT and FTA regulations codified or to be codified in Title 49, Code of Federal Regulations; and FTA Circulars.

Therese W. McMillan,

Deputy Administrator.

[FR Doc. 2014–01888 Filed 1–30–14; 8:45 am]

BILLING CODE P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

Marine Transportation System National Advisory Council

ACTION: National Advisory Council Public Meeting.

SUMMARY: The Maritime Administration announces that the Marine Transportation System National Advisory Council (MTSNAC) will hold a meeting to discuss potential recommendations to the Secretary on the integration of marine highways into the national transportation system, options to provide a steady and reliable funding mechanism for port infrastructure development, methods to mitigate the impact of cargo diverted as a result of natural disasters, and surface transportation reauthorization issues. A public comment period will commence at 1:15 p.m. on February 13, 2014. To provide time for as many people to speak as possible, speaking time for each individual will be limited to three minutes. Members of the public who would like to speak are asked to contact Richard J. Lolich by February 7, 2014. Commenters will be placed on the agenda in the order in which notifications are received. If time allows, additional comments will be permitted. Copies of oral comments must be submitted in writing at the meeting. Additional written comments are welcome and must be filed by February 17, 2014.

DATES: The meeting will be held on Thursday, February 13, 2014, from 8:30 a.m. to 5:00 p.m.

ADDRESSES: The meeting will be held in the Media Center at the U.S. Department of Transportation Headquarters, 1200 New Jersey Ave. SE., Washington, DC 20590. To participate via teleconference, please contact Richard Lolich at the Maritime Administration as indicated below.

FOR FURTHER INFORMATION CONTACT: Richard Lolich, (202) 366–0704; Maritime Administration, MAR–540, Room W21–310, 1200 New Jersey Ave. SE., Washington, DC 20590–0001; *richard.lolich@dot.gov*.

(Authority: 5 U.S.C. App 2, Sec. 9(a)(2); 41 CFR 101–6. 1005; DOT Order 1120.3B)

Dated: January 28, 2014.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02036 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0005]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel SUNBABY; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build

requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0005. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov*. All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov*.

FOR FURTHER INFORMATION CONTACT: Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE., Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov*.

SUPPLEMENTARY INFORMATION:

As described by the applicant the intended service of the vessel SUNBABY is:

Intended Commercial Use of Vessel: ''Passenger charter''.

Geographic Region: California.

The complete application is given in DOT docket MARAD–2014–0005 at *http://www.regulations.gov*. Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR Part 388.

Privacy Act

Anyone is able to search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review DOT's complete Privacy Act Statement in the **Federal Register** published on April 11, 2000 (Volume 65, Number 70; Pages 19477–78).

By Order of the Maritime Administrator.
Dated: January 28, 2014.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02041 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0004]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel KATHLEEN ANNE; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0004. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov.* All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE., Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov.*

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel KATHLEEN ANNE is:

Intended Commercial Use of Vessel: ''Vessel is to be used for charter fishing''

Geographic Region: ''New York.''

The complete application is given in DOT docket MARAD–2014–0004 at *http://www.regulations.gov.* Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

Privacy Act

Anyone is able to search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review DOT's complete Privacy Act Statement in the **Federal Register** published on April 11, 2000 (Volume 65, Number 70; Pages 19477–78).

Dated: January 28, 2014.

By Order of the Maritime Administrator.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02046 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0008]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel SPIRIT; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0008. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov.* All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE., Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov.*

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel SPIRIT is:

Intended Commercial Use of Vessel: ''Private Vessel Charters, Passengers Only.''

Geographic Region: ''Maine, New Hampshire, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Delaware, Maryland, Virginia, North Carolina, South Carolina, Georgia, Florida, California, Oregon, Washington, and Alaska (excluding waters in Southeastern Alaska and waters north of a line between Gore Point to Cape Suckling [including the North Gulf Coast and Prince William Sound]).''

The complete application is given in DOT docket MARAD–2014–0008 at *http://www.regulations.gov.* Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR Part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

Privacy Act

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By Order of the Maritime Administrator.
Dated: January 28, 2014.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02047 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0010]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel BLESSED AGAIN; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0010. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE, Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov.* All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT:

Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE, Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov.*

SUPPLEMENTARY INFORMATION:

As described by the applicant the intended service of the vessel BLESSED AGAIN is:

Intended Commercial Use of Vessel: 6pk tourist boat for snorkel/fishing charter, with a captain and 1 crew, established business known as Delphine Charters''

Geographic Region: ''Florida''

The complete application is given in DOT docket MARAD–2014–0010 at *http://www.regulations.gov.* Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

Privacy Act

Anyone is able to search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review DOT's complete Privacy Act Statement in the **Federal Register** published on April 11, 2000 (Volume 65, Number 70; Pages 19477–78).

By Order of the Maritime Administrator.
Dated: January 28, 2014.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02032 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0007]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel SOJOURN; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0007. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov*. All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov*.

FOR FURTHER INFORMATION CONTACT: Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE, Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov*.

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel SOJOURN is:

Intended Commercial Use of Vessel: ''Luxurious canal cruises upon NY State waterways by professional United States crew personnel.''

Geographic Region: ''New York State''.

The complete application is given in DOT docket MARAD–2014–0007 at *http://www.regulations.gov*. Interested parties may comment on the effect this action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

Privacy Act

Anyone is able to search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review DOT's complete Privacy Act Statement in the **Federal Register** published on April 11, 2000 (Volume 65, Number 70; Pages 19477–78).

Dated: January 28, 2014.
By Order of the Maritime Administrator.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02042 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF TRANSPORTATION

Maritime Administration

[Docket No. MARAD–2014 0006]

Requested Administrative Waiver of the Coastwise Trade Laws: Vessel ZOAR; Invitation for Public Comments

AGENCY: Maritime Administration, Department of Transportation.

ACTION: Notice.

SUMMARY: As authorized by 46 U.S.C. 12121, the Secretary of Transportation, as represented by the Maritime Administration (MARAD), is authorized to grant waivers of the U.S.-build requirement of the coastwise laws under certain circumstances. A request for such a waiver has been received by MARAD. The vessel, and a brief description of the proposed service, is listed below.

DATES: Submit comments on or before March 3, 2014.

ADDRESSES: Comments should refer to docket number MARAD–2014–0006. Written comments may be submitted by hand or by mail to the Docket Clerk, U.S. Department of Transportation, Docket Operations, M–30, West Building Ground Floor, Room W12–140, 1200 New Jersey Avenue SE., Washington, DC 20590. You may also send comments electronically via the Internet at *http://www.regulations.gov.* All comments will become part of this docket and will be available for inspection and copying at the above address between 10 a.m. and 5 p.m., E.T., Monday through Friday, except federal holidays. An electronic version of this document and all documents entered into this docket is available on the World Wide Web at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: Linda Williams, U.S. Department of Transportation, Maritime Administration, 1200 New Jersey Avenue SE., Room W23–453, Washington, DC 20590. Telephone 202–366–0903, Email *Linda.Williams@dot.gov.*

SUPPLEMENTARY INFORMATION: As described by the applicant the intended service of the vessel ZOAR is:

Intended Commercial Use of Vessel: ''Short cruises—sunset, lunch, or similar.''

Geographic Region: ''New York, Pennsylvania, Ohio, North Carolina, South Carolina, Georgia, Florida.''

The complete application is given in DOT docket MARAD–2014–0006 at *http://www.regulations.gov.* Interested parties may comment on the effect this

action may have on U.S. vessel builders or businesses in the U.S. that use U.S.-flag vessels. If MARAD determines, in accordance with 46 U.S.C. 12121 and MARAD's regulations at 46 CFR part 388, that the issuance of the waiver will have an unduly adverse effect on a U.S.-vessel builder or a business that uses U.S.-flag vessels in that business, a waiver will not be granted. Comments should refer to the docket number of this notice and the vessel name in order for MARAD to properly consider the comments. Comments should also state the commenter's interest in the waiver application, and address the waiver criteria given in § 388.4 of MARAD's regulations at 46 CFR part 388.

Privacy Act

Anyone is able to search the electronic form of all comments received into any of our dockets by the name of the individual submitting the comment (or signing the comment, if submitted on behalf of an association, business, labor union, etc.). You may review DOT's complete Privacy Act Statement in the **Federal Register** published on April 11, 2000 (Volume 65, Number 70; Pages 19477–78).

By Order of the Maritime Administrator.
Dated: January 28, 2014.

Christine Gurland,

Acting Secretary, Maritime Administration.

[FR Doc. 2014–02045 Filed 1–30–14; 8:45 am]

BILLING CODE 4910–81–P

DEPARTMENT OF THE TREASURY

Submission for OMB Review; Comment Request

January 28, 2014.

The Department of the Treasury will submit the following information collection requests to the Office of Management and Budget (OMB) for review and clearance in accordance with the Paperwork Reduction Act of 1995, Public Law 104–13, on or after the date of publication of this notice.

DATES: Comments should be received on or before March 3, 2014 to be assured of consideration.

ADDRESSES: Send comments regarding the burden estimate, or any other aspect of the information collection, including suggestions for reducing the burden, to (1) Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: Desk Officer for Treasury, New Executive Office Building, Room 10235, Washington, DC 20503, or email at *OIRA_Submission@OMB.EOP.gov* and (2) Treasury PRA Clearance Officer, 1750 Pennsylvania Ave. NW., Suite 8141–D, Washington, DC 20220, or email at *PRA@treasury.gov.*

FOR FURTHER INFORMATION CONTACT: Copies of the submission(s) may be obtained by calling (202) 622–1295, email at *PRA@treasury.gov,* or the entire information collection request may be found at *www.reginfo.gov.*

Alcohol and Tobacco Tax and Trade Bureau (TTB)

OMB Number: 1513–0036.

Type of Review: Extension without change of a currently approved collection.

Title: Signing Authority for Corporate Officials.

Form: TTB F 5100.1.

Abstract: TTB F 5100.1 is used to document the authority of an individual or office to sign for the corporation in TTB matters. The form identifies the corporation, the individual or, office authorized to sign, and documents the authorization.

Affected Public: Private sector: Businesses or other for-profits.

Estimated Annual Burden Hours: 502.

OMB Number: 1513–0041.

Type of Review: Revision of a currently approved collection.

Title: Monthly Report of Processing Operations—TTB REC 5110/03.

Form: TTB F 5110.28.

Abstract: The information collected accounts for and verifies the processing of distilled spirits in bond. It is used to monitor proprietor activities, in auditing plant operations, compiling statistics.

Affected Public: Private sector: Businesses or other for-profits; State, Local, and Tribal Governments.

Estimated Annual Burden Hours: 23,884.

OMB Number: 1513–0095.

Type of Review: Extension without change of a currently approved collection.

Title: Application for Registration for Tax-Free Transactions Under 26 U.S.C. 4221.

Form: TTB F 5300.28.

Abstract: Businesses, State and local governments apply for registration to sell or purchase firearms or ammunition tax-free on this form. TTB uses the form to determine if a transaction is qualified for tax-free status.

Affected Public: Private sector: Businesses or other for-profits; State, Local, and Tribal Governments.

Estimated Annual Burden Hours: 951.

Dawn D. Wolfgang,

Treasury PRA Clearance Officer.

[FR Doc. 2014–01980 Filed 1–30–14; 8:45 am]

BILLING CODE 4810–25–P

DEPARTMENT OF THE TREASURY

Submission for OMB Review; Comment Request

January 28, 2014

The Department of the Treasury will submit the following information collection requests to the Office of Management and Budget (OMB) for review and clearance in accordance with the Paperwork Reduction Act of 1995, Public Law 104–13, on or after the date of publication of this notice.

DATES: Comments should be received on or before March 3, 2014 to be assured of consideration.

ADDRESSES: Send comments regarding the burden estimate, or any other aspect of the information collection, including suggestions for reducing the burden, to (1) Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: Desk Officer for Treasury, New Executive Office Building, Room 10235, Washington, DC 20503, or email at *OIRA_Submission@OMB.EOP.gov* and (2) Treasury PRA Clearance Officer, 1750 Pennsylvania Ave. NW., Suite 8141, Washington, DC 20220, or email at *PRA@treasury.gov.*

FOR FURTHER INFORMATION CONTACT: Copies of the submission(s) may be obtained by calling (202) 622–1295, emailing *PRA@treasury.gov,* or the entire information collection request may be found at *www.reginfo.gov.*

Internal Revenue Service (IRS)

OMB Number: 1545–0575.

Type of Review: Extension without change of a currently approved collection.

Title: Return of Excise Taxes Related to Employee Benefit Plans.

Form: Form 5330.

Abstract: Internal Revenue Code sections 4971, 4972, 4973(a)(3), 4975, 4976, 4977, 4978, 4978A, 4978B, 4979, 4979A and 4980 impose various excise taxes in connection with employee benefit plans. Form 5330 is used to compute and collect these taxes.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 540,145.

OMB Number: 1545–0715.

Type of Review: Revision of a currently approved collection.

Title: Proceeds From Broker and Barter Exchange Transactions.

Form: Form 1099–B.

Abstract: Form 1099–B is used by brokers and barter exchanges to report proceeds from transactions to the Internal Revenue Service. The form will be used by IRS to verify compliance

with the reporting rules and to verify that the recipient has included the proper amount of income on his or her return.

Affected Public: Individuals or households; Businesses or other for-profits.

Estimated Annual Burden Hours: 49,396,988.

OMB Number: 1545–1601.

Type of Review: Extension without change of a currently approved collection.

Title: Revenue Procedure 98–32, EFTPS Programs for Reporting Agents.

Abstract: The Batch and Bulk Filer programs are used by filers for electronically submitting enrollments, federal tax deposits, and federal tax payments on behalf of multiple taxpayers. These programs are part of the Electronic Federal Tax Payment System (EFTPS).

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 246,877.

OMB Number: 1545–1614.

Type of Review: Extension without change of a currently approved collection.

Title: REG–106177–97 (NPRM) Qualified State Tuition Programs.

Abstract: Respondents are states and eligible educational institutions that establish and maintain qualified state tuition programs. Respondents include distributees who receive benefits under the programs. Information verifies that programs are qualified and that distributions are used for qualified educational expenses.

Affected Public: Individuals or households; State, local, or tribal governments.

Estimated Annual Burden Hours: 4,258,260.

OMB Number: 1545–1616.

Type of Review: Extension without change of a currently approved collection.

Title: REG–115393–98 (Final) Roth IRAs.

Abstract: This collection of information contains regulations relating to Roth IRAs under section 408A of the Internal Revenue Code. The regulations provide guidance on establishing Roth IRAs, contributions to Roth IRAs, converting amounts to Roth IRAs, recharacterizing IRA contributions, Roth IRA distributions and Roth IRA reporting requirements.The regulations affect individuals establishing Roth IRAs, beneficiaries under Roth IRAs, and trustees, custodians or issuers of Roth IRAs.

Affected Public: Individuals or households; Businesses or other for-profits; and Not-for-profit institutions.

Estimated Annual Burden Hours: 125,000.

OMB Number: 1545–1623.

Type of Review: Extension without change of a currently approved collection.

Title: REG–246256–96 (Final) Excise Taxes on Excess Benefit Transactions.

Abstract: The rule affects organizations described in Internal Revenue Code section 501(c)(3) and (4) applicable tax-exempt organizations). The collection of information entails obtaining and relying on appropriate comparability data and documenting the basis of an organization's determination that compensation is reasonable, or a property transfer (or transfer of the right to use property) is at fair market value. These actions comprise two of the requirements specified in the legislative history for obtaining the rebuttable presumption of reasonableness.

Affected Public: Not-for-profit institutions.

Estimated Annual Burden Hours: 910,083.

OMB Number: 1545–1731.

Type of Review: Extension without change of a currently approved collection.

Title: Revenue Procedure 2001–37, Extraterritorial Income Exclusion Elections.

Abstract: A taxpayer that wants to revoke its election to be treated as a domestic corporation for all purposes of the Internal Revenue Code must file a revocation statement with the Internal Revenue Service. This revenue procedure provides guidance for implementing the elections (and revocation of such elections) established under the ''FSC Repeal and Extraterritorial Income Exclusion Act of 2000.''

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 19.

OMB Number: 1545–1751.

Type of Review: Extension without change of a currently approved collection.

Title: REG–107151–00 (TD 9035—Final) Constructive Transfers and Transfers of Property to a Third Party on Behalf of a Spouse.

Abstract: The regulation sets forth the required information that will permit spouses or former spouses to treat a redemption by a corporation of stock of one spouse or former spouse as a transfer of that stock to the other spouse or former spouse in exchange for the redemption proceeds and a redemption of the stock from the latter spouse or former spouse in exchange for the redemption proceeds.

Affected Public: Individuals or households; Businesses or other for-profits.

Estimated Annual Burden Hours: 500.

OMB Number: 1545–1899.

Type of Review: Extension without change of a currently approved collection.

Title: REG–138176–02 (Final) Timely Mailing Treated As Timely Filing.

Abstract: Section 7502(a) of the Internal Revenue Code provides that a document received after the due date for filing will be treated as filed on the date of the United States postmark on the envelope containing the document if the postmark date is on or before the date for filing the document and the document is placed in the U.S. mail on or before the due date. Under I.R.C. Sec. 7502, in order for taxpayers to establish the postmark date and prima facie evidence of delivery when using registered or certified mail to file documents with the IRS, taxpayers will need to retain the sender's receipt.

Affected Public: Individuals or households; Businesses or other for-profits; Not-for-profit institutions; Farms; Federal government; and State, local, or tribal governments.

Estimated Annual Burden Hours: 1,084,765.

OMB Number: 1545–1906.

Type of Review: Extension without change of a currently approved collection.

Title: REG–149524–03, LIFO Recapture Under Section 1363(d).

Abstract: This collection of information is required to inform the IRS of partnerships electing to increase the basis of inventory to reflect any amount included in a partner's income under section 1363(d).Section 1.1363–2(e)(ii) allows a partnership to elect to adjust the basis of its inventory to take account of LIFO recapture. Section 1.1363–2(e)(3) provides guidance on how to make this election.

Affected Public: Individuals or households; Businesses or other for-profits.

Estimated Annual Burden Hours: 200.

OMB Number: 1545–2061.

Type of Review: Extension without change of a currently approved collection.

Title: Supplemental Attachment to Schedule M–3.

Form: Form 8916–A.

Abstract: Form 8916–A provides a detailed schedule that reconciles the amount of the of cost of goods sold reported on Schedule M–3 for the Form

1120, Form 1065, or Form 1120–S. The authority is Internal Revenue Code section 6011 (P.L. 105–206, Title II, Sections 2001 through 2005).

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 5,049,720.

OMB Number: 1545–2065.

Type of Review: Extension without change of a currently approved collection.

Title: Notice of Qualified Equity Investment for New Markets Credit.

Form: Form 8874–A.

Abstract: Internal Revenue Code sections 6109 and 6103 code section 45N. Section 45N was added by section 405 of the Tax Relief and Health Care Act of 2006. Form 8874–A provides a means for the qualified mining company to compute and claim the credit.

Affected Public: Individuals or households; Businesses or other for-profits.

Estimated Annual Burden Hours: 2,715.

OMB Number: 1545–2067.

Type of Review: Extension without change of a currently approved collection.

Title: Mine Rescue Team Training Credit.

Form: Form 8923.

Abstract: Form 8923, Mine Rescue Team Training Credit, provides a means for the qualified mining company to compute and claim the credit.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 292.

OMB Number: 1545–2068.

Type of Review: Extension without change of a currently approved collection.

Title: TD 9340 (Final) Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts.

Abstract: The collection of information in the regulations is in final regulations under section 403(b) of the Internal Revenue Code and under related provisions of sections 402(b), 402(g), 402A, and 414(c). The regulations provide updated guidance on section 403(b) contracts of public schools and tax-exempt organizations described in section 501(c)(3). Such information exchange is necessary to ensure compliance with tax law requirements relating to loans and hardship distributions from section 403(b) plans and sponsors of section 403(b) contracts, administrators, participants, and beneficiaries.

Affected Public: Individuals or households; Not-for-profit institutions; and State, local, or tribal governments.

Estimated Annual Burden Hours: 45,000.

OMB Number: 1545–2169.

Type of Review: Extension without change of a currently approved collection.

Title: Notice 2010–30/Notice 2012–41—Transitional Guidance for Taxpayers Claiming Relief Under the Military Spouses Residency Relief Act for Taxable Year 2009 and subsequent years.

Abstract: On April 15, 2010, the Department of the Treasury and the IRS published Notice 2010–30, 2010–18 I.R.B. 650, which provides relief and procedures for certain taxpayers who are spouses (civilian spouses) of active duty members of the uniformed services (servicemembers). The relief and procedures were made available to civilian spouses who (A) accompany their servicemember spouses to a military duty station in American Samoa, Guam, the Northern Mariana Islands (NMI), Puerto Rico, or the U.S. Virgin Islands (USVI) (each a ''U.S. territory'') and claim residence or domicile (tax residence) in one of the 50 States or the District of Columbia under the Military Spouses Residency Relief Act (MSRRA) or (B) accompany their servicemember spouses to a military duty station in one of the 50 States or the District of Columbia and claim tax residence in a U.S. territory under MSRRA. The relief and procedures set forth in Notice 2010–30 were initially available for the taxable year 2009.

On June 7, 2012, the Treasury Department and the IRS published Notice 2012–41, which extended the relief and procedures announced in Notice 2010–30 to the subsequent taxable years. This notice further extends the relief set forth in Notice 2010–30 for civilian spouses described in the prior paragraph to taxable years beginning after November 11, 2010 and subsequent calendar years, and provides that such civilian spouses should follow the applicable procedures described in Notice 2010–30.

Affected Public: Individuals or households.

Estimated Annual Burden Hours: 6,200.

OMB Number: 1545–2173.

Type of Review: Extension without change of a currently approved collection.

Title: Hiring Incentives to Restore Employment (HIRE) Act Employee Affidavit.

Form: Form W–11.

Abstract: This form was created in response to the Hiring Incentives to Restore Employment (HIRE) Act, which was signed on March 18, 2010. The form was developed as a template for the convenience of employers who must collect affidavits from qualifying employees. The form is not filed; rather, an employer must retain the affidavit in order to justify claiming certain HIRE Act benefits. A model form is needed as soon as possible so that employers can begin confidently claiming payroll exemptions. The useful life of the form is only from March 18, 2010 to December 31, 2010.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 227,000.

OMB Number: 1545–2174.

Type of Review: Extension without change of a currently approved collection.

Title: Form 14134, Application for Certificate of Subordination of Federal Tax Lien, and Form 14135, Application for Certificate of Discharge of Property from Federal Tax Lien.

Form: Form 14134, Form 14135.

Abstract: The collection of information is required by 26 CFR 301.6325–1(b)(5) for consideration of the United States discharging property from the federal tax lien and is required by 26 CFR 301.6325–1(d)(4) for consideration that the United States subordinate its interest in property. These forms will provide guidance to ensure proper documentation is submitted to the IRS.

Affected Public: Individuals or households; Businesses or other for-profits; Not-for-profit institutions; Farms; Federal government; and State, local, or tribal governments.

Estimated Annual Burden Hours: 22,665.

OMB Number: 1545–2175.

Type of Review: Extension without change of a currently approved collection.

Title: Form 8942—Application for Certification of Qualified Investments Eligible for Credits; Notice 2010–45—Qualifying Therapeutic Discovery Project Credit.

Form: Form 8942.

Abstract: On March 23, 2010, the President signed the Patient Protection and Affordable Care Act (Act) (Pub. L. 111–148). Section 9023(a) of the Act adds section 48D to the Internal Revenue Code. Section 48D provides a 50-percent nonrefundable investment tax credit, and corresponding grant in lieu of a tax credit, for qualified investments in qualifying therapeutic discovery projects. The credit and grant are designed to encourage investments in new therapies relating to diseases.

Form 8942 will be used to apply for certification and credit.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 14,545.

Brenda Simms,

Treasury PRA Clearance Officer.

[FR Doc. 2014–02025 Filed 1–30–14; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Submission for OMB Review; Comment Request

January 27, 2014.

The Department of the Treasury will submit the following information collection requests to the Office of Management and Budget (OMB) for review and clearance in accordance with the Paperwork Reduction Act of 1995, Public Law 104–13, on or after the date of publication of this notice.

DATES: Comments should be received on or before March 3, 2014 to be assured of consideration.

ADDRESSES: Send comments regarding the burden estimate, or any other aspect of the information collection, including suggestions for reducing the burden, to (1) Office of Information and Regulatory Affairs, Office of Management and Budget, Attention: Desk Officer for Treasury, New Executive Office Building, Room 10235, Washington, DC 20503, or email at *OIRA_Submission@OMB.EOP.gov* and (2) Treasury PRA Clearance Officer, 1750 Pennsylvania Ave. NW., Suite 8141, Washington, DC 20220, or email at *PRA@treasury.gov.*

FOR FURTHER INFORMATION CONTACT: Copies of the submission(s) may be obtained by calling (202) 622–1295, emailing *PRA@treasury.gov,* or the entire information collection request may be found at *www.reginfo.gov.*

Internal Revenue Service (IRS)

OMB Number: 1545–0140.

Type of Review: Extension without change of a currently approved collection.

Title: Form 2210, Underpayment of Estimated Tax by Individuals, Estate, and Trusts; Form 2210–F, Underpayment of Estimated Tax by Farmers and Fishermen.

Form: Form 2210, Form 2210–F.

Abstract: Internal Revenue Code section 6654 imposes a penalty for failure to pay estimated tax. These forms are used by taxpayers to determine whether they are subject to the penalty and to compute the penalty if it applies. The IRS uses this information to determine whether the taxpayer is subject to the penalty and to verify the penalty amount.

Affected Public: Individuals or households; businesses or other for-profits; and farms.

Estimated Annual Burden Hours: 2,405,663.

OMB Number: 1545–0531.

Type of Review: Extension without change of a currently approved collection.

Title: Form 706–NA, United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States.

Form: Form 706–NA.

Abstract: Under section 6018, executors must file estate tax returns for nonresident non-citizens that had property in the U.S. Executors use Form 706–NA for this purpose. IRS uses the information to determine correct tax and credits.

Affected Public: Individuals or households.

Estimated Annual Burden Hours: 3,584.

OMB Number: 1545–0807.

Type of Review: Extension without change of a currently approved collection.

Title: (TD 7533) Final, DISC Rules on Procedure and Administration; Rules on Export Trade Corporations, and (TD 7896) Final, Income from Trade Shows.

Abstract: Section 1.6071–1(b) requires that when a taxpayer files a late return for a short period, proof of unusual circumstances for late filing must be given to the District Director. Sections 1.6072(b),(c),(d), and (e) of the IRC deal with the filing dates of certain corporate returns. Regulation section 1.6072–2 provides additional information concerning these filing dates. The information is used to ensure timely filing of corporate income tax returns.

Affected Public: Individuals or households; Businesses or other for-profits; not-for-profit institutions; farms; and State, local, or tribal governments.

Estimated Annual Burden Hours: 3,104.

OMB Number: 1545–1056.

Type of Review: Extension without change of a currently approved collection.

Title: REG–209020–86 (formerly INTL–61–86) NPRM & Temporary Foreign Tax Credit; Notification and Adjustment Due to Foreign Tax Redeterminations.

Abstract: Section 905(c) requires that a taxpayer notify the Internal Revenue Service of a change in the taxpayer's foreign income tax liability that may affect its foreign tax credit. New 1.905–4T provides rules concerning the time, manner, and contents of such notification. Should the taxpayer fail to notify the IRS, penalties under section 6689 may be imposed. Respondents are U.S. taxpayers that claim a foreign tax credit under sections 901, 902, or 960.

Affected Public: Individuals or households; businesses or other for-profits.

Estimated Annual Burden Hours: 54,000.

OMB Number: 1545–1058.

Type of Review: Revision of a currently approved collection.

Title: Form 8655-Reporting Agent Authorization; Revenue Procedure 2012–32.

Form: Form 8655.

Abstract: Revenue Procedure 2007–38 tells the clients of reporting agents how to monitor the tax deposits agents make for them. It obligates reporting agents to remind their clients regularly of this retained tax obligation. The Service may on occasion seek the notices to monitor reporting agent compliance with the notice rules and to document that clients have been informed of the clients' retained tax obligations. Revenue Procedure 2012–32 modifies and supersedes Rev. Proc. 2007–38 and provides the requirements for completing and submitting Form 8655, Reporting Agent Authorization (Authorization). An Authorization allows a taxpayer to designate a Reporting Agent to perform certain acts on behalf of a taxpayer.

Form 8655: Allows a taxpayer to designate a reporting agent to file certain employment tax returns electronically, and to submit Federal tax deposits. This form allows IRS to disclose tax account information and to provide duplicate copies of taxpayer correspondence to authorized agents. Reporting agents are persons or organizations preparing and filing electronically the federal tax returns and/or submitting federal tax deposits.

Affected Public: Private sector: Businesses or other for-profits.

Estimated Annual Burden Hours: 819,050.

OMB Number: 1545–1596.

Type of Review: Extension without change of a currently approved collection.

Title: Request for Innocent Spouse Relief.

Form: Form 8857, Form 8857(SP).

Abstract: Section 6103(e) of the Internal revenue code allows taxpayers to request, and IRS to grant, ''innocent spouse'' relief when: taxpayer filed a

joint return with tax substantially understated; taxpayer establishes no knowledge of or benefit from, the understatement; and it would be inequitable to hold the taxpayer liable. GAO Report GAO/GGD–97–34 recommended that IRS develop a form to make relief easier for the public to request.

Affected Public: Individuals or households.

Estimated Annual Burden Hours: 240,500.

OMB Number: 1545–1622.

Type of Review: Revision of a currently approved collection.

Title: Form 8866—Interest Computation Under the Look-Back Method for Property Depreciated Under the Income Forecast Method.

Form: Form 8866.

Abstract: Taxpayers depreciating property under the income forecast method and placed in service after September 13, 1995, must use Form 8866 to compute and report interest due or to be refunded under IRC 167(g)(2). The IRS uses Form 8866 to determine if the interest has been figured correctly.

Affected Public: Individuals or households; businesses or other for-profits.

Estimated Annual Burden Hours: 45,738.

OMB Number: 1545–1886.

Type of Review: Revision of a currently approved collection.

Title: Revenue Procedure 2004–35, Late Spousal S Corp Consents in Community Property States.

Abstract: This revenue procedure requires the collection of certain information in order for the taxpayer to gain relief for late shareholder consents for Subchapter S elections. The information is designed to make sure that applications for relief meet the requirements set out in the revenue procedure.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 200.

OMB Number: 1545–1892.

Type of Review: Revision of a currently approved collection.

Title: REG–153841–02 (TD 9208) (Final), Election Out of GST Deemed Allocations.

Abstract: The information collected will be used by the IRS to identify the trusts to which the election or termination of election will apply. The collection of information in this proposed regulation is in sections 26.2632–1(b)(2)(ii), 26.2632–1(b)(2)(iii), and 26.2632–1(b)(2). This information is required by the IRS for taxpayers who elect to have the automatic allocation rules not apply to the current transfer and/or to future transfers to the trust or to terminate such election. This information is also required by the IRS for taxpayers who elect to treat trusts described in section 2632(c)(3)(B)(i) through (vi) as generation-skipping transfer (GST) trusts or to terminate such election.

Affected Public: Individuals or households.

Estimated Annual Burden Hours: 12,500.

OMB Number: 1545–1902.

Type of Review: Extension without change of a currently approved collection.

Title: Qualified Severance of a Trust for Generation-Skipping Transfer (GST) Tax Purposes (TD 9348—Final).

Abstract: This regulation requires taxpayers to report a qualified severance by filing a Form 706–GS(T), or such other form that may be published by the Internal Revenue Service in the future that is specifically designated to be utilized to report qualified severances. Where Form 706–GS(T) is used, the filer should attach a Notice of Qualified Severance to the return that clearly identifies the trust that is being severed and the new trusts created as a result of the severance. The Notice must also provide the inclusion ratio of the trust that was severed and the inclusion ratios of the new trusts resulting from the severance. The information collected will be used by the IRS to identify the trusts being severed and the new trusts created upon severance. The collection of information is required in order to have a qualified severance. If there were no reporting requirement, the IRS would be unable to achieve its objectives.

Affected Public: Individuals or households.

Estimated Annual Burden Hours: 12,500.

OMB Number: 1545–2066.

Type of Review: Extension without change of a currently approved collection.

Title: Notice of Recapture Event for New Markets Credit.

Form: Form 8874–B.

Abstract: Form 8874–B, Notice of Recapture Event for New Markets Credit, was developed because qualified community development entities (CDEs) must provide taxpayers holding a qualified equity investment with a completed Form 8874–B when a recapture event occurs. Regulations section 1.45D–1(g)(2)(i)(B).

Affected Public: Individuals or households; businesses or other for-profits.

Estimated Annual Burden Hours: 2,755.

OMB Number: 1545–2070.

Type of Review: Extension without change of a currently approved collection.

Title: Rev. Proc. 2007–48 Rotable Spare Parts Safe Harbor Method.

Abstract: The information for which the agency is requesting to collect will support a taxpayer's claim for eligibility to use the safe harbor method of accounting for rotable spare parts provided in the proposed revenue procedures. The information will be submitted as a supporting schedule for the Form 3115, Application for Change in Accounting Method.

Affected Public: Businesses or other for-profits.

Estimated Annual Burden Hours: 75.

Brenda Simms,

Treasury PRA Clearance Officer.

[FR Doc. 2014–01892 Filed 1–30–14; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Alcohol and Tobacco Tax and Trade Bureau

[Docket No. TTB–2014–0002]

Proposed Information Collections; Comment Request

AGENCY: Alcohol and Tobacco Tax and Trade Bureau; Treasury.

ACTION: Notice and request for comments.

SUMMARY: As part of our continuing effort to reduce paperwork and respondent burden, and as required by the Paperwork Reduction Act of 1995, we invite comments on the proposed or continuing information collections listed below in this notice.

DATES: We must receive your written comments on or before April 1, 2014.

ADDRESSES: Please note that TTB has adopted a new method for receiving public comments on its information collections. As described below, you may send comments on the information collections listed in this document using the ''Regulations.gov'' online comment form for this document, or you may send written comments via U.S. mail or hand delivery. TTB no longer accepts public comments via email or fax.

- *http://www.regulations.gov:* Use the comment form for this document posted within Docket No. TTB–2014–0002 on ''Regulations.gov,'' the Federal e-rulemaking portal, to submit comments via the Internet;

• *U.S. Mail:* Mary A. Wood, Regulations and Rulings Division, Alcohol and Tobacco Tax and Trade Bureau, 1310 G Street NW., Box 12, Washington, DC 20005.

• *Hand Delivery/Courier in Lieu of Mail:* Mary A. Wood, Alcohol and Tobacco Tax and Trade Bureau, 1310 G Street, NW., Suite 200–E, Washington, DC 20005.

Please submit separate comments for each specific information collection listed in this document. You must reference the information collection's title, form or recordkeeping requirement number, and OMB number (if any) in your comment.

You may view copies of this document, the information collections listed in it and any associated instructions, and all comments received in response to this document within Docket No. TTB–2014–0002 at *http://www.regulations.gov.* You may also obtain paper copies of this document, the information collections described in it and any associated instructions, and any comments received in response to this document by contacting Mary A. Wood at the addresses or telephone number shown below.

FOR FURTHER INFORMATION CONTACT: Mary A. Wood, Alcohol and Tobacco Tax and Trade Bureau, 1310 G Street NW., Box 12, Washington, DC 20005; or telephone 202–453–1039, ext. 165.

SUPPLEMENTARY INFORMATION:

Request for Comments

The Department of the Treasury and its Alcohol and Tobacco Tax and Trade Bureau (TTB), as part of their continuing effort to reduce paperwork and respondent burden, invite the general public and other Federal agencies to comment on the proposed or continuing information collections listed below in this notice, as required by the Paperwork Reduction Act of 1995 (44 U.S.C. 3501 *et seq.*).

Comments submitted in response to this notice will be included or summarized in our request for Office of Management and Budget (OMB) approval of the relevant information collection. All comments are part of the public record and subject to disclosure. Please do not include any confidential or inappropriate material in your comments.

We invite comments on: (a) Whether this information collection is necessary for the proper performance of the agency's functions, including whether the information has practical utility; (b) the accuracy of the agency's estimate of the information collection's burden; (c) ways to enhance the quality, utility, and clarity of the information collected; (d) ways to minimize the information collection's burden on respondents, including through the use of automated collection techniques or other forms of information technology; and (e) estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide the requested information.

Information Collections Open for Comment

Currently, we are seeking comments on the following TTB surveys, forms, and recordkeeping requirements:

Title: Tax Information Authorization.

OMB Control Number: 1513–0001.

TTB Form Number: 5000.19.

Abstract: TTB provides form TTB F 5000.19 as a means for an industry member to authorize its representatives to obtain confidential information from TTB regarding that industry member. TTB uses this form to properly identify the representative authorized by an industry member to obtain confidential tax information.

Current Actions: We are submitting this information collection for extension purposes only. The information collection, estimated number of respondents, and estimated total annual burden hours remain unchanged.

Type of Review: Extension of a currently approved collection.

Affected Public: Business or other for-profit; individuals or households.

Estimated Number of Respondents: 50.

Estimated Total Annual Burden Hours: 50.

Title: Referral of Information.

OMB Control Number: 1513–0003.

TTB Form Numbers: 5000.21.

Abstract: TTB uses form TTB F 5000.21 to make referrals of potential violations of Federal, State, or local law to Federal, State, or local agencies, and to obtain information from those agencies about actions related to the referral.

Current Actions: We are submitting this information collection for extension purposes only. The information collection, estimated number of respondents, and estimated total annual burden hours remain unchanged.

Type of Review: Extension of a currently approved collection.

Affected Public: Federal Government; State, Local, or Tribal Government.

Estimated Number of Respondents: 500.

Estimated Total Annual Burden Hours: 500.

Titles: Brewer's Bond; Brewer's Bond Continuation Certificate; Brewer's Collateral Bond; and Brewer's Collateral Bond Continuation Certificate.

OMB Control Number: 1513–0015.

TTB Form Numbers: 5130.22, 5130.23, 5130.25, and 5130.27, respectively.

Abstract: The Internal Revenue Code of 1986 (IRC) requires brewers to obtain a bond to protect the Federal excise tax revenue and to ensure compliance with the requirements of the IRC and the regulations promulgated thereunder. Under the IRC and TTB regulations, once in four years, the brewer must submit either a new bond or a Continuation Certificate. The bond forms and continuation certificate forms are provided by TTB for brewers to use to meet these requirements.

Current Actions: We are submitting this information collection as a revision. We are updating the number of respondents, burden hours, and adding a sentence to TTB F 5130.23, 5130.25, and 5130.27 stating that affirmative responses to certain questions require the submission of further explanatory information. That statement already appears on TTB F 5130.22, and TTB F 5130.22 remains unchanged.

Type of Review: Revision of a currently approved collection.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 3,300.

Estimated Total Annual Burden Hours: 989.

Title: Notice of Release of Tobacco Products, Cigarette Papers, or Cigarette Tubes.

OMB Control Number: 1513–0025.

TTB Form Number: 5200.11.

Abstract: The form TTB F 5200.11 is used by a manufacturer of tobacco products or an export warehouse to obtain the release of tobacco products and cigarette papers and tubes from Customs custody, without payment of tax, under internal revenue bond. Such products may also include tobacco products and cigarette papers and tubes exported and returned to the original manufacturer or to an export warehouse authorized by that manufacturer. The form is used by TTB to ensure compliance with laws and regulations at the time of these transactions and for post audit examinations.

Current Actions: We are submitting this information collection for extension purposes only. The information collection, estimated number of respondents, and estimated total annual burden hours remain unchanged.

Type of Review: Extension of a currently approved collection.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 268.

Estimated Total Annual Burden Hours: 536.

Title: Usual and Customary Business Records Maintained by Brewers.

OMB Control Number: 1513–0058.

TTB Recordkeeping Number: 5130/1.

Abstract: The Internal Revenue Code of 1986 requires brewers to keep records, in such form and containing such information as prescribed by regulation and as necessary for protection of the revenue. The TTB regulations set forth the records that brewers must keep regarding their operations. TTB audits brewers' records to verify production of beer and cereal beverage and to verify the quantity of beer removed subject to tax and removed without payment of tax. TTB believes that these records would be normally kept in the course of doing business.

Current Actions: We are submitting this information collection as a revision. The information collection and estimated total annual burden hours remain unchanged. However, the estimated number of respondents has increased.

Type of Review: Revision of a currently approved collection.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 3,300.

Estimated Total Annual Burden Hours: 1 (one).

Title: Recordkeeping for Tobacco Products Removed in Bond from a Manufacturer's Premises for Experimental Purposes—27 CFR 40.232(e).

OMB Control Number: 1513–0110.

TTB Form or Recordkeeping Number: None.

Abstract: The IRC provides that manufacturers of tobacco products may remove tobacco products without payment of Federal excise tax for experimental purposes, in such quantities and in such manner as prescribed by regulation. The TTB regulations set forth the standards for such removals and the prescribed records are used by TTB to ensure that the products meet the standards for experimental purposes and that the removals are in compliance with the IRC and TTB regulations.

Current Actions: We are submitting this information collection request as a revision. The estimated number of respondents increased, however the total annual burden hour remains unchanged.

Type of Review: Revision of a currently approved collection.

Affected Public: Business or other for-profit.

Estimated Number of Respondents: 210.

Estimated Total Annual Burden Hours: 1 (one).

Title: Generic Clearance for the Collection of Qualitative Feedback on Agency Service Delivery.

OMB Control Number: 1513–0132.

TTB Form or Recordkeeping Number: None.

Abstract: Executive Order 12862 directs Federal agencies to provide service to the public that matches or exceeds the best service available in the private sector. In order to work continuously to ensure that our programs are effective and meet our customers' needs, TTB seeks to obtain OMB approval of a generic clearance to collect qualitative feedback on our service delivery. Qualitative feedback refers to substantive feedback that provides useful information on customers' perceptions and opinions, but is not in the form of a survey that yields quantitative, numerical, results.

Current Actions: We are submitting this information collection as an extension. The estimated number of respondents and the total annual burden hours remain unchanged.

Type of Review: Extension of a currently approved collection.

Affected Public: Individuals and households, businesses and organizations, State, Local or Tribal Government, farms.

Estimated Number of Respondents: 1,000.

Estimated Annual Responses: 1,000.

Estimated Total Annual Burden Hours: 1,000.

Dated: January 28, 2014.

Rochelle E. Stern,

Director, Regulations and Rulings Division.

[FR Doc. 2014–01992 Filed 1–30–14; 8:45 am]

BILLING CODE 4810–31–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0623]

Proposed Information Collection (VAAR Clause 852.236.91, Special Notes) Activity: Comment Request

AGENCY: Office of Management, Department of Veterans Affairs

ACTION: Notice

SUMMARY: The Office of Management (OM), Department of Veterans Affairs (VA), is announcing an opportunity for public comment on the proposed collection of certain information by the agency. Under the Paperwork Reduction Act (PRA) of 1995, Federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of information, including each extension without change of a currently approved collection, and allow 60 days for public comment in response to the notice. This notice solicits comments on the information needed to evaluate bidder's qualification and to support claims for price adjustment due to delay in construction caused by severe weather.

DATES: Written comments and recommendations on the proposed collection of information should be received on or before April 1, 2014.

ADDRESSES: Submit written comments on the collection of information through the Federal Docket Management System (FDMS) at www.Regulations.gov; or to Waleska Pierantoni-Monge, Office of Acquisition and Logistics (003A2A), Department of Veterans Affairs, 810 Vermont Avenue NW, Washington, DC 20420; or email: waleska.pierantoni-monge@va.gov. Please refer to ''OMB Control No. 2900–0623'' in any correspondence. During the comment period, comments may be viewed online through FDMS.

FOR FURTHER INFORMATION CONTACT: Waleska Pierantoni-Monge at (202) 632–5400, Fax 202–343–1434.

SUPPLEMENTARY INFORMATION: Under the PRA of 1995 (Pub. L. 104–13; 44 U.S.C. 3501—3521), Federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. This request for comment is being made pursuant to Section 3506(c)(2)(A) of the PRA.

With respect to the following collection of information, OM invites comments on: (1) Whether the proposed collection of information is necessary for the proper performance of OM's functions, including whether the information will have practical utility; (2) the accuracy of OM's estimate of the burden of the proposed collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or the use of other forms of information technology.

Title: Department of Veterans Affairs Acquisition Regulation (VAAR) Clause 852.236.91.

OMB Control Number: 2900–0623.

Type of Review: Extension without change of a currently approved collection.

Abstract: VAAR Clause 852.236.91 requires bidders to furnish information on previous experience, technical qualifications, financial resources, and facilities available to perform the work. The clause also requires contractors submitting a claim for price adjustment due to severe weather delay to provide climatologically data covering the period of the claim and covering the same period for the ten preceding years. VA uses the data collected to evaluate the bidder's qualification and responsibility, and to evaluate the contractor's claims for contract price adjustment due to weather-related delays.

Affected Public: Business or other for-profit and not-for-profit institutions.

Estimated Annual Burden: 778 hours.

a. Qualifications Data: 758 hours.

b. Weather Data: 20 hours.

Estimated Average Burden Per Respondent: 1 hour, 30 mins.

a. Qualifications Data: 30 min.

b. Weather Data: 1 hour.

Frequency of Response: On occasion.

Estimated Number of Respondents: 1,536.

a. Qualifications Data: 1,516

b. Weather Data: 20.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer, Department of Veterans Affairs.

[FR Doc. 2014–01907 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0663]

Proposed Information Collection (Pay Now Enter Info Page) Activity: Comment Request

AGENCY: Office of Management, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: The Office of Management (OM), Department of Veterans Affairs (VA), is announcing an opportunity for public comment on the proposed collection of certain information by the agency. Under the Paperwork Reduction Act (PRA) of 1995, Federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of information, including each extension of a currently approved collection, and allow 60 days for public comment in response to the notice. This notice solicits comments on information needed to electronically submit payment for debts owed.

DATES: Written comments and recommendations on the proposed collection of information should be received on or before April 1, 2014.

ADDRESSES: Submit written comments on the collection of information through Federal Docket Management System (FDMS) at *www.Regulations.gov* or to Dawn Eggers, VA Debt Management Center, Bishop Henry Whipple Federal Building, P.O. Box 11930, St. Paul, MN 55111–0930 or email to: *dawn.eggers@va.gov.* Please refer to ''OMB Control No. 2900–0663'' in any correspondence. During the comment period, comments may be viewed online through FDMS.

FOR FURTHER INFORMATION CONTACT: Dawn Eggers at (612) 713–6361 or Fax (612) 970–5687.

SUPPLEMENTARY INFORMATION: Under the PRA of 1995 (Pub. L. 104–13; 44 U.S.C. 3501–3521), Federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. This request for comment is being made pursuant to Section 3506(c)(2)(A) of the PRA.

With respect to the following collection of information, OM invites comments on: (1) Whether the proposed collection of information is necessary for the proper performance of OM's functions, including whether the information will have practical utility; (2) the accuracy of OM's estimate of the burden of the proposed collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or the use of other forms of information technology.

Title: Pay Now Enter Info Page.

OMB Control Number: 2900–0663.

Type of Review: Extension of a currently approved collection.

Abstract: Claimants who participated in VA's benefit programs and owe debts to VA can voluntary make online payments through VA's Pay Now Enter Info Page Web site. Data enter on the Pay Now Enter Info Page is redirected to the Department of Treasury's Pay.gov Web site allowing claimants to make payments with credit or debit cards, or directly from their bank account. At the conclusion of the transaction, the claimant will receive a confirmation acknowledging the success or failure of the transaction.

Affected Public: Individuals or households.

Estimated Annual Burden: 24,667 hours.

Estimated Average Burden Per Respondent: 10 minutes.

Frequency of Response: Daily.

Estimated Number of Respondents: 148,000.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer, Department of Veterans Affairs.

[FR Doc. 2014–01929 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0116]

Agency Information Collection (Notice to Department of Veterans Affairs of Veteran or Beneficiary Incarcerated in Penal Institution) Activity Under OMB Review

AGENCY: Veterans Benefits Administration, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3521), this notice announces that the Veterans Benefits Administration (VBA), Department of Veterans Affairs, will submit the collection of information abstracted below to the Office of Management and Budget (OMB) for review and comment. The PRA submission describes the nature of the information collection and its expected cost and burden; it includes the actual data collection instrument.

DATES: Comments must be submitted on or before March 3, 2014.

ADDRESSES: Submit written comments on the collection of information through *www.Regulations.gov* or to Office of Information and Regulatory Affairs, Office of Management and Budget, Attn: VA Desk Officer, 725 17th St. NW., Washington, DC 20503, or send through electronic mail to *oira_submission@omb.eop.gov.* Please refer to ''OMB Control No. 2900–0116'' in any correspondence.

FOR FURTHER INFORMATION CONTACT: Crystal Rennie, Enterprise Records Service (005R1B), Department of Veterans Affairs, 810 Vermont Avenue NW., Washington, DC 20420, (202) 632–7492 or email *crystal.rennie@va.gov* . Please refer to ''OMB Control No. 2900–0116.''

SUPPLEMENTARY INFORMATION:

Title: Notice to Department of Veterans Affairs of Veteran or Beneficiary Incarcerated in Penal Institution, VA Form 21–4193.

OMB Control Number: 2900–0116.

Type of Review: Extension of a currently approved collection.

Abstract: The data collected on VA Form 21–4193 is used to determine whether a beneficiary's VA compensation or pension rate should be reduced or terminated when he or she is incarcerated in a penal institution in excess of 60 days after conviction.

An agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number. The **Federal Register** Notice with a 60-day comment period soliciting comments on this collection of information was published 78 FR 46420 (July 31, 2013).

Affected Public: State, Local or Tribal Governments.

Estimated Annual Burden: 416 hours.

Estimated Average Burden Per Respondent: 15 minutes.

Frequency of Response: One–time.

Estimated Number of Respondents: 1,664.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer, Department of Veterans Affairs.

[FR Doc. 2014–01938 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0590]

Proposed Information Collection (Department of Veterans Affairs Acquisition Regulations Clause 852.237–7, Indemnification and Medical Liability Insurance) Activity: Comment Request

AGENCY: Office of Management, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: The Office of Management (OM), Department of Veterans Affairs (VA), is announcing an opportunity for public comment on the proposed collection of certain information by the agency. Under the Paperwork Reduction Act (PRA) of 1995, Federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of information, including each extension without change of a currently approved collection, and allow 60 days for public comment in response to the notice. This notice solicits comments on information needed to determine if offerors and contractors have adequate insurance coverage prior to contract awarded.

DATES: Written comments and recommendations on the proposed collection of information should be received on or before April 1, 2014.

ADDRESSES: Submit written comments on the collection of information through the Federal Docket Management System (FDMS) at *www.Regulations.gov;* or to Waleska Pierantoni-Monge, Office of Acquisition and Logistics (003A2A), Department of Veterans Affairs, 810 Vermont Avenue NW., Washington, DC 20420; or email: *waleska.pierantoni-monge@va.gov*. Please refer to ''OMB Control No. 2900–0590'' in any correspondence. During the comment period, comments may be viewed online through FDMS.

FOR FURTHER INFORMATION CONTACT: Waleska Pierantoni-Monge at (202) 632–5400, Fax 202–343–1434

SUPPLEMENTARY INFORMATION: Under the PRA of 1995 (Pub. L. 104–13; 44 U.S.C. 3501—3521), Federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. This request for comment is being made pursuant to Section 3506(c)(2)(A) of the PRA.

With respect to the following collection of information, OM invites comments on: (1) Whether the proposed collection of information is necessary for the proper performance of OM's functions, including whether the information will have practical utility; (2) the accuracy of OM's estimate of the burden of the proposed collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or the use of other forms of information technology.

Titles:

a. Veterans Affairs Acquisition Regulation Clause 852.237–7, Indemnification and Medical Liability Insurance.

b. Veterans Affairs Acquisition Regulation Clause 852.228–71, Indemnification and Insurance.

c. Veterans Affairs Acquisition Regulation Clause 852.207–70, Report of Employment Under Commercial Activities.

OMB Control Number: 2900–0590.

Type of Review: Extension without change of a currently approved collection.

≤*Abstracts:*

a. VA Acquisition Regulation Clause 852.237–7 is used in solicitations and contracts for the acquisition of non-personal health care services. It requires the bidder/offeror prior to contract award to furnish evidence of insurability of the offeror and/or all healthcare providers who will perform under the contract. The information provided is used to ensure that VA will not be held liable for any negligent acts of the contractor or it employees and that VA and VA beneficiaries are protected by adequate insurance coverage.

b. Clause 852.228–71(formerly 852.237.71) is used in solicitations for vehicle or aircraft services. It requires the bidder/offeror prior to contract award to furnish evidence that the firm possesses the types and amounts of insurance required by the solicitation. The information is necessary to ensure that VA beneficiaries and the public are protected by adequate insurance coverage.

c. Clause 852.207–70 is used in solicitations for commercial items and services where the work is currently being performed by VA employees and where those employees might be displaced as a result of an award to a commercial firm. The clause requires the contractor to report the names of the affected Federal employees offered employment opening and the names of employees who applied for but not offered employment and the reasons for withholding offers to those employees. The information collected is used by contracting officers to monitor and ensure compliance by the contractor under the requirements of Federal Acquisition Regulation Clause 52.207–3, Right of First Refusal of Employment.

Affected Public: Business or other for-profit; individuals and households; not-for-profit institutions, and State, Local or Tribal Government.

Estimated Annual Burden:

a. Veterans Affairs Acquisition Regulation Clause 852.237–7, Indemnification and Medical Liability Insurance—750 hours

b. Veterans Affairs Acquisition Regulation Clause 852.228–71(formerly 852.237.71), Indemnification and Insurance—250 hours.

c. Veterans Affairs Acquisition Regulation Clause 852.207–70, Report of Employment under Commercial Activities—15 hours.

Estimated Average Burden Per Respondent:

a. Veterans Affairs Acquisition Regulation Clause 852.237–7, Indemnification and Medical Liability Insurance—30 minutes.

b. Veterans Affairs Acquisition Regulation Clause 852.228–71(formerly 852.237.71), Indemnification and Insurance—30 minutes.

c. Veterans Affairs Acquisition Regulation Clause 852.207–70, Report of Employment Under Commercial Activities 30- minutes.

Frequency of Response: On occasion.

Estimated Number of Respondents:

a. Veterans Affairs Acquisition Regulation Clause 852.237–7, Indemnification and Medical Liability Insurance—1,500.

b. Veterans Affairs Acquisition Regulation Clause 852.228–71(formerly 852.237.71), Indemnification and Insurance—500.

c. Veterans Affairs Acquisition Regulation Clause 852.207–70, Report of Employment Under Commercial Activities—10.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer.

[FR Doc. 2014–01913 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0622]

Proposed Information Collection (VAAR Clause 852.236.89, Buy American Act) Activity: Comment Request

AGENCY: Office of Management, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: The Office of Management (OM), Department of Veterans Affairs (VA), is announcing an opportunity for public comment on the proposed collection of certain information by the agency. Under the Paperwork Reduction Act (PRA) of 1995, Federal agencies are required to publish notice in the **Federal Register** concerning each proposed collection of information, including each extension without change of a currently approved collection, and allow 60 days for public comment in response to the notice. This notice solicits comments on the information needed to consider the use of domestic foreign construction material.

DATES: Written comments and recommendations on the proposed collection of information should be received on or before April 1, 2014.

ADDRESSES: Submit written comments on the collection of information through the Federal Docket Management System (FDMS) at www.Regulations.gov; or to Waleska Pierantoni-Monge, Office of Acquisition and Logistics (003A2A), Department of Veterans Affairs, 810 Vermont Avenue NW, Washington, DC 20420; or email: Waleska.pierantoni-monge@va.gov. Please refer to ''OMB Control No. 2900–0622'' in any correspondence. During the comment period, comments may be viewed online through FDMS.

FOR FURTHER INFORMATION CONTACT: Waleska Pierantoni-Monge at (202) 632–5400–6859, Fax 202–343–1434

SUPPLEMENTARY INFORMATION: Under the PRA of 1995 (Pub. L. 104–13; 44 U.S.C. 3501—3521), Federal agencies must obtain approval from the Office of Management and Budget (OMB) for each collection of information they conduct or sponsor. This request for comment is being made pursuant to Section 3506(c)(2)(A) of the PRA.

With respect to the following collection of information, OM invites comments on: (1) whether the proposed collection of information is necessary for the proper performance of OM's functions, including whether the information will have practical utility; (2) the accuracy of OM's estimate of the burden of the proposed collection of information; (3) ways to enhance the quality, utility, and clarity of the information to be collected; and (4) ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or the use of other forms of information technology.

Title: Department of Veterans Affairs Acquisition Regulation (VAAR) Clause 852.236–89, Buy American Act.

OMB Control Number: 2900–0622.

Type of Review: Extension without change of a currently approved collection.

Abstract: The Buy American Act requires that only domestic construction material shall be used to perform domestic Federal contracts for construction, with certain exceptions. Despite the allowable exceptions, it is VA policy not to accept foreign construction material. VAAR clause 852.236–89 advises bidders of theses provisions and requires bidders who choose to submit a bid that includes foreign construction material to identify and list the price of such material. VA uses the information to determine whether to accept or not accept a bid that includes foreign construction material.

Affected Public: Business or other for-profit and Not-for-profit institutions.

Estimated Annual Burden: 20 hours.

Estimated Average Burden per Respondent: 30 min.

Frequency of Response: On occasion.

Estimated Number of Respondents: 40.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer, Department Clearance Officer.

[FR Doc. 2014–01914 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0252]

Agency Information Collection (Application for Authority to Close Loans on an Automatic Basis—Nonsupervised Lenders) Activity Under OMB Review

AGENCY: Veterans Benefits Administration, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3521), this notice announces that the Veterans Benefits Administration (VBA), Department of Veterans Affairs, has submitted the collection of information abstracted below to the Office of Management and Budget (OMB) for review and comment. The PRA submission describes the nature of the information collection and its expected cost and burden; it includes the actual data collection instrument.

DATES: Comments must be submitted on or before March 3, 2014

ADDRESSES: Submit written comments on the collection of information through *www.Regulations.gov,* or to Office of Information and Regulatory Affairs, Office of Management and Budget, Attn: VA Desk Officer; 725 17th St. NW., Washington, DC 20503 or sent through electronic mail to *oira_submission@omb.eop.gov.* Please refer to ''OMB Control No. 2900–0252'' in any correspondence.

FOR FURTHER INFORMATION CONTACT: Crystal Rennie, Enterprise Records Service (005R1B), Department of Veterans Affairs, 810 Vermont Avenue NW., Washington, DC 20420, (202) 632–7492 or email *crystal.rennie@va.gov.* Please refer to ''OMB Control No. 2900–0252.''

SUPPLEMENTARY INFORMATION:

Title: Application for Authority to Close Loans on an Automatic Basis—Nonsupervised Lenders, VA Form 26–8736.

OMB Control Number: 2900–0252.

Type of Review: Extension without change of a currently approved collection.

Abstract: VA Form 26–8736 is used by nonsupervised lenders requesting approval to close loans on an automatic basis. Automatic lending privileges eliminate the requirement for submission of loans to VA for prior approval. Lending institutions with automatic loan privileges may process and disburse such loans and subsequently report the loan to VA for issuance of guaranty. The form requests information considered crucial for VA to make acceptability determinations as to lenders who shall be approved for this privilege.

An agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number. The **Federal Register** Notice with a 60-day comment period soliciting comments on this collection of information was published on July 31, 2013 at page 46419.

Affected Public: Business or other for-profit.

Estimated Annual Burden: 50 hours.

Estimated Average Burden per Respondent: 25 minutes.

Frequency of Response: One time.

Estimated Number of Respondents: 120.

Dated: January 27, 2014.

By direction of the Secretary.

Crystal Rennie,

Department Clearance Officer, Department of Veterans Affairs.

[FR Doc. 2014–01889 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

[OMB Control No. 2900–0253]

Agency Information Collection (Nonsupervised Lender's Nomination and Recommendation of Credit Underwriter) Activity Under OMB Review

AGENCY: Veterans Benefits Administration, Department of Veterans Affairs.

ACTION: Notice.

SUMMARY: In compliance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3521), this notice announces that the Veterans Benefits Administration (VBA), Department of Veterans Affairs, will submit the collection of information abstracted below to the Office of Management and Budget (OMB) for review and comment. The PRA submission describes the nature of the information collection and its expected cost and burden; it includes the actual data collection instrument.

DATES: Comments must be submitted on or before March 3, 2014.

ADDRESSES: Submit written comments on the collection of information through *www.Regulations.gov*, or to Office of Information and Regulatory Affairs, Office of Management and Budget, Attn: VA Desk Officer; 725 17th St. NW., Washington, DC 20503 or sent through electronic mail to *oira_submission@omb.eop.gov.* Please refer to ''OMB Control No. 2900–0253'' in any correspondence.

FOR FURTHER INFORMATION CONTACT: Crystal Rennie, Enterprise Records Service (005R1B), Department of Veterans Affairs, 810 Vermont Avenue NW., Washington, DC 20420, (202) 632–7492 or email *crystal.rennie@va.gov.* Please refer to ''OMB Control No. 2900–0253.''

SUPPLEMENTARY INFORMATION:

Title: Nonsupervised Lender's Nomination and Recommendation of Credit Underwriter, VA Form 26–8736a.

OMB Control Number: 2900–0253.

Type of Review: Revision of a currently approved collection.

Abstract: VA Form 26–8736a is completed by nonsupervised lender's and the lender's nominee for credit underwriting with the Department of Veterans Affairs. Lenders are authorized by VA to make automatic guaranteed loans if approved for such purposes. The lender is required to have a qualified underwriter to review loans to be closed on automatic basis and determine that the loan meets VA's credit underwriting standards. VA uses the data collected on the form to evaluate the nominee's credit underwriting experience.

An agency may not conduct or sponsor, and a person is not required to respond to a collection of information unless it displays a currently valid OMB control number. The **Federal Register** Notice with a 60-day comment period soliciting comments on this collection of information was published on July 31, 2013, at pages 46416–46417.

Affected Public: Business or other for-profit.

Estimated Annual Burden: 500 hours.

Estimated Average Burden per Respondent: 20 minutes.

Frequency of Response: On occasion.

Estimated Number of Respondents: 1,500.

Dated: January 27, 2014.

By direction of the Secretary:

Crystal Rennie,

Department Clearance Officer, Department of Veterans Affairs.

[FR Doc. 2014–01930 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

DEPARTMENT OF VETERANS AFFAIRS

Voluntary Service National Advisory Committee; Notice of Meeting

Late Notice: Due to exceptional circumstances, namely, because of the Federal Government shut down in October 2013, the Department of Veterans Affairs (VA) was unable to publish in a timely manner the original notice for this meeting. In the interest of promoting openness and transparency—the goals of the Federal Advisory Committee Act (FACA)—we are publishing a late notice in the **Federal Register** to inform the public that the meeting was held on the dates and times listed in the original notice below. The meeting records can be viewed by the public at *http://www.volunteer.va.gov/NAC.asp* and the public may submit written comments as described below.

VA gives notice under FACA, 5 U.S.C. App. 2, that the Executive Committee of the VA Voluntary Service (VAVS) National Advisory Committee (NAC) will meet October 24–25, 2013, at the Embassy Suites Raleigh-Durham Research Triangle Park, 201 Harrison Oaks Boulevard, Cary, North Carolina. The sessions will begin at 8:30 a.m. each day and end at 4:30 p.m. on October 24, and at 12 noon on October 25, 2013. The meeting is open to the public. Please note that less than 15 calendar days' notice of this meeting is being provided due to exceptional circumstances, namely, that because of the Government shut down, the **Federal Register** was unable to timely publish the original notice for this meeting. See 41 CFR 102–3.150(b).

The Committee, comprised of fifty-four National voluntary organizations, advises the Secretary, through the Under Secretary for Health, on the coordination and promotion of volunteer activities within VA health care facilities. The Executive Committee consists of twenty representatives from the NAC member organizations.

On October 24, agenda topics will include NAC goals and objectives; review of the March 2013 NAC annual meeting minutes; VAVS update on the Voluntary Service program's activities; Parke Board update; evaluations of the 2013 NAC annual meeting; review of membership criteria and process; and

plans for 2014 NAC annual meeting (to include workshops and plenary sessions).

On October 25, agenda topics will include subcommittee reports; review of standard operating procedures; review of Fiscal Year 2013 organization data; 2015 NAC annual meeting plans; and any new business.

No time will be allocated at this meeting for receiving oral presentations from the public. However, the public may submit written statements for the Committee's review to Mrs. Sabrina C. Clark, Designated Federal Officer, Voluntary Service Office (10B2A), Department of Veterans Affairs, 810 Vermont Avenue NW., Washington, DC 20420, or email at *Sabrina.Clark@VA.gov.* Any member of the public wishing to attend the meeting or seeking additional information should contact Mrs. Clark at (202) 461–7300.

By Direction of the Secretary.

William F. Russo,

Deputy Director, Office of Regulation Policy and Management, Office of the General Counsel.

[FR Doc. 2014–01054 Filed 1–30–14; 8:45 am]

BILLING CODE 8320–01–P

FEDERAL REGISTER

Vol. 79 Friday,

No. 21 January 31, 2014

Book 2 of 2 Books

Pages 5535–6076

Part II

Department of the Treasury

Office of the Comptroller of the Currency

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

Securities and Exchange Commission

12 CFR Parts 44, 248, and 351

17 CFR Part 255

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 44

[Docket No. OCC–2011–0014]

RIN 1557–AD44

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

12 CFR Part 248

[Docket No. R–1432]

RIN 7100 AD82

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 351

RIN 3064–AD85

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 255

[Release No. BHCA–1; File No. S7–41–11]

RIN 3235–AL07

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

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

ACTION: Final rule.

SUMMARY: The OCC, Board, FDIC, and SEC (individually, an ''Agency,'' and collectively, ''the Agencies'') are adopting a rule that would implement section 13 of the BHC Act, which was added by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (''Dodd-Frank Act''). Section 13 contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

DATES: The final rule is effective April 1, 2014.

FOR FURTHER INFORMATION CONTACT:

OCC: Ursula Pfeil, Counsel, or Deborah Katz, Assistant Director, Legislative and Regulatory Activities Division, (202) 649–5490; Ted Dowd, Assistant Director, or Roman Goldstein, Senior Attorney, Securities and Corporate Practices Division, (202) 649–5510; Kurt Wilhelm, Director for Financial Markets Group, (202) 649–6360; Stephanie Boccio, Technical Expert for Credit and Market Risk Group, (202) 649–6360, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Christopher M. Paridon, Counsel, (202) 452–3274, or Anna M. Harrington, Senior Attorney, Legal Division, (202) 452–6406; Mark E. Van Der Weide, Deputy Director, Division of Bank Supervision and Regulation, (202) 452–2263; or Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452–3760, Board of Governors of the Federal Reserve System, 20th and C Streets NW., Washington, DC 20551.

FDIC: Bobby R. Bean, Associate Director, *bbean@fdic.gov*, or Karl R. Reitz, Chief, Capital Markets Strategies Section, *kreitz@fdic.gov,* Capital Markets Branch, Division of Risk Management Supervision, (202) 898–6888; Michael B. Phillips, Counsel, *mphillips@fdic.gov*, or Gregory S. Feder, Counsel, *gfeder@fdic.gov*, Legal Division, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

SEC: Josephine J. Tao, Assistant Director, Angela R. Moudy, Branch Chief, John Guidroz, Branch Chief, Jennifer Palmer or Lisa Skrzycki, Attorney Advisors, Office of Trading Practices, Catherine McGuire, Counsel, Division of Trading and Markets, (202) 551–5777; W. Danforth Townley, Attorney Fellow, Jane H. Kim, Brian McLaughlin Johnson or Marian Fowler, Senior Counsels, Division of Investment Management, (202) 551–6787; David Beaning, Special Counsel, Office of Structured Finance, Division of Corporation Finance, (202) 551–3850; John Cross, Office of Municipal Securities, (202) 551–5680; or Adam Yonce, Assistant Director, or Matthew Kozora, Financial Economist, Division of Economic and Risk Analysis, (202) 551–6600, U.S. Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549.

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I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (''BHC Act'') (codified at 12 U.S.C. 1851) that generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (''covered fund''), subject to certain exemptions.[2] New section 13 of the BHC Act also provides that a nonbank financial company designated by the Financial Stability Oversight Council (''FSOC'') for supervision by the Board (while not a banking entity under section 13 of the BHC Act) would be subject to additional capital requirements, quantitative limits, or other restrictions if the company engages in certain proprietary trading or covered fund activities.[3]

Section 13 of the BHC Act generally prohibits banking entities from engaging as principal in proprietary trading for the purpose of selling financial instruments in the near term or otherwise with the intent to resell in order to profit from short-term price movements.[4] Section 13(d)(1) expressly exempts from this prohibition, subject to conditions, certain activities, including:

- Trading in U.S. government, agency and municipal obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activities;
- Trading on behalf of customers;
- Trading for the general account of insurance companies; and
- Foreign trading by non-U.S. banking entities.[5]

Section 13 of the BHC Act also generally prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, a hedge fund or private equity fund. Section 13 contains several exemptions that permit banking entities to make limited investments in hedge funds and private equity funds, subject to a number of restrictions designed to ensure that banking entities do not rescue investors in these funds from loss and are not themselves exposed to

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] *See* 12 U.S.C. 1851.

[3] *See* 12 U.S.C. 1851(a)(2) and (f)(4). The Agencies note that two of the three companies currently designated by FSOC for supervision by the Board are affiliated with insured depository institutions, and are therefore currently banking entities for purposes of section 13 of the BHC Act. The Agencies are continuing to review whether the remaining company engages in any activity subject to section 13 of the BHC Act and what, if any, requirements apply under section 13.

[4] *See* 12 U.S.C. 1851(a)(1)(A) and (B).

[5] *See id.* at 1851(d)(1).

significant losses from investments or other relationships with these funds.

Section 13 of the BHC Act does not prohibit a nonbank financial company supervised by the Board from engaging in proprietary trading, or from having the types of ownership interests in or relationships with a covered fund that a banking entity is prohibited or restricted from having under section 13 of the BHC Act. However, section 13 of the BHC Act provides that these activities be subject to additional capital charges, quantitative limits, or other restrictions.[6]

II. Notice of Proposed Rulemaking: Summary of General Comments

Authority for developing and adopting regulations to implement the prohibitions and restrictions of section 13 of the BHC Act is divided among the Board, the Federal Deposit Insurance Corporation (''FDIC''), the Office of the Comptroller of the Currency (''OCC''), the Securities and Exchange Commission (''SEC''), and the Commodity Futures Trading Commission (''CFTC'').[7] As required by section 13(b)(2) of the BHC Act, the Board, OCC, FDIC, and SEC in October 2011 invited the public to comment on proposed rules implementing that section's requirements.[8] The period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012.[9] In January 2012, the CFTC requested comment on a proposal for the same common rule to implement section 13 with respect to those entities for which it is the primary financial regulatory agency and invited public comment on its proposed implementing rule through April 16, 2012.[10] The statute requires the Agencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act.[11]

The proposed rules invited comment on a multi-faceted regulatory framework to implement section 13 consistent with the statutory language. In addition, the Agencies invited comments on the potential economic impacts of the proposed rule and posed a number of questions seeking information on the costs and benefits associated with each aspect of the proposal, as well as on any significant alternatives that would minimize the burdens or amplify the benefits of the proposal in a manner consistent with the statute. The Agencies also encouraged commenters to provide quantitative information and data about the impact of the proposal on entities subject to section 13, as well as on their clients, customers, and counterparties, specific markets or asset classes, and any other entities potentially affected by the proposed rule, including non-financial small and mid-size businesses.

The Agencies received over 18,000 comments addressing a wide variety of aspects of the proposal, including definitions used by the proposal and the exemptions for market making-related activities, risk-mitigating hedging activities, covered fund activities and investments, the use of quantitative metrics, and the reporting proposals. The vast majority of these comments were from individuals using a version of a short form letter to express support for the proposed rule. More than 600 comment letters were unique comment letters, including from members of Congress, domestic and foreign banking entities and other financial services firms, trade groups representing banking, insurance, and the broader financial services industry, U.S. state and foreign governments, consumer and public interest groups, and individuals. To improve understanding of the issues raised by commenters, the Agencies met with a number of these commenters to discuss issues relating to the proposed rule, and summaries of these meetings are available on each of the Agency's public Web sites.[12] The CFTC staff also hosted a public roundtable on the proposed rule.[13] Many of the commenters generally expressed support for the broader goals of the proposed rule. At the same time, many commenters expressed concerns about various aspects of the proposed rule. Many of these commenters requested that one or more aspects of the proposed rule be modified in some manner in order to reflect their viewpoints and to better accommodate the scope of activities that they argued were encompassed within section 13 of the BHC Act. The comments addressed all major sections of the proposed rule.

Section 13 of the BHC Act also required the FSOC to conduct a study (''FSOC study'') and make recommendations to the Agencies by January 21, 2011 on the implementation of section 13 of the BHC Act. The FSOC study was issued on January 18, 2011. The FSOC study included a detailed discussion of key issues related to implementation of section 13 and recommended that the Agencies consider taking a number of specified actions in issuing rules under section 13 of the BHC Act.[14] The FSOC study also recommended that the Agencies adopt a four-part implementation and supervisory framework for identifying and preventing prohibited proprietary trading, which included a programmatic compliance regime requirement for banking entities, analysis and reporting of quantitative metrics by banking entities, supervisory review and oversight by the Agencies, and

[6] *See* 12 U.S.C. 1851(a)(2) and (d)(4).

[7] *See* 12 U.S.C. 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13's prohibitions and restrictions must be issued by: (i) The appropriate Federal banking agencies (*i.e.,* the Board, the OCC, and the FDIC), jointly, with respect to insured depository institutions; (ii) the Board, with respect to any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act, any nonbank financial company supervised by the Board, and any subsidiary of any of the foregoing (other than a subsidiary for which an appropriate Federal banking agency, the SEC, or the CFTC is the primary financial regulatory agency); (iii) the CFTC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act; and (iv) the SEC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act. *See id.*

[8] *See* 76 FR 68846 (Nov. 7, 2011) (''Joint Proposal'').

[9] *See* 77 FR 23 (Jan. 23, 2012) (extending the comment period to February 13, 2012).

[10] *See* 77 FR 8332 (Feb. 14, 2012) (''CFTC Proposal'').

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

[12] *See http://www.regulations.gov/#!docketDetail;D=OCC-2011-0014* (OCC); *http://www.federalreserve.gov/newsevents/reform_systemic.htm* (Board); *http://www.fdic.gov/regulations/laws/federal/2011/11comAD85.html* (FDIC); *http://www.sec.gov/comments/s7-41-11/s74111.shtml* (SEC); and *http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm* (CFTC).

[13] *See* Commodity Futures Trading Commission, CFTC Staff to Host a Public Roundtable to Discuss the Proposed Volcker Rule (May 24, 2012), *available at http://www.cftc.gov/PressRoom/PressReleases/pr6263-12*; transcript *available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript053112.pdf.*

[14] *See* Financial Stability Oversight Counsel, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011), *available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf.* (''FSOC study''). *See* 12 U.S.C. 1851(b)(1). Prior to publishing its study, FSOC requested public comment on a number of issues to assist in conducting its study. *See* 75 FR 61,758 (Oct. 6, 2010). Approximately 8,000 comments were received from the public, including from members of Congress, trade associations, individual banking entities, consumer groups, and individuals.

enforcement procedures for violations.[15] The Agencies carefully considered the FSOC study and its recommendations.

In formulating this final rule, the Agencies carefully reviewed all comments submitted in connection with the rulemaking and considered the suggestions and issues they raise in light of the statutory restrictions and provisions as well as the FSOC study. The Agencies have sought to reasonably respond to all of the significant issues commenters raised. The Agencies believe they have succeeded in doing so notwithstanding the complexities involved. The Agencies also carefully considered different options suggested by commenters in light of potential costs and benefits in order to effectively implement section 13 of the BHC Act. The Agencies made numerous changes to the final rule in response to the issues and information provided by commenters. These modifications to the rule and explanations that address comments are described in more detail in the section-by-section description of the final rule. To enhance uniformity in both rules that implement section 13 and administration of the requirements of that section, the Agencies have been regularly consulting with each other in the development of this final rule.

Some commenters requested that the Agencies repropose the rule and/or delay adoption pending the collection of additional information.[16] As described in part above, the Agencies have provided many and various types of opportunities for commenters to provide input on implementation of section 13 of the BHC Act and have collected substantial information in the process. In addition to the official comment process described above, members of the public submitted comment letters in advance of the official comment period for the proposed rules and met with staff of the Agencies to explain issues of concern; the public also provided substantial comment in response to a request for comment from the FSOC regarding its findings and recommendations for implementing section 13.[17] The Agencies provided a detailed proposal and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. In addition, the Agencies have continued to receive comment letters after the extended comment period deadline, which the Agencies have considered. Thus, the Agencies believe interested parties have had ample opportunity to review the proposed rules, as well as the comments made by others, and to provide views on the proposal, other comment letters, and data to inform our consideration of the final rules.

In addition, the Agencies have been mindful of the importance of providing certainty to banking entities and financial markets and of providing sufficient time for banking entities to understand the requirements of the final rule and to design, test, and implement compliance and reporting systems. The further substantial delay that would necessarily be entailed by reproposing the rule would extend the uncertainty that banking entities would face, which could prove disruptive to banking entities and the financial markets.

The Agencies note, as discussed more fully below, that the final rule incorporates a number of modifications designed to address the issues raised by commenters in a manner consistent with the statute. The preamble below also discusses many of the issues raised by commenters and explains the Agencies' response to those comments.

To achieve the purpose of the statute, without imposing unnecessary costs, the final rule builds on the multi-faceted approach in the proposal, which includes development and implementation of a compliance program at each banking entity engaged in trading activities or that makes investments subject to section 13 of the BHC Act; the collection and evaluation of data regarding these activities as an indicator of areas meriting additional attention by the banking entity and the relevant agency; appropriate limits on trading, hedging, investment and other activities; and supervision by the Agencies. To allow banking entities sufficient time to develop appropriate systems, the Agencies have provided for a phased-in schedule for the collection of data, limited data reporting requirements only to banking entities that engage in significant trading activity, and agreed to review the merits of the data collected and revise the data collection as appropriate over the next 21 months. Importantly, as explained in detail below, the Agencies have also reduced the compliance burden for banking entities with total assets of less than $10 billion. The final rule also eliminates compliance burden for firms that do not engage in covered activities or investments beyond investing in U.S. government obligations, agency guaranteed obligations, or municipal obligations.

Moreover, the Agencies believe the data that will be collected in connection with the final rule, as well as the compliance efforts made by banking entities and the supervisory experience that will be gained by the Agencies in reviewing trading and investment activity under the final rule, will provide valuable insights into the effectiveness of the final rule in achieving the purpose of section 13 of the BHC Act. The Agencies remain committed to implementing the final rule, and revisiting and revising the rule as appropriate, in a manner designed to ensure that the final rule faithfully implements the requirements and purposes of the statute.[18]

Finally, the Board has determined, in accordance with section 13 of the BHC Act, to provide banking entities with additional time to conform their activities and investments to the statute and the final rule. The restrictions and prohibitions of section 13 of the BHC Act became effective on July 21, 2012.[19] The statute provided banking entities a period of two years to conform their activities and investments to the requirement of the statute, until July 21, 2014. Section 13 also permits the Board to extend this conformance period, one year at a time, for a total of no more than three additional years.[20] Pursuant to this authority and in connection with this rulemaking, the Board has in a separate action extended the conformance period for an additional year until July 21, 2015.[21] The Board will continue to monitor developments to determine whether additional extensions of the conformance period are in the public interest, consistent with the statute. Accordingly, the Agencies do not believe that a reproposal or further delay is necessary or appropriate.

Commenters have differing views on the overall economic impacts of section 13 of the BHC Act.

[15] *See* FSOC study at 5–6.

[16] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); Chamber (Nov. 2011); Chamber (Nov. 2013); Members of Congress (Dec. 2011); IIAC; Real Estate Roundtable; Ass'n. of German Banks; Allen & Overy (Clearing); JPMC; Goldman (Prop. Trading); BNY Mellon *et al.;* State Street (Feb. 2012); ICI Global; Chamber (Feb. 2012); Société Générale; HSBC; Western Asset Mgmt.; Abbott Labs *et al.* (Feb. 2012); PUC Texas; Columbia Mgmt.; ICI (Feb. 2012); IIB/EBF; British Bankers' Ass'n.; ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Ralph Saul (Apr. 2012); BPC.

[17] *See* 75 FR 61,758 (Oct. 6, 2010).

[18] If any provision of this rule, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

[19] *See* 12 U.S.C. 1851(c)(1).

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

[21] *See,* Board Order Approving Extension of Conformance Period, available at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.*

Some commenters remarked that proprietary trading restrictions will have detrimental impacts on the economy such as: reduction in efficiency of markets, economic growth, and in employment due to a loss in liquidity.[22] In particular, a commenter expressed concern that there may be high transition costs as non-banking entities replace some of the trading activities currently performed by banking entities.[23] Another commenter focused on commodity markets remarked about the potential reduction in commercial output and curtailed resource exploration due to a lack of hedging counterparties.[24] Several commenters stated that section 13 of the BHC Act will reduce access to debt markets—especially for smaller companies—raising the costs of capital for firms and lowering the returns on certain investments.[25] Further, some commenters mentioned that U.S. banks may be competitively disadvantaged relative to foreign banks due to proprietary trading restrictions and compliance costs.[26]

On the other hand, other commenters stated that restricting proprietary trading activity by banking entities may reduce systemic risk emanating from the financial system and help to lower the probability of the occurrence of another financial crisis.[27] One commenter contended that large banking entities may have a moral hazard incentive to engage in risky activities without allocating sufficient capital to them, especially if market participants believe these institutions will not be allowed to fail.[28] Commenters argued that large banking entities may engage in activities that increase the upside return at the expense of downside loss exposure which may ultimately be borne by Federal taxpayers [29] and that subsidies associated with bank funding may create distorted economic outcomes.[30] Furthermore, some commenters remarked that non-banking entities may fill much of the void in liquidity provision left by banking entities if banking entities reduce their current trading activities.[31] Finally, some commenters mentioned that hyper-liquidity that arises from, for instance, speculative bubbles, may harm the efficiency and price discovery function of markets.[32]

The Agencies have taken these concerns into account in the final rule. As described below with respect to particular aspects of the final rule, the Agencies have addressed these issues by reducing burdens where appropriate, while at the same time ensuring that the final rule serves its purpose of promoting healthy economic activity. In that regard, the Agencies have sought to achieve the balance intended by Congress under section 13 of the BHC Act. Several comments suggested that a costs and benefits analysis be performed by the Agencies.[33] On the other hand, some commenters [34] correctly stated that a costs and benefits analysis is not legally required.[35] However, the Agencies find certain of the information submitted by commenters concerning costs and benefits and economic effects to be relevant to consideration of the rule, and so have considered this information as appropriate, and, on the basis of these and other considerations, sought to achieve the balance intended by Congress in section 619 of the Dodd-Frank Act. The relevant comments are addressed therein.

III. Overview of Final Rule

The Agencies are adopting this final rule to implement section 13 of the BHC Act with a number of changes to the proposal, as described further below. The final rule adopts a risk-based approach to implementation that relies on a set of clearly articulated characteristics of both prohibited and permitted activities and investments and is designed to effectively accomplish the statutory purpose of reducing risks posed to banking entities by proprietary trading activities and investments in or relationships with covered funds. As explained more fully below in the section-by-section analysis, the final rule has been designed to ensure that banking entities do not engage in prohibited activities or investments and to ensure that banking entities engage in permitted trading and investment activities in a manner designed to identify, monitor and limit the risks posed by these activities and investments. For instance, the final rule requires that any banking entity that is engaged in activity subject to section 13 develop and administer a compliance program that is appropriate to the size, scope and risk of its activities and investments. The rule requires the largest firms engaged in these activities to develop and implement enhanced compliance programs and regularly report data on trading activities to the Agencies. The Agencies believe this will permit banking entities to effectively engage in permitted activities, and the Agencies to enforce compliance with section 13 of the BHC Act. In addition, the enhanced compliance programs will help both the banking entities and the Agencies identify, monitor, and limit risks of activities permitted under section 13, particularly involving banking entities posing the greatest risk to financial stability.

A. General Approach and Summary of Final Rule

The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act, which include prohibiting banking entities from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that are critical to capital generation for businesses of all sizes, households and individuals, and that facilitate liquid markets. These client-oriented financial services, which include underwriting, market making, and asset management services, are important to the U.S. financial markets and the participants in those markets. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions.

As noted above, the final rule takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the final rule includes a framework that clearly describes the key characteristics of both prohibited and permitted

[22] *See, e.g.,* Oliver Wyman (Dec. 2011); Chamber (Dec. 2011); Thakor Study; Prof. Duffie; IHS.

[23] *See* Prof. Duffie.

[24] *See* IHS.

[25] *See, e.g.,* Chamber (Dec. 2011); Thakor Study; Oliver Wyman (Dec. 2011); IHS.

[26] *See, e.g.,* RBC; Citigroup (Feb. 2012); Goldman (Covered Funds).

[27] *See, e.g.,* Profs. Admati & Pfleiderer; AFR (Nov. 2012); Better Markets (Dec. 2011); Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[28] *See* Occupy.

[29] *See* Profs. Admati & Pfleiderer; Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[30] *See* Profs. Admati & Pfleiderer; Johnson & Prof. Stiglitz.

[31] *See* AFR *et al.* (Feb. 2012); Better Markets (Apr. 16, 2012); David McClean; Public Citizen; Occupy.

[32] *See* Johnson & Prof. Stiglitz (citing Thomas Phillipon (2011)); AFR *et al.* (Feb. 2012); Occupy.

[33] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; ABA (Keating); Chamber (Feb. 2012); Société Générale; FTN; SVB; ISDA (Feb. 2012); Comm. on Capital Market Regulation; Real Estate Roundtable.

[34] *See, e.g.,* Better Markets (Feb. 2012); Randel Pilo.

[35] For example, with respect to the CFTC, Section 15(a) of the CEA requires such consideration only when ''promulgating a regulation under this [Commodity Exchange] Act.'' This final rule is not promulgated under the CEA, but under the BHC Act. CEA section 15(a), therefore, does not apply.

activities. The final rule also requires banking entities to establish a comprehensive compliance program designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the banking entity's activities, size, scope and complexity. With respect to proprietary trading, the final rule also requires the large firms that are active participants in trading activities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities.

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

- Subpart A of the final rule describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;
- Subpart B of the final rule prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;
- Subpart C of the final rule prohibits or restricts acquiring or retaining an ownership interest in, and certain relationships with, a covered fund, defines terms relevant to covered fund activities and investments, as well as establishes exemptions from the restrictions on covered fund activities and investments and limitations on those exemptions;
- Subpart D of the final rule generally requires banking entities to establish a compliance program regarding compliance with section 13 of the BHC Act and the final rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;
- Appendix A of the final rule details the quantitative measurements that certain banking entities may be required to compute and report with respect to certain trading activities;
- Appendix B of the final rule details the enhanced minimum standards for programmatic compliance that certain banking entities must meet with respect to their compliance program, as required under subpart D.

B. Proprietary Trading Restrictions

Subpart B of the final rule implements the statutory prohibition on proprietary trading and the various exemptions to this prohibition included in the statute. Section ____.3 of the final rule contains the core prohibition on proprietary trading and defines a number of related terms, including ''proprietary trading'' and ''trading account.'' The final rule's definition of proprietary trading generally parallels the statutory definition and covers engaging as principal for the trading account of a banking entity in any transaction to purchase or sell specified types of financial instruments.[36]

The final rule's definition of trading account also is consistent with the statutory definition.[37] In particular, the definition of trading account in the final rule includes three classes of positions. First, the definition includes the purchase or sale of one or more financial instruments taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[38] For purposes of this part of the definition, the final rule also contains a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for the trading account of the banking entity if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase (or sale).[39] Second, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, the definition includes the purchase or sale of one or more financial instruments subject to the prohibition on proprietary trading that are treated as ''covered positions and trading positions'' (or hedges of other market risk capital rule covered positions) under those capital rules, other than certain foreign exchange and commodities positions.[40] Third, the definition includes the purchase or sale of one or more financial instruments by a banking entity that is licensed or registered or required to be licensed or registered to engage in the business of a dealer, swap dealer, or security-based swap dealer to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such or is engaged in those businesses outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[41]

The definition of proprietary trading also contains clarifying exclusions for certain purchases and sales of financial instruments that generally do not involve the requisite short-term trading intent, such as the purchase and sale of financial instruments arising under certain repurchase and reverse repurchase arrangements or securities lending transactions and securities acquired or taken for *bona fide* liquidity management purposes.[42]

In Section ____.3, the final rule also defines a number of other relevant terms, including the term ''financial instrument.'' This term is used to define the scope of financial instruments subject to the prohibition on proprietary trading. Consistent with the statutory language, such financial instruments include securities, derivatives, commodity futures, and options on such instruments, but do not include loans, spot foreign exchange or spot physical commodities.[43]

In Section ____.4, the final rule implements the statutory exemptions for underwriting and market making-related activities. For each of these permitted activities, the final rule defines the exempt activity and provides a number of requirements that must be met in order for a banking entity to rely on the applicable exemption. As more fully discussed below, these include establishment and enforcement of a compliance program targeted to the activity; limits on positions, inventory and risk exposure addressing the requirement that activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; limits on the duration of holdings and positions; defined escalation procedures to change or exceed limits; analysis justifying established limits; internal controls and independent testing of compliance with limits; senior management accountability and limits on incentive compensation. In addition, the final rule requires firms with significant market-making or underwriting activities to report data involving several metrics that may be used by the banking entity and the Agencies to identify trading activity that may warrant more detailed compliance review.

These requirements are generally designed to ensure that the banking

[36] *See* final rule § ____.3(a).

[37] *See* final rule § ____.3(b).

[38] *See* final rule § ____.3(b)(1)(i).

[39] *See* final rule § ____.3(b)(2).

[40] *See* final rule § ____.3(b)(1)(ii).

[41] *See* final rule § ____.3(b)(1)(iii).

[42] *See* final rule § ____.3(d).

[43] *See* final rule § ____.3(c).

entity's trading activity is limited to underwriting and market making-related activities and does not include prohibited proprietary trading.[44] These requirements are also intended to work together to ensure that banking entities identify, monitor and limit the risks associated with these activities.

In Section ____.5, the final rule implements the statutory exemption for risk-mitigating hedging. As with the underwriting and market-making exemptions, § ____.5 of the final rule contains a number of requirements that must be met in order for a banking entity to rely on the exemption. These requirements are generally designed to ensure that the banking entity's hedging activity is limited to risk-mitigating hedging in purpose and effect.[45] Section ____.5 also requires banking entities to document, at the time the transaction is executed, the hedging rationale for certain transactions that present heightened compliance risks.[46] As with the exemptions for underwriting and market making-related activity, these requirements form part of a broader implementation approach that also includes the compliance program requirement and the reporting of quantitative measurements.

In Section ____.6, the final rule implements statutory exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside of the United States. Section ____.6(a) of the final rule describes the government obligations in which a banking entity may trade, which include U.S. government and agency obligations, obligations and other instruments of specified government sponsored entities, and State and municipal obligations.[47] Section ____.6(b) of the final rule permits trading in certain foreign government obligations by affiliates of foreign banking entities in the United State and foreign affiliates of a U.S. banking entity abroad.[48] Section ____.6(c) of the final rule describes permitted trading on behalf of customers and identifies the types of transactions that would qualify for the exemption.[49] Section ____.6(d) of the final rule describes permitted trading by a regulated insurance company or an affiliate thereof for the general account of the insurance company, and also permits those entities to trade for a separate account of the insurance company.[50] Finally, § ____.6(e) of the final rule describes trading permitted outside of the United States by a foreign banking entity.[51] The exemption in the final rule clarifies when a foreign banking entity will qualify to engage in such trading pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity not currently subject to the BHC Act. As explained in detail below, the exemption also provides that the risk as principal, the decision-making, and the accounting for this activity must occur solely outside of the United States, consistent with the statute.

In Section ____.7, the final rule prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[52] This section also describes the terms material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

C. Restrictions on Covered Fund Activities and Investments

Subpart C of the final rule implements the statutory prohibition on, directly or indirectly, acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section ____.10 of the final rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including ''covered fund'' and ''ownership interest.''[53] The definition of covered fund contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, foreign pension or retirement funds, insurance company separate accounts, and public welfare investment funds. The final rule also implements the statutory rule of construction in section 13(g)(2) and provides that a securitization of loans, which would include loan securitization, qualifying asset backed commercial paper conduit, and qualifying covered bonds, is not covered by section 13 or the final rule.[54]

The definition of ''ownership interest'' in the final rule provides further guidance regarding the types of interests that would be considered to be an ownership interest in a covered fund.[55] As described in this Supplementary Information, these interests may take various forms. The definition of ownership interest also explicitly excludes from the definition ''restricted profit interest'' that is solely performance compensation for services provided to the covered fund by the banking entity (or an employee or former employee thereof), under certain circumstances.[56] Section ____.10 of the final rule also defines a number of other relevant terms, including the terms ''prime brokerage transaction,'' ''sponsor,'' and ''trustee.''

Section ____.11 of the final rule implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. Section ____.11(a) of the final rule outlines the conditions that must be met in order for a banking entity to organize and offer a covered fund under this authority. These requirements are contained in the statute and are intended to allow a banking entity to engage in certain traditional asset management and advisory businesses, subject to certain limits contained in section 13 of the BHC Act.[57] The requirements are discussed in detail in Part IV.B.2. of this **SUPPLEMENTARY INFORMATION**. Section ____.11 also explains how these requirements apply to covered funds that are issuing entities of asset-backed securities, as well as implements the statutory exemption for underwriting and market-making ownership interests of a covered fund, including explaining the limitations imposed on such activities under the final rule.

In Section ____.12, the final rule permits a banking entity to acquire and

[44] *See* final rule § ____.4(a), (b).

[45] *See* final rule § ____.5.

[46] *See* final rule § ____.5(c).

[47] *See* final rule § ____.6(a).

[48] *See* final rule § ____.6(b).

[49] *See* final rule § ____.6(c).

[50] *See* final rule § ____.6(d).

[51] *See* final rule § ____.6(e).

[52] *See* final rule § ____.7.

[53] *See* final rule § ____.10(b).

[54] The Agencies believe that most securitization transactions are currently structured so that the issuing entity with respect to the securitization is not an affiliate of a banking entity under the BHC Act. However, with respect to any securitization that is an affiliate of a banking entity and that does not meet the requirements of the loan securitization exclusion, the related banking entity will need to determine how to bring the securitization into compliance with this rule.

[55] *See* final rule § ____.10(d)(6).

[56] *See* final rule § ____.10(b)(6)(ii).

[57] *See* 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

retain, as an investment in a covered fund, an ownership interest in a covered fund that the banking entity organizes and offers or holds pursuant to other authority under § ____.11.[58] This section implements section 13(d)(4) of the BHC Act and related provisions. Section 13(d)(4)(A) of the BHC Act permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section ____ .12 of the final rule implements this authority and related limitations, including limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments. In addition, § ____.12 requires that the aggregate value of all investments in covered funds, plus any earnings on these investments, be deducted from the capital of the banking entity for purposes of the regulatory capital requirements, and explains how that deduction must occur. Section ____.12 of the final rule also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from applicable capital, as relevant), and sets forth how a banking entity may request an extension of the period of time within which it must conform an investment in a single covered fund. This section also explains how a banking entity must apply the covered fund investment limits to a covered fund that is an issuing entity of asset backed securities or a covered fund that is part of a master-feeder or fund-of-funds structure.

In Section ____.13, the final rule implements the statutory exemptions described in sections 13(d)(1)(C), (D), (F), and (I) of the BHC Act that permit a banking entity: (i) to acquire and retain an ownership interest in a covered fund as a risk-mitigating hedging activity related to employee compensation; (ii) in the case of a non-U.S. banking entity, to acquire and retain an ownership interest in, or act as sponsor to, a covered fund solely outside the United States; and (iii) to acquire and retain an ownership interest in, or act as sponsor to, a covered fund by an insurance company for its general or separate accounts.[59]

In Section ____.14, the final rule implements section 13(f) of the BHC Act and generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act.[60] Section ____.14(a)(2) of the final rule describes the transactions between a banking entity and a covered fund that remain permissible under the statute and the final rule. Section ____.14(b) of the final rule implements the statute's requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and a covered fund is subject to section 23B of the Federal Reserve Act,[61] which, in general, requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

In Section ____.15, the final rule prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[62] This section also describes material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

D. Metrics Reporting Requirement

Under the final rule, a banking entity that meets relevant thresholds specified in the rule must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

The final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in approach based on the size of trading assets and liabilities. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States). Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in the final rule unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion in consolidated trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis. All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by the final rule unless another time is requested by the primary supervisory Agency for the entity except for a transitional six month period during which reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[63]

[58] *See* final rule § ____.12.

[59] *See* final rule § ____.13(a)–(c).

[60] *See* 12 U.S.C. 371c; *see also* final rule § ____.14.

[61] 12 U.S.C. 371c–1.

[62] *See* final rule § ____.15.

[63] *See* final rule § ____.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

E. Compliance Program Requirement

Subpart D of the final rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the final rule.[64] To reduce the overall burden of the rule, the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments.[65] In addition, to reduce the burden on smaller banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities or investments may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.[66]

For banking entities with total assets greater than $10 billion and less than $50 billion, the final rule specifies six elements that each compliance program established under subpart D must, at a minimum, include. These requirements focus on written policies and procedures reasonably designed to ensure compliance with the final rules, including limits on underwriting and market-making; a system of internal controls; clear accountability for compliance and review of limits, hedging, incentive compensation, and other matters; independent testing and audits; additional documentation for covered funds; training; and recordkeeping requirements.

A banking entity with $50 billion or more total consolidated assets (or a foreign banking entity that has total U.S. assets of $50 billion or more) or that is required to report metrics under Appendix A is required to adopt an enhanced compliance program with more detailed policies, limits, governance processes, independent testing and reporting. In addition, the Chief Executive Officer of these larger banking entities must attest that the banking entity has in place a program reasonably designed to achieve compliance with the requirements of section 13 of the BHC Act and the final rule.

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

IV. Final Rule

A. Subpart B—Proprietary Trading Restrictions

1. Section ____.3: Prohibition on Proprietary Trading and Related Definitions

Section 13(a)(1)(A) of the BHC Act prohibits a banking entity from engaging in proprietary trading unless otherwise permitted in section 13.[67] Section 13(h)(4) of the BHC Act defines proprietary trading, in relevant part, as engaging as principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, a security, derivative, contract of sale of a commodity for future delivery, or other financial instrument that the Agencies include by rule.[68]

Section ____.3(a) of the proposed rule implemented section 13(a)(1)(A) of the BHC Act by prohibiting a banking entity from engaging in proprietary trading unless otherwise permitted under §§____.4 through ____.6 of the proposed rule. Section ____.3(b)(1) of the proposed rule defined proprietary trading in accordance with section 13(h)(4) of the BHC Act and clarified that proprietary trading does not include acting solely as agent, broker, or custodian for an unaffiliated third party. The preamble to the proposed rule explained that acting in these types of capacities does not involve trading as principal.[69]

Several commenters expressed concern about the breadth of the ban on proprietary trading.[70] Some of these commenters stated that proprietary trading must be carefully and narrowly defined to avoid prohibiting activities that Congress did not intend to limit and to preclude significant, unintended consequences for capital markets, capital formation, and the broader economy.[71] Some commenters asserted that the proposed definition could result in banking entities being unwilling to take principal risk to provide liquidity for institutional investors; could unnecessarily constrain liquidity in secondary markets, forcing asset managers to service client needs through alternative non-U.S. markets; could impose substantial costs for all institutions, especially smaller and mid-size institutions; and could drive risk-taking to the shadow banking system.[72] Others urged the Agencies to determine that trading as agent, broker, or custodian for an affiliate was not proprietary trading.[73]

Commenters also suggested alternative approaches for defining proprietary trading. In general, these approaches sought to provide a bright-line definition to provide increased certainty to banking entities[74] or make the prohibition easier to apply in practice.[75] One commenter stated the Agencies should focus on the economics of banking entities' transactions and ban trading if the banking entity is exposed to market risk for a significant period of time or is profiting from changes in the value of the asset.[76] Several commenters, including individual members of the public, urged the Agencies to prohibit banking entities from engaging in any kind of proprietary trading and require separation of trading from traditional banking activities.[77] After carefully considering comments, the Agencies are defining proprietary trading as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more

[64] *See* final rule § ____.20.

[65] *See* final rule § ____.20(f)(1).

[66] *See* final rule § ____.20(f)(2).

[67] 12 U.S.C. 1851(a)(1)(A).

[68] 12 U.S.C. 1851(h)(4).

[69] *See* Joint Proposal, 76 FR 68,857.

[70] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); Capital Group; Comm. on Capital Markets Regulation; IAA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Chamber (Feb. 2012); Wellington.

[71] *See* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012).

[72] *See* Chamber (Feb. 2012).

[73] *See* Japanese Bankers Ass'n.

[74] *See, e.g.,* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[75] *See* Public Citizen.

[76] *See* Sens. Merkley & Levin (Feb. 2012).

[77] *See generally* Occupy; Public Citizen; AFR *et al.* (Feb. 2012). The Agencies received over fifteen thousand form letters in support of a rule with few exemptions, many of which expressed a desire to return to the regulatory scheme as governed by the Glass-Steagall affiliation provisions of the U.S. Banking Act of 1933, as repealed through the Graham-Leach-Bliley Act of 1999. *See generally* Sarah McGee; Christopher Wilson; Michael Itlis; Barry Rein; Edward Bright. Congress rejected such an approach, however, opting instead for the more narrowly tailored regulatory approach embodied in section 13 of the BHC Act.

financial instruments.[78] The Agencies believe this effectively restates the statutory definition. The Agencies are not adopting commenters' suggested modifications to the proposed definition of proprietary trading or the general prohibition on proprietary trading because they generally appear to be inconsistent with Congressional intent. For instance, some commenters appeared to suggest an approach to defining proprietary trading that would capture only bright-line, speculative proprietary trading and treat the activities covered by the statutory exemptions as completely outside the rule.[79] However, such an approach would appear to be inconsistent with Congressional intent because, for instance, it would not give effect to the limitations on permitted activities in section 13(d) of the BHC Act.[80] For similar reasons, the Agencies are not adopting a bright-line definition of proprietary trading.[81]

A number of commenters expressed concern that, as a whole, the proposed rule may result in certain negative economic impacts, including: (i) Reduced market liquidity; [82] (ii) wider spreads or otherwise increased trading costs; [83] (iii) higher borrowing costs for businesses or increased cost of capital; [84] and/or (iv) greater market volatility.[85] The Agencies have carefully considered commenters' concerns about the proposed rule's potential impact on overall market liquidity and quality. As discussed in more detail in Parts IV.A.2. and IV.A.3., the final rule will permit banking entities to continue to provide beneficial market-making and underwriting services to customers, and therefore provide liquidity to customers and facilitate capital-raising. However, the statute upon which the final rule is based prohibits proprietary trading activity that is not exempted. As such, the termination of non-exempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants.[86] Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

To respond to concerns raised by commenters while remaining consistent with Congressional intent, the final rule has been modified to provide that certain purchases and sales are not proprietary trading as described in more detail below.[87]

a. Definition of ''Trading Account''

As explained above, section 13 defines proprietary trading as engaging as principal ''for the trading account of the banking entity'' in certain types of transactions. Section 13(h)(6) of the BHC Act defines trading account as any account used for acquiring or taking positions in financial instruments principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the Agencies may, by rule, determine.[88]

The proposed rule defined trading account to include three separate accounts. First, the proposed definition of trading account included, consistent with the statute, any account that is used by a banking entity to acquire or take one or more covered financial positions for short-term trading purposes (the ''short-term trading account'').[89] The proposed rule identified four purposes that would indicate short-term trading intent: (i) Short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more positions described in (i), (ii) or (iii). The proposed rule presumed that an account is a trading account if it is used to acquire or take a covered financial position (other than a position in the market risk rule trading account or the dealer trading account) that the banking entity holds for 60 days or less.[90]

Second, the proposed definition of trading account included, for certain entities, any account that contains positions that qualify for trading book capital treatment under the banking agencies' market risk capital rules other than positions that are foreign exchange derivatives, commodity derivatives or contracts of sale of a commodity for delivery (the ''market risk rule trading account'').[91] ''Covered positions'' under the banking agencies' market-risk capital rules are positions that are generally held with the intent of sale in the short-term.

Third, the proposed definition of trading account included any account used by a banking entity that is a securities dealer, swap dealer, or

[78] *See* final rule § ____.3(a). The final rule also replaces all references to the proposed term ''covered financial position'' with the term ''financial instrument.'' This change has no substantive impact because the definition of ''financial instrument'' is substantially identical to the proposed definition of ''covered financial position.'' Consistent with this change, the final rule replaces the undefined verbs ''acquire'' or ''take'' with the defined terms ''purchase'' or ''sale'' and ''sell.'' *See* final rule §§ ____.3(c), ____.2(u), (x).

[79] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012); JPMC.

[80] *See* 156 Cong. Rec. S5895–96 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating the statute ''permits underwriting and market-making-related transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services.'').

[81] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[82] *See, e.g.,* AllianceBernstein; Obaid Syed; Rep. Bachus *et al.;* EMTA; NASP; Sen. Hagan; Investure; Lord Abbett; Sumitomo Trust; EFAMA; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); STANY; ABA (Keating); ICE; ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Capital Group; RBC; Columbia Mgmt.; SSgA (Feb. 2012); Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Clearing House Ass'n.; Thakor Study. *See also* CalPERS (acknowledging that the systemic protections afforded by the Volcker Rule come at a price, including reduced liquidity to all markets).

[83] *See, e.g.,* AllianceBernstein; Obaid Syed; NASP; Investure; Lord Abbett; CalPERS; Credit Suisse (Seidel); Citigroup (Feb. 2012); ABA (Keating); SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[84] *See, e.g.,* Rep. Bachus *et al.;* Members of Congress (Dec. 2011); Lord Abbett; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); ABA (Abernathy); ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ACLI (Feb. 2012); UBS; Wells Fargo (Prop. Trading); Capital Group; Sen. Carper *et al.;* Fidelity; Invesco; Clearing House Ass'n.; Thakor Study.

[85] *See, e.g.,* CalPERS (expressing the belief that a decline in banking entity proprietary trading will increase the volatility of the corporate bond market, especially during times of economic weakness or periods where risk taking declines, but noting that portfolio managers have experienced many different periods of market illiquidity and stating that the market will adapt post-implementation (*e.g.,* portfolio managers will increase their use of CDS to reduce economic risk to specific bond positions as the liquidation process of cash bonds takes more time, alternative market matching networks will be developed)); Morgan Stanley; Capital Group; Fidelity; British Bankers' Ass'n.; Invesco.

[86] *See* David McClean; Public Citizen; Occupy. In response to commenters who expressed concern about risks associated with proprietary trading activities moving to non-banking entities, the Agencies note that section 13's prohibition on proprietary trading and related exemptions apply only to banking entities. *See, e.g.,* Chamber (Feb. 2012).

[87] *See* final rule § ____.3(d).

[88] *See* 12 U.S.C. 1851(h)(6).

[89] *See* proposed rule § ____.3(b)(2)(i)(A).

[90] *See* proposed rule § ____.3(b)(2)(ii).

[91] *See* proposed rule §§ ____.3(b)(2)(i)(B); ____.3(b)(3).

security-based swap dealer to acquire or take positions in connection with its dealing activities (the ''dealer trading account'').[92] The proposed rule also included as a trading account any account used to acquire or take any covered financial position by a banking entity in connection with the activities of a dealer, swap dealer, or security-based swap dealer outside of the United States.[93] Covered financial positions held by banking entities that register or file notice as securities or derivatives dealers as part of their dealing activity were included because such positions are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions).[94]

The proposed rule also set forth four clarifying exclusions from the definition of trading account. The proposed rule provided that no account is a trading account to the extent that it is used to acquire or take certain positions under repurchase or reverse repurchase arrangements, positions under securities lending transactions, positions for *bona fide* liquidity management purposes, or positions held by derivatives clearing organizations or clearing agencies.[95]

Overall, commenters did not raise significant concerns with or objections to the short-term trading account. Several commenters argued that the definition of trading account should be limited to only this portion of the proposed definition of trading account.[96] However, a few commenters raised concerns regarding the treatment of arbitrage trading under the proposed rule.[97] Several commenters asserted that the proposed definition of trading account was too broad and covered trading not intended to be covered by the statute.[98] Some of these commenters maintained that the Agencies exceeded their statutory authority under section 13 of the BHC Act in defining trading account to include the market risk rule trading account and dealer trading account, and argued that the definition should be limited to the short-term trading account definition.[99] Commenters argued, for example, that an overly broad definition of trading account may cause traditional bank activities important to safety and soundness of a banking entity to fall within the prohibition on proprietary trading to the detriment of banking organizations, customers, and financial markets.[100] A number of commenters suggested modifying and narrowing the trading account definition to remove the implicit negative presumption that any position creates a trading account, or that all principal trading constitutes prohibited proprietary trading unless it qualifies for a narrowly tailored exemption, and to clearly exempt activities important to safety and soundness.[101] For example, one commenter recommended that a covered financial position be considered a trading account position only if it qualifies as a GAAP trading position.[102] A few commenters requested the Agencies define the phrase ''short term'' in the rule.[103]

Several commenters argued that the market risk rule should not be referenced as part of the definition of trading account.[104] A few of these commenters argued instead that the capital treatment of a position be used only as an indicative factor rather than a dispositive test.[105] One commenter thought that the market risk rule trading account was redundant because it includes only positions that have short-term trading intent.[106] Commenters also contended that it was difficult to consider and comment on this aspect of the proposal because the market risk capital rules had not been finalized.[107]

A number of commenters objected to the dealer trading account prong of the definition.[108] Commenters asserted that this prong was an unnecessary and unhelpful addition that went beyond the requirements of section 13 of the BHC Act, and that it made the trading account determination more complex and difficult.[109] In particular, commenters argued that the dealer trading account was too broad and introduced uncertainty because it presumed that dealers always enter into positions with short-term intent.[110] Commenters also expressed concern about the difficulty of applying this test outside the United States and requested that, if this account is retained, the final rule be explicit about how it applies to a swap dealer outside the United States and treat U.S. swap dealers consistently.[111]

In contrast, other commenters contended that the proposed rule's definition of trading account was too narrow, particularly in its focus on short-term positions,[112] or should be simplified.[113] One commenter argued that the breadth of the trading account definition was critical because positions excluded from the trading account definition would not be subject to the proposed rule.[114] One commenter supported the proposed definition of trading account.[115] Other commenters believed that reference to the market-risk rule was an important addition to the definition of trading account. Some expressed the view that it should include all market risk capital rule covered positions and not just those requiring short-term trading intent.[116]

Certain commenters proposed alternate definitions. Several commenters argued against using the term ''account'' and instead advocated applying the prohibition on proprietary trading to trading positions.[117] Foreign banks recommended applying the definition of trading account applicable to such banks in their home country, if the home country provided a clear definition of this term.[118] These commenters argued that new definitions in the proposed rule, like trading account, would require foreign banking

[92] *See* proposed rule § ____.3(b)(2)(i)(C).

[93] *See* proposed rule § ____.3(b)(2)(i)(C)(5).

[94] *See* Joint Proposal, 76 FR 68,860.

[95] *See* proposed rule § ____.3(b)(2)(iii).

[96] *See* ABA (Keating); JPMC.

[97] *See* AFR *et al.* (Feb. 2012); Paul Volcker; Credit Suisse (Seidel); ISDA (Feb. 2012); Japanese Bankers Ass'n.

[98] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop.Trading) (Feb. 2012); State Street (Feb. 2012).

[99] *See* ABA (Keating); JPMC; SIFMA *et al.* (Prop.Trading) (Feb. 2012); State Street (Feb. 2012).

[100] *See* ABA (Keating); Credit Suisse (Seidel).

[101] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop.Trading) (Feb. 2012); SVB; Wellington.

[102] *See* ABA (Keating).

[103] *See* NAIB *et al.;* Occupy; *but See* Alfred Brock.

[104] *See* ABA; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC; SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[105] *See* BoA; SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[106] *See* ISDA (Feb. 2012).

[107] *See* ABA (Keating); BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC. The banking agencies adopted a final rule that amends their respective market risk capital rules on August 30, 2012. *See* 77 FR 53,060 (Aug. 30, 2012). The Agencies continued to receive and consider comments on the proposed rule to implement section 13 of the BHC Act after that time.

[108] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[109] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); JPMC; State Street (Feb. 2012); ISDA (Feb. 2012); SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[110] *See* ABA (Keating); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC.

[111] *See* Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; JPMC.

[112] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[113] *See, e.g.,* Public Citizen.

[114] *See* AFR *et al.* (Feb. 2012).

[115] *See* Alfred Brock.

[116] *See* AFR *et al.* (Feb. 2012).

[117] *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[118] *See* Japanese Bankers Ass'n.; Norinchukin.

entities to develop new and complex procedures and expensive systems.[119]

Commenters also argued that various types of trading activities should be excluded from the trading account definition. For example, one commenter asserted that arbitrage trading should not be considered trading account activity,[120] while other commenters argued that arbitrage positions and strategies are proprietary trading and should be included in the definition of trading account and prohibited by the final rule.[121] Another commenter argued that the trading account should include only positions primarily intended, when the position is entered into, to profit from short-term changes in the value of the assets, and that liquidity investments that do not have price changes and that can be sold whenever the banking entity needs cash should be excluded from the trading account definition.[122]

After carefully reviewing the comments, the Agencies have determined to retain in the final rule the proposed approach for defining trading account that includes the short-term, market risk rule, and dealer trading accounts with modifications to address issues raised by commenters. The Agencies believe that this multi-prong approach is consistent with both the language and intent of section 13 of the BHC Act, including the express statutory authority to include ''any such other account'' as determined by the Agencies.[123] The final definition effectuates Congress's purpose to generally focus on short-term trading while addressing commenters' desire for greater certainty regarding the definition of the trading account.[124] In addition, the Agencies believe commenters' concerns about the scope of the proposed definition of trading account are substantially addressed by the refined exemptions in the final rule for customer-oriented activities, such as market making-related activities, and the exclusions from proprietary trading.[125] Moreover, the Agencies believe that it is appropriate to focus on the economics of a banking entity's trading activity to help determine whether it is engaged in proprietary trading, as discussed further below.[126]

As explained above, the short-term trading prong of the definition largely incorporates the statutory provisions. This prong covers trading involving short-term resale, price movements, and arbitrage profits, and hedging positions that result from these activities. Specifically, the reference to short-term resale is taken from the statute's definition of trading account. The Agencies continue to believe it is also appropriate to include in the short-term trading prong an account that is used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions captured by the short-term trading prong. The provisions regarding price movements and arbitrage focus on the intent to engage in transactions to benefit from short-term price movements (*e.g.,* entering into a subsequent transaction in the near term to offset or close out, rather than sell, the risks of a position held by the banking entity to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction) or to benefit from differences in multiple market prices, including scenarios where movement in those prices is not necessary to realize the intended profit.[127] These types of transactions are economically equivalent to transactions that are principally for the purpose of selling in the near term or with the intent to resell to profit from short-term price movements, which are expressly covered by the statute's definition of trading account. Thus, the Agencies believe it is necessary to include these provisions in the final rule's short-term trading prong to provide clarity about the scope of the definition and to prevent evasion of the statute and final rule.[128] In addition, like the proposed rule, the final rule's short-term trading prong includes hedging one or more of the positions captured by this prong because the Agencies assume that a banking entity generally intends to hold the hedging position for only so long as the underlying position is held.

The remaining two prongs to the trading account definition apply to types of entities that engage actively in trading activities. Each prong focuses on analogous or parallel short-term trading activities. A few commenters stated these prongs were duplicative of the short-term trading prong, and argued the Agencies should not include these prongs in the definition of trading account, or should only consider them as non-determinative factors.[129] To the extent that an overlap exists between the prongs of this definition, the Agencies believe they are mutually reinforcing, strengthen the rule's effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the trading account.[130]

The market risk capital prong covers trading positions that are covered positions for purposes of the banking agency market-risk capital rules, as well as hedges of those positions. Trading positions under those rules are positions held by the covered entity ''for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or to lock-in arbitrage profits.'' [131] This definition largely parallels the provisions of section 13(h)(4) of the BHC Act and mirrors the short-term trading account prong of both the proposed and final rules. Covered positions are trading positions under the rule that subject the covered entity to risks and exposures that must be actively managed and limited—a requirement consistent with the purposes of the section 13 of the BHC Act.

Incorporating this prong into the trading account definition reinforces the consistency between governance of the types of positions that banking entities identify as ''trading'' for purposes of the market risk capital rules and those that are trading for purposes of the final rule under section 13 of the BHC Act. Moreover, this aspect of the final rule reduces the compliance burden on banking entities with substantial trading

[119] *See* Japanese Bankers Ass'n.

[120] *See* Alfred Brock.

[121] *See* AFR *et al.* (Feb. 2012); Paul Volcker.

[122] *See* NAIB *et al. See infra* Part IV.A.1.d.2. (discussing the liquidity management exclusion).

[123] 12 U.S.C. 1851(h)(6).

[124] In response to commenters' concerns about the meaning of account, the Agencies note the term ''trading account'' is a statutory concept and does not necessarily refer to an actual account. Trading account is simply nomenclature for the set of transactions that are subject to the final rule's restrictions on proprietary trading. *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[125] For example, several commenters' concerns about the potential impact of the proposed definition of trading account were tied to the perceived narrowness of the proposed exemptions. *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Wellington.

[126] *See* Sens. Merkley & Levin (Feb. 2012). However, as discussed in this **SUPPLEMENTARY INFORMATION,** the Agencies are not prohibiting any trading that involves profiting from changes in the value of the asset, as suggested by this commenter, because permitted activities, such as market making, can involve price appreciation-related revenues. *See infra* Part IV.A.3. (discussing the final market-making exemption).

[127] *See* Joint Proposal, 76 FR 68,857–68,858.

[128] As a result, the Agencies are not excluding arbitrage trading from the trading account definition, as suggested by at least one commenter. *See, e.g.,* Alfred Brock.

[129] *See* ISDA (Feb. 2012); JPMC; ABA (Keating); BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[130] *See* Occupy.

[131] 12 CFR part 225, Appendix E.

activities by establishing a clear, bright-line rule for determining that a trade is within the trading account.[132]

After reviewing comments, the Agencies also continue to believe that financial instruments purchased or sold by registered dealers in connection with their dealing activity are generally held with short-term intent and should be captured within the trading account. The Agencies believe the scope of the dealer prong is appropriate because, as noted in the proposal, positions held by a registered dealer in connection with its dealing activity are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions), which is indicative of short-term intent.[133] Moreover, the final rule includes a number of exemptions for the activities in which securities dealers, swap dealers, and security-based swap dealers typically engage, such as market making, hedging, and underwriting. Thus, the Agencies believe the broad scope of the dealer trading account is balanced by the exemptions that are designed to permit dealer entities to continue to engage in customer-oriented trading activities, consistent with the statute. This approach is designed to ensure that registered dealer entities are engaged in permitted trading activities, rather than prohibited proprietary trading.

The final rule adopts the dealer trading account substantially as proposed,[134] with streamlining that eliminates the specific references to different types of securities and derivatives dealers. The final rule adopts the proposed approach to covering trading accounts of banking entities that regularly engage in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States. In the case of both domestic and foreign entities, this provision applies only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily *all* of the activities of that banking entity.[135] Activities of a banking entity that are not covered by the dealer prong may, however, be covered by the short-term or market risk rule trading accounts if the purchase or sale satisfies the requirements of §§ ____.3(b)(1)(i) or (ii).[136]

A few commenters stated that they do not currently analyze whether a particular activity would require dealer registration, so the dealer prong of the trading account definition would require banking entities to engage in a new type of analysis.[137] The Agencies recognize that banking entities that are registered dealers may not currently engage in such an analysis with respect to their current trading activities and, thus, this may represent a new regulatory requirement for these entities. If the regulatory analysis otherwise engaged in by banking entities is substantially similar to the dealer prong analysis required under the trading account definition, then any increased compliance burden could be small or insubstantial.[138]

In response to commenters' concerns regarding the application of this prong to banking entities acting as dealers in jurisdictions outside the United States,[139] the Agencies continue to believe including the activities of a banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business, is appropriate. As noted above, dealer activity generally involves short-term trading. Further, the Agencies are concerned that differing requirements for U.S. and foreign dealers may lead to regulatory arbitrage. For foreign banking entities acting as dealers outside of the United States that are eligible for the exemption for trading conducted by foreign banking entities, the Agencies believe the risk-based approach to this exemption in the final rule should help address the concerns about the scope of this prong of the definition.[140]

In response to one commenter's suggestion that the Agencies define the term trading account to allow a foreign banking entity to use of the relevant foreign regulator's definition of this term, where available, the Agencies are concerned such an approach could lead to regulatory arbitrage and otherwise inconsistent applications of the rule.[141] The Agencies believe this commenter's general concern about the impact of the statute and rule on foreign banking entities' activities outside the United States should be substantially addressed by the exemption for trading conducted by foreign banking entities under § ____.6(e) of the final rule.

Finally, the Agencies have declined to adopt one commenter's recommendation that a position in a financial instrument be considered a trading account position only if it qualifies as a GAAP trading position.[142] The Agencies continue to believe that formally incorporating accounting standards governing trading securities is not appropriate because: (i) The statutory proprietary trading provisions under section 13 of the BHC Act applies to financial instruments, such as derivatives, to which the trading security accounting standards may not apply; (ii) these accounting standards permit companies to classify, at their discretion, assets as trading securities, even where the assets would not otherwise meet the definition of trading securities; and (iii) these accounting standards could change in the future without consideration of the potential impact on section 13 of the BHC Act and these rules.[143]

b. Rebuttable Presumption for the Short-Term Trading Account

The proposed rule included a rebuttable presumption clarifying when a covered financial position, by reason of its holding period, is traded with short-term intent for purposes of the short-term trading account. The Agencies proposed this presumption primarily to provide guidance to banking entities that are not subject to the market risk capital rules or are not covered dealers or swap entities and accordingly may not have experience evaluating short-term trading intent. In particular, § __.3(b)(2)(ii) of the proposed rule provided that an account would be presumed to be a short-term trading account if it was used to acquire

[132] Accordingly, the Agencies are not using a position's capital treatment as merely an indicative factor, as suggested by a few commenters.

[133] *See* Joint Proposal, 76 FR 68,860.

[134] *See* final rule § ____.3(b)(1)(iii).

[135] An insured depository institution may be registered as a swap dealer, but only the swap dealing activities that require it to be so registered are covered by the dealer trading account. If an insured depository institution purchases or sells a financial instrument in connection with activities of the insured depository institution that do not trigger registration as a swap dealer, such as lending, deposit-taking, the hedging of business risks, or other end-user activity, the financial instrument is included in the trading account only if the instrument falls within the statutory trading account under § ____.3(b)(1)(i) or the market risk rule trading account under § ____.3(b)(1)(ii) of the final rule.

[136] *See* final rule §§ ____.3(b)(1)(i) and (ii).

[137] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[138] *See, e.g.,* Goldman (Prop. Trading) (''For instance, a banking entity's market making-related activities with respect to credit trading may involve making a market in bonds (traded in a broker-dealer), single-name CDSs (in a security-based swap dealer) and CDS indexes (in a swap dealer). For regulatory or other reasons, these transactions could take place in different legal entities. . .'').

[139] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations).

[140] *See* final rule § ____.6(e).

[141] *See* Japanese Bankers Ass'n.

[142] *See* ABA (Keating).

[143] *See* Joint Proposal, 76 FR 68,859.

or take a covered financial position that the banking entity held for a period of 60 days or less.

Several commenters supported the rebuttable presumption, but suggested either shortening the holding period to 30 days or less,[144] or extending the period to 90 days,[145] to several months,[146] or to one year.[147] Some of these commenters argued that specifying an overly short holding period would be contrary to the statute, invite gamesmanship,[148] and miss speculative positions held for longer than the specified period.[149] Commenters also suggested turning the presumption into a safe harbor [150] or into guidance.[151]

Other commenters opposed the inclusion of the rebuttable presumption for a number of reasons and requested that it be removed.[152] For example, these commenters argued that the presumption had no statutory basis; [153] was arbitrary; [154] was not supported by data, facts, or analysis; [155] would dampen market-making and underwriting activity; [156] or did not take into account the nature of trading in different types of securities.[157] Some commenters also questioned whether the Agencies would interpret rebuttals of the presumption consistently,[158] and stressed the difficulty and costliness of rebutting the presumption,[159] such as enhanced documentation or other administrative burdens.[160] One foreign banking association also argued that requiring foreign banking entities to rebut a U.S. regulatory requirement would be costly and inappropriate given that the trading activities of the banking entity are already reviewed by home country supervisors.[161] This commenter also contended that the presumption could be problematic for financial instruments purchased for long-term investment purposes that are closed within 60 days due to market fluctuations or other changed circumstances.[162]

After carefully considering the comments received, the Agencies continue to believe the rebuttable presumption is appropriate to generally define the meaning of ''short-term'' for purposes of the short-term trading account, especially for small and regional banking entities that are not subject to the market risk capital rules and are not registered dealers or swap entities. The range of comments the Agencies received on what ''short-term'' should mean—from 30 days to one year—suggests that a clear presumption would ensure consistency in interpretation and create a level playing field for all banking entities with covered trading activities subject to the short-term trading account. Based on their supervisory experience, the Agencies find that 60 days is an appropriate cut off for a regulatory presumption.[163] Further, because the purpose of the rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the trading account, the Agencies believe that implementing different holding periods based on the type of financial instrument would insert unnecessary complexity into the presumption.[164] The Agencies are not providing a safe harbor or a reverse presumption (*i.e.,* a presumption for positions that are outside of the trading account), as suggested by some commenters, in recognition that some proprietary trading could occur outside of the 60 day period.[165]

Adopting a presumption allows the Agencies and affected banking entities to evaluate all the facts and circumstances surrounding trading activity in determining whether the activity implicates the purpose of the statute. For example, trading in a financial instrument for long-term investment that is disposed of within 60 days because of unexpected developments (*e.g.,* an unexpected increase in the financial instrument's volatility or a need to liquidate the instrument to meet unexpected liquidity demands) may not be trading activity covered by the statute. To reduce the costs and burdens of rebutting the presumption, the Agencies will allow a banking entity to rebut the presumption for a group of related positions.[166]

The final rule provides three clarifying changes to the proposed rebuttable presumption. First, in response to comments, the final rule replaces the reference to an ''account'' that is presumed to be a trading account with the purchase or sale of a ''financial instrument.'' [167] This change clarifies that the presumption only applies to the purchase or sale of a financial instrument that is held for fewer than 60 days, and not the entire account that is used to make the purchase or sale. Second, the final rule clarifies that basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk), are subject to the rebuttable presumption.[168] Third, in order to maintain consistency with definitions used throughout the final rule, the references to ''acquire'' or ''take'' a financial position have been replaced with references to ''purchase'' or ''sell'' a financial instrument.[169]

[144] *See* Japanese Bankers Ass'n.

[145] *See* Capital Group.

[146] *See* AFR *et al.* (Feb. 2012).

[147] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen (arguing that one-year demarks tax law covering short term capital gains).

[148] *See* Sens. Merkley & Levin (Feb. 2012).

[149] *See* Occupy.

[150] *See* Capital Group.

[151] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[152] *See* ABA (Keating); Am. Express; Business Roundtable; Capital Group; ICI (Feb. 2012); Investure; JPMC; Liberty Global; STANY; Chamber (Feb. 2012).

[153] *See* ABA (Keating); JPMC; Chamber (Feb. 2012).

[154] *See* Am. Express; ICI (Feb. 2012).

[155] *See* ABA (Keating); Chamber (Feb. 2012).

[156] *See* AllianceBernstein; Business Roundtable; ICI (Feb. 2012); Investure; Liberty Global; STANY. Because the rebuttable presumption does not impact the availability of the exemptions for underwriting, market making, and other permitted activities, the Agencies do not believe this provision creates any additional burdens on permissible activities.

[157] *See* Am. Express (noting that most foreign exchange forward transactions settle in less than one week and are used as commercial payment instruments, and not speculative trades); Capital Group.

[158] *See* ABA (Keating). As discussed below in Part IV.C., the Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.

[159] *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC.

[160] *See* NAIB *et al.*; Capital Group.

[161] *See* Japanese Bankers Ass'n. As noted above, the Agencies believe concerns about the impacts of the definition of trading account on foreign banking entity trading activity outside of the United States are substantially addressed by the final rule's exemption for proprietary trading conducted by foreign banking entities in final rule § .6(e).

[162] *Id.*

[163] *See* final rule § .3(b)(2). Commenters did not provide persuasive evidence of the benefits associated with a rebuttable presumption for positions held for greater or fewer than 60 days.

[164] *See, e.g.,* Am. Express; Capital Group; Sens. Merkley & Levin (Feb. 2012).

[165] *See* Capital Group; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[166] The Agencies believe this should help address commenters' concerns about the burdens associated with rebutting the presumption. *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC; NAIB *et al.*; Capital Group.

[167] *See, e.g.,* ABA (Keating); Clearing House Ass'n.; JPMC.

[168] The rebuttable presumption covered these trades in the proposal, but the final rule's use of ''financial instrument'' rather than ''covered financial position'' necessitated clarifying this point in the rule text. *See* final rule § .3(b)(2). *See also* Public Citizen.

[169] The Agencies do not believe these revisions have a substantive effect on the operation or scope of the final rule in comparison to the statute or proposed rule.

c. Definition of ''Financial Instrument''

Section 13 of the BHC Act generally prohibits proprietary trading, which is defined in section 13(h)(4) to mean engaging as principal for the trading account in any purchase or sale of any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instruments that the Agencies may, by rule, determine.[170] The proposed rule defined the term ''covered financial position'' to reference the instruments listed in section 13(h)(4), including: (i) A security, including an option on a security; (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or an option on such a contract.[171] To provide additional clarity, the proposed rule also provided that, consistent with the statute, any position that is itself a loan, a commodity, or foreign exchange or currency was not a covered financial position.[172]

The proposal also defined a number of other terms used in the definition of covered financial position, including commodity, derivative, loan, and security.[173] These terms were generally defined by reference to the federal securities laws or the Commodity Exchange Act because these existing definitions are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities, commodities, and derivatives trading.

As noted above, the proposed rule included derivatives within the definition of covered financial position. Derivative was defined to include any swap (as that term is defined in the Commodity Exchange Act) and security-based swap (as that term is defined in the Exchange Act), in each case as further defined by the CFTC and SEC by joint regulation, interpretation, guidance, or other action, in consultation with the Board pursuant to section 712(d) of the Dodd-Frank Act.[174] The proposed rule also included within the definition of derivative certain other transactions that, although not included within the definition of swap or security-based swap, also appear to be, or operate in economic substance as, derivatives, and which if not included could permit banking entities to engage in proprietary trading that is inconsistent with the purpose of section 13 of the BHC Act. Specifically, the proposed definition also included: (i) Any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as those terms are defined in the Commodity Exchange Act);[175] (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act;[176] (iv) any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act;[177] and (v) any transactions authorized under section 19 of the Commodity Exchange Act.[178] In addition, the proposed rule excluded from the definition of derivative (i) any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap or security-based swap, and (ii) any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

Commenters expressed a variety of views regarding the definition of covered financial position, as well as other defined terms used in that definition. For instance, some commenters argued that the definition should be expanded to include transactions in spot commodities or foreign currency, even though those instruments are not included by the statute.[179] Other commenters strongly supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute, arguing that these instruments are part of the traditional business of banking and do not represent the types of instruments that Congress designed section 13 to address. These commenters argued that including spot commodities and foreign exchange within the definition of covered financial position in the final rule would put U.S. banking entities at a competitive disadvantage and prevent them from conducting routine banking operations.[180] One commenter argued that the proposed definition of covered financial position was effective and recommended that the definition should not be expanded.[181] Another commenter argued that an instrument be considered to be a spot foreign exchange transaction, and thus not a covered financial position, if it settles within 5 days of purchase.[182] Another commenter argued that covered financial positions used in interaffiliate transactions should expressly be excluded because they are used for internal risk management purposes and not for proprietary trading.[183]

Some commenters requested that the final rule exclude additional instruments from the definition of covered financial position. For instance, some commenters requested that the Agencies exclude commodity and foreign exchange futures, forwards, and swaps, arguing that these instruments typically have a commercial and not financial purpose and that making them subject to the prohibitions of section 13 would negatively affect the spot market for these instruments.[184] A few commenters also argued that foreign exchange swaps and forwards are used in many jurisdictions to provide U.S. dollar-funding for foreign banking entities and that these instruments should be excluded since they contribute to the stability and liquidity of the market for spot foreign exchange.[185] Other commenters contended that foreign exchange swaps and forwards should be excluded because they are an integral part of banking entities' ability to provide trust and custody services to customers and are necessary to enable banking entities to deal in the exchange of currencies for customers.[186]

One commenter argued that the inclusion of certain instruments within the definition of derivative, such as purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled, was inappropriate.[187] This commenter alleged that these instruments are not derivatives but

[170] *See* 12 U.S.C. 1851(h)(4).

[171] *See* proposed rule § .3(c)(3)(i).

[172] *See* proposed rule § .3(c)(3)(ii).

[173] *See* proposed rule § .2(l), (q), (w); § .3(c)(1) and (2).

[174] *See* 7 U.S.C. 1a(47) (defining ''swap''); 15 U.S.C. 78c(a)(68) (defining ''security-based swap'').

[175] 7 U.S.C. 1a(24), (25).

[176] 7 U.S.C. 2(c)(2)(C)(i).

[177] 7 U.S.C. 2(c)(2)(D)(i).

[178] 7 U.S.C. 23.

[179] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[180] *See* Northern Trust; Morgan Stanley; JPMC; Credit Suisse (Seidel); Am. Express; *See also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange).

[181] *See* Alfred Brock.

[182] *See* Credit Suisse (Seidel).

[183] *See* GE (Feb. 2012).

[184] *See* JPMC; BoA; Citigroup (Feb. 2012).

[185] *See* Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; *See also* Norinchukin.

[186] *See* Northern Trust; Citigroup (Feb. 2012).

[187] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

should instead be viewed as contracts for purchase of specific commodities to be delivered at a future date. This commenter also argued that the Agencies do not have authority under section 13 to include these instruments as ''other securities or financial instruments'' subject to the prohibition on proprietary trading.[188]

Some commenters also argued that, because the CFTC and SEC had not yet finalized their definitions of swap and security-based swap, it was inappropriate to use those definitions as part of the proposed definition of derivative.[189] One commenter argued that the definition of derivative was effective, although this commenter argued that the final rule should not cross-reference the definition of swap and security-based swap under the federal commodities and securities laws.[190]

After carefully considering the comments received on the proposal, the final rule continues to apply the prohibition on proprietary trading to the same types of instruments as listed in the statute and the proposal, which the final rule defines as ''financial instrument.'' Under the final rule, a financial instrument is defined as: (i) A security, including an option on a security; [191] (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[192] The final rule excludes from the definition of financial instrument: (i) A loan; [193] (ii) a commodity that is not an excluded commodity (other than foreign exchange or currency), a derivative, a contract of sale of a commodity for future delivery, or an option on a contract of sale of a commodity for future delivery; or (iii) foreign exchange or currency.[194] An excluded commodity is defined to have the same meaning as in section 1a(19) of the Commodity Exchange Act.

The Agencies continue to believe that these instruments and transactions, which are consistent with those referenced in section 13(h)(4) of the BHC Act as part of the statutory definition of proprietary trading, represent the type of financial instruments which the proprietary trading prohibition of section 13 was designed to cover. While some commenters requested that this definition be expanded to include spot transactions [195] or loans,[196] the Agencies do not believe that it is appropriate at this time to expand the scope of instruments subject to the ban on proprietary trading.[197] Similarly, while some commenters requested that certain other instruments, such as foreign exchange swaps and forwards, be excluded from the definition of financial instrument,[198] the Agencies believe that these instruments appear to be, or operate in economic substance as, derivatives (which are by statute included within the scope of instruments subject to the prohibitions of section 13). If these instruments were not included within the definition of financial instrument, banking entities could use them to engage in proprietary trading that is inconsistent with the purpose and design of section 13 of the BHC Act.

As under the proposal, loans, commodities, and foreign exchange or currency are not included within the scope of instruments subject to section 13. The exclusion of these types of instruments is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities, and foreign exchange or currency—none of which are referred to in section 13(h)(4) of the BHC Act—are outside the scope of transactions to which the proprietary trading restrictions apply. For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.

The final rule also adopts the definitions of security and derivative as proposed.[199] These definitions, which reference existing definitions under the federal securities and commodities laws, are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities and commodities trading activities. While some commenters argued that it would be inappropriate to use the definition of swap and security-based swap because those terms had not yet been finalized pursuant to public notice and comment,[200] the CFTC and SEC have subsequently finalized those definitions after receiving extensive public comment on the rulemakings.[201] The Agencies believe that this notice and comment process provided adequate opportunity for market participants to comment on and understand those terms, and as such they are incorporated in the definition of derivative under this final rule.

While some commenters requested that foreign exchange swaps and forwards be excluded from the definition of derivative or financial instrument, the Agencies have not done so for the reasons discussed above. However, as explained below in Part IV.A.1.d., the Agencies note that to the extent a banking entity purchases or sells a foreign exchange forward or swap, or any other financial instrument, in a manner that meets an exclusion from proprietary trading, that transaction would not be considered to be proprietary trading and thus would not be subject to the requirements of section 13 of the BHC Act and the final rule. This includes, for instance, the purchase or sale of a financial instrument by a banking entity acting solely as agent, broker, or custodian, or the purchase or sale of a security as part of a *bona fide* liquidity management plan.

d. Proprietary Trading Exclusions

The proposed rule contained four exclusions from the definition of trading account for categories of transactions that do not fall within the scope of section 13 of the BHC Act because they do not involve short-term trading activities subject to the statutory prohibition on proprietary trading. These exclusions covered the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending arrangements, for *bona fide*

[188] *See id.*

[189] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); ISDA (Feb. 2012).

[190] *See* Alfred Brock.

[191] The definition of security under the final rule is the same as under the proposal. *See* final rule § __ __.2(y).

[192] *See* final rule § .3(c)(1).

[193] The definition of loan, as well as comments received regarding that definition, is discussed in detail below in Part IV.B.1.c.8.a.

[194] *See* final rule § .3(c)(2).

[195] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[196] *See* Occupy.

[197] Several commenters supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute. *See* Northern Trust; Morgan Stanley; State Street (Feb. 2012); JPMC; Credit Suisse (Seidel); Am. Express; *See also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange). One commenter stated that the proposed definition should not be expanded. *See* Alfred Brock. With respect to the exclusion for loans, the Agencies note this is generally consistent with the rule of statutory construction regarding the sale and securitization of loans. *See* 12 U.S.C. 1851(g)(2).

[198] *See* JPMC; BAC; Citigroup (Feb. 2012); Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; Northern Trust; *See also* Norinchukin.

[199] *See* final rule §§ __.2(h), (y).

[200] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[201] *See* CFTC and SEC, *Further Definition of ''Swap,'' ''Security-Based Swap,''* and *''Security-Based Swap Agreement''; Mixed swaps; Security Based Swap Agreement Recordkeeping,* 78 FR 48,208 (Aug. 13, 2012).

liquidity management purposes, and by a clearing agency or derivatives clearing organization in connection with clearing activities.

As discussed below, the final rule provides exclusions for the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending agreements; for *bona fide* liquidity management purposes; by certain clearing agencies, derivatives clearing organizations in connection with clearing activities; by a member of a clearing agency, derivatives clearing organization, or designated financial market utility engaged in excluded clearing activities; to satisfy existing delivery obligations; to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding; solely as broker, agent, or custodian; through a deferred compensation or similar plan; and to satisfy a debt previously contracted. After considering comments on these issues, which are discussed in more detail below, the Agencies believe that providing clarifying exclusions for these non-proprietary activities will likely promote more cost-effective financial intermediation and robust capital formation. Overly narrow exclusions for these activities would potentially increase the cost of core banking services, while overly broad exclusions would increase the risk of allowing the types of trades the statute was designed to prohibit. The Agencies considered these issues in determining the appropriate scope of these exclusions. Because the Agencies do not believe these excluded activities involve proprietary trading, as defined by the statute and the final rule, the Agencies do not believe it is necessary to use our exemptive authority in section 13(d)(1)(J) of the BHC Act to deem these activities a form of permitted proprietary trading.

1. Repurchase and Reverse Repurchase Arrangements and Securities Lending

The proposed rule's definition of trading account excluded an account used to acquire or take one or more covered financial positions that arise under (i) a repurchase or reverse repurchase agreement pursuant to which the banking entity had simultaneously agreed, in writing at the start of the transaction, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty,[202] or (ii) a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.[203] Positions held under these agreements operate in economic substance as a secured loan and are not based on expected or anticipated movements in asset prices. Accordingly, these types of transactions do not appear to be of the type the statutory definition of trading account was designed to cover.[204]

Several commenters expressed support for these exclusions and requested that the Agencies expand them.[205] For example, one commenter requested clarification that all types of repurchase transactions qualify for the exclusion.[206] Some commenters requested expanding this exclusion to cover all positions financed by, or transactions related to, repurchase and reverse repurchase agreements.[207] Other commenters requested that the exclusion apply to all transactions that are analogous to extensions of credit and are not based on expected or anticipated movements in asset prices, arguing that the exclusion would be too limited in scope to achieve its objective if it is based on the legal form of the underlying contract.[208] Additionally, some commenters suggested expanding the exclusion to cover transactions that are for funding purposes, including prime brokerage transactions, or for the purpose of asset-liability management.[209] Commenters also recommended expanding the exclusion to include re-hypothecation of customer securities, which can produce financing structures that, like a repurchase agreement, are functionally loans.[210]

In contrast, other commenters argued that there was no statutory or policy justification for excluding repurchase and reverse repurchase agreements from the trading account, and requested that this exclusion be removed from the final rule.[211] Some of these commenters argued that repurchase agreements could be used for prohibited proprietary trading[212] and suggested that, if repurchase agreements are excluded from the trading account, documentation detailing the use of liquidity derived from repurchase agreements should be required.[213] These commenters suggested that unless the liquidity is used to secure a position for a willing customer, repurchase agreements should be regarded as a strong indicator of proprietary trading.[214] As an alternative, commenters suggested that the Agencies instead use their exemptive authority pursuant to section 13(d)(1)(J) of the BHC Act to permit repurchase and reverse repurchase transactions so that such transactions must comply with the statutory limits on material conflicts of interests and high-risks assets and trading strategies, and compliance requirements under the final rule.[215] These commenters urged the Agencies to specify permissible collateral types, haircuts, and contract terms for securities lending agreements and require that the investment of proceeds from securities lending transactions be limited to high-quality liquid assets in order to limit potential risks of these activities.[216]

After considering the comments received, the Agencies have determined to exclude repurchase and reverse repurchase agreements and securities lending agreements from the definition of proprietary trading under the final rule. The final rule defines these terms subject to the same conditions as were in the proposal. This determination recognizes that repurchase and reverse repurchase agreements and securities lending agreements excluded from the definition operate in economic substance as secured loans and do not in normal practice represent proprietary

[202] *See* proposed rule § ____.3(b)(2)(iii)(A).

[203] *See* proposed rule § __.3(b)(2)(iii)(B). The language that described securities lending transactions in the proposed rule generally mirrored that contained in Rule 3a5–3 under the Exchange Act. *See* 17 CFR 240.3a5–3.

[204] *See* Joint Proposal, 76 FR 68,862.

[205] *See generally* ABA (Keating); Alfred Brock; Citigroup (Feb. 2012); GE (Feb. 2012); Goldman (Prop. Trading); ICBA; Japanese Bankers Ass'n.; JPMC; Norinchukin; RBC; RMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012); T. Rowe Price; UBS; Wells Fargo (Prop. Trading). *See infra* Part IV.A.d.10. for the discussion of commenters' requests for additional exclusions from the trading account.

[206] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[207] *See* FIA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[208] *See* Goldman (Prop. Trading); JPMC; UBS.

[209] *See* Goldman (Prop. Trading); UBS. For example, one commenter suggested that fully collateralized swap transactions should be exempted from the definition of trading account because they serve as funding transactions and are economically similar to repurchase agreements. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[210] *See* Goldman (Prop. Trading).

[211] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[212] *See* AFR *et al.* (Feb. 2012).

[213] *See* Public Citizen.

[214] *See* Public Citizen.

[215] *See* AFR *et al.* (Feb. 2012); Occupy.

[216] *See* AFR *et al.* (Feb. 2012); Occupy.

trading.[217] The Agencies will, however, monitor these transactions to ensure this exclusion is not used to engage in prohibited proprietary trading activities.

To avoid evasion of the rule, the Agencies note that, in contrast to certain commenters' requests,[218] only the transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement are excluded. For example, the collateral or position that is being financed by the repurchase or reverse repurchase agreement is not excluded and may involve proprietary trading. The Agencies further note that if a banking entity uses a repurchase or reverse repurchase agreement to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion.[219] Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.

Additionally, the Agencies have determined not to exclude all transactions, in whatever legal form that may be construed to be an extension of credit, as suggested by commenters, because such a broad exclusion would be too difficult to assess for compliance and would provide significant opportunity for evasion of the prohibitions in section 13 of the BHC Act.

2. Liquidity Management Activities

The proposed definition of trading account excluded an account used to acquire or take a position for the purpose of *bona fide* liquidity management, subject to certain requirements.[220] The preamble to the proposed rule explained that *bona fide* liquidity management seeks to ensure that the banking entity has sufficient, readily-marketable assets available to meet its expected near-term liquidity needs, not to realize short-term profit or benefit from short-term price movements.[221]

To curb abuse, the proposed rule required that a banking entity acquire or take a position for liquidity management in accordance with a documented liquidity management plan that meets five criteria.[222] Moreover, the Agencies stated in the preamble that liquidity management positions that give rise to appreciable profits or losses as a result of short-term price movements would be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be considered proprietary trading.[223]

The Agencies received a number of comments regarding the exclusion. Many commenters supported the exclusion of liquidity management activities from the definition of trading account as appropriate and necessary. At the same time, some commenters expressed the view that the exclusion was too narrow and should be replaced with a broader exclusion permitting trading activity for asset-liability management (''ALM''). Commenters argued that two aspects of the proposed rule's definition of ''trading account'' would cause ALM transactions to fall within the prohibition on proprietary trading—the 60-day rebuttable presumption and the reference to the market risk rule trading account.[224] For example, commenters expressed concern that hedging transactions associated with a banking entity's residential mortgage pipeline and mortgage servicing rights, and managing credit risk, earnings at risk, capital, asset-liability mismatches, and foreign exchange risks would be among positions that may be held for 60 days or less.[225] These commenters contended that the exclusion for liquidity management and the activity exemptions for risk-mitigating hedging and trading in U.S. government obligations would not be sufficient to permit a wide variety of ALM activities.[226] These commenters contended that prohibiting trading for ALM purposes would be contrary to the goals of enhancing sound risk management, the safety and soundness of banking entities, and U.S. financial stability,[227] and would limit banking entities' ability to manage liquidity.[228]

Some commenters argued that the requirements of the exclusion would not provide a banking entity with sufficient flexibility to respond to liquidity needs arising from changing economic conditions.[229] Some commenters argued the requirement that any position taken for liquidity management purposes be limited to the banking entity's near-term funding needs failed to account for longer-term liquidity management requirements.[230] These commenters further argued that the requirements of the liquidity management exclusion might not be synchronized with the Basel III framework, particularly with respect to the liquidity coverage ratio if ''near-term'' is considered less than 30 days.[231]

Commenters also requested clarification on a number of other issues regarding the exclusion. For example, one commenter requested clarification that purchases and sales of U.S. registered mutual funds sponsored by a banking entity would be permissible.[232] Another commenter requested clarification that the deposits resulting from providing custodial services that are invested largely in high-quality securities in conformance with the banking entity's ALM policy would not be presumed to be ''short-term trading'' under the final rule.[233] Commenters also urged that the final rule not prohibit interaffiliate transactions essential to the ALM function.[234]

In contrast, other commenters supported the liquidity management exclusion criteria[235] and suggested tightening these requirements. For example, one commenter recommended that the rule require that investments made under the liquidity management exclusion consist only of high-quality liquid assets.[236] Other commenters argued that the exclusion for liquidity management should be eliminated.[237] One commenter argued that there was no need to provide a special exemption for liquidity management or ALM activities given the exemptions for

[217] Congress recognized that repurchase agreements and securities lending agreements are loans or extensions of credit by including them in the legal lending limit. *See* Dodd–Frank Act section 610 (amending 12 U.S.C. 84b). The Agencies believe the conditions of the final rule's exclusions for repurchase agreements and securities lending agreements identify those activities that do not in normal practice represent proprietary trading and, thus, the Agencies decline to provide additional requirements for these activities, as suggested by some commenters. *See* Public Citizen; AFR *et al.* (Feb. 2012); Occupy.

[218] *See* Goldman (Prop. Trading); JPMC; UBS.

[219] *See* CFTC Proposal, 77 FR 8348.

[220] *See* proposed rule § ____.3(b)(2)(iii)(C).

[221] *Id.*

[222] *See* proposed rule § ____.3(b)(2)(iii)(C)(1)–(5).

[223] *See* Joint Proposal, 76 FR 68,862.

[224] *See* ABA (Keating); BoA; CH/ABASA; JPMC. *See supra* Part IV.A.1.b. (discussing the rebuttable presumption under § ____3.(b)(2) of the final rule); *See also supra* Part IV.A.1.a. (discussing the market risk rule trading account under § ____3.(b)(1)(ii) of the final rule).

[225] *See* CH/ABASA; Wells Fargo (Prop. Trading).

[226] *See* CH/ABASA; JPMC; State Street (Feb. 2012); Wells Fargo (Prop. Trading). *See also* BaFin/Deutsche Bundesbank.

[227] *See* BoA; JPMC; RBC.

[228] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); JPMC; NAIB *et al.;* State Street (Feb. 2012); T. Rowe Price.

[229] *See* ABA (Keating); CH/ABASA; JPMC.

[230] *See* ABA (Keating); BoA; CH/ABASA; JPMC.

[231] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); BoA; CH/ABASA

[232] *See* T. Rowe Price.

[233] *See* State Street (Feb. 2012).

[234] *See* State Street (Feb. 2012); JPMC. *See also* Part IV.A.1.d.10. (discussing commenter requests to exclude inter-affiliate transactions).

[235] *See* AFR *et al.* (Feb. 2012); Occupy.

[236] *See* Occupy.

[237] *See* Sens. Merkley & Levin (Feb. 2012).

trading in government obligations and risk-mitigating hedging activities.[238]

After carefully reviewing the comments received, the Agencies have adopted the proposed exclusion for liquidity management with several important modifications. As limited below, liquidity management activity serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act and in rules and guidance of the Agencies, of ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs.[239]

To ensure that this exclusion is not misused for the purpose of proprietary trading, the final rule imposes a number of requirements. First, the liquidity management plan of the banking entity must be limited to securities (in keeping with the liquidity management requirements proposed by the Federal banking agencies) and specifically contemplate and authorize the particular securities to be used for liquidity management purposes; describe the amount, types, and risks of securities that are consistent with the entity's liquidity management; and the liquidity circumstances in which the particular securities may or must be used.[240] Second, any purchase or sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes. Third, the plan must require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to instruments the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements.[241] Fourth, the plan must limit any securities purchased or sold for liquidity management purposes to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan.[242] Fifth, the banking entity must incorporate into its compliance program internal controls, analysis and independent testing designed to ensure that activities undertaken for liquidity management purposes are conducted in accordance with the requirements of the final rule and the entity's liquidity management plan. Finally, the plan must be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Agency responsible for regulating the banking entity.

The final rule retains the provision that the financial instruments purchased and sold as part of a liquidity management plan be highly liquid and not reasonably expected to give rise to appreciable profits or losses as a result of short-term price movements. This requirement is consistent with the Agencies' expectation for liquidity management plans in the supervisory context. It is not intended to prevent firms from recognizing profits (or losses) on instruments purchased and sold for liquidity management purposes. Instead, this requirement is intended to underscore that the purpose of these transactions must be liquidity management. Thus, the timing of purchases and sales, the types and duration of positions taken and the incentives provided to managers of these purchases and sales must all indicate that managing liquidity, and not taking short-term profits (or limiting short-term losses), is the purpose of these activities.

The exclusion as adopted does not apply to activities undertaken with the stated purpose or effect of hedging aggregate risks incurred by the banking entity or its affiliates related to asset-liability mismatches or other general market risks to which the entity or affiliates may be exposed. Further, the exclusion does not apply to any trading activities that expose banking entities to substantial risk from fluctuations in market values, unrelated to the management of near-term funding needs, regardless of the stated purpose of the activities.[243]

Overall, the Agencies do not believe that the final rule will stand as an obstacle to or otherwise impair the ability of banking entities to manage the risks of their businesses and operate in a safe and sound manner. Banking entities engaging in *bona fide* liquidity management activities generally do not purchase or sell financial instruments for the purpose of short-term resale or to benefit from actual or expected short-term price movements. The Agencies have determined, in contrast to certain commenters' requests, not to expand this liquidity management provision to broadly allow asset-liability management, earnings management, or scenario hedging.[244] To the extent these activities are for the purpose of profiting from short-term price movements or to hedge risks not related to short-term funding needs, they represent proprietary trading subject to section 13 of the BHC Act and the final rule; the activity would then be permissible only if it meets all of the requirements for an exemption, such as the risk-mitigating hedging exemption, the exemption for trading in U.S. government securities, or another exemption.

3. Transactions of Derivatives Clearing Organizations and Clearing Agencies

A banking entity that is a central counterparty for clearing and settlement activities engages in the purchase and sale of financial instruments as an integral part of clearing and settling those instruments. The proposed definition of trading account excluded an account used to acquire or take one or more covered financial positions by

[238] *See* Sens. Merkley & Levin (Feb. 2012).

[239] *See* section 165(b)(1)(A)(ii) of the Dodd-Frank Act; Enhanced Prudential Standards, 77 FR 644 at 645 (Jan. 5, 2012), *available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf*; *See also* Enhanced Prudential Standards, 77 FR 76,678 at 76,682 (Dec. 28, 2012), *available at http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf*.

[240] To ensure sufficient flexibility to respond to liquidity needs arising from changing economic times, a banking entity should envision and address a range of liquidity circumstances in its liquidity management plan, and provide a mechanism for periodically reviewing and revising the liquidity management plan.

[241] The requirement to use highly liquid instruments is consistent with the focus of the clarifying exclusion on a banking entity's near-term liquidity needs. Thus, the final rules do not include commenters' suggested revisions to this requirement. *See* Clearing House Ass'n.; *See also* Occupy; Sens. Merkley & Levin (Feb. 2012). The Agencies decline to identify particular types of securities that will be considered highly liquid for purposes of the exclusion, as requested by some commenters, in recognition that such a determination will depend on the facts and circumstances. *See* T. Rowe Price; State Street (Feb. 2012).

[242] The Agencies plan to construe ''near-term funding needs'' in a manner that is consistent with the laws, regulations, and issuances related to liquidity risk management. *See, e.g.,* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 FR 71,818 (Nov. 29, 2013); Basel Committee on Bank Supervision, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Management Tools (January 2013) *available at http://www.bis.org/publ/bcbs238.htm.* The Agencies believe this should help address commenters' concerns about the proposed requirement. *See, e.g.,* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); CH/ABASA; BoA; JPMC.

[243] *See, e.g.,* Staff of S. Comm. on Homeland Sec. & Governmental Affairs Permanent Subcomm. on Investigations, 113th Cong., Report: JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses (Apr. 11, 2013), *available at http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15–2013*.

[244] *See, e.g.,* ABA (Keating); BoA; CH/ABASA; JPMC.

a derivatives clearing organization registered under the Commodity Exchange Act or a clearing agency registered under the Securities Exchange Act of 1934 in connection with clearing derivatives or securities transactions.[245] The preamble to the proposed rule noted that the purpose of these transactions is to provide a clearing service to third parties, not to profit from short-term resale or short-term price movements.[246]

Several commenters supported the proposed exclusion for derivatives clearing organizations and urged the Agencies to expand the exclusion to cover a banking entity's clearing-related activities, such as clearing a trade for a customer, trading with a clearinghouse, or accepting positions of a defaulting member, on grounds that these activities are not proprietary trades and reduce systemic risk.[247] One commenter recommended expanding the exclusion to non-U.S. central counterparties [248] In contrast, one commenter argued that the exclusion for derivatives clearing organizations and clearing agencies had no statutory basis and should instead be a permitted activity under section 13(d)(1)(J).[249]

After considering the comments received, the final rule retains the exclusion for purchases and sales of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with its clearing activities.[250] In response to comments,[251] the Agencies have also incorporated two changes to the rule. First, the final rule applies the exclusion to the purchase and sale of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with clearing financial instrument transactions. Second, in response to comments,[252] the exclusion in the final rule is not limited to clearing agencies or derivatives clearing organizations that are subject to SEC or CFTC registration requirements and, instead, certain foreign clearing agencies and foreign derivatives clearing organizations will be permitted to rely on the exclusion if they are banking entities.

The Agencies believe that clearing and settlement activity is not designed to create short-term trading profits. Moreover, excluding clearing and settlement activities prevents the final rule from inadvertently hindering the Dodd–Frank Act's goal of promoting central clearing of financial transactions. The Agencies have narrowly tailored this exclusion by allowing only central counterparties to use it and only with respect to their clearing and settlement activity.

4. Excluded Clearing-Related Activities of Clearinghouse Members

In addition to the exclusion for trading activities of a derivatives clearing organization or clearing agency, some commenters requested an additional exclusion from the definition of ''trading account'' for clearing-related activities of members of these entities.[253] These commenters noted that the proposed definition of ''trading account'' provides an exclusion for positions taken by registered derivatives clearing organizations and registered clearing agencies [254] and requested a corresponding exclusion for certain clearing-related activities of banking entities that are members of a clearing agency or members of a derivatives clearing organization (collectively, ''clearing members'').[255]

Several commenters argued that certain aspects of the clearing process may require a clearing member to engage in principal transactions. For example, some commenters argued that a clearinghouse's default management process may require clearing members to take positions in financial instruments upon default of another clearing member.[256] According to commenters, default management processes can involve: (i) Collection of initial and variation margin from customers under an ''agency model'' of clearing; (ii) porting, where a defaulting clearing member's customer positions and margin are transferred to another non-defaulting clearing member; [257] (iii) hedging, where the clearing house looks to clearing members and third parties to enter into risk-reducing transactions and to flatten the market risk associated with the defaulting clearing member's house positions and non-ported customer positions; (iv) unwinding, where the defaulting member's open positions may be allocated to other clearing members, affiliates, or third parties pursuant to a mandatory auction process or forced allocation; [258] and (v) imposing certain obligations on clearing members upon exhaustion of a guaranty fund.[259]

Commenters argued that, absent an exclusion from the definition of ''trading account,'' some of these clearing-related activities could be considered prohibited proprietary trading under the proposal. Two commenters specifically contended that the dealer prong of the definition of ''trading account'' may cause certain of these activities to be considered proprietary trading.[260] Some commenters suggested alternative avenues for permitting such clearing-related activity under the rules.[261] Commenters argued that such clearing-related activities of banking entities should not be subject to the rule because they are risk-reducing, beneficial for the financial system, required by law under certain circumstances (*e.g.,* central clearing requirements for swaps and security-based swaps under Title VII of the Dodd-Frank Act), and not used by banking entities to engage in proprietary trading.[262]

Commenters further argued that certain activities undertaken as part of a clearing house's daily risk management process may be impacted by the rule, including unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired credit default swap (''CDS'') protection on itself as a result of a merger with another firm) [263] and trade crossing, a mechanism employed by

[245] *See* proposed rule § ____.3(b)(2)(iii)(D).

[246] *See* Joint Proposal, 76 FR 68,863.

[247] *See* Allen & Overy (Clearing); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[248] *See* IIB/EBF.

[249] *See* Sens. Merkley & Levin (Feb. 2012).

[250] ''Clearing agency'' is defined in the final rule with reference to the definition of this term in the Exchange Act. *See* final rule § ____.3(e)(2). ''Derivatives clearing organization'' is defined in the final rule as (i) a derivatives clearing organization registered under section 5b of the Commodity Exchange Act; (ii) a derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act; or (iii) a foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

[251] *See* IIB/EBF; BNY Mellon *et al.;* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading).

[252] *See* IIB/EBF; Allen & Overy (Clearing).

[253] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[254] *See* proposed rule § ____.3(b)(2)(iii)(D).

[255] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[256] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[257] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing).

[258] *See* Allen & Overy (Clearing).

[259] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[260] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (arguing that the SEC has suggested that entities that collect margins from customers for cleared swaps may be required to be registered as broker-dealers); State Street (Feb. 2012).

[261] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012); ISDA (Feb. 2012).

[262] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); State Street (Feb. 2012); Allen & Overy (Clearing).

[263] *See* Allen & Overy (Clearing).

certain clearing houses to ensure the accuracy of the price discovery process in the course of, among other things, calculating settlement prices and margin requirements.[264]

The Agencies do not believe that certain core clearing-related activities conducted by a clearing member, often as required by regulation or the rules and procedures of a clearing agency, derivatives clearing organization, or designated financial market utility, represent proprietary trading as contemplated by the statute. For example, the clearing and settlement activities discussed above are not conducted for the purpose of profiting from short-term price movements. The Agencies believe that these clearing-related activities provide important benefits to the financial system.[265] In particular, central clearing reduces counterparty credit risk,[266] which can lead to a host of other benefits, including lower hedging costs, increased market participation, greater liquidity, more efficient risk sharing that promotes capital formation, and reduced operational risk.[267]

Accordingly, in response to comments, the final rule provides that proprietary trading does not include specified excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility.[268] ''Excluded clearing activities'' is defined in the rule to identify particular core clearing-related activities, many of which were raised by commenters.[269] Specifically, the final rule will exclude the following activities by clearing members: (i) Any purchase or sale necessary to correct error trades made by or on behalf of customers with respect to customer transactions that are cleared, provided the purchase or sale is conducted in accordance with certain regulations, rules, or procedures; (ii) any purchase or sale related to the management of a default or threatened imminent default of a customer, subject to certain conditions, another clearing member, or the clearing agency, derivatives clearing organization, or designated financial market utility itself; [270] and (iii) any purchase or sale required by the rules or procedures of a clearing agency, derivatives clearing organization, or designated financial market utility that mitigates risk to such agency, organization, or utility that would result from the clearing by a clearing member of security-based swaps that references the member or an affiliate of the member.[271]

The Agencies are identifying specific activities in the rule to limit the potential for evasion that may arise from a more generalized approach. However, the relevant supervisory Agencies will be prepared to provide further guidance or relief, if appropriate, to ensure that the terms of the exclusion do not limit the ability of clearing agencies, derivatives clearing organizations, or designated financial market utilities to effectively manage their risks in accordance with their rules and procedures. In response to commenters requesting that the exclusion be available when a clearing member is required by rules of a clearing agency, derivatives clearing organization, or designated financial market utility to purchase or sell a financial instrument as part of establishing accurate prices to be used by the clearing agency, derivatives clearing organization, or designated financial market utility in its end of day settlement process,[272] the Agencies note that whether this is an excluded clearing activity depends on the facts and circumstances. Similarly, the availability of other exemptions to the rule, such as the market-making exemption, depend on the facts and circumstances. This exclusion applies only to excluded clearing activities of clearing members. It does not permit a banking entity to engage in proprietary trading and claim protection for that activity because trades are cleared or settled through a central counterparty.

5. Satisfying an Existing Delivery Obligation

A few commenters requested additional or expanded exclusions from the definition of ''trading account'' for covering short sales or failures to deliver.[273] These commenters alleged that a banking entity engages in this activity for purposes other than to benefit from short term price movements and that it is not proprietary trading as defined in the statute. In response to these comments, the final rule provides that a purchase or sale by a banking entity that satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity is not proprietary trading.

Among other things, this exclusion will allow a banking entity that is an SEC-registered broker-dealer to take action to address failures to deliver arising from its own trading activity or the trading activity of its customers.[274] In certain circumstances, SEC-registered broker-dealers are required to take such action under SEC rules.[275] In addition, buy-in procedures of a clearing agency, securities exchange, or national securities association may require a

[264] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop.Trading) (Feb. 2012). These commenters stated that, in order to ensure that a clearing member is providing accurate end-of-day prices for its open positions, a clearing house may require the member to provide firm bids for such positions, which may be tested through a ''forced trade'' with another member. *See id.; See also* ISDA (Feb. 2012).

[265] For example, Title VII of the Dodd-Frank Act mandates the central clearing of swaps and security-based swaps, and requires that banking entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants collect variation margin from many counterparties on a daily basis for their swap or security-based swap activity. *See* 7 U.S.C. 2(h); 15 U.S.C. 78c–3; 7 U.S.C. 6s(e); 15 U.S.C. 78o–10(e); *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 76 FR 23,732 (Apr. 28, 2011). Additionally, the SEC's Rule 17Ad–22(d)(11) requires that each registered clearing agency establish, implement, maintain and enforce policies and procedures that set forth the clearing agency's default management procedures. *See* 17 CFR 240.17Ad–22(d)(11). *See also* Exchange Act Release No. 68,080 (Oct. 12, 2012), 77 FR 66,220, 66,283 (Nov. 2, 2012).

[266] Centralized clearing affects counterparty risk in three basic ways. First, it redistributes counterparty risk among members through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. Second, margin requirements and monitoring reduce moral hazard, reducing counterparty risk. Finally, clearing may reallocate counterparty risk outside of the clearing agency because netting may implicitly subordinate outside creditors' claims relative to other clearing member claims.

[267] *See* Proposed Rule, Cross-Border Security-Based Swap Activities, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30,968, 31,162–31,163 (May 23, 2013).

[268] *See* final rule § ____.3(d)(5).

[269] *See* final rule § ____.3(e)(7).

[270] A number of commenters discussed the default management process and requested an exclusion for such activities. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[271] *See* Allen & Overy (Clearing) (discussing rules that require unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired CDS protection on itself as a result of a merger with another firm)).

[272] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* ISDA (Feb. 2012).

[273] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[274] In order to qualify for this exclusion, a banking entity's principal trading activity that results in its own failure to deliver must have been conducted in compliance with these rules.

[275] *See, e.g.,* 17 CFR 242.204 (requiring, among other things, that a participant of a registered clearing agency or, upon reasonable allocation, a broker-dealer for which the participant clears trades or from which the participant receives trades for settlement, take action to close out a fail to deliver position in any equity security by borrowing or purchasing securities of like kind and quantity); 17 CFR 240.15c3–3(m) (providing that, if a broker-dealer executes a sell order of a customer and does not obtain possession of the securities from the customer within 10 business days after settlement, the broker-dealer must immediately close the transaction with the customer by purchasing securities of like kind and quantity).

banking entity to deliver securities if a party with a fail to receive position takes certain action.[276] When a banking entity purchases securities to meet an existing delivery obligation, it is engaging in activity that facilitates timely settlement of securities transactions and helps provide a purchaser of the securities with the benefits of ownership (*e.g.,* voting and lending rights). In addition, a banking entity has limited discretion to determine when and how to take action to meet an existing delivery obligation.[277] Providing a limited exclusion for this activity will avoid the potential for SEC-registered broker-dealers being subject to conflicting or inconsistent regulatory requirements with respect to activity required to meet the broker-dealer's existing delivery obligations.

6. Satisfying an Obligation in Connection With a Judicial, Administrative, Self-Regulatory Organization, or Arbitration Proceeding

The Agencies recognize that, under certain circumstances, a banking entity may be required to purchase or sell a financial instrument at the direction of a judicial or regulatory body. For example, an administrative agency or self-regulatory organization (''SRO'') may require a banking entity to purchase or sell a financial instrument in the course of disciplinary proceedings against that banking entity.[278] A banking entity may also be obligated to purchase or sell a financial instrument in connection with a judicial or arbitration proceeding.[279] Such transactions do not represent trading for short-term profit or gain and do not constitute proprietary trading under the statute.

Accordingly, the Agencies have determined to adopt a provision clarifying that a purchase or sale of one or more financial instruments that satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding is not proprietary trading for purposes of these rules. This clarification will avoid the potential for conflicting or inconsistent legal requirements for banking entities.

7. Acting Solely as Agent, Broker, or Custodian

The proposal clarified that proprietary trading did not include acting solely as agent, broker, or custodian for an unaffiliated third party.[280] Commenters generally supported this aspect of the proposal. One commenter suggested that acting as agent, broker, or custodian for affiliates should be explicitly excluded from the definition of proprietary trading in the same manner as acting as agent, broker, or custodian for unaffiliated third parties.[281]

Like the proposal, the final rule expressly provides that the purchase or sale of one or more financial instruments by a banking entity acting solely as agent, broker, or custodian is not proprietary trading because acting in these types of capacities does not involve trading as principal, which is one of the requisite aspects of the statutory definition of proprietary trading.[282] The final rule has been modified to include acting solely as agent, broker, or custodian on behalf of an affiliate. However, the affiliate must comply with section 13 of the BHC Act and the final implementing rule; and may not itself engage in prohibited proprietary trading. To the extent a banking entity acts in both a principal and agency capacity for a purchase or sale, it may only use this exclusion for the portion of the purchase or sale for which it is acting as agent. The banking entity must use a separate exemption or exclusion, if applicable, to the extent it is acting in a principal capacity.

8. Purchases or Sales Through a Deferred Compensation or Similar Plan

While the proposed rule provided that the prohibition on covered fund activities and investments did not apply to certain instances where the banking entity acted through or on behalf of a pension or similar deferred compensation plan, no such similar treatment was given for proprietary trading. One commenter argued that the proposal restricted a banking entity's ability to engage in principal-based trading as an asset manager that serves the needs of the institutional investors, such as through ERISA pension and 401(k) plans.[283]

To address these concerns, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the laws of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of the employees of the banking entity or members of their immediate family. Banking entities often establish and act as trustee to pension or similar deferred compensation plans for their employees and, as part of managing these plans, may engage in trading activity. The Agencies believe that purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute.

The Agencies note that if a banking entity engages in trading activity for an unaffiliated pension or similar deferred compensation plan, the trading activity of the banking entity would not be proprietary trading under the final rule to the extent the banking entity was acting solely as agent, broker, or custodian.

9. Collecting a Debt Previously Contracted

Several commenters argued that the final rule should exclude collecting and disposing of collateral in satisfaction of debts previously contracted from the definition of proprietary trading.[284] Commenters argued that acquiring and

[276] *See, e.g.,* NSCC Rule 11, NASDAQ Rule 11810, FINRA Rule 11810.

[277] *See, e.g.,* 17 CFR 242.204 (requiring action to close out a fail to deliver position in an equity security within certain specified timeframes); 17 CFR 240.15c3–3(m) (requiring a broker-dealer to ''immediately'' close a transaction under certain circumstances).

[278] For example, an administrative agency or SRO may require a broker-dealer to offer to buy securities back from customers where the agency or SRO finds the broker-dealer fraudulently sold securities to those customers. *See, e.g., In re* Raymond James & Assocs., Exchange Act Release No. 64767, 101 S.E.C. Docket 1749 (June 29, 2011); *FINRA Dep't of Enforcement* v. *Pinnacle Partners Fin. Corp.,* Disciplinary Proceeding No. 2010021324501 (Apr. 25, 2012); *FINRA Dep't of Enforcement* v. *Fifth Third Sec., Inc.,* No. 2005002244101 (Press Rel. Apr. 14, 2009).

[279] For instance, section 29 of the Exchange Act may require a broker-dealer to rescind a contract with a customer that was made in violation of the Exchange Act. Such rescission relief may involve the broker-dealer's repurchase of a financial instrument from a customer. *See* 15 U.S.C. 78cc; *Reg'l Props., Inc.* v. *Fin. & Real Estate Consulting Co.,* 678 F.2d 552 (5th Cir. 1982); *Freeman* v. *Marine Midland Bank N.Y.,* 419 F.Supp. 440 (E.D.N.Y. 1976).

[280] *See* proposed rule § ____.3(b)(1).

[281] *See* Japanese Bankers Ass'n.

[282] *See* 12 U.S.C. 1851(h)(4). A common or collective investment fund that is an investment company under section 3(c)(3) or 3(c)(11) will not be deemed to be acting as principal within the meaning of § ____.3(a) because the fund is performing a traditional trust activity and purchases and sells financial instruments solely on behalf of customers as trustee or in a similar fiduciary capacity, as evidenced by its regulation under 12 CFR part 9 (Fiduciary Activities of National Banks) or similar state laws.

[283] *See* Ass'n. of Institutional Investors (Nov. 2012).

[284] *See* LSTA (Feb. 2012); JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012).

disposing of collateral in satisfaction of debt previously contracted does not involve trading with the intent of profiting from short-term price movements and, thus, should not be proprietary trading for purposes of this rule. Rather, this activity is a prudent and desirable part of lending and debt collection activities.

The Agencies believe that the purchase and sale of a financial instrument in satisfaction of a debt previously contracted does not constitute proprietary trading. The Agencies believe an exclusion for purchases and sales in satisfaction of debts previously contracted is necessary for banking entities to continue to lend to customers, because it allows banking entities to continue lending activity with the knowledge that they will not be penalized for recouping losses should a customer default. Accordingly, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable within the time period permitted or required by the appropriate financial supervisory agency.[285]

As a result of this exclusion, banking entities, including SEC-registered broker-dealers, will be able to continue providing margin loans to their customers and may take possession of margined collateral following a customer's default or failure to meet a margin call under applicable regulatory requirements.[286] Similarly, a banking entity that is a CFTC-registered swap dealer or SEC-registered security-based swap dealer may take, hold, and exchange any margin collateral as counterparty to a cleared or uncleared swap or security-based swap transaction, in accordance with the rules of the Agencies.[287] This exclusion will allow banking entities to comply with existing regulatory requirements regarding the divestiture of collateral taken in satisfaction of a debt.

10. Other Requested Exclusions

Commenters requested a number of additional exclusions from the trading account and, in turn, the prohibition on proprietary trading. In order to avoid potential evasion of the final rule, the Agencies decline to adopt any exclusions from the trading account other than the exclusions described above.[288] The Agencies believe that various modifications to the final rule, including in particular to the exemption for market-making related activities, address many of commenters' concerns regarding unintended consequences of the prohibition on proprietary trading.

2. Section ____.4(a): Underwriting Exemption

a. Introduction

After carefully considering comments on the proposed underwriting exemption, the Agencies are adopting the proposed underwriting exemption substantially as proposed, but with certain refinements and clarifications to the proposed approach to better reflect the range of securities offerings that an underwriter may help facilitate on behalf of an issuer or selling security holder and the types of activities an underwriter may undertake in connection with a distribution of securities to facilitate the distribution process and provide important benefits to issuers, selling security holders, or purchasers in the distribution. The Agencies are adopting such an approach because the statute specifically permits banking entities to continue providing these beneficial services to clients, customers, and counterparties. At the same time, to reduce the potential for evasion of the general prohibition on proprietary trading, the Agencies are requiring, among other things, that the trading desk make reasonable efforts to sell or otherwise reduce its underwriting position (accounting for the liquidity, maturity, and depth of the market for the relevant type of security) and be subject to a robust risk limit structure that is designed to prevent a trading desk from having an underwriting position that exceeds the reasonably expected near term demands of clients, customers, or counterparties.

b. Overview

1. Proposed Underwriting Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities and certain other instruments in connection with underwriting activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[289]

Section ____.4(a) of the proposed rule would have implemented this exemption by requiring that a banking entity's underwriting activities comply with seven requirements. As discussed in more detail below, the proposed underwriting exemption required that: (i) A banking entity establish a compliance program under § ____.20; (ii) the covered financial position be a security; (iii) the purchase or sale be effected solely in connection with a distribution of securities for which the banking entity is acting as underwriter; (iv) the banking entity meet certain dealer registration requirements, where applicable; (v) the underwriting activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; (vi) the underwriting activities be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or to hedging of covered financial positions; and (vii) the compensation arrangements of persons performing underwriting activities be designed not to reward proprietary risk-taking.[290] The proposal explained that these seven criteria were proposed so that any banking entity relying on the underwriting exemption would be engaged in *bona fide* underwriting activities and would conduct those activities in a way that would not be susceptible to abuse through the taking of speculative, proprietary positions as

[285] *See* final rule § ____.3(d)(9).

[286] For example, if any margin call is not met in full within the time required by Regulation T, then Regulation T requires a broker-dealer to liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less. *See* 12 CFR 220.4(d).

[287] *See* SEC Proposed Rule, *Capital, Margin, Segregation, Reporting and Recordkeeping Requirements for Security-Based Swap Dealers,* Exchange Act Release No. 68071, 77 FR 70,214 (Nov. 23, 2012); CFTC Proposed Rule, *Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants,* 76 FR 23,732 (Apr. 28, 2011); Banking Agencies' Proposed Rule, *Margin and Capital Requirements for Covered Swap Entities,* 76 FR 27,564 (May 11, 2011).

[288] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (transactions that are not based on expected or anticipated movements in asset prices, such as fully collateralized swap transactions that serve funding purposes); Norinchukin and Wells Fargo (Prop. Trading) (derivatives that qualify for hedge accounting); GE (Feb. 2012) (transactions related to commercial contracts); Citigroup (Feb. 2012) (FX swaps and FX forwards); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (interaffiliate transactions); T. Rowe Price (purchase and sale of shares in sponsored mutual funds); RMA (cash collateral pools); Alfred Brock (arbitrage trading); ICBA (securities traded pursuant to 12 U.S.C. 1831a(f)). The Agencies are concerned that these exclusions could be used to conduct impermissible proprietary trading, and the Agencies believe some of these exclusions are more appropriately addressed by other provisions of the rule. For example, derivatives qualifying for hedge accounting may be permitted under the hedging exemption.

[289] 12 U.S.C. 1851(d)(1)(B).

[290] *See* proposed rule § ____.4(a).

part of, or mischaracterized as, underwriting activity.[291]

2. Comments on Proposed Underwriting Exemption

As a general matter, a few commenters expressed overall support for the proposed underwriting exemption.[292] Some commenters indicated that the proposed exemption is too narrow and may negatively impact capital markets.[293] As discussed in more detail below, many commenters expressed views on the effectiveness of specific requirements of the proposed exemption. Further, some commenters requested clarification or expansion of the proposed exemption for certain activities that may be conducted in the course of underwriting.

Several commenters suggested alternative approaches to implementing the statutory exemption for underwriting activities.[294] More specifically, commenters recommended that the Agencies: (i) Provide a safe harbor for low risk, standard underwritings; [295] (ii) better incorporate the statutory limitations on high-risk activity or conflicts of interest; [296] (iii) prohibit banking entities from underwriting illiquid securities; [297] (iv) prohibit banking entities from participating in private placements; [298] (v) place greater emphasis on adequate internal compliance and risk management procedures; [299] or (vi) make the exemption as broad as possible.[300]

3. Final Underwriting Exemption

After considering the comments received, the Agencies are adopting the underwriting exemption substantially as proposed, but with important modifications to clarify provisions or to address commenters' concerns. As discussed above, some commenters were generally supportive of the proposed approach to implementing the underwriting exemption, but noted certain areas of concern or uncertainty. The underwriting exemption the Agencies are adopting addresses these issues by further clarifying the scope of activities that qualify for the exemption. In particular, the Agencies are refining the proposed exemption to better capture the broad range of capital-raising activities facilitated by banking entities acting as underwriters on behalf of issuers and selling security holders.

The final underwriting exemption includes the following components:

- A framework that recognizes the differences in underwriting activities across markets and asset classes by establishing criteria that will be applied flexibly based on the liquidity, maturity, and depth of the market for the particular type of security.
- A general focus on the ''underwriting position'' held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with the distribution of securities for which such banking entity or affiliate is acting as an underwriter.[301]
- A definition of the term ''trading desk'' that focuses on the functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a banking entity or across two or more affiliates.[302]
- Five standards for determining whether a banking entity is engaged in permitted underwriting activities. Many of these criteria have similarities to those included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - The banking entity act as an ''underwriter'' for a ''distribution'' of securities and the trading desk's underwriting position be related to such distribution. The final rule includes refined definitions of ''distribution'' and ''underwriter'' to better capture the broad scope of securities offerings used by issuers and selling security holders and the range of roles that a banking entity may play as intermediary in such offerings.[303]
  - The amount and types of securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[304]
  - The banking entity establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:
    - The products, instruments, or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;
    - Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the amount, types, and risk of the trading desk's underwriting position, level of exposures to relevant risk factors arising from the trading desk's underwriting position, and period of time a security may be held;
    - Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and
    - Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent

[291] *See* Joint Proposal, 76 FR 68,866; CFTC Proposal, 77 FR 8352.

[292] *See* Barclays (stating that the proposed exemption generally effectuates the aims of the statute while largely avoiding undue interference, although the commenter also requested certain technical changes to the rule text); Alfred Brock.

[293] *See, e.g.,* Lord Abbett; BoA; Fidelity; Chamber (Feb. 2012).

[294] *See* Sens. Merkley & Levin (Feb. 2012); BoA; Fidelity; Occupy; AFR *et al.* (Feb. 2012).

[295] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting a safe harbor for underwriting efforts that meet certain low-risk criteria, including that: The underwriting be in plain vanilla stock or bond offerings, including commercial paper, for established business and governments; and the distribution be completed within relevant time periods, as determined by asset classes, with relevant factors being the size of the issuer and the market served); Johnson & Prof. Stiglitz (expressing support for a narrow safe harbor for underwriting of basic stocks and bonds that raise capital for real economy firms).

[296] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting that, for example, the exemption plainly prevent high-risk, conflict ridden underwritings of securitizations and structured products and cross-reference Section 621 of the Dodd-Frank Act, which prohibits certain material conflicts of interest in connection with asset-backed securities).

[297] *See* AFR *et al.* (Feb. 2012) (recommending that the Agencies prohibit banking entities from acting as underwriter for assets classified as Level 3 under FAS 157, which would prohibit underwriting of illiquid and opaque securities without a genuine external market, and representing that such a restriction would be consistent with the statutory limitation on exposures to high-risk assets).

[298] *See* Occupy.

[299] *See* BoA (recommending that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rules as long as the banking entity has adequate compliance and risk management procedures).

[300] *See* Fidelity (suggested that the rules be revised to ''provide the broadest exemptions possible under the statute'' for underwriting and certain other permitted activities).

[301] *See infra* Part IV.A.2.c.1.c.

[302] *See infra* Part IV.A.2.c.1.c. The term ''trading desk'' is defined in final rule § ____.3(e)(13) as ''the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.''

[303] *See* final rule §§ ____.4(a)(2)(i), ____.4(a)(3), ____.4(a)(4); *See also infra* Part IV.A.2.c.1.c.

[304] *See* final rule § ____.4(a)(2)(ii); *See also infra* Part IV.A.2.c.2.c.

increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval.[305]

○ The compensation arrangements of persons performing the banking entity's underwriting activities are designed not to reward or incentivize prohibited proprietary trading.[306]

○ The banking entity is licensed or registered to engage in the activity described in the underwriting exemption in accordance with applicable law.[307]

After considering commenters' suggested alternative approaches to implementing the statute's underwriting exemption, the Agencies have determined to retain the general structure of the proposed underwriting exemption. For instance, two commenters suggested providing a safe harbor for ''plain vanilla'' or ''basic'' underwritings of stocks and bonds.[308] The Agencies do not believe that a safe harbor is necessary to provide certainty that a banking entity may act as an underwriter in these particular types of offerings. This is because ''plain vanilla'' or ''basic'' underwriting activity should be able to meet the requirements of the final rule. For example, the final definition of ''distribution'' includes any offering of securities made pursuant to an effective registration statement under the Securities Act.[309]

Further, in response to one commenter's request that the final rule prohibit a banking entity from acting as an underwriter in illiquid assets that are determined to not have observable price inputs under accounting standards,[310] the Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule.[311] Moreover, the Agencies do not believe it is necessary to differentiate between liquid and less liquid securities for purposes of determining whether a banking entity may underwrite a distribution of securities because, in either case, a banking entity must have a reasonable expectation of purchaser demand for the securities and must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period under the final rule.[312]

Another commenter suggested that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rule as long as the banking entity has adequate compliance and risk management procedures.[313] While strong compliance and risk management procedures are important for banking entities' permitted activities, the Agencies believe that an approach focused solely on the establishment of a compliance program would likely increase the potential for evasion of the general prohibition on proprietary trading. Similarly, the Agencies are not adopting an exemption that is unlimited, as requested by one commenter, because the Agencies believe controls are necessary to prevent potential evasion of the statute through, among other things, retaining an unsold allotment when there is sufficient customer interest for the securities and to limit the risks associated with these activities.[314]

Underwriters play an important role in facilitating issuers' access to funding, and thus underwriters are important to the capital formation process and economic growth.[315] Obtaining new financing can be expensive for an issuer because of the natural information advantage that less well-known issuers have over investors about the quality of their future investment opportunities. An underwriter can help reduce these costs by mitigating the information asymmetry between an issuer and its potential investors. The underwriter does this based in part on its familiarity with the issuer and other similar issuers as well as by collecting information about the issuer. This allows investors to look to the reputation and experience of the underwriter as well as its ability to provide information about the issuer and the underwriting. For these and other reasons, most U.S. issuers rely on the services of an underwriter when raising funds through public offerings. As recognized in the statute, the exemption is intended to permit banking entities to continue to perform the underwriting function, which contributes to capital formation and its positive economic effects.

c. Detailed Explanation of the Underwriting Exemption

1. Acting as an Underwriter for a Distribution of Securities

a. Proposed Requirements That the Purchase or Sale be Effected Solely in Connection With a Distribution of Securities for Which the Banking Entity Acts as an Underwriter and That the Covered Financial Position be a Security

Section ____.4(a)(2)(iii) of the proposed rule required that the purchase or sale be effected solely in connection with a distribution of securities for which a banking entity is acting as underwriter.[316] As discussed below, the Agencies proposed to define the terms ''distribution'' and ''underwriter'' in the proposed rule. The proposed rule also required that the covered financial position being purchased or sold by the banking entity be a security.[317]

i. Proposed Definition of ''Distribution''

The proposed definition of ''distribution'' mirrored the definition of this term used in the SEC's Regulation M under the Exchange Act.[318] More specifically, the proposed rule defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.''[319] The Agencies did not propose to define the terms ''magnitude'' and ''special selling efforts and selling methods,'' but stated that the Agencies would expect to rely on the same factors considered in Regulation M for assessing these elements.[320] The Agencies noted that

[305] *See* final rule § ____.4(a)(2)(iii); *See also infra* Part IV.A.2.c.3.c.

[306] *See* final rule § ____.4(a)(2)(iv); *See also infra* Part IV.A.2.c.4.c.

[307] *See* final rule § ____.4(a)(2)(v); *See also infra* Part IV.A.2.c.5.c.

[308] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz. One of these commenters also suggested that the Agencies better incorporate the statutory limitations on material conflicts of interest and high-risk activities in the underwriting exemption by including additional provisions in the exemption to refer to these limitations. *See* Sens. Merkley & Levin (Feb. 2012). The Agencies note that these limitations are adopted in § ____.7 of the final rules, and this provision will apply to underwriting activities, as well as all other exempted activities.

[309] *See* final rule § ____.4(a)(3).

[310] *See* AFR *et al.* (Feb. 2012).

[311] *See* Joint Proposal, 76 FR 68,859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR 8344 n.107.

[312] *See infra* Part IV.A.2.c.2.c.

[313] *See* BoA.

[314] *See* Fidelity.

[315] *See, e.g.,* BoA (''The underwriting activities of U.S. banking entities are essential to capital formation and, therefore, economic growth and job creation.''); Goldman (Prop. Trading); Sens. Merkley & Levin (Feb. 2012).

[316] *See* proposed rule § ____.4(a)(2)(iii).

[317] *See* proposed rule § ____.4(a)(2)(ii).

[318] *See* Joint Proposal, 76 FR 68,866–68,867; CFTC Proposal, 77 FR 8352; 17 CFR 242.101; proposed rule § ____.4(a)(3).

[319] *See* proposed rule § ____.4(a)(3).

[320] *See* Joint Proposal, 76 FR 68,867 (''For example, the number of shares to be sold, the percentage of the outstanding shares, public float, and trading volume that those shares represent are all relevant to an assessment of magnitude. In

Continued

''magnitude'' does not imply that a distribution must be large and, therefore, this factor would not preclude small offerings or private placements from qualifying for the proposed underwriting exemption.[321]

ii. Proposed Definition of ''Underwriter''

Like the proposed definition of ''distribution,'' the Agencies proposed to define ''underwriter'' in a manner similar to the definition of this term in the SEC's Regulation M.[322] The definition of ''underwriter'' in the proposed rule was: (i) Any person who has agreed with an issuer or selling security holder to: (a) Purchase securities for distribution; (b) engage in a distribution of securities for or on behalf of such issuer or selling security holder; or (c) manage a distribution of securities for or on behalf of such issuer or selling security holder; and (ii) a person who has an agreement with another person described in the preceding provisions to engage in a distribution of such securities for or on behalf of the issuer or selling security holder.[323]

In connection with this proposed requirement, the Agencies noted that the precise activities performed by an underwriter may vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. To determine whether a banking entity is acting as an underwriter as part of a distribution of securities, the Agencies proposed to take into consideration the extent to which a banking entity is engaged in the following activities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[324]

The proposal recognized that there may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. The Agencies stated that if the unsold securities were acquired in connection with underwriting under the proposed exemption, then the underwriter would be able to dispose of such securities at a later time.[325]

iii. Proposed Requirement That the Covered Financial Position Be a Security

Pursuant to § ____.4(a)(2)(ii) of the proposed exemption, a banking entity would be permitted to purchase or sell a covered financial position that is a security only in connection with its underwriting activities.[326] The proposal stated that this requirement was meant to reflect the common usage and understanding of the term ''underwriting.''[327] It was noted, however, that a derivative or commodity future transaction may be otherwise permitted under another exemption (*e.g.,* the exemptions for market making-related or risk-mitigating hedging activities).[328]

b. Comments on the Proposed Requirements That the Trade Be Effected Solely in Connection With a Distribution for Which the Banking Entity Is Acting as an Underwriter and That the Covered Financial Position Be a Security

In response to the proposed requirement that a purchase or sale be ''effected solely in connection with a distribution of securities'' for which the ''banking entity is acting as underwriter,'' commenters generally focused on the proposed definitions of ''distribution'' and ''underwriter'' and the types of activities that should be permitted under the ''in connection with'' standard. Commenters did not directly address the requirement in § ____.4(a)(2)(ii) of the proposed rule, which provided that the covered financial position purchased or sold under the exemption must be a security. A number of commenters expressed general concern that the proposed underwriting exemption's references to a ''purchase or sale of a covered financial position'' could be interpreted to require compliance with the proposed rule on a transaction-by-transaction basis. These commenters indicated that such an approach would be overly burdensome.[329]

i. Definition of ''Distribution''

Several commenters stated that the proposed definition of ''distribution'' is too narrow,[330] while one commenter stated that the proposed definition is too broad.[331] Commenters who viewed the proposed definition as too narrow stated that it may exclude important capital-raising and financing transactions that do not appear to involve ''special selling efforts and selling methods'' or ''magnitude.''[332] In particular, these commenters stated that the proposed definition of ''distribution'' may preclude a banking entity from participating in commercial paper issuances,[333] bridge loans,[334] ''at-the-market'' offerings or ''dribble out'' programs conducted off issuer shelf registrations,[335] offerings in response to reverse inquiries,[336] offerings through an automated execution system,[337] small private offerings,[338] or selling security holders' sales of securities of issuers with large market capitalizations that are executed as underwriting transactions in the normal course.[339]

Several commenters suggested that the proposed definition be modified to

addition, delivering a sales document, such as a prospectus, and conducting road shows are generally indicative of special selling efforts and selling methods. Another indicator of special selling efforts and selling methods is compensation that is greater than that for secondary trades but consistent with underwriting compensation for an offering.''); CFTC Proposal, 77 FR 8352; *Review of Antimanipulation Regulation of Securities Offering,* Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21,681, 21,684–21,685 (Apr. 26, 1994).

[321] *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352.

[322] *See* Joint Proposal, 76 FR 68,866–68,867; CFTC Proposal, 77 FR 8352; 17 CFR 242.101; proposed rule § ____.4(a)(4).

[323] *See* proposed rule § ____.4(a)(4). As noted in the proposal, the proposed rule's definition differed from the definition in Regulation M because the proposed rule's definition would also include a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder. *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352.

[324] *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352.

[325] *See id.*

[326] *See* proposed rule § ____.4(a)(2)(ii).

[327] *See* Joint Proposal, 76 FR 68,866; CFTC Proposal, 77 FR 8352.

[328] *See* Joint Proposal, 76 FR 68,866 n.132; CFTC Proposal, 77 FR 8352 n.138.

[329] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[330] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[331] *See* Occupy.

[332] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[333] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). In addition, one commenter expressed general concern that the proposed rule would cause a reduction in underwriting services with respect to commercial paper, which would reduce liquidity in commercial paper markets and raise the costs of capital in already tight credit markets. *See* Chamber (Feb. 2012).

[334] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC; LSTA (Feb. 2012).

[335] *See* Goldman (Prop. Trading).

[336] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[337] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[338] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[339] *See* RBC.

include some or all of these types of offerings.[340] For example, two commenters requested that the definition explicitly include all offerings of securities by an issuer.[341] One of these commenters further requested a broader definition that would include any offering by a selling security holder that is registered under the Securities Act or that involves an offering document prepared by the issuer.[342] Another commenter suggested that the rule explicitly authorize certain forms of offerings, such as offerings under Rule 144A, Regulation S, Rule 101(b)(10) of Regulation M, or the so-called ''section 4(1½)'' of the Securities Act, as well as transactions on behalf of selling security holders.[343] Two commenters proposed approaches that would include the resale of notes or other debt securities received by a banking entity from a borrower to replace or refinance a bridge loan.[344] One of these commenters stated that permitting a banking entity to receive and resell notes or other debt securities from a borrower to replace or refinance a bridge loan would preserve the ability of a banking entity to extend credit and offer customers a range of financing options. This commenter further represented that such an approach would be consistent with the exclusion of loans from the proposed definition of ''covered financial position'' and the commenter's recommended exclusion from the definition of ''trading account'' for collecting debts previously contracted.[345]

One commenter, however, stated that the proposed definition of ''distribution'' is too broad. This commenter suggested that the underwriting exemption should only be available for registered offerings, and the rule should preclude a banking entity from participating in a private placement. According to the commenter, permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading.[346]

ii. Definition of ''Underwriter''

Several commenters stated that the proposed definition of ''underwriter'' is too narrow.[347] Other commenters, however, stated that the proposed definition is too broad, particularly due to the proposed inclusion of selling group members.[348]

Commenters requesting a broader definition generally stated that the Agencies should instead use the Regulation M definition of ''distribution participant'' or otherwise revise the definition of ''underwriter'' to incorporate the concept of a ''distribution participant,'' as defined under Regulation M.[349] According to these commenters, using the term ''distribution participant'' would better reflect current market practice and would include dealers that participate in an offering but that do not deal directly with the issuer or selling security holder and do not have a written agreement with the underwriter.[350] One commenter further represented that the proposed provision for selling group members may be less inclusive than the Agencies intended because individual selling dealers or dealer groups may or may not have written agreements with an underwriter in privity of contract with the issuer.[351] Another commenter requested that, if the ''distribution participant'' concept is not incorporated into the rule, the proposed definition of ''underwriter'' be modified to include a person who has an agreement with an affiliate of an issuer or selling security holder (*e.g.,* an agreement with a parent company to distribute the issuer's securities).[352]

Other commenters opposed the inclusion of selling group members in the proposed definition of ''underwriter.'' These commenters stated that because selling group members do not provide a price guarantee to an issuer, they do not provide services to a customer and their activities should not qualify for the underwriting exemption.[353]

A number of commenters stated that it is unclear whether the proposed underwriting exemption would permit a banking entity to act as an authorized participant (''AP'') to an ETF issuer, particularly with respect to the creation and redemption of ETF shares or ''seeding'' an ETF for a short period of time when it is initially launched.[354] For example, a few commenters noted that APs typically do not perform some or all of the activities that the Agencies proposed to consider to help determine whether a banking entity is acting as an underwriter in connection with a distribution of securities, including due diligence, advising an issuer on market conditions and assisting in preparation of a registration statement or offering documents, and participating in or organizing a syndicate of investment banks.[355]

However, one commenter appeared to oppose applying the underwriting exemption to certain AP activities. According to this commenter, APs are generally reluctant to concede that they are statutory underwriters because they do not perform all the activities associated with the underwriting of an operating company's securities. Further, this commenter expressed concern that, if an AP had to rely on the proposed underwriting exemption, the AP could be subject to heightened risk of incurring underwriting liability on the issuance of ETF shares traded by the AP. As a result of these considerations,

[340] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[341] *See* Goldman (Prop. Trading) (stating that this would capture, among other things, commercial paper issuances, issuer ''dribble out'' programs, and small private offerings, which involve the purchase of securities directly from an issuer with a view toward resale, but may not always be clearly distinguished by ''special selling efforts and selling methods'' or by ''magnitude''); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[342] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter indicated that expanding the definition of ''distribution'' to include both offerings of securities by an issuer and offerings by a selling security holder that are registered under the Securities Act or that involve an offering document prepared by the issuer would ''include, for example, an offering of securities by an issuer or a selling security holder where securities are sold through an automated order execution system, offerings in response to reverse inquiries and commercial paper issuances.'' *Id.*

[343] *See* RBC.

[344] *See* Goldman (Prop. Trading); RBC. In addition, one commenter requested the Agencies clarify that permitted underwriting activities include the acquisition and resale of securities issued in lieu of or to refinance bridge loan facilities, irrespective of whether such activities qualify as ''distributions'' under the proposal. *See* LSTA (Feb. 2012).

[345] *See* Goldman (Prop. Trading).

[346] *See* Occupy.

[347] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[348] *See* AFR *et al.* (Feb. 2012); Public Citizen; Occupy (suggesting that the Agencies exceeded their statutory authority by incorporating the Regulation M definition of ''underwriter,'' rather than the Securities Act definition of ''underwriter'').

[349] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). The term ''distribution participant'' is defined in Rule 100 of Regulation M as ''an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.'' 17 CFR 242.100.

[350] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[351] *See* Goldman (Prop. Trading).

[352] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also requested a technical amendment to proposed rule § ____.4(a)(4)(ii) to clarify that the person is ''participating'' in a distribution, not ''engaging'' in a distribution. *See id.*

[353] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[354] *See* BoA; ICI Global; Vanguard; ICI (Feb. 2012); SSgA (Feb. 2012). As one commenter explained, an AP may ''seed'' an ETF for a short period of time at its inception by entering into several initial creation transactions with the ETF issuer and refraining from selling those shares to investors or redeeming them for a period of time to facilitate the ETF achieving its liquidity launch goals. *See* BoA.

[355] *See* ICI Global; ICI (Feb. 2012); Vanguard.

the commenter believed that a banking entity may be less willing to act as an AP for an ETF issuer if it were required to rely on the underwriting exemption.[356]

iii. ''Solely in Connection With'' Standard

To qualify for the underwriting exemption, the proposed rule required a purchase or sale of a covered financial position to be effected ''solely in connection with'' a distribution of securities for which the banking entity is acting as underwriter. Several commenters expressed concern that the word ''solely'' in this provision may result in an overly narrow interpretation of permissible activities. In particular, these commenters indicated that the ''solely in connection with'' standard creates uncertainty about certain activities that are currently conducted in the course of an underwriting, such as customary underwriting syndicate activities.[357] One commenter represented that such activities are traditionally undertaken to: Support the success of a distribution; mitigate risk to issuers, investors, and underwriters; and facilitate an orderly aftermarket.[358] A few commenters further stated that requiring a trade to be ''solely'' in connection with a distribution by an underwriter would be inconsistent with the statute,[359] may reduce future innovation in the capital-raising process,[360] and could create market disruptions.[361]

A number of commenters stated that it is unclear whether certain activities would qualify for the proposed underwriting exemption and requested that the Agencies adopt an exemption that is broad enough to permit such activities.[362] Commenters stated that there are a number of activities that should be permitted under the underwriting exemption, including: (i) Creating a naked or covered syndicate short position in connection with an offering;[363] (ii) creating a stabilizing bid;[364] (iii) acquiring positions via overallotments[365] or trading in the market to close out short positions in connection with an overallotment option or in connection with other stabilization activities;[366] (iv) using call spread options in a convertible debt offering to mitigate dilution of existing shareholders;[367] (v) repurchasing existing debt securities of an issuer in the course of underwriting a new series of debt securities in order to stimulate demand for the new issuance;[368] (vi) purchasing debt securities of comparable issuers as a price discovery mechanism in connection with underwriting a new debt security;[369] (vii) hedging the underwriter's exposure to a derivative strategy engaged in with an issuer;[370] (viii) organizing and assembling a resecuritized product, including, for example, sourcing bond collateral over a period of time in anticipation of issuing new securities;[371] and (ix) selling a security to an intermediate entity as part of the creation of certain structured products.[372]

c. Final Requirement That the Banking Entity Act as an Underwriter for a Distribution of Securities and the Trading Desk's Underwriting Position Be Related to Such Distribution

The final rule requires that the banking entity act as an underwriter for a distribution of securities and the trading desk's underwriting position be related to such distribution.[373] This requirement is substantially similar to the proposed rule,[374] but with five key refinements. First, to address commenters' confusion about whether the underwriting exemption applies on a transaction-by-transaction basis, the phrase ''purchase or sale'' has been modified to instead refer to the trading desk's ''underwriting position.'' Second, to balance this more aggregated position-based approach, the final rule specifies that the trading desk is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed. Third, the Agencies have made important modifications to the definition of ''distribution'' to better capture the various types of private and registered offerings a banking entity may be asked to underwrite by an issuer or selling security holder. Fourth, the definition of ''underwriter'' has been refined to clarify that both members of the underwriting syndicate and selling group members may qualify as underwriters for purposes of this exemption. Finally, the word ''solely'' has been removed to clarify that a broader scope of activities conducted in connection with underwriting (*e.g.,* stabilization activities) are permitted under this exemption. These issues are discussed in turn below.

i. Definition of ''Underwriting Position''

In response to commenters' concerns about transaction-by-transaction analyses,[375] the Agencies are modifying

[356] *See* SSgA (Feb. 2012).

[357] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[358] *See* Goldman (Prop. Trading).

[359] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[360] *See* Goldman (Prop. Trading).

[361] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[362] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[363] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''The reason for creating the short positions (covered and naked) is to facilitate an orderly aftermarket and to reduce price volatility of newly offered securities. This provides significant value to issuers and selling security holders, as well as to investors, by giving the syndicate buying power that helps protect against immediate volatility in the aftermarket.''); RBC; Goldman (Prop. Trading).

[364] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''Underwriters may also engage in stabilization activities under Regulation M by creating a stabilizing bid to prevent or slow a decline in the market price of a security. These activities should be encouraged rather than restricted by the Volcker Rule because they reduce price volatility and facilitate the orderly pricing and aftermarket trading of underwritten securities, thereby contributing to capital formation.'').

[365] *See* RBC.

[366] *See* Goldman (Prop. Trading).

[367] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (stating that the call spread arrangement ''may make a wider range of financing options feasible for the issuer of the convertible debt'' and ''can help it to raise more capital at more attractive prices'').

[368] *See* Wells Fargo (Prop. Trading). The commenter further stated that the need to purchase the issuer's other debt securities from investors may arise if an investor has limited risk tolerance to the issuer's credit or has portfolio restrictions. According to the commenter, the underwriter would typically sell the debt securities it purchased from existing investors to new investors. *See id.*

[369] *See* Wells Fargo (Prop. Trading).

[370] *See* Goldman (Prop. Trading).

[371] *See* ASF (Feb. 2012) (stating that, for example, a banking entity may respond to customer or general market demand for highly-rated mortgage paper by accumulating residential mortgage-backed securities over time and holding such securities in inventory until the transaction can be organized and assembled).

[372] *See* ICI (Feb. 2012) (stating that the sale of assets to an intermediate asset-backed commercial paper or tender option bond program should be permitted under the underwriting exemption if the sale is part of the creation of a structured security). *See also* AFR *et al.* (Feb. 2012) (stating that the treatment of a sale to an intermediate entity should depend on whether the banking entity or an external client is the driver of the demand and, if the banking entity is the driver of the demand, then the near term demand requirement should not be met). Two commenters stated that the underwriting exemption should not permit a banking entity to sell a security to an intermediate entity in the course of creating a structured product. *See* Occupy; Alfred Brock. These commenters were generally responding to a question on this issue in the proposal. *See* Joint Proposal, 76 FR 68,868–68,869 (question 78); CFTC Proposal, 77 FR 8354 (question 78).

[373] Final rule § ____.4(a)(2)(i). The terms ''distribution'' and ''underwriter'' are defined in final rule § ____.4(a)(3) and § ____.4(a)(4), respectively.

[374] Proposed rule § ____.4(a)(2)(iii) required that ''[t]he purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter.''

[375] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

the exemption to clarify the level at which compliance with certain provisions will be assessed. The proposal was not intended to impose a transaction-by-transaction approach, and the final rule's requirements generally focus on the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or its affiliate is acting as an underwriter. Like § ____.4(a)(2)(ii) of the proposed rule, the definition of ''underwriting position'' is limited to positions in securities because the common usage and understanding of the term ''underwriting'' is limited to activities in securities.

A trading desk's underwriting position constitutes the securities positions that are acquired in connection with a single distribution for which the relevant banking entity is acting as an underwriter. A trading desk may not aggregate securities positions acquired in connection with two or more distributions to determine its ''underwriting position.'' A trading desk may, however, have more than one ''underwriting position'' at a particular point in time if the banking entity is acting as an underwriter for more than one distribution. As a result, the underwriting exemption's requirements pertaining to a trading desk's underwriting position will apply on a distribution-by-distribution basis.

A trading desk's underwriting position can include positions in securities held at different affiliated legal entities, provided the banking entity is able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section 13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's underwriting position for purposes of the underwriting exemption. Banking entities should be prepared to provide all records that identify all of the positions included in a trading desk's underwriting position and where such positions are held.

The Agencies believe that a distribution-by-distribution approach is appropriate due to the relatively distinct nature of underwriting activities for a single distribution on behalf of an issuer or selling security holder. The Agencies do not believe that a narrower transaction-by-transaction analysis is necessary to determine whether a banking entity is engaged in permitted underwriting activities. The Agencies also decline to take a broader approach, which would allow a banking entity to aggregate positions from multiple distributions for which it is acting as an underwriter, because it would be more difficult for the banking entity's internal compliance personnel and Agency supervisors and examiners to review the trading desk's positions to assess the desk's compliance with the underwriting exemption. A more aggregated approach would increase the number of positions in different types of securities that could be included in the underwriting position, which would make it more difficult to determine that an individual position is related to a particular distribution of securities for which the banking entity is acting as an underwriter and, in turn, increase the potential for evasion of the general prohibition on proprietary trading.

ii. Definition of ''Trading Desk''

The proposed underwriting exemption would have applied certain requirements across an entire banking entity. To promote consistency with the market-making exemption and address potential evasion concerns, the final rule applies the requirements of the underwriting exemption at the trading desk level of organization.[376] This approach will result in the requirements of the underwriting exemption applying to the aggregate trading activities of a relatively limited group of employees on a single desk. Applying requirements at the trading desk level should facilitate banking entity and Agency monitoring and review of compliance with the exemption by limiting the location where underwriting activity may occur and allowing better identification of the aggregate trading volume that must be reviewed to determine whether the desk's activities are being conducted in a manner that is consistent with the underwriting exemption, while also allowing adequate consideration of the particular facts and circumstances of the desk's trading activities.

The trading desk should be managed and operated as an individual unit and should reflect the level at which the profit and loss of employees engaged in underwriting activities is attributed. The term ''trading desk'' in the underwriting context is intended to encompass what is commonly thought of as an underwriting desk. A trading desk engaged in underwriting activities would not necessarily be an active market participant that engages in frequent trading activities.

A trading desk may manage an underwriting position that includes positions held by different affiliated legal entities.[377] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. The geographic location of individual traders is not dispositive for purposes of determining whether the employees are engaged in activities for a single trading desk.

iii. Definition of ''Distribution''

The term ''distribution'' is defined in the final rule as: (i) An offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act.[378] In response to comments, the proposed definition has been revised to eliminate the need to consider the ''magnitude'' of an offering and instead supplements the definition with an alternative prong for registered offerings under the Securities Act.[379]

The proposed definition's reference to magnitude caused some commenter concern with respect to whether it could be interpreted to preclude a banking entity from intermediating a small private placement. After considering comments, the Agencies have determined that the requirement to have special selling efforts and selling methods is sufficient to distinguish between permissible securities offerings and prohibited proprietary trading, and the additional magnitude factor is not needed to further this objective.[380] As proposed, the Agencies will rely on the same factors considered under Regulation M to analyze the presence of special selling efforts and selling

[376] *See infra* Part IV.A.3.c. (discussing the final market-making exemption).

[377] *See supra* note 302 and accompanying text.

[378] Final rule § ____.4(a)(3).

[379] Proposed rule § ____.4(a)(3) defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.''

[380] The policy goals of this rule differ from those of the SEC's Regulation M, which is an anti-manipulation rule. The focus on magnitude is appropriate for that regulation because it helps identify offerings that can give rise to an incentive to condition the market for the offered security. To the contrary, this rule is intended to allow banking entities to continue to provide client-oriented financial services, including underwriting services. The SEC emphasizes that this rule does not have any impact on Regulation M.

methods.[381] Indicators of special selling efforts and selling methods include delivering a sales document (*e.g.,* a prospectus), conducting road shows, and receiving compensation that is greater than that for secondary trades but consistent with underwriting compensation.[382] For purposes of the final rule, each of these factors need not be present under all circumstances. Offerings that qualify as distributions under this prong of the definition include, among others, private placements in which resales may be made in reliance on the SEC's Rule 144A or other available exemptions [383] and, to the extent the commercial paper being offered is a security, commercial paper offerings that involve the underwriter receiving special compensation.[384]

The Agencies are also adopting a second prong to this definition, which will independently capture all offerings of securities that are made pursuant to an effective registration statement under the Securities Act.[385] The registration prong of the definition is intended to provide another avenue by which an offering of securities may be conducted under the exemption, absent other special selling efforts and selling methods or a determination of whether such efforts and methods are being conducted. The Agencies believe this prong reduces potential administrative burdens by providing a bright-line test for what constitutes a distribution for purposes of the final rule. In addition, this prong is consistent with the purpose and goals of the statute because it reflects a common type of securities offering and does not raise evasion concerns as it is unlikely that an entity would go through the registration process solely to facilitate or engage in speculative proprietary trading.[386] This prong would include, among other things, the following types of registered securities offerings: Offerings made pursuant to a shelf registration statement (whether on a continuous or delayed basis),[387] bought deals,[388] at the market offerings,[389] debt offerings, asset-backed security offerings, initial public offerings, and other registered offerings. An offering can be a distribution for purposes of either § ____.4(a)(3)(i) or § ____.4(a)(3)(ii) of the final rule regardless of whether the offering is issuer driven, selling security holder driven, or arises as a result of a reverse inquiry.[390] Provided the definition of distribution is met, an offering can be a distribution for purposes of this rule regardless of how it is conducted, whether by direct communication, exchange transactions, or automated execution system.[391]

As discussed above, some commenters expressed concern that the proposed definition of ''distribution'' would prevent a banking entity from acquiring and reselling securities issued in lieu of or to refinance bridge loan facilities in reliance on the underwriting exemption. Bridge financing arrangements can be structured in many different ways, depending on the context and the specific objectives of the parties involved. As a result, the treatment of securities acquired in lieu of or to refinance a bridge loan and the subsequent sale of such securities under the final rule depends on the facts and circumstances. A banking entity may meet the terms of the underwriting exemption for its bridge loan activity, or it may be able to rely on the market-making exemption. If the banking entity's bridge loan activity does not qualify for an exemption under the rule, then it would not be permitted to engage in such activity.

iv. Definition of ''Underwriter''

In response to comments, the Agencies are adopting certain modifications to the proposed definition of ''underwriter'' to better capture selling group members and to more closely resemble the definition of ''distribution participant'' in Regulation M. In particular, the Agencies are defining ''underwriter'' as: (i) A person who has agreed with an issuer or selling security holder to: (A) Purchase securities from the issuer or selling security holder for distribution; (B) engage in a distribution of securities for or on behalf of the issuer or selling security holder; or (C) manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.[392]

A number of commenters requested that the Agencies broaden the underwriting exemption to permit activities in connection with a distribution of securities by any distribution participant. A few of these commenters interpreted the proposed definition of ''underwriter'' as requiring a selling group member to have a written agreement with the underwriter

[381] *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352.

[382] *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352; *Review of Antimanipulation Regulation of Securities Offering,* Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21,681, 21,684–21,685 (Apr. 26, 1994).

[383] The final rule does not provide safe harbors for particular distribution techniques. A safe harbor-based approach would provide certainty for specific types of offerings, but may not account for evolving market practices and distribution techniques that could technically satisfy a safe harbor but that might implicate the concerns that led Congress to enact section 13 of the BHC Act. *See* RBC.

[384] This clarification is intended to address commenters' concern regarding potential limitations on banking entities' ability to facilitate commercial paper offerings under the proposed underwriting exemption. *See supra* Part IV.A.2.c.1.b.i.

[385] *See, e.g.,* Form S–1 (17 CFR 239.11); Form S–3 (17 CFR 239.13); Form S–8 (17 CFR 239.16b); Form F–1 (17 CFR 239.31); Form F–3 (17 CFR 239.33).

[386] Although the Agencies are providing an additional prong to the definition of ''distribution'' for registered offerings, the final rule does not limit the availability of the underwriting exemption to registered offerings, as suggested by one commenter. The statute does not include such an express limitation, and the Agencies decline to construe the statute to require such an approach. In response to the commenter stating that permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading, the Agencies believe this concern is addressed by the provision in the final rule requiring that a trading desk have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution and make reasonable efforts to sell its underwriting position within a reasonable period. As discussed below, the Agencies believe this requirement in the final rule appropriately addresses evasion concerns that a banking entity may retain an unsold allotment for purely speculative purposes. Further, the Agencies believe that preventing a banking entity from facilitating a private offering could unnecessarily hinder capital-raising without providing commensurate benefits because issuers use private offerings to raise capital in a variety of situations and the underwriting exemption's requirements limit the potential for evasion for both registered and private offerings, as noted above.

[387] *See Securities Offering Reform,* Securities Act Release No. 8591 (July 19, 2005), 70 FR 44,722 (Aug. 3, 2005); 17 CFR 230.405 (defining ''automatic shelf registration statement'' as a registration statement filed on Form S–3 (17 CFR 239.13) or Form F–3 (17 CFR 239.33) by a well-known seasoned issuer pursuant to General Instruction I.D. or I.C. of such forms, respectively); 17 CFR 230.415.

[388] A bought deal is a distribution technique whereby an underwriter makes a bid for securities without engaging in a preselling effort, such as book building or distribution of a preliminary prospectus. *See, e.g., Delayed or Continuous Offering and Sale of Securities,* Securities Act Release No. 6470 (June 9, 1983), n.5.

[389] *See, e.g.,* 17 CFR 230.415(a)(4) (defining ''at the market offering'' as ''an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price''). At the market offerings may also be referred to as ''dribble out'' programs.

[390] Under the ''reverse inquiry'' process, an investor may be allowed to purchase securities from the issuer through an underwriter that is not designated in the prospectus as the issuer's agent by having such underwriter approach the issuer with an interest from the investor. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012).

[391] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[392] *See* final rule § ____.4(a)(4).

to participate in the distribution.[393] These commenters noted that such a written agreement may not exist under all circumstances. The Agencies did not intend to require that members of the underwriting syndicate or the lead underwriter have a written agreement with all selling group members for each offering or that they be in privity of contract with the issuer or selling security holder. To provide clarity on this issue, the Agencies have modified the language of subparagraph (ii) of the definition to include firms that, while not members of the underwriting syndicate, have agreed to participate or are participating in a distribution of securities for or on behalf of the issuer or selling security holder.

The final rule does not adopt a narrower definition of ''underwriter,'' as suggested by two commenters.[394] Although selling group members do not have a direct relationship with the issuer or selling security holder, they do help facilitate the successful distribution of securities to a wider variety of purchasers, such as regional or retail purchasers that members of the underwriting syndicate may not be able to access as easily. Thus, the Agencies believe it is consistent with the purpose of the statutory underwriting exemption and beneficial to recognize and allow the current market practice of an underwriting syndicate and selling group members collectively facilitating a distribution of securities. The Agencies note that because banking entities that are selling group members will be underwriters under the final rule, they will be subject to all the requirements of the underwriting exemption.

As provided in the preamble to the proposed rule, engaging in the following activities may indicate that a banking entity is acting as an underwriter under § ____.4(a)(4) as part of a distribution of securities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[395]

The Agencies continue to take the view that the precise activities performed by an underwriter will vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. A banking entity is not required to engage in each of the above-noted activities to be considered an underwriter for purposes of this rule. In addition, the Agencies note that, to the extent a banking entity does not meet the definition of ''underwriter'' in the final rule, it may be able to rely on the market-making exemption in the final rule for its trading activity. In response to comments noting that APs for ETFs do not engage in certain of these activities and inquiring whether an AP would be able to qualify for the underwriting exemption for certain of its activities, the Agencies believe that many AP activities, such as conducting general creations and redemptions of ETF shares, are better suited for analysis under the market-making exemption because they are driven by the demands of other market participants rather than the issuer, the ETF.[396] Whether an AP may rely on the underwriting exemption for its activities in an ETF will depend on the facts and circumstances, including, among other things, whether the AP meets the definition of ''underwriter'' and the offering of ETF shares qualifies as a ''distribution.''

To provide further clarity about the scope of the definition of ''underwriter,'' the Agencies are defining the terms ''selling security holder'' and ''issuer'' in the final rule. The Agencies are using the definition of ''issuer'' from the Securities Act because this definition is commonly used in the context of securities offerings and is well understood by market participants.[397] A ''selling security holder'' is defined as ''any person, other than an issuer, on whose behalf a distribution is made.''[398] This definition is consistent with the definition of ''selling security holder'' found in the SEC's Regulation M.[399]

v. Activities Conducted ''in Connection With'' a Distribution

As discussed above, several commenters expressed concern that the proposed underwriting exemption would not allow a banking entity to engage in certain auxiliary activities that may be conducted in connection with acting as an underwriter for a distribution of securities in the normal course. These commenters' concerns generally arose from the use of the word ''solely'' in § ____.4(a)(2)(iii) of the proposed rule, which commenters noted was not included in the statute's underwriting exemption.[400] In addition, a number of commenters discussed particular activities they believed should be permitted under the underwriting exemption and indicated the term ''solely'' created uncertainty about whether such activities would be permitted.[401]

To reduce uncertainty in response to comments, the final rule requires a trading desk's underwriting position to be ''held . . . and managed . . . in connection with'' a single distribution

[393] The basic documents in firm commitment underwritten securities offerings generally are: (i) The agreement among underwriters, which establishes the relationship among the managing underwriter, any co-managers, and the other members of the underwriting syndicate; (ii) the underwriting (or ''purchase'') agreement, in which the underwriters commit to purchase the securities from the issuer or selling security holder; and (iii) the selected dealers agreement, in which selling group members agree to certain provisions relating to the distribution. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012), Ch. 2. The Agencies understand that two firms may enter into a master agreement that governs all offerings in which both firms participate as members of the underwriting syndicate or as a member of the syndicate and a selling group member. *See, e.g.,* SIFMA Master Selected Dealers Agreement (June 10, 2011), *available at www.sifma.org.*

[394] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[395] *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8352. Post-issuance secondary market activity is expected to be conducted in accordance with the market-making exemption.

[396] *See infra* Part IV.A.3.

[397] *See* final rule § ____.3(e)(9) (defining the term ''issuer'' for purposes of the proprietary trading provisions in subpart B of the final rule). Under section 2(a)(4) of the Securities Act, ''issuer'' is defined as ''every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term 'issuer' means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.'' 15 U.S.C. 77b(a)(4).

[398] Final rule § ____.4(a)(5).

[399] *See* 17 CFR 242.100(b).

[400] *See supra* Part IV.A.2.c.1.b.iii.

[401] *See supra* notes 357, 358, 363–372 and accompanying text.

for which the relevant banking entity is acting as an underwriter, rather than requiring that a purchase or sale be ''effected solely in connection with'' such a distribution. Importantly, for purposes of establishing an underwriting position in reliance on the underwriting exemption, a trading desk may only engage in activities that are related to a particular distribution of securities for which the banking entity is acting as an underwriter. Activities that may be permitted under the underwriting exemption include stabilization activities,[402] syndicate shorting and aftermarket short covering,[403] holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so,[404] and helping the issuer mitigate its risk exposure arising from the distribution of its securities (*e.g.,* entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).[405] Such activities should be intended to effectuate the distribution process and provide benefits to issuers, selling security holders, or purchasers in the distribution. Existing laws, regulations, and self-regulatory organization rules limit or place certain requirements around many of these activities. For example, an underwriter's subsequent sale of an unsold allotment must comply with applicable provisions of the federal securities laws and the rules thereunder. Moreover, any position resulting from these activities must be included in the trading desk's underwriting position, which is subject to a number of restrictions in the final rule. Specifically, as discussed in more detail below, the trading desk must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period,[406] and each trading desk must have robust limits on, among other things, the amount, types, and risks of its underwriting position and the period of time a security may be held.[407] Thus, in general, the underwriting exemption would not permit a trading desk, for example, to acquire a position as part of its stabilization activities and hold that position for an extended period.

This approach does not mean that any activity that is arguably connected to a distribution of securities is permitted under the underwriting exemption. Certain activities noted by commenters are not core to the underwriting function and, thus, are not permitted under the final underwriting exemption. However, a banking entity may be able to rely on another exemption for such activities (*e.g.,* the market-making or hedging exemptions), if applicable. For example, a trading desk would not be able to use the underwriting exemption to purchase a financial instrument from a customer to facilitate the customer's ability to buy securities in the distribution.[408] Further, purchasing another financial instrument to help determine how to price the securities that are subject to a distribution would not be permitted under the underwriting exemption.[409] These two activities may be permitted under the market-making exemption, depending on the facts and circumstances. In response to one commenter's suggestion that hedging the underwriter's risk exposure be permissible under this exemption, the Agencies emphasize that hedging the underwriter's risk exposure is not permitted under the underwriting exemption.[410] A banking entity must comply with the hedging exemption for such activity.

In response to comments about the sale of a security to an intermediate entity in connection with a structured finance product,[411] the Agencies have not modified the underwriting exemption. Underwriting is distinct from product development. Thus, parties must adjust activities associated with developing structured finance products or meet the terms of other available exemptions. Similarly, the accumulation of securities or other assets in anticipation of a securitization or resecuritization is not an activity conducted ''in connection with'' underwriting for purposes of the exemption.[412] This activity is typically engaged in by an issuer or sponsor of a securitized product in that capacity, rather than in the capacity of an underwriter. The underwriting exemption only permits a banking entity's activities when it is acting as an underwriter.

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Like the statute, § ____.4(a)(2)(v) of the proposed rule required that the underwriting activities of the banking entity with respect to the covered

[402] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See Anti-Manipulation Rules Concerning Securities Offerings,* Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520, 535 (Jan. 3, 1997) (''Although stabilization is price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.'').

[403] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). *See Proposed Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings*, Exchange Act Release No. 50831 (Dec. 9, 2004), 69 FR 75,774, 75,780 (Dec. 17, 2004) (''In the typical offering, the syndicate agreement allows the managing underwriter to 'oversell' the offering, *i.e.,* establish a short position beyond the number of shares to which the underwriting commitment relates. The underwriting agreement with the issuer often provides for an 'overallotment option' whereby the syndicate can purchase additional shares from the issuer or selling shareholders in order to cover its short position. To the extent that the syndicate short position is in excess of the overallotment option, the syndicate is said to have taken an 'uncovered' short position. The syndicate short position, up to the amount of the overallotment option, may be covered by exercising the option or by purchasing shares in the market once secondary trading begins.'').

[404] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; BoA; BDA (Feb. 2012).

[405] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading).

[406] *See* final rule § ____.4(a)(2)(ii); *infra* Part IV.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[407] *See* final rule § ____.4(a)(2)(iii)(B); *infra* Part IV.A.2.c.3.c. (discussing the required limits for trading desks engaged in underwriting activity).

[408] *See* Wells Fargo (Prop. Trading). The Agencies do not believe this activity is consistent with underwriting activity because it could result in an underwriting desk holding a variety of positions over time that are not directly related to a distribution of securities the desk is conducting on behalf of an issuer or selling security holder. Further, the Agencies believe this activity may be more appropriately analyzed under the market-making exemption because market makers generally purchase or sell a financial instrument at the request of customers and otherwise routinely stand ready to purchase and sell a variety of related financial instruments.

[409] *See id.* The Agencies view this activity as inconsistent with underwriting because underwriters typically engage in other activities, such as book-building and other marketing efforts, to determine the appropriate price for a security and these activities do not involve taking positions that are unrelated to the securities subject to distribution. *See infra* IV.A.2.c.2.

[410] Although one commenter suggested that an underwriter's hedging activity be permitted under the underwriting exemption, we do not believe the requirements in the proposed hedging exemption would be unworkable or overly burdensome in the context of an underwriter's hedging activity. *See* Goldman (Prop. Trading). As noted above, underwriting activity is of a relatively distinct nature, which is substantially different from market-making activity, which is more dynamic and involves more frequent trading activity giving rise to a variety of positions that may naturally hedge the risks of certain other positions. The Agencies believe it is appropriate to require that a trading desk comply with the requirements of the hedging exemption when it is hedging the risks of its underwriting position, while allowing a trading desk's market making-related hedging under the market-making exemption.

[411] *See* ICI (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Alfred Brock.

[412] A banking entity may accumulate loans in anticipation of securitization because loans are not financial instruments under the final rule. *See supra* Part IV.A.1.c.

financial position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[413]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

Both the statute and the proposed rule require a banking entity's underwriting activity to be ''designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.''[414] Several commenters requested that this standard be interpreted in a flexible manner to allow a banking entity to participate in an offering that may require it to retain an unsold allotment for a period of time.[415] In addition, one commenter stated that the final rule should provide flexibility in this standard by recognizing that the concept of ''near term'' differs between asset classes and depends on the liquidity of the market.[416] Two commenters expressed views on how the near term customer demand requirement should work in the context of a securitization or creating what the commenters characterized as ''structured products'' or ''structured instruments.''[417]

Many commenters expressed concern that the proposed requirement, if narrowly interpreted, could prevent an underwriter from holding a residual position for which there is no immediate demand from clients, customers, or counterparties.[418] Commenters noted that there are a variety of offerings that present some risk of an underwriter having to hold a residual position that cannot be sold in the initial distribution, including ''bought deals,''[419] rights offerings,[420] and fixed-income offerings.[421] A few commenters noted that similar scenarios can arise in the case of an AP creating more shares of an ETF than it can sell[422] and bridge loans.[423] Two commenters indicated that if the rule does not provide greater clarity and flexibility with respect to the near term customer demand requirement, a banking entity may be less inclined to participate in a distribution where there is the potential risk of an unsold allotment, may price such risk into the fees charged to underwriting clients, or may be forced into a ''fire sale'' of the unsold allotment.[424]

Several other commenters provided views on whether a banking entity should be able to hold a residual position from an offering pursuant to the underwriting exemption, although they did not generally link their comments to the proposed near term demand requirement.[425] Many of these commenters expressed concern about permitting a banking entity to retain a portion of an underwriting and noted potential risks that may arise from such activity.[426] For example, some of these commenters stated that retention or warehousing of underwritten securities can be an indication of impermissible proprietary trading intent (particularly if systematic), or may otherwise result in high-risk exposures or conflicts of interests.[427] One of these commenters recommended the Agencies use a metric to monitor the size of residual positions retained by an underwriter,[428] while another commenter suggested adding a requirement to the proposed exemption to provide that a ''substantial'' unsold or retained allotment would be an indication of prohibited proprietary trading.[429] Similarly, one commenter recommended that the Agencies consider whether there are sufficient provisions in the proposed rule to reduce the risks posed by banking entities retaining or warehousing underwritten instruments, such as subprime mortgages, collateralized debt obligation tranches, and high yield debt of leveraged buyout issuers, which poses heightened financial risk at the top of economic cycles.[430]

Other commenters indicated that undue restrictions on an underwriter's ability to retain a portion of an offering may result in certain harms to the capital-raising process. These commenters represented that unclear or negative treatment of residual positions will make banking entities averse to the risk of an unsold allotment, which may result in banking entities underwriting smaller offerings, less capital generation for issuers, or higher underwriting discounts, which would increase the cost of raising capital for businesses.[431] One of these commenters suggested that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions.[432]

In addition, in response to a question in the proposal, one commenter

[413] *See* proposed rule § ____.4(a)(2)(v); Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8353.

[414] *See supra* Part IV.A.2.c.2.a.

[415] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC. Another commenter requested that this requirement be eliminated or changed to ''underwriting activities of the banking entity with respect to the covered financial position must be designed to meet the near-term demands of clients, customers, or counterparties.'' *See* Japanese Bankers Ass'n.

[416] *See* RBC (stating that the Board has found acceptable the retention of assets acquired in connection with underwriting activities for a period of 90 to 180 days and has further permitted holding periods of up to a year in certain circumstances, such as for less liquid securities).

[417] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[418] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[419] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC. These commenters generally stated that an underwriter for a ''bought deal'' may end up with an unsold allotment because, pursuant to this type of offering, an underwriter makes a commitment to purchase securities from an issuer or selling security holder, without pre-commitment marketing to gauge customer interest, in order to provide greater speed and certainty of execution. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[420] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (representing that because an underwriter generally backstops a rights offering by committing to exercise any rights not exercised by shareholders, the underwriter may end up holding a residual portion of the offering if investors do not exercise all of the rights).

[421] *See* BDA (Feb. 2012). This commenter stated that underwriters frequently underwrite bonds in the fixed-income market knowing that they may need to retain unsold allotments in their inventory. The commenter indicated that this scenario arises because the fixed-income market is not as deep as other markets, so underwriters frequently cannot sell bonds when they go to market; instead, the underwriters will retain the bonds until a sufficient amount of liquidity is available in the market. *See id.*

[422] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[423] *See* BoA; RBC; LSTA (Feb. 2012). One of these commenters stated that, in the case of securities issued in lieu of or to refinance bridge loan facilities, market conditions or investor demand may change during the period of time between extension of the bridge commitment and when the bridge loan is required to be funded or such securities are required to be issued. As a result, this commenter requested that the near term demands of clients, customers, or counterparties be measured at the time of the initial extension of the bridge commitment. *See* LSTA (Feb. 2012).

[424] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[425] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Goldman (Prop. Trading); Fidelity; Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[426] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[427] *See* AFR *et al.* (Feb. 2012) (recognizing, however, that a small portion of an underwriting may occasionally be ''hung''); CalPERS; Occupy (stating that a banking entity's retention of unsold allotments may result in potential conflicts of interest).

[428] *See* AFR *et al.* (Feb. 2012).

[429] *See* Occupy (stating that the meaning of the term ''substantial'' would depend on the circumstances of the particular offering).

[430] *See* CalPERS.

[431] *See* Goldman (Prop. Trading); Fidelity (expressing concern that this may result in a more concentrated supply of securities and, thus, decrease the opportunity for diversification in the portfolios of shareholders' funds).

[432] *See* Goldman (Prop. Trading).

expressed the view that the rule should not require documentation with respect to residual positions held by an underwriter.[433] In the case of securitizations, one commenter stated that if the underwriter wishes to retain some of the securities or bonds in its longer-term investment book, such decisions should be made by a separate officer, subject to different standards and compensation.[434]

Two commenters discussed how the near term customer demand requirement should apply in the context of a banking entity acting as an underwriter for a securitization or structured product.[435] One of these commenters indicated that the near term demand requirement should be interpreted to require that a distribution of securities facilitate pre-existing client demand. This commenter stated that a banking entity should not be considered to meet the terms of the proposed requirement if, on the firm's own initiative, it designs and structures a complex, novel instrument and then seeks customers for the instrument, while retaining part of the issuance on its own book. The commenter further emphasized that underwriting should involve two-way demand—clients who want assistance in marketing their securities and customers who may wish to purchase the securities—with the banking entity serving as an intermediary.[436] Another commenter indicated that an underwriting should likely be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding any amount required for credit risk retention purposes) along a time line designed not to exceed reasonably expected near term demands of clients, customers, or counterparties. According to the commenter, this approach would serve to minimize the arbitrage and risk concentration possibilities that can arise through the securitization and sale of some tranches and the retention of other tranches.[437]

One commenter expressed concern that the proposed near term customer demand requirement may impact a banking entity's ability to act as primary dealer because some primary dealers are obligated to bid on each issuance of a government's sovereign debt, without regard to expected customer demand.[438] Two other commenters expressed general concern that the proposed underwriting exemption may be too narrow to permit banking entities that act as primary dealers in or for foreign jurisdictions to continue to meet the relevant jurisdiction's primary dealer requirements.[439]

c. Final Near Term Customer Demand Requirement

The final rule requires that the amount and types of the securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[440] As noted above, the near term demand standard originates from section 13(d)(1)(B) of the BHC Act, and a similar requirement was included in the proposed rule.[441] The Agencies are making certain modifications to the proposed approach in response to comments.

In particular, the Agencies are clarifying the operation of this requirement, particularly with respect to unsold allotments.[442] Under this requirement, a trading desk must have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[443] Such reasonable expectation may be based on factors such as current market conditions and prior experience with similar offerings of securities. A banking entity is not required to engage in book-building or similar marketing efforts to determine investor demand for the securities pursuant to this requirement, although such efforts may form the basis for the trading desk's reasonable expectation of demand. While an issuer or selling security holder can be considered to be a client, customer, or counterparty of a banking entity acting as an underwriter for its distribution of securities, this requirement cannot be met by accounting solely for the issuer's or selling security holder's desire to sell the securities.[444] However, the expectation of demand does not require a belief that the securities will be placed immediately. The time it takes to carry out a distribution may differ based on the liquidity, maturity, and depth of the market for the type of security.[445]

[433] *See* Japanese Bankers Ass'n.

[434] *See* Sens. Merkley & Levin (Feb. 2012).

[435] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[436] *See* AFR *et al.* (Feb. 2012)

[437] *See* Sens. Merkley & Levin (Feb. 2012).

[438] *See* Banco de México.

[439] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIB/EBF. One of these commenters represented that many banking entities serve as primary dealers in jurisdictions in which they operate, and primary dealers often: (i) Are subject to minimum purchase and other obligations in the jurisdiction's foreign sovereign debt; (ii) play important roles in underwriting and market making in State, provincial, and municipal debt issuances; and (iii) act as intermediaries through which a government's financial and monetary policies operate. This commenter stated that, due to these considerations, restrictions on the ability of banking entities to act as primary dealer are likely to harm the governments they serve. *See* IIB/EBF.

[440] Final rule § ____.4(a)(2)(ii).

[441] The proposed rule required the underwriting activities of the banking entity with respect to the covered financial position to be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § ____.4(a)(2)(v).

[442] *See supra* Part IV.A.2.c.2.b. (discussing commenters' concerns that the proposed near term customer demand requirement may limit a banking entity's ability to retain an unsold allotment).

[443] A banking entity may not structure a complex instrument on its own initiative using the underwriting exemption. It may use the underwriting exemption only with respect to distributions of securities that comply with the final rule. The Agencies believe this requirement addresses one commenter's concern that a banking entity could rely on the underwriting exemption without regard to anticipated customer demand. *See* AFR *et al.* (Feb. 2012) In addition, a trading desk hedging the risks of an underwriting position in a complex, novel instrument must comply with the hedging exemption in the final rule.

[444] An issuer or selling security holder for purposes of this rule may include, among others, corporate issuers, sovereign issuers for which the banking entity acts as primary dealer (or functional equivalent), or any other person that is an issuer, as defined in final rule § ____.3(e)(9), or a selling security holder, as defined in final rule § ____ .4(a)(5). The Agencies believe that the underwriting exemption in the final rule should generally allow a primary dealer (or functional equivalent) to act as an underwriter for a sovereign government's issuance of its debt because, similar to other underwriting activities, this involves a banking entity agreeing to distribute securities for an issuer (in this case, the foreign sovereign) and engaging in a distribution of such securities. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIB/EBF; Banco de México. A banking entity acting as primary dealer (or functional equivalent) may also be able to rely on the market-making exemption or other exemptions for some of its activities. *See infra* Part IV.A.3.c.2.c. The final rule defines ''client, customer, or counterparty'' for purposes of the underwriting exemption as ''market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.'' Final rule § ____.4(a)(7).

[445] One commenter stated that, in the case of a securitization, an underwriting should be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding the amount required for credit risk retention purposes) along a time line designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* Sens. Merkley & Levin (Feb. 2012). The final rule's near term customer demand requirement considers the liquidity, maturity, and depth of the market for the type of security and recognizes that the amount of time a trading desk may need to hold an underwriting position may vary based on these factors. The final rule does not, however, adopt a standard that applies differently based solely on the particular type of security being distributed (*e.g.,* an asset-backed security versus an equity security) or that precludes certain types of securities from being distributed by a banking entity acting as an underwriter in accordance with the

This requirement is not intended to prevent a trading desk from distributing an offering over a reasonable time consistent with market conditions or from retaining an unsold allotment of the securities acquired from an issuer or selling security holder where holding such securities is necessary due to circumstances such as less-than-expected purchaser demand at a given price.[446] An unsold allotment is, however, subject to the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position.[447] The definition of ''underwriting position'' includes, among other things, any residual position from the distribution that is managed by the trading desk. The final rule includes the requirement to make reasonable efforts to sell or otherwise reduce the trading desk's underwriting position in order to respond to comments on the issue of when a banking entity may retain an unsold allotment when it is acting as an underwriter, as discussed in more detail below, and ensure that the exemption is available only for activities that involve underwriting activities, and not prohibited proprietary trading.[448]

As a general matter, commenters expressed differing views on whether an underwriter should be permitted to hold an unsold allotment for a certain period of time after the initial distribution. For example, a few commenters suggested that limitations on retaining an unsold allotment would increase the cost of raising capital[449] or would negatively impact certain types of securities offerings (*e.g.,* bought deals, rights offerings, and fixed-income offerings).[450] Other commenters, however, expressed concern that the proposed exemption would allow a banking entity to retain a portion of a distribution for speculative purposes.[451]

The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position appropriately addresses both sets of comments. More specifically, this standard clarifies that an underwriter generally may retain an unsold allotment that it was unable to sell to purchasers as part of the initial distribution of securities, provided it had a reasonable expectation of buying interest and engaged in reasonable selling efforts.[452] This should reduce the potential for the negative impacts of a more stringent approach predicted by commenters, such as increased fees for underwriting, greater costs to businesses for raising capital, and potential fire sales of unsold allotments.[453] However, to address concerns that a banking entity may retain an unsold allotment for purely speculative purposes, the Agencies are requiring that reasonable efforts be made to sell or otherwise reduce the underwriting position, which includes any unsold allotment, within a reasonable period. The Agencies agree with these commenters that systematic retention of an underwriting position, without engaging in efforts to sell the position and without regard to whether the trading desk is able to sell the securities at a commercially reasonable price, would be indicative of impermissible proprietary trading intent.[454] The Agencies recognize that the meaning of ''reasonable period'' may differ based on the liquidity, maturity, and depth of the market for the relevant type of securities. For example, an underwriter may be more likely to retain an unsold allotment in a bond offering because liquidity in the fixed-income market is generally not as deep as that in the equity market. If a trading desk retains an underwriting position for a period of time after the distribution, the trading desk must manage the risk of its underwriting position in accordance with its inventory and risk limits and authorization procedures. As discussed above, hedging transactions undertaken in connection with such risk management activities must be conducted in compliance with the

requirements of this exemption because the Agencies believe the statute is best read to permit a banking entity to engage in underwriting activity to facilitate distributions of securities by issuers and selling security holders, regardless of type, to provide client-oriented financial services. That reading is consistent with the statute's language and finds support in the legislative history. *See* 156 Cong. Rec. S5895–S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the underwriting exemption permits ''transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services''). In addition, with respect to this commenter's statement regarding credit risk retention requirements, the Agencies note that compliance with the credit risk retention requirements of Section 15G of the Exchange Act would not impact the availability of the underwriting exemption in the final rule.

[446] This approach should help address commenters' concerns that an inflexible interpretation of the near term demand requirement could result in fire sales, higher fees for underwriting services, or reluctance to act as an underwriter for certain types of distributions that present a greater risk of unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. Further, the Agencies believe this should reduce commenters' concerns that, to the extent a delayed distribution of securities, which are acquired as a result of an outstanding bridge loan, is able to qualify for the underwriting exemption, a stringent interpretation of the near term demand requirement could prevent a banking entity from retaining such securities if market conditions are suboptimal or marketing efforts are not entirely successful. *See* RBC; BoA; LSTA (Feb. 2012). In response to one commenter's request that the Agencies allow a banking entity to assess near term demand at the time of the initial extension of the bridge commitment, the Agencies believe it could be appropriate to determine whether the banking entity has a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired at that time, but note that the trading desk would continue to be subject to the requirement to make reasonable efforts to sell the resulting underwriting position at the time of the initial distribution and for the remaining time the securities are in its inventory. *See* LSTA (Feb. 2012).

[447] The Agencies believe that requiring a trading desk to make reasonable efforts to sell or otherwise reduce its underwriting position addresses commenters' concerns about the risks associated with unsold allotments or the retention of underwritten instruments because this requirement is designed to prevent a trading desk from retaining an unsold allotment for speculative purposes when there is customer buying interest for the relevant security at commercially reasonable prices. Thus, the Agencies believe this obviates the need for certain additional requirements suggested by commenters. *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); CalPERS. The final rule strikes an appropriate balance between the concerns raised by these commenters and those noted by other commenters regarding the potential market impacts of strict requirements against holding an unsold allotment, such as higher fees to underwriting clients, fire sales of unsold allotments, or general reluctance to participate in any distribution that presents a risk of an unsold allotment. The requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should not cause the market impacts predicted by these commenters because it does not prevent an underwriter from retaining an unsold allotment for a reasonable period or impose strict holding period limits on unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading); Fidelity.

[448] This approach is generally consistent with one commenter's suggested approach to addressing the issue of unsold allotments. *See, e.g.,* Goldman (Prop. Trading) (suggesting that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions). In addition, allowing an underwriter to retain an unsold allotment under certain circumstances is consistent with the proposal. *See* Joint Proposal, 76 FR 68,867 (''There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.''); CFTC Proposal, 77 FR 8352. A number of commenters raised questions about whether the rule would permit retaining an unsold allotment. *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC; AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[449] *See* Goldman (Prop. Trading); Fidelity.

[450] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC.

[451] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[452] To the extent that an AP for an ETF is able to meet the terms of the underwriting exemption for its activity, it may be able to retain ETF shares that it created if it had a reasonable expectation of buying interest in the ETF shares and engages in reasonable efforts to sell the ETF shares. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[453] *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[454] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy.

hedging exemption in § ____.5 of the final rule.

The Agencies emphasize that the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position applies to the entirety of the trading desk's underwriting position. As a result, this requirement applies to a number of different scenarios in which an underwriter may hold a long or short position in the securities that are the subject of a distribution for a period of time. For example, if an underwriter is facilitating a distribution of securities for which there is sufficient investor demand to purchase the securities at the offering price, this requirement would prevent the underwriter from retaining a portion of the allotment for its own account instead of selling the securities to interested investors. If instead there was insufficient investor demand at the time of the initial offering, this requirement would recognize that it may be appropriate for the underwriter to hold an unsold allotment for a reasonable period of time. Under these circumstances, the underwriter would need to make reasonable efforts to sell the unsold allotment when there is sufficient market demand for the securities.[455] This requirement would also apply in situations where the underwriters sell securities in excess of the number of securities to which the underwriting commitment relates, resulting in a syndicate short position in the same class of securities that were the subject of the distribution.[456] This provision of the final exemption would require reasonable efforts to reduce any portion of the syndicate short position attributable to the banking entity that is acting as an underwriter. Such reduction could be accomplished if, for example, the managing underwriter exercises an overallotment option or shares are purchased in the secondary market to cover the short position.

The near term demand requirement, including the requirement to make reasonable efforts to reduce the underwriting position, represents a new regulatory requirement for banking entities engaged in underwriting. At the margins, this requirement could alter the participation decision for some banking entities with respect to certain types of distributions, such as distributions that are more likely to result in the banking entity retaining an underwriting position for a period of time.[457] However, the Agencies recognize that liquidity, maturity, and depth of the market vary across types of securities, and the Agencies expect that the express recognition of these differences in the rule should help mitigate any incentive to exit the underwriting business for certain types of securities or types of distributions.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

Section ____.4(a)(2)(i) of the proposed exemption required a banking entity to establish an internal compliance program, as required by § ____.20 of the proposed rule, that is designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, and independent testing.[458] This requirement was proposed so that any banking entity relying on the underwriting exemption would have reasonably designed written policies and procedures, internal controls, and independent testing in place to support its compliance with the terms of the exemption.[459]

b. Comments on the Proposed Compliance Program Requirement

Commenters did not directly address the proposed compliance program requirement in the underwriting exemption. Comments on the proposed compliance program requirement of § ____.20 of the proposed rule are discussed in Part IV.C., below.

c. Final Compliance Program Requirement

The final rule includes a compliance program requirement that is similar to the proposed requirement, but the Agencies are making certain enhancements to emphasize the importance of a strong internal compliance program. More specifically, the final rule requires that a banking entity's compliance program specifically include reasonably designed written policies and procedures, internal controls, analysis and independent testing[460] identifying and addressing: (i) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;[461] (ii) limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties;[462] (iii) internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits;[463] and (iv) authorization procedures, including escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis of the basis for any temporary or permanent increase to one or more of a trading desk's limits, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[464]

As noted above, the proposed compliance program requirement did not include the four specific elements listed above in the proposed underwriting exemption, although each of these provisions was included in some form in the detailed compliance program requirement under Appendix C of the proposed rule.[465] The Agencies are moving these particular requirements, with certain enhancements, into the underwriting exemption because the Agencies believe these are core elements of a program to ensure compliance with the underwriting exemption. These compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in underwriting activity under § ____.4(a) of the final rule. Each of the

[455] The trading desk's retention and sale of the unsold allotment must comply with the federal securities laws and regulations, but is otherwise permitted under the underwriting exemption.

[456] *See supra* note 403.

[457] For example, some commenters suggested that the proposed underwriting exemption could have a chilling effect on banking entities' willingness to engage in underwriting activities. *See, e.g.,* Lord Abbett; Fidelity. Further, some commenters expressed concern that the proposed near term customer demand requirement might negatively impact certain forms of capital-raising if the requirement is interpreted narrowly or inflexibly. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[458] *See* proposed rule § ____.4(a)(2)(i).

[459] *See* Joint Proposal, 76 FR 68,866; CFTC Proposal, 77 FR 8352.

[460] The independent testing standard is discussed in more detail in Part IV.C., which discusses the compliance program requirement in § ____.20 of the final rule.

[461] *See* final rule § ____.4(a)(2)(iii)(A).

[462] *See* final rule § ____.4(a)(2)(iii)(B). A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. *See id.*

[463] *See* final rule § ____.4(a)(2)(iii)(C).

[464] *See* final rule § ____.4(a)(2)(iii)(D).

[465] *See* Joint Proposal, 76 FR 68,963–68,967 (requiring certain banking entities to establish, maintain, and enforce compliance programs with, among other things: (i) Written policies and procedures that describe a trading unit's authorized instruments and products; (ii) internal controls for each trading unit, including risk limits for each trading unit and surveillance procedures; and (iii) a management framework, including management procedures for overseeing compliance with the proposed rule).

requirements in paragraphs (a)(2)(iii)(A) through (D) must be appropriately tailored to the individual trading activities and strategies of each trading desk.

The compliance program requirement in the underwriting exemption is substantially similar to the compliance program requirement in the market-making exemption, except that the Agencies are requiring more detailed risk management procedures in the market-making exemption due to the nature of that activity.[466] The Agencies believe including similar compliance program requirements in the underwriting and market-making exemptions may reduce burdens associated with building and maintaining compliance programs for each trading desk.

Identifying in the compliance program the relevant products, instruments, and exposures in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the underwriting exemption. For example, this requirement should prevent an individual trader on an underwriting desk from establishing positions in instruments that are unrelated to the desk's underwriting function. Further, the identification of permissible products, instruments, and exposures will help form the basis for the specific types of position and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, maturity, and depth of the market for the relevant type of security.

A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. Limits established under this provision, and any modifications to these limits made through the required escalation procedures, must account for the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties. Among other things, these limits should be designed to prevent a trading desk from systematically retaining unsold allotments even when there is customer demand for the positions that remain in the trading desk's inventory. The Agencies recognize that trading desks' limits may differ across types of securities and acknowledge that trading desks engaged in underwriting activities in less liquid securities, such as corporate bonds, may require different inventory, risk exposure, and holding period limits than trading desks engaged in underwriting activities in more liquid securities, such as certain equity securities. A trading desk hedging the risks of an underwriting position must comply with the hedging exemption, which provides for compliance procedures regarding risk management.[467]

Furthermore, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits.[468] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes).

As noted above, a banking entity's compliance program for trading desks engaged in underwriting activity must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval.[469] Thus, to increase a limit of a trading desk, there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § ____.20(b)(6).

As discussed in more detail in Part IV.C., the Agencies recognize that the compliance program requirements in the final rule will impose certain costs on banking entities but, on balance, the Agencies believe such requirements are necessary to facilitate compliance with the statute and the final rule and to reduce the risk of evasion.[470]

4. Compensation Requirement

a. Proposed Compensation Requirement

Another provision of the proposed underwriting exemption required that the compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking.[471] In connection with this requirement, the proposal clarified that although a banking entity relying on the underwriting exemption may appropriately take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the banking entity should provide compensation incentives that primarily reward client revenues and effective client service, not proprietary risk-taking.[472]

b. Comments on the Proposed Compensation Requirement

A few commenters expressed general support for the proposed requirement, but suggested certain modifications that they believed would enhance the requirement and make it more effective.[473] Specifically, one commenter suggested tailoring the requirement to underwriting activity by, for example, ensuring that personnel involved in underwriting are given compensation incentives for the successful distribution of securities off the firm's balance sheet and are not rewarded for profits associated with securities that are not successfully distributed (although losses from such positions should be taken into consideration in determining the employee's compensation). This commenter further recommended that bonus compensation for a deal be withheld until all or a high percentage of the relevant securities are distributed.[474] Finally, one commenter suggested that the term ''designed'' should be removed from this provision.[475]

c. Final Compensation Requirement

Similar to the proposed rule, the underwriting exemption in the final rule requires that the compensation arrangements of persons performing the banking entity's underwriting activities, as described in the exemption, be

[466] *See* final rule §§ ____.4(a)(2)(iii), ____.4(b)(2)(iii).

[467] *See* final rule § ____.5.

[468] *See* final rule § ____.4(a)(2)(iii)(C).

[469] *See* final rule § ____.4(a)(2)(iii)(D).

[470] *See* Part IV.C. (discussing the compliance program requirement in § ____.20 of the final rule).

[471] *See* proposed rule § ____.4(a)(2)(vii); Joint Proposal, 76 FR 68,868; CFTC Proposal, 77 FR 8353.

[472] *See id.*

[473] *See* Occupy; AFR *et al.* (Feb. 2012); Better Markets (Feb. 2012).

[474] *See* AFR *et al.* (Feb. 2012).

[475] *See* Occupy.

designed not to reward or incentivize prohibited proprietary trading.[476] The Agencies do not intend to preclude an employee of an underwriting desk from being compensated for successful underwriting, which involves some risk-taking.

Consistent with the proposal, activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of securities underwritten by the banking entity are inconsistent with the underwriting exemption. A banking entity may, however, take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk. The banking entity should provide compensation incentives that primarily reward client revenues and effective client services, not prohibited proprietary trading. For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the underwriting exemption.

The Agencies are not adopting an approach that prevents an employee from receiving any compensation related to profits arising from an unsold allotment, as suggested by one commenter, because the Agencies believe the final rule already includes sufficient controls to prevent a trading desk from intentionally retaining an unsold allotment to make a speculative profit when such allotment could be sold to customers.[477] The Agencies also are not requiring compensation to be vested for a period of time, as recommended by one commenter to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement because a banking entity must establish limits for a trading desk's underwriting position and the trading desk must make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period.[478] The Agencies continue to believe it is appropriate to focus on the design of a banking entity's compensation structure, so the Agencies are not removing the term ''designed'' from this provision.[479] This retains an objective focus on actions that the banking entity can control—the design of its incentive compensation program—and avoids a subjective focus on whether an employee feels incentivized by compensation, which may be more difficult to assess. In addition, the framework of the final compensation requirement will allow banking entities to better plan and control the design of their compensation arrangements, which should reduce costs and uncertainty and enhance monitoring, than an approach focused solely on individual outcomes.

5. Registration Requirement

a. Proposed Registration Requirement

Section ____.4(a)(2)(iv) of the proposed rule would have required that a banking entity have the appropriate dealer registration or be exempt from registration or excluded from regulation as a dealer to the extent that, in order to underwrite the security at issue, a person must generally be a registered securities dealer, municipal securities dealer, or government securities dealer.[480] Further, if the banking entity was engaged in the business of a dealer outside the United States in a manner for which no U.S. registration is required, the proposed rule would have required the banking entity to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.

b. Comments on Proposed Registration Requirement

Commenters generally did not address the proposed dealer requirement in the underwriting exemption. However, as discussed below in Part IV.A.3.c.2.b., a number of commenters addressed a similar requirement in the proposed market-making exemption.

c. Final Registration Requirement

The requirement in § ____.4(a)(2)(vi) of the underwriting exemption, which provides that the banking entity must be licensed or registered to engage in underwriting activity in accordance with applicable law, is substantively similar to the proposed dealer registration requirement in § ____ .4(a)(2)(iv) of the proposed rule. The primary difference between the proposed requirement and the final requirement is that the Agencies have simplified the language of the rule. The Agencies have also made conforming changes to the corresponding requirement in the market-making exemption to promote consistency across the exemptions, where appropriate.[481]

As was proposed, this provision will require a U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[482] To the extent that a banking entity relies on the underwriting exemption in connection with a distribution of municipal securities or government securities, rather than the exemption in § ____.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer, if required by applicable law. However, this provision does not require a banking entity to register in order to qualify for the underwriting exemption if the banking entity is not otherwise required to register by applicable law.

The Agencies have determined that, for purposes of the underwriting exemption, rather than require a banking entity engaged in the business of a securities dealer outside the United States to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration provisions if required under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). In response to comments, the final rule recognizes that certain foreign jurisdictions may not provide for substantive regulation of dealing

[476] *See* final rule § ____.4(a)(2)(iv); proposed rule § ____.4(a)(2)(vii). This is consistent with the final compensation requirements in the market-making and hedging exemptions. *See* final rule § ____ .4(b)(2)(v); final rule § ____.5(b)(3).

[477] *See* AFR *et al.* (Feb. 2012); *supra* Part IV.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[478] *See* AFR *et al.* (Feb. 2012).

[479] *See* Occupy.

[480] *See* proposed rule § ____.4(a)(2)(iv); Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8353. The proposal clarified that, in the case of a financial institution that is a government securities dealer, such institution must have filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act. *See* Joint Proposal, 76 FR 68,867; CFTC Proposal, 77 FR 8353.

[481] *See* Part IV.A.3.c.6. (discussing the registration requirement in the market-making exemption).

[482] For example, if a banking entity is a bank engaged in underwriting asset-backed securities for which it would be required to register as a securities dealer but for the exclusion contained in section 3(a)(5)(C)(iii) of the Exchange Act, the final rule would not require the banking entity to be a registered securities dealer to underwrite the asset-backed securities. *See* 15 U.S.C. 78c(a)(5)(C)(iii).

businesses.[483] The Agencies do not believe it is necessary to preclude banking entities from engaging in underwriting activities in such foreign jurisdictions to achieve the goals of section 13 of the BHC Act because these banking entities would continue to be subject to the other requirements of the underwriting exemption.

6. Source of Revenue Requirement

a. Proposed Source of Revenue Requirement

Under § ____.4(a)(2)(vi) of the proposed rule, the underwriting activities of a banking entity would have been required to be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions.[484] The proposal clarified that underwriting spreads would include any ''gross spread'' (*i.e.,* the difference between the price an underwriter sells securities to the public and the price it purchases them from the issuer) designed to compensate the underwriter for its services.[485] This requirement provided that activities conducted in reliance on the underwriting exemption should demonstrate patterns of revenue generation and profitability consistent with, and related to, the services an underwriter provides to its customers in bringing securities to market, rather than changes in the market value of the underwritten securities.[486]

b. Comments on the Proposed Source of Revenue Requirement

A few commenters requested certain modifications to the proposed source of revenue requirement. These commenters' suggested revisions were generally intended either to refine the standard to better account for certain activities or to make it more stringent.[487] Three commenters expressed concern that the proposed source of revenue requirement would negatively impact a banking entity's ability to act as a primary dealer or in a similar capacity.[488]

With respect to suggested modifications, one commenter recommended that ''customer revenue'' include revenues attributable to syndicate activities, hedging activities, and profits and losses from sales of residual positions, as long as the underwriter makes a reasonable effort to dispose of any residual position in light of existing market conditions.[489] Another commenter indicated that the rule would better address securitization if it required compensation to be linked in part to risk minimization for the securitizer and in part to serving customers. This commenter suggested that such a framework would be preferable because, in the context of securitizations, fee-based compensation structures did not previously prevent banking entities from accumulating large and risky positions with significant market exposure.[490]

To strengthen the proposed requirement, one commenter requested that the terms ''designed'' and ''primarily'' be removed and replaced by the word ''solely.''[491] Two other commenters requested that this requirement be interpreted to prevent a banking entity from acting as an underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price.[492]

c. Final Rule's Approach To Assessing Source of Revenue

The Agencies believe the final rule includes sufficient controls around an underwriter's source of revenue and have determined not to adopt the additional requirement included in proposed rule § ____.4(a)(2)(vi). The Agencies believe that removing this requirement addresses commenters' concerns that the proposed requirement did not appropriately reflect certain revenue sources from underwriting activity[493] or may impact primary dealer activities.[494] At the same time, the final rule continues to include provisions that focus on whether an underwriter is generating underwriting-related revenue and that should limit an underwriter's ability to generate revenues purely from price appreciation. In particular, the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period, which was not included in the proposed rule, should limit an underwriter's ability to gain revenues purely from price appreciation related to its underwriter position. Similarly, the determination of whether an underwriter receives special compensation for purposes of the definition of ''distribution'' takes into account whether a banking entity is generating underwriting-related revenue.

The final rule does not adopt a requirement that prevents an underwriter from generating any revenue from price appreciation out of concern that such a requirement could prevent an underwriter from retaining an unsold allotment under any circumstances, which would be inconsistent with other provisions of the exemption.[495] Similarly, the Agencies are not adopting a source of revenue requirement that would prevent a banking entity from acting as underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price, as suggested by two commenters.[496] The Agencies believe these commenters' concern is mitigated by the near term demand requirement, which requires a trading desk to have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[497] Further, one commenter recommended a revenue requirement directed at securitization activities to prevent banking entities from accumulating large and risky positions with significant market

[483] *See infra* Part IV.A.3.c.6.c. (discussing comments on this issue with respect to the proposed dealer registration requirement in the market-making exemption).

[484] *See* proposed rule § ____.4(a)(2)(vi); Joint Proposal, 76 FR 68,867–68,868; CFTC Proposal, 77 FR 8353.

[485] *See* Joint Proposal, 76 FR 68,867–68,868 n.142; CFTC Proposal, 77 FR 8353 n.148.

[486] *See* Joint Proposal, 76 FR 68,867–68,868; CFTC Proposal, 77 FR 8353.

[487] *See* Goldman (Prop. Trading); Occupy; Sens. Merkley & Levin (Feb. 2012).

[488] *See* Banco de México (stating that primary dealers need to profit from resulting proprietary positions in foreign sovereign debt, including by holding significant positions in anticipation of future price movements, in order to make the primary dealer business financially attractive); IIB/EBF (noting that primary dealers may actively seek to profit from price and interest rate movements of their holdings, which the relevant sovereign entity supports because such activity provides much-needed liquidity for securities that are otherwise largely purchased pursuant to buy-and-hold strategies by institutional investors and other entities seeking safe returns and liquidity buffers); Japanese Bankers Ass'n.

[489] *See* Goldman (Prop. Trading).

[490] *See* Sens. Merkley & Levin (Feb. 2012).

[491] *See* Occupy (requesting that the rule require automatic disgorgement of any profits arising from appreciation in the value of positions in connection with underwriting activities).

[492] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[493] *See* Goldman (Prop. Trading).

[494] *See* Banco de México; IIB/EBF; Japanese Bankers Ass'n.

[495] *See* Occupy; *supra* Part IV.A.2.c.2. (discussing comments on unsold allotments and the requirement in the final rule to make reasonable efforts to sell or otherwise reduce the underwriting position).

[496] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[497] *See supra* Part IV.A.2.c.2.

exposure.[498] The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should achieve this stated goal and, thus, the Agencies do not believe an additional revenue requirement for securitization activity is needed.[499]

3. Section ____.4(b): Market-Making Exemption

a. Introduction

In adopting the final rule, the Agencies are striving to balance two goals of section 13 of the BHC Act: To allow market making, which is important to well-functioning markets as well as to the economy, and simultaneously to prohibit proprietary trading, unrelated to market making or other permitted activities, that poses significant risks to banking entities and the financial system. In response to comments on the proposed market-making exemption, the Agencies are adopting certain modifications to the proposed exemption to better account for the varying characteristics of market making-related activities across markets and asset classes, while requiring that banking entities maintain a robust set of risk controls for their market making-related activities. A flexible approach to this exemption is appropriate because the activities a market maker undertakes to provide important intermediation and liquidity services will differ based on the liquidity, maturity, and depth of the market for a given type of financial instrument. The statute specifically permits banking entities to continue to provide these beneficial services to their clients, customers, and counterparties.[500] Thus, the Agencies are adopting an approach that recognizes the full scope of market making-related activities banking entities currently undertake and requires that these activities be subject to clearly defined, verifiable, and monitored risk parameters.

b. Overview

1. Proposed Market-Making Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities, derivatives, contracts of sale of a commodity for future delivery, and options on any of the foregoing in connection with market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[501]

Section ____.4(b) of the proposed rule would have implemented this statutory exemption by requiring that a banking entity's market making-related activities comply with seven standards. As discussed in the proposal, these standards were designed to ensure that any banking entity relying on the exemption would be engaged in *bona fide* market making-related activities and, further, would conduct such activities in a way that was not susceptible to abuse through the taking of speculative, proprietary positions as a part of, or mischaracterized as, market making-related activities. The Agencies proposed to use additional regulatory and supervisory tools in conjunction with the proposed market-making exemption, including quantitative measurements for banking entities engaged in significant covered trading activity in proposed Appendix A, commentary on how the Agencies proposed to distinguish between permitted market making-related activity and prohibited proprietary trading in proposed Appendix B, and a compliance regime in proposed § ____ .20 and, where applicable, Appendix C of the proposal. This multi-faceted approach was intended to address the complexities of differentiating permitted market making-related activities from prohibited proprietary trading.[502]

2. Comments on the Proposed Market-Making Exemption

The Agencies received significant comment regarding the proposed market-making exemption. In this Part, the Agencies highlight the main issues, concerns, and suggestions raised by commenters with respect to the proposed market-making exemption. As discussed in greater detail below, commenters' views on the effectiveness of the proposed exemption varied. Commenters discussed a broad range of topics related to the proposed market-making exemption including, among others: The overall scope of the proposed exemption and potential restrictions on market making in certain markets or asset classes; the potential market impact of the proposed market-making exemption; the appropriate level of analysis for compliance with the proposed exemption; the effectiveness of the individual requirements of the proposed exemption; and specific activities that should or should not be considered permitted market making-related activity under the rule.

a. Comments on the Overall Scope of the Proposed Exemption

With respect to the general scope of the exemption, a number of commenters expressed concern that the proposed approach to implementing the market-making exemption is too narrow or restrictive, particularly with respect to less liquid markets. These commenters expressed concern that the proposed exemption would not be workable in many markets and asset classes and does not take into account how market-making services are provided in those markets and asset classes.[503] Some commenters expressed particular concern that the proposed exemption may restrict or limit certain activities currently conducted by market makers (*e.g.,* holding inventory or interdealer trading).[504] Several commenters stated

[498] *See* Sens. Merkley & Levin (Feb. 2012).

[499] *See* final rule § ____.4(a)(2)(ii). Further, as noted above, this exemption does not permit the accumulation of assets for securitization. *See supra* Part IV.A.2.c.1.c.v.

[500] As discussed in Part IV.A.3.c.2.c.i., *infra,* the terms ''client,'' ''customer,'' and ''counterparty'' are defined in the same manner in the final rule. Thus, the Agencies use these terms synonymously throughout this discussion and sometimes use the term ''customer'' to refer to all entities that meet the definition of ''client, customer, and counterparty'' in the final rule's market-making exemption.

[501] 12 U.S.C. 1851(d)(1)(B).

[502] *See* Joint Proposal, 76 FR 68,869; CFTC Proposal, 77 FR 8354–8355.

[503] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that the proposed exemption ''seems to view market making based on a liquid, exchange-traded equity model in which market makers are simple intermediaries akin to agents'' and that ''[t]his view does not fit market making even in equity markets and widely misses the mark for the vast majority of markets and asset classes''); SIFMA (Asset Mgmt.) (Feb. 2012); Credit Suisse (Seidel); ICI (Feb. 2012); BoA; Columbia Mgmt.; Comm. on Capital Markets Regulation; Invesco; ASF (Feb. 2012) (''The seven criteria in the proposed rule, and the related criterion for identifying permitted hedging, are overly restrictive and will make it impractical for dealers to continue making markets in most securitized products.''); Chamber (Feb. 2012) (expressing particular concern about the commercial paper market).

[504] Several commenters stated that the proposed rule would limit a market maker's ability to maintain inventory. *See, e.g.,* NASP; Oliver Wyman (Dec. 2011); Wellington; Prof. Duffie; Standish Mellon; MetLife; Lord Abbett; NYSE Euronext; CIEBA; British Columbia; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Shadow Fin. Regulatory Comm.; Credit Suisse (Seidel); Morgan Stanley; Goldman (Prop. Trading); BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); IRSG; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); Australian Bankers Ass'n. (Feb. 2012); FEI; ASF (Feb. 2012); RBC; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; IHS; Oliver Wyman (Feb. 2012); Thakor Study (stating that by artificially constraining the security holdings that a banking entity can have in its inventory for market making or proprietary trading purposes, section 13 of the BHC Act will make bank risk management less efficient and may adversely impact the diversified financial services business model of banks). However, some commenters stated that market makers should seek to minimize their inventory or should not need large inventories. *See,*

that the proposed exemption would create too much uncertainty regarding compliance [505] and, further, may have a chilling effect on banking entities' market making-related activities.[506] Due to the perceived restrictions and burdens of the proposed exemption, many commenters indicated that the rule may change the way in which market-making services are provided.[507] A number of commenters expressed the view that the proposed exemption is inconsistent with Congressional intent because it would restrict and reduce banking entities' current market making-related activities.[508]

Other commenters, however, stated that the proposed exemption was too broad and recommended that the rule place greater restrictions on market making, particularly in illiquid, nontransparent markets.[509] Many of these commenters suggested that the exemption should only be available for traditional market-making activity in relatively safe, ''plain vanilla'' instruments.[510] Two commenters represented that the proposed exemption would have little to no impact on banking entities' current market making-related services.[511]

Commenters expressed differing views regarding the ease or difficulty of distinguishing permitted market making-related activity from prohibited proprietary trading. A number of commenters represented that it is difficult or impossible to distinguish prohibited proprietary trading from permitted market making-related activity.[512] With regard to this issue, several commenters recommended that the Agencies not try to remove all aspects of proprietary trading from market making-related activity because doing so would likely restrict certain legitimate market-making activity.[513]

Other commenters were of the view that it is possible to differentiate between prohibited proprietary trading and permitted market making-related activity.[514] For example, one commenter stated that, while the analysis may involve subtle distinctions, the fundamental difference between a banking entity's market-making activities and proprietary trading activities is the emphasis in market making on seeking to meet customer needs on a consistent and reliable basis throughout a market cycle.[515] According to another commenter, holding substantial securities in a trading book for an extended period of time assumes the character of a proprietary position and, while there may be occasions when a customer-oriented purchase and subsequent sale extend over days and cannot be more quickly executed or hedged, substantial holdings of this character should be relatively rare and limited to less liquid markets.[516]

Several commenters expressed general concern that the proposed exemption may be applied on a transaction-by-transaction basis and explained the burdens that may result from such an approach.[517] Commenters appeared to attribute these concerns to language in the proposed exemption referring to a ''purchase or sale of a [financial instrument]'' [518] or to language in Appendix B indicating that the Agencies may assess certain factors and criteria at different levels, including a ''single significant transaction.'' [519] With respect to the burdens of a transaction-by-transaction analysis, some commenters noted that banking entities can engage in a large volume of market-making transactions daily, which would make it burdensome to apply the exemption to each trade.[520] A few commenters indicated that, even if the Agencies did not intend to require transaction-by-transaction analysis, the proposed rule's language can be read to imply such a requirement. These commenters indicated that ambiguity on this issue could have a chilling effect on market making or could allow some examiners to rigidly apply the requirements of the exemption on a trade-by-trade basis.[521] Other commenters indicated that it would be difficult to determine whether a particular trade was or was not a market-making trade without consideration of the relevant unit's overall activities.[522] One commenter elaborated on this point by stating that

e.g., AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz. Other commenters expressed concern that the proposed rule could limit interdealer trading. *See, e.g.,* Prof. Duffie; Credit Suisse (Seidel); JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); Oliver Wyman (Dec. 2011).

[505] *See, e.g.,* BlackRock; Putnam; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); MetLife; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Sen. Bennet; Sen. Corker; PUC Texas; Fidelity; ICI (Feb. 2012); Invesco.

[506] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Commissioner Barnier; NYSE Euronext; BoA; Citigroup (Feb. 2012); STANY; ICE; Chamber (Feb. 2012); BDA (Feb. 2012); Putnam; FTN; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; CME Group; Capital Group; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; ICI (Feb. 2012); Invesco; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Thakor Study.

[507] For example, some commenters stated that market makers may revert to an agency or ''special order'' model. *See, e.g.,* Barclays; Goldman (Prop. Trading); ACLI (Feb. 2012); Vanguard; RBC. In addition, some commenters stated that new systems will be developed, such as alternative market matching networks, but these commenters disagreed about whether such changes would happen in the near term. *See, e.g.,* CalPERS; BlackRock; Stuyvesant; Comm. on Capital Markets Regulation. Other commenters stated that it is unlikely that new systems will be developed. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012). One commenter stated that the proposed rule may cause a banking organization that engages in significant market-making activity to give up its banking charter or spin off its market-making operations to avoid compliance with the proposed exemption. *See* Prof. Duffie.

[508] *See, e.g.,* NASP; Wellington; JPMC; Morgan Stanley; Credit Suisse (Seidel); BoA; Goldman (Prop. Trading); Citigroup (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ICI (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Sen. Corker; Invesco.

[509] *See, e.g.,* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[510] *See, e.g.,* Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[511] *See* Occupy (''[I]t is unclear that this rule, as written, will markedly alter the current customer-serving business. Indeed, this rule has gone to excessive lengths to protect the covered banking entities' ability to maintain responsible customer-facing business.''); Alfred Brock.

[512] *See, e.g.,* Rep. Bachus *et al.;* IIF; Morgan Stanley (stating that beyond walled-off proprietary trading, the line is hard to draw, particularly because both require principal risk-taking and the features of market making vary across markets and asset classes and become more pronounced in times of market stress); CFA Inst. (representing that the distinction is particularly difficult in the fixed-income market); ICFR; Prof. Duffie; WR Hambrecht.

[513] *See, e.g.,* Chamber (Feb. 2012) (citing an article by Stephen Breyer stating that society should not expend disproportionate resources trying to reduce or eliminate ''the last 10 percent'' of the risks of a certain problem); JPMC; RBC; ICFR; Sen. Hagan. One of these commenters indicated that any concerns that banking entities would engage in speculative trading as a result of an expansive market-making exemption would be addressed by other reform initiatives (*e.g.,* Basel III implementation will provide laddered disincentives to holding positions as principal as a result of capital and liquidity requirements). *See* RBC.

[514] *See* Wellington; Paul Volcker; Better Markets (Feb. 2012); Occupy.

[515] *See* Wellington.

[516] *See* Paul Volcker.

[517] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); HSBC; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); PUC Texas; ERCOT; Invesco. *See also* IAA (stating that it is unclear whether the requirements must be applied on a transaction-by-transaction basis or if compliance with the requirements is based on overall activities). This issue is addressed in Part IV.A.3.c.1.c., *infra.*

[518] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading) (Feb. 2012). As explained above, the term ''covered financial position'' from the proposal has been replaced by the term ''financial instrument'' in the final rule. Because the types of instruments included in both definitions are identical, the term ''financial instrument'' is used throughout this Part.

[519] *See, e.g.,* Goldman (Prop. Trading); Wellington.

[520] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays (stating that ''hundreds or thousands of trades can occur in a single day in a single trading unit'').

[521] *See, e.g.,* ICI (Feb. 2012); Barclays; Goldman (Prop. Trading).

[522] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

''an analysis that seeks to characterize specific transactions as either market making. . . or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.'' [523] This commenter noted that a position entered into as part of market making-related activities may serve multiple functions at one time, such as responding to customer demand, hedging a risk, and building inventory. The commenter also expressed concern that individual transactions or positions may not be severable or separately identifiable as serving a market-making purpose.[524] Two commenters suggested that the requirements in the market-making exemption be applied at the portfolio level rather than the trade level.[525]

Moreover, commenters also set forth their views on the organizational level at which the requirements of the proposed market-making exemption should apply.[526] The proposed exemption generally applied requirements to a ''trading desk or other organizational unit'' of a banking entity. In response to this proposed approach, commenters stated that compliance should be assessed at each trading desk or aggregation unit [527] or at each trading unit.[528]

Several commenters suggested alternative or additive means of implementing the statutory exemption for market making-related activity.[529] Commenters' recommended approaches varied, but a number of commenters requested approaches involving one or more of the following elements: (i) Safe harbors,[530] bright lines,[531] or presumptions of compliance with the exemption based on the existence of certain factors (*e.g.,* compliance program, metrics, general customer focus or orientation, providing liquidity, and/or exchange registration as a market maker); [532] (ii) a focus on metrics or other objective factors; [533] (iii) guidance on permitted market making-related activity, rather than rule requirements; [534] (iv) risk management structures and/or risk limits; [535] (v) adding a new customer-facing criterion or focusing on client-related activities; [536] (vi) capital and liquidity requirements; [537] (vii) development of individualized plans for each banking entity, in coordination with regulators; [538] (viii) ring fencing affiliates engaged in market making-related activity; [539] (ix) margin requirements; [540] (x) a compensation-focused approach; [541] (xi) permitting all swap dealing activity; [542] (xii) additional provisions regarding material conflicts of interest and high-risk assets and trading strategies; [543] and/or (xiii) making the exemption as broad as possible under the statute.[544]

b. Comments Regarding the Potential Market Impact of the Proposed Exemption

As discussed above, several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity. Many of these commenters represented that, as a result, the proposed exemption would likely result in reduced liquidity,[545]

[523] SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[524] *See id.* (suggesting that the Agencies ''give full effect to the statutory intent to allow market making by viewing the permitted activity on a holistic basis'').

[525] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable.

[526] *See* Wellington; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable. The Agencies address this topic in Part IV.A.3.c.1.c., *infra.*

[527] *See* Wellington. This commenter did not provide greater specificity about how it would define ''trading desk'' or ''aggregation unit.'' *See id.*

[528] *See* Morgan Stanley (stating that ''trading unit'' should be defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity''); SIFMA *et al.* (Prop. Trading) (Feb. 2012). One of these commenters discussed its suggested definition of ''trading unit'' in the context of the proposed requirement to record and report certain quantitative measurements, but it is unclear that the commenter was also suggesting that this definition be used for purposes of the market-making exemption. For example, this commenter expressed support for a multi-level approach to defining ''trading unit,'' and it is not clear how a definition that captures multiple organizational levels across a banking organization would work in the context of the market-making exemption. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggested that ''trading unit'' be defined ''at a level that presents its activities in the context of the whole'' and noting that the appropriate level may differ depending on the structure of the banking entity).

[529] *See, e.g.,* Wellington; Japanese Bankers Ass'n.; Prof. Duffie; IR&M; G2 FinTech; MetLife; NYSE Euronext; Anthony Flynn and Koral Fusselman; IIF; CalPERS; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Shadow Fin. Regulatory Comm.; John Reed; Prof. Richardson; Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Johnson & Prof. Stiglitz; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); WR Hambrecht; Vanguard; Capital Group; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Fidelity; Occupy; AFR *et al.* (Feb. 2012); Invesco; ISDA (Feb. 2012); Stephen Roach; Oliver Wyman (Feb. 2012). The Agencies respond to these comments in Part IV.A.3.b.3., *infra.*

[530] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Feb. 2012) (Oct. 2012) (suggesting a safe harbor for any trading desk that effects more than 50 percent of its transactions through sales representatives).

[531] *See, e.g.,* Flynn & Fusselman; Prof. Colesanti *et al.*

[532] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading) (suggesting that the rule: (i) Provide a general grant of authority to engage in any transactions entered into as part of a banking entity's market-making business, where ''market making'' is defined as ''the business of being willing to facilitate customer purchases and sales of [financial instruments] as an intermediary over time and in size, including by holding positions in inventory;'' and (ii) allow banking entities to monitor compliance with this exemption internally through their compliance and risk management infrastructure); PNC *et al.;* Oliver Wyman (Feb. 2012).

[533] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[534] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[535] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[536] *See, e.g.,* Morgan Stanley; Stephen Roach.

[537] *See, e.g.,* Prof. Duffie; CalPERS; STANY; ICE; Vanguard; Capital Group.

[538] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[539] *See, e.g.,* Prof. Duffie; Shadow Fin. Regulatory Comm. *See also* Wedbush.

[540] *See* WR Hambrecht.

[541] *See* G2 FinTech.

[542] *See* ISDA (Feb. 2012); ISDA (Apr. 2012).

[543] *See* Sens. Merkley & Levin (Feb. 2012) (stating that the exemption should expressly mention the conflicts provision and provide examples to warn against particular conflicts, such as recommending clients buy poorly performing assets in order to remove them from the banking entity's book or attempting to move market prices in favor of trading positions a banking entity has built up in order to make a profit); Stephen Roach (suggesting that the exemption integrate the limitations on permitted activities).

[544] *See* Fidelity (stating that the exemption needs to be as broad as possible to account for customer-facing principal trades, block trades, and market making in OTC derivatives). *See also* STANY (stating that it is better to make the exemption too broad than too narrow).

[545] *See, e.g.,* AllianceBernstein; Rep. Bachus *et al.* (Dec. 2011); EMTA; NASP; Wellington; Japanese Bankers Ass'n.; Sen. Hagan; Prof. Duffie; Investure; Standish Mellon; IR&M; MetLife; Lord Abbett; Commissioner Barnier; Quebec; IIF; Sumitomo Trust; Liberty Global; NYSE Euronext; CIEBA; EFAMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); BDA (Feb. 2012); Putnam; Fixed Income Forum/Credit Roundtable; Western Asset Mgmt.; ACLI (Feb. 2012); IAA; CME Group; Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Australian Bankers Ass'n. (Feb. 2012); FEI; AFMA; Sen. Carper *et al.;* PUC Texas; ERCOT; IHS; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Eaton Vance; Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Union Asset; Sen. Casey; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012) (providing estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on hypothetical liquidity reduction

wider bid-ask spreads,[546] increased market volatility,[547] reduced price discovery or price transparency,[548] increased costs of raising capital or higher financing costs,[549] greater costs for investors or consumers,[550] and slower execution times.[551] Some commenters expressed particular concern about potential impacts on institutional investors (*e.g.,* mutual funds and pension funds)[552] or on small or midsized companies.[553] A number of commenters discussed the interrelationship between primary and secondary market activity and indicated that restrictions on market making would impact the underwriting process.[554]

A few commenters expressed the view that reduced liquidity would not necessarily be a negative result.[555] For example, two commenters noted that liquidity is vulnerable to liquidity spirals, in which a high level of market liquidity during one period feeds a sharp decline in liquidity during the next period by initially driving asset prices upward and supporting increased leverage. The commenters explained that liquidity spirals lead to ''fire sales'' by market speculators when events reveal that assets are overpriced and speculators must sell their assets to reduce their leverage.[556] According to another commenter, banking entities' access to the safety net allows them to distort market prices and, arguably, produce excess liquidity. The commenter further represented that it would be preferable to allow the discipline of the market to choose the pricing of securities and the amount of liquidity.[557] Some commenters cited an economic study indicating that the U.S. financial system has become less efficient in generating economic growth in recent years, despite increased trading volumes.[558]

Some commenters stated that it is unlikely the proposed rule would result in the negative market impacts identified above, such as reduced market liquidity.[559] For example, a few commenters stated that other market participants, who are not subject to section 13 of the BHC Act, may enter the market or increase their trading activities to make up for any reduction in banking entities' market-making

scenarios); Thakor Study. The Agencies respond to comments regarding the potential market impact of the rule in Part IV.A.3.b.3., *infra.*

[546] *See, e.g.,* AllianceBernstein; Wellington; Investure; Standish Mellon; MetLife; Lord Abbett; Barclays; Goldman (Prop. Trading); Citigroup (Feb. 2012); BlackRock; Putnam; ACLI (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Sen. Carper *et al.;* IHS; Columbia Mgmt.; ICI (Feb. 2012) British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Thakor Study (stating that section 13 of the BHC Act will likely result in higher bid-ask spreads by causing at least some retrenchment of banks from market making, resulting in fewer market makers and less competition).

[547] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Lord Abbett; IIF; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); BDA (Feb. 2012); IHS; FTN; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; British Bankers' Ass'n.; Comm. on Capital Markets Regulation.

[548] *See, e.g.,* Prof. Duffie (arguing that, for example, ''during the financial crisis of 2007–2009, the reduced market making capacity of major dealer banks caused by their insufficient capital levels resulted in dramatic downward distortions in corporate bond prices''); IIF; Barclays; IAA; Vanguard; Wellington; FTN.

[549] *See, e.g.,* AllianceBernstein; Chamber (Dec. 2011); Members of Congress (Dec. 2011); Wellington; Sen. Hagan; Prof. Duffie; IR&M; MetLife; Lord Abbett; Liberty Global; NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); NCSHA; ASF (Feb. 2012) (stating that ''[f]ailure to permit the activities necessary for banking entities to act in [a] market-making capacity [in asset-backed securities] would have a dramatic adverse effect on the ability of securitizers to access the asset-backed securities markets and thus to obtain the debt financing necessary to ensure a vibrant U.S. economy''); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; Chamber (Feb. 2012); IHS; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; FEI; AFMA; SSgA (Feb. 2012); PNC *et al.;* ICI (Feb. 2012); British Bankers' Ass'n.; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); GE (Feb. 2012); Thakor Study (stating that when a firm's cost of capital goes up, it invests less—resulting in lower economic growth and lower employment—and citing supporting data indicating that a 1 percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in aggregate annual capital spending by U.S. nonfarm firms and job losses between 550,000 and 1.1 million per year in the nonfarm sector). One commenter further noted that a higher cost of capital can lead a firm to make riskier, short-term investments. *See* Thakor Study.

[550] *See, e.g.,* Wellington; Standish Mellon; IR&M; MetLife; Lord Abbett; NYSE Euronext; CIEBA; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Vanguard; Australian Bankers Ass'n. (Feb. 2012); FEI; Sen. Carper *et al.;* Columbia Mgmt.; SSgA (Feb. 2012); ICI (Feb. 2012); Comm. on Capital Markets Regulation; TMA Hong Kong; Sen. Casey; IHS; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); Thakor Study.

[551] *See, e.g.,* Barclays; FTN; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012).

[552] *See, e.g.,* AllianceBernstein (stating that, to the extent the rule reduces liquidity provided by market makers, open end mutual funds that are largely driven by the need to respond to both redemptions and subscriptions will be immediately impacted in terms of higher trading costs); Wellington (indicating that periods of extreme market stress are likely to exacerbate costs and challenges, which could force investors such as mutual funds and pension funds to accept distressed prices to fund redemptions or pay current benefits); Lord Abbett (stating that certain factors, such as reduced bank capital to support market-making businesses and economic uncertainty, have already reduced liquidity and caused asset managers to have an increased preference for highly liquid credits and expressing concern that, if section 13 of the BHC Act further reduces liquidity, then: (i) Asset managers' increased preference for highly liquid credit could lead to unhealthy portfolio concentrations, and (ii) asset managers will maintain a larger cash cushion in portfolios that may be subject to redemption, which will likely result in investors getting poorer returns); EFAMA; BlackRock (stating that investment decisions are heavily dependent on a liquidity factor input, so as liquidity dissipates, investment strategies become more limited and returns to investors are diminished by wider spreads and higher transaction costs); CFA Inst. (noting that a mutual fund that tries to liquidate holdings to meet redemptions may have difficulty selling at acceptable prices, thus impairing the fund's NAV for both redeeming investors and for those that remain in the fund); Putnam; Fixed Income Forum/Credit Roundtable; ACLI; T. Rowe Price; Vanguard; IAA; FEI; Sen. Carper *et al.;* Columbia Mgmt.; ICI (Feb. 2012); Invesco; Union Asset; Standish Mellon; Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[553] *See, e.g.,* CIEBA (stating that for smaller issuers in particular, market makers need to have incentives to make markets, and the proposal removes important incentives); ACLI (indicating that lower liquidity will most likely result in higher costs for issuers of debt and, for lesser known or lower quality issuers, this cost may be significant and in some cases prohibitive because the cost will vary depending on the credit quality of the issuer, the amount of debt it has in the market, and the maturity of the security); PNC *et al.* (expressing concern that a regional bank's market-making activity for small and middle market customers is more likely to be inappropriately characterized as impermissible proprietary trading due to lower trading volume involving less liquid securities); Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[554] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; RBC; NYSE Euronext; Credit Suisse (Seidel).

[555] *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson.

[556] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker (stating that at some point, greater liquidity, or the perception of greater liquidity, may encourage more speculative trading).

[557] *See* Prof. Richardson.

[558] *See, e.g.,* Johnson & Prof. Stiglitz (citing Thomas Phillippon, *Has the U.S. Finance Industry Become Less Efficient?,* NYU Working Paper, Nov. 2011); AFR *et al.* (Feb. 2012); Public Citizen; Better Markets (Feb. 2012); Prof. Johnson.

[559] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012) (stating that there is no convincing, independent evidence that the rule would increase trading costs or reduce liquidity, and the best evidence available suggests that the buy-side firms would greatly benefit from the competitive pressures that transparency can bring); Better Markets (Feb. 2012) (''Industry's claim that [section 13 of the BHC Act] will 'reduce market liquidity, capital formation, and credit availability, and thereby hamper economic growth and job creation' disregard the fact that the financial crisis did more damage to those concerns than any rule or reform possibly could.''); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012); AFR *et al.* (Feb. 2012). One commenter stated that the proposed rule would improve market liquidity, efficiency, and price transparency. *See* Alfred Brock.

activity or other trading activity.[560] For instance, one of these commenters suggested that the revenue and profits from market making will be sufficient to attract capital and competition to that activity.[561] In addition, one commenter expressed the view that prohibiting proprietary trading may support more liquid markets by ensuring that banking entities focus on providing liquidity as market makers, rather than taking liquidity from the market in the course of ''trading to beat'' institutional buyers like pension funds, university endowments, and mutual funds.[562] Another commenter stated that, while section 13 of the BHC Act may temporarily reduce trading volume and excessive liquidity at the peak of market bubbles, it should increase the long-run stability of the financial system and render genuine liquidity and credit availability more reliable over the long term.[563]

Other commenters, however, indicated that it is uncertain or unlikely that non-banking entities will enter the market or increase their trading activities, particularly in the short term.[564] For example, one commenter noted the investment that banking entities have made in infrastructure for trading and compliance would take smaller or new firms years and billions of dollars to replicate.[565] Another commenter questioned whether other market participants, such as hedge funds, would be willing to dedicate capital to fully serving customer needs, which is required to provide ongoing liquidity.[566] One commenter stated that even if non-banking entities move in to replace lost trading activity from banking entities, the value of the current interdealer network among market makers will be reduced due to the exit of banking entities.[567] Several commenters expressed the view that migration of market making-related activities to firms outside the banking system would be inconsistent with Congressional intent and would have potentially adverse consequences for the safety and soundness of the U.S. financial system.[568]

Many commenters requested additional clarification on how the proposed market-making exemption would apply to certain asset classes and markets or to particular types of market making-related activities. In particular, commenters requested greater clarity regarding the permissibility of: (i) interdealer trading,[569] including trading for price discovery purposes or to test market depth; [570] (ii) inventory management; [571] (iii) block positioning activity; [572] (iv) acting as an authorized participant or market maker in ETFs; [573] (v) arbitrage or other activities that promote price transparency and liquidity; [574] (vi) primary dealer activity; [575] (vii) market making in futures and options; [576] (viii) market making in new or bespoke products or customized hedging contracts; [577] and (ix) inter-affiliate transactions.[578] As discussed in more detail in Part IV.B.2.c., a number of commenters requested that the market-making exemption apply to the restrictions on acquiring or retaining an ownership interest in a covered fund.[579] Some commenters stated that no other activities should be considered permitted market making-related activity under the rule.[580] In addition, a few commenters requested clarification that high-frequency trading would not qualify for the market-making exemption.[581]

3. Final Market-Making Exemption

After carefully considering comment letters, the Agencies are adopting certain refinements to the proposed market-making exemption. The Agencies are adopting a market-making exemption that is consistent with the statutory exemption for this activity and designed to permit banking entities to continue providing intermediation and liquidity services. The Agencies note that, while all market-making activity should ultimately be related to the intermediation of trading, whether directly to individual customers through bilateral transactions or more broadly to

[560] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012). Similarly, one commenter indicated that non-banking entity market participants could fill the current role of banking entities in the market if implementation of the rule is phased in. *See* ACLI (Feb. 2012).

[561] *See* Better Markets (Feb. 2012).

[562] *See* Prof. Johnson.

[563] *See* AFR *et al.* (Feb. 2012).

[564] *See, e.g.,* Wellington; Prof. Duffie; Investure; IIF; Liberty Global; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); FTN; Western Asset Mgmt.; IAA; PUC Texas; ICI (Feb. 2012); IIB/EBF; Invesco. In addition, some commenters recognized that other market participants are likely to fill banking entities' roles in the long term, but not in the short term. *See, e.g.,* ICFR; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012).

[565] *See* Oliver Wyman (Feb. 2012) (''Major bank-affiliated market makers have large capital bases, balance sheets, technology platforms, global operations, relationships with clients, sales forces, risk infrastructure, and management processes that would take smaller or new dealers years and billions of dollars to replicate.'').

[566] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[567] *See* Thakor Study.

[568] *See, e.g.,* Prof. Duffie; Oliver Wyman (Feb. 2012).

[569] *See, e.g.,* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[570] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading).

[571] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[572] *See infra* Part IV.A.3.c.1.b.ii. (discussing commenters' requests for greater clarity regarding the permissibility of block positioning activity).

[573] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012).

[574] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012).

[575] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); Banco de México; IIB/EBF.

[576] *See* CME Group (requesting clarification that the market-making exemption permits a banking entity to engage in market making in exchange-traded futures and options because the dealer registration requirement in § ____.4(b)(2)(iv) of the proposed rule did not refer to such instruments and stating that lack of an explicit exemption would reduce market-making activities in these instruments, which would decrease liquidity). But *See* Johnson & Prof. Stiglitz (stating that the Agencies should pay special attention to options trading and other derivatives because they are highly volatile assets that are difficult if not impossible to effectively hedge, except through a completely matched position, and suggesting that options and similar derivatives may need to be required to be sold only as riskless principal under § ____.6(b)(1)(ii) of the proposed rule or significantly limited through capital charges); Sens. Merkley & Levin (Feb. 2012) (stating that asset classes that are particularly hard to hedge, such as options, should be given special attention under the hedging exemption).

[577] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). Other commenters, however, stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or customized derivatives. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

[578] *See, e.g.,* Japanese Bankers Ass'n. (stating that transactions with affiliates and subsidiaries and related to hedging activities are a type of market making-related activity or risk-mitigating hedging activity that should be exempted by the rule); SIFMA *et al.* (Prop. Trading) (Feb. 2012). According to one of these commenters, inter-affiliate transactions should be viewed as part of a coordinated activity for purposes of determining whether a banking entity qualifies for an exemption. This commenter stated that, for example, if a market maker shifts positions held in inventory to an affiliate that is better able to manage the risk of such positions, both the market maker and its affiliate would be engaged in permitted market making-related activity. This commenter further represented that fitting the inter-affiliate swap into the exemption may be difficult (*e.g.,* one of the affiliates entering into the swap may not be holding itself out as a willing counterparty). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[579] *See, e.g.,* Cleary Gottlieb; JPMC; BoA; Credit Suisse (Williams).

[580] *See, e.g.,* Occupy; Alfred Brock.

[581] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

a given marketplace, certain characteristics of a market-making business may differ among markets and asset classes.[582] The final rule is intended to account for these differences to allow banking entities to continue to engage in market making-related activities by providing customer intermediation and liquidity services across markets and asset classes, if such activities do not violate the statutory limitations on permitted activities (*e.g.,* by involving or resulting in a material conflict of interest with a client, customer, or counterparty) and are conducted in conformance with the exemption.

At the same time, the final rule requires development and implementation of trading, risk and inventory limits, risk management strategies, analyses of how the specific market making-related activities are designed not to exceed the reasonably expected near term demands of customers, compensation standards, and monitoring and review requirements that are consistent with market-making activities.[583] These requirements are designed to distinguish exempt market making-related activities from impermissible proprietary trading. In addition, these requirements are designed to ensure that a banking entity is aware of, monitors, and limits the risks of its exempt activities consistent with the prudent conduct of market making-related activities.

As described in detail below, the final market-making exemption consists of the following elements:

- A framework that recognizes the differences in market making-related activities across markets and asset classes by establishing criteria that can be applied based on the liquidity, maturity, and depth of the market for the particular type of financial instrument.
- A general focus on analyzing the overall ''financial exposure'' and ''market-maker inventory'' held by any given trading desk rather than a transaction-by-transaction analysis. The ''financial exposure'' reflects the aggregate risks of the financial instruments, and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of its market making-related activities. The ''market-maker inventory'' means all of the positions, in the financial instruments for which the trading desk stands ready to make a market that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[584]
- A definition of the term ''trading desk'' that focuses on the operational functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a single banking entity or across two or more affiliates.[585]
- Five requirements for determining whether a banking entity is engaged in permitted market making-related activities. Many of these criteria have similarities to the factors included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - ○ The trading desk that establishes and manages a financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;[586]
  - ○ The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute and based on certain factors and analysis;[587]
  - ○ The banking entity has established and implements, maintains, and enforces an internal compliance program that is reasonably designed to ensure its compliance with the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:
    - ▪ The financial instruments each trading desk stands ready to purchase and sell in accordance with § ____ .4(b)(2)(i) of the final rule;
    - ▪ The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with its established limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;[588]
    - ▪ Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, including factors used to determine the reasonably expected near term demands of clients, customers, or counterparties, on: the amount, types, and risks of its market-maker inventory; the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; the level of exposures to relevant risk factors arising from its financial exposure; and the period of time a financial instrument may be held;
    - ▪ Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and
    - ▪ Authorization procedures, including escalation procedures that

[582] Consistent with the FSOC study and the proposal, the final rule recognizes that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular type of financial instrument. *See* Joint Proposal, 76 FR 68,870; CFTC Proposal, 77 FR 8356; FSOC study (stating that ''characteristics of permitted activities in one market or asset class may not be the same in another market (*e.g.,* permitted activities in a liquid equity securities market may vary significantly from an illiquid over-the-counter derivatives market)'').

[583] Certain of these requirements, like the requirements to have risk and inventory limits, risk management strategies, and monitoring and review requirements were included in the enhanced compliance program requirement in proposed Appendix C, but were not separately included in the proposed market-making exemption. Like the statute, the proposed rule would have required that market making-related activities be designed not to exceed the reasonably expected near term demand of clients, customers, or counterparties. The Agencies are adding an explicit requirement in the final rule that a trading desk conduct analyses of customer demand for purposes of complying with this statutory requirement.

[584] *See infra* Part IV.A.3.c.1.c.ii. *See also* final rule §§ ____.4(b)(4), (5).

[585] *See infra* Part IV.A.3.c.1.c.i. The term ''trading desk'' is defined as ''the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof.'' Final rule § ____.3(e)(13).

[586] *See* final rule § ____.4(b)(2)(i); *infra* Part IV.A.3.c.1.c.iii.

[587] *See* final rule § ____.4(b)(2)(ii); *infra* Part IV.A.3.c.2.c. In addition, the Agencies are adopting a definition of the terms ''client,'' ''customer,'' and ''counterparty'' in § ____.4(b)(3) of the final rule.

[588] Routine market making-related risk management activity by a trading desk is permitted under the market-making exemption and, provided the standards of the exemption are met, is not required to separately meet the requirements of the hedging exemption. The circumstances under which risk management activity relating to the trading desk's financial exposure is permitted under the market-making exemption or must separately comply with the hedging exemption are discussed in more detail in Parts IV.A.3.c.1.c.ii. and IV.A.3.c.4., *infra.*

require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of the market-making exemption, and independent review of such demonstrable analysis and approval;[589]

○ To the extent that any limit identified above is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;[590]

○ The compensation arrangements of persons performing market making-related activities are designed not to reward or incentivize prohibited proprietary trading;[591] and

○ The banking entity is licensed or registered to engage in market making-related activities in accordance with applicable law.[592]

• The use of quantitative measurements to highlight activities that warrant further review for compliance with the exemption.[593] As discussed further in Part IV.C.3., the Agencies have reduced some of the compliance burdens by adopting a more tailored subset of metrics than was proposed to better focus on those metrics that the Agencies believe are most germane to the evaluation of the activities that firms conduct under the market-making exemption.

In refining the proposed approach to implementing the statute's market-making exemption, the Agencies closely considered the various alternative approaches suggested by commenters.[594] However, like the proposed approach, the final market-making exemption continues to adhere to the statutory mandate that provides for an exemption to the prohibition on proprietary trading for market making-related activities. Therefore, the final rule focuses on providing a framework for assessing whether trading activities are consistent with market making. The Agencies believe this approach is consistent with the statute[595] and strikes an appropriate balance between commenters' desire for both clarity and flexibility. For example, while a bright-line or safe harbor based approach would generally provide a high degree of certainty about whether an activity qualifies for the market-making exemption, it would also provide less flexibility to recognize the differences in market-making activities across markets and asset classes.[596] In addition, any bright-line approach would be more likely to be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the market-making exemption.[597] Although a purely guidance-based approach would provide greater flexibility, it would also provide less clarity, which could make it difficult for trading personnel, internal compliance personnel, and Agency supervisors and examiners to determine whether an activity complies with the rule and would lead to an increased risk of evasion of the statutory requirements.[598]

Some commenters suggested an approach to implementing the market-making exemption that would focus on metrics or other objective factors.[599] As discussed below, a number of commenters expressed support for using the metrics as a tool to monitor trading activity and not to determine compliance with the rule.[600] While the Agencies agree that quantitative measurements are useful for purposes of monitoring a trading desk's activities and are requiring certain banking entities to calculate, record, and report quantitative measurements to the Agencies in the final rule, the Agencies do not believe that quantitative measurements should be used as a dispositive tool for determining compliance with the market-making exemption.[601]

In response to two commenters' request that the final rule focus on a banking entity's risk management structures or risk limits and not on attempting to define market-making activities,[602] the Agencies do not believe that management of risk, on its own, is sufficient to differentiate permitted market making-related activities from impermissible proprietary trading. For example, the existence of a risk management framework or risk limits, while important, would not ensure that a trading desk is acting as a market maker by engaging in customer-facing activity and providing intermediation and liquidity services.[603] The Agencies also decline to take an approach to implementing the market-making exemption that would require the development of individualized plans for each banking entity in coordination with the Agencies, as suggested by a few

[589] *See* final rule § ____.4(b)(2)(iii); *infra* Part IV.A.3.c.3.

[590] *See* final rule § ____.4(b)(2)(iv).

[591] *See* final rule § ____.4(b)(2)(v); *infra* Part IV.A.3.c.5.

[592] *See* final rule § ____.4(b)(2)(vi); *infra* Part IV.A.3.c.6. As discussed further below, this provision pertains to legal registration or licensing requirements that may apply to an entity engaged in market making-related activities, depending on the facts and circumstances. This provision would not require a banking entity to comply with registration requirements that are not required by law, such as discretionary registration with a national securities exchange as a market maker on that exchange.

[593] *See infra* Part IV.C.3.

[594] *See supra* Part IV.A.3.b.2.

[595] Certain approaches suggested by commenters, such as relying solely on capital requirements, requiring ring fencing, permitting all swap dealing activity, or focusing solely on how traders are compensated do not appear to be consistent with the statutory language because they do not appear to limit market making-related activity to that which is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute. *See* Prof. Duffie; STANY; ICE; Shadow Fin. Regulatory Comm.; ISDA (Feb. 2012); ISDA (Apr. 2012); G2 FinTech.

[596] While an approach establishing a number of safe harbors that are each tailored to a specific asset class would address the need to recognize differences across asset classes, such an approach may also increase the complexity of the final rule. Further, commenters did not provide sufficient information to determine the appropriate parameters of a safe harbor-based approach.

[597] As noted above, a number of commenters suggested the Agencies adopt a bright-line rule, provide a safe harbor for certain types of activities, or establish a presumption of compliance based on certain factors. *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Oct. 2012); Flynn & Fusselman; Prof. Colesanti *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading); PNC *et al.;* Oliver Wyman (Feb. 2012). Many of these commenters expressed general concern that the proposed market-making exemption may create uncertainty for individual traders engaged in market making-related activity and suggested that their proposed approach would alleviate such concern. The Agencies believe that the enhanced focus on risk and inventory limits for each trading desk (which must be tied to the near term customer demand requirement) and the clarification that the final market-making exemption does not require a trade-by-trade analysis should address concerns about individual traders having to assess whether they are complying with the market-making exemption on a trade-by-trade basis.

[598] Several commenters suggested a guidance-based approach, rather than requirements in the final rule. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could then be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[599] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[600] *See infra* Part IV.C.3. (discussing the final rule's metrics requirement). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); RBC; ICI (Feb. 2012); Occupy (stating that there are serious limits to the capabilities of the metrics and the potential for abuse and manipulation of the input data is significant); Alfred Brock.

[601] *See infra* Part IV.C.3. (discussing the final metrics requirement).

[602] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[603] However, as discussed below, the Agencies believe risk limits can be a useful tool when they must account for the nature and amount of a particular trading desk's market making-related activities, including the reasonably expected near term demands of clients, customers, or counterparties.

commenters.[604] The Agencies believe it is useful to establish a consistent framework that will apply to all banking entities to reduce the potential for unintended competitive impacts that could arise if each banking entity is subject to an individualized plan that is tailored to its specific organizational structure and trading activities and strategies.

Although the Agencies are not in the final rule modifying the basic structure of the proposed market-making exemption, certain general items suggested by commenters, such as enhanced compliance program elements and risk limits, have been incorporated in the final rule text for the market-making exemption, instead of a separate appendix.[605] Moreover, as described below, the final market-making exemption includes specific substantive changes in response to a wide variety of commenter concerns.

The Agencies understand that the economics of market making—and financial intermediation in general—require a market maker to be active in markets. In determining the appropriate scope of the market-making exemption, the Agencies have been mindful of commenters' views on market making and liquidity. Several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity, with corresponding reductions in market liquidity.[606] However, commenters disagreed about whether reduced liquidity would be beneficial or detrimental to the market, or if any such reductions would even materialize.[607] Many commenters stated that reduced liquidity could lead to other negative market impacts, such as wider spreads, higher transaction costs, greater market volatility, diminished price discovery, and increased cost of capital.

The Agencies understand that market makers play an important role in providing and maintaining liquidity throughout market cycles and that restricting market-making activity may result in reduced liquidity, with corresponding negative market impacts. For instance, absent a market maker who stands ready to buy and sell, investors may have to make large price concessions or otherwise expend resources searching for counterparties. By stepping in to intermediate trades and provide liquidity, market makers thus add value to the financial system by, for example, absorbing supply and demand imbalances. This often means taking on financial exposures, in a principal capacity, to satisfy reasonably expected near term customer demand, as well as to manage the risks associated with meeting such demand.

The Agencies recognize that, as noted by commenters, liquidity can be associated with narrower spreads, lower transaction costs, reduced volatility, greater price discovery, and lower costs of capital.[608] The Agencies agree with these commenters that liquidity provides important benefits to the financial system, as more liquid markets are characterized by competitive market makers, narrow bid-ask spreads, and frequent trading, and that a narrowly tailored market-making exemption could negatively impact the market by, as described above, forcing investors to make price concessions or unnecessarily expend resources searching for counterparties.[609] For example, while bid-ask spreads compensate market makers for providing liquidity when asset values are uncertain, under competitive forces, dealers compete with respect to spreads, thus lowering their profit margins on a per trade basis and benefitting investors.[610] Volatility is driven by both uncertainty about fundamental value and the liquidity needs of investors. When markets are illiquid, participants may have to make large price concessions to find a counterparty willing to trade, increasing the importance of the liquidity channel for addressing volatility. If liquidity-based volatility is not diversifiable, investors will require a risk premium for holding liquidity risk, increasing the cost of capital.[611] Commenters additionally suggested that the effects of diminished liquidity could be concentrated in securities markets for small or midsize companies or for lesser-known issuers, where trading is already infrequent.[612] Volume in these

[604] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[605] The Agencies are not, however, adding certain additional requirements suggested by commenters, such as a new customer-facing criterion, margin requirements, or additional provisions regarding material conflicts of interest or high-risk assets or trading strategies. *See, e.g.,* Morgan Stanley; Stephen Roach; WR Hambrecht; Sens. Merkley & Levin (Feb. 2012). The Agencies believe that the final rule includes sufficient requirements to ensure that a trading desk relying on the market-making exemption is engaged in customer-facing activity (for example, the final rule requires the trading desk to stand ready to buy and sell a type of financial instrument as market maker and that the trading desk's market-maker inventory is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties). The Agencies decline to include margin requirements in the final exemption because banking entities are currently subject to a number of different margin requirements, including those applicable to, among others: SEC-registered broker-dealers; CFTC-registered swap dealers; SEC-registered security-based swap dealers: And foreign dealer entities. Further, the Agencies are not providing new requirements regarding material conflicts of interest and high-risk assets and trading strategies in the market-making exemption because the Agencies believe these issues are adequately addressed in § ____.7 of the final rule. The limitations in § ____ .7 will apply to market making-related activities and all other exempted activities.

[606] *See supra* note 545 and accompanying text. The Agencies acknowledge that reduced liquidity can be costly. One commenter provided estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on certain hypothetical scenarios of reduced market liquidity. This commenter noted that its hypothetical liquidity shifts of 5, 10, and 15 percentile points were ''necessarily arbitrary'' but judged ''to be realistic potential outcomes of the proposed rule.'' Oliver Wyman (Feb. 2012). Because the Agencies have made significant modifications to the proposed rule in response to comments, the Agencies believe this commenter's concerns about the market impacts of the proposed rule have been substantially addressed.

[607] As noted above, a few commenters stated that reduced liquidity may provide certain benefits. *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson. However, a number of commenters stated that reduced liquidity would have negative market impacts. *See supra* note 545 and accompanying text.

[608] *See supra* Part IV.A.3.b.2.b.

[609] *See supra* Part IV.A.3.b.2.b. As discussed above, a few other commenters suggested that to the extent liquidity is vulnerable to destabilizing liquidity spirals, any reduced liquidity stemming from section 13 of the BHC Act and its implementing rules would not necessarily be a negative result. *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker. These commenters also suggested that the Agencies adopt stricter conditions in the market-making exemption, as discussed throughout this Part IV.A.3. However, liquidity—essentially, the ease with which assets can be converted into cash—is not destabilizing in and of itself. Rather, liquidity spirals are a function of how firms are funded. During market downturns, when margin requirements tend to increase, firms that fund their operations with leverage face higher costs of providing liquidity; firms that run up against their maximum leverage ratios may be forced to retreat from market making, contributing to the liquidity spiral. Viewed in this light, it is institutional features of financial markets—in particular, leverage—rather than liquidity itself that contributes to liquidity spirals.

[610] Wider spreads can be costly for investors. For example, one commenter estimated that a 10 basis point increase in spreads in the corporate bond market would cost investors $29 billion per year. *See* Wellington. Wider spreads can also be particularly costly for open-end mutual funds, which must trade in and out of the fund's portfolio holdings on a daily basis in order to satisfy redemptions and subscriptions. *See* Wellington; AllianceBernstein.

[611] A higher cost of capital increases financing costs and translates into reduced capital investment. While one commenter estimated that a one percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in capital investments by U.S. nonfarm firms, the Agencies cannot independently verify these potential costs. Further, this commenter did not indicate what aspect of the proposed rule could cause a one percent increase in the cost of capital. *See* Thakor Study. In any event, the Agencies have made significant changes to the proposed approach to implementing the market-making exemption that should help address this commenter's concern.

[612] *See, e.g.,* CIEBA; ACLI; PNC *et al.;* Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.*

Continued

markets can be low, increasing the inventory risk of market makers. The Agencies recognize that, if the final rule creates disincentives for banking entities to provide liquidity, these low volume markets may be impacted first.

As discussed above, the Agencies received several comments suggesting that the negative consequences associated with reduced liquidity would be unlikely to materialize under the proposed rule. For example, a few commenters stated that non-bank financial intermediaries, who are not subject to section 13 of the BHC Act, may increase their market-making activities in response to any reduction in market making by banking entities, a topic the Agencies discuss in more detail below.[613] In addition, some commenters suggested that the restrictions on proprietary trading would support liquid markets by encouraging banking entities to focus on financial intermediation activities that supply liquidity, rather than proprietary trades that demand liquidity, such as speculative trades or trades that front-run institutional investors.[614] The statute prohibits proprietary trading activity that is not exempted. As such, the termination of nonexempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants. Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

Based on the many detailed comments provided, the Agencies have made substantive refinements to the market-making exemption that the Agencies believe will reduce the likelihood that the rule, as implemented, will negatively impact the ability of banking entities to engage in the types of market making-related activities permitted under the statute and, therefore, will continue to promote the benefits to investors and other market participants described above, including greater market liquidity, narrower bid-ask spreads, reduced price concessions and price impact, lower volatility, and reduced counterparty search costs, thus reducing the cost of capital. For instance, the final market-making exemption does not require a trade-by-trade analysis, which was a significant source of concern from commenters who represented, among other things, that a trade-by-trade analysis could have a chilling effect on individual traders' willingness to engage in market-making activities.[615] Rather, the final rule has been crafted around the overall market making-related activities of individual trading desks, with various requirements that these activities be demonstrably related to satisfying reasonably expected near term customer demands and other market-making activities. The Agencies believe that applying certain requirements to the aggregate risk exposure of a trading desk, along with the requirement to establish risk and inventory limits to routinize a trading desk's compliance with the near term customer demand requirement, will reduce negative potential impacts on individual traders' decision-making process in the normal course of market making.[616] In addition, in response to a large number of comments expressing concern that the proposed market-making exemption would restrict or prohibit market making-related activities in less liquid markets, the Agencies are clarifying that the application of certain requirements in the final rule, such as the frequency of required quoting and the near term demand requirement, will account for the liquidity, maturity, and depth of the market for a given type of financial instrument. Thus, banking entities will be able to continue to engage in market making-related activities across markets and asset classes.

At the same time, the Agencies recognize that an overly broad market-making exemption may allow banking entities to mask speculative positions as liquidity provision or related hedges. The Agencies believe the requirements included in the final rule are necessary to prevent such evasion of the market-making exemption, ensure compliance with the statute, and facilitate internal banking entity and external Agency reviews of compliance with the final rule. Nevertheless, the Agencies acknowledge that these additional costs may have an impact on banking entities' willingness to engage in market making-related activities. Banking entities will incur certain compliance costs in connection with their market making-related activities under the final rule. For example, banking entities may not currently limit their trading desks' market-maker inventory to that which is designed not to exceed reasonably expected near term customer demand, as required by the statute.

As discussed above, commenters presented diverging views on whether non-banking entities are likely to enter the market or increase their market-making activities if the final rule should cause banking entities to reduce their market-making activities.[617] The Agencies note that prior to the Gramm-Leach-Bliley Act of 1999, market-making services were more commonly provided by non-bank-affiliated broker-dealers than by banking entities. As discussed above, by intermediating and facilitating trading, market makers provide value to the markets and profit from providing liquidity. Should banking entities retreat from making markets, the profit opportunities available from providing liquidity will provide an incentive for non-bank-affiliated broker-dealers to enter the market and intermediate trades. The Agencies are unable to assess the likely effect with any certainty, but the Agencies recognize that a market-making operation requires certain infrastructure and capital, which will impact the ability of non-banking entities to enter the market-making business or to increase their presence. Therefore, should banking entities retreat from making markets, there could be a transition period with reduced liquidity as non-banking entities build up the needed infrastructure and obtain capital. However, because the Agencies have substantially modified this exemption in response to comments to ensure that

(Feb. 14, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[613] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012).

[614] *See, e.g.,* Prof. Johnson.

[615] *See supra* note 517 (discussing commenters' concerns regarding a trade-by-trade analysis).

[616] For example, by clarifying that individual trades will not be viewed in isolation and requiring strong compliance procedures, this approach will generally allow an individual trader to operate within the compliance framework established for his or her trading desk without having to assess whether each individual transaction complies with all requirements of the market-making exemption.

[617] *See supra* notes 560 and 564 and accompanying text (discussing comments on the issue of whether non-banking entities are likely to enter the market or increase their trading activities in response to reduced trading activity by banking entities). For example, one commenter stated that broker-dealers that are not affiliated with a bank would have reduced access to lender-of-last resort liquidity from the central bank, which could limit their ability to make markets during times of market stress or when capital buffers are small. *See* Prof. Duffie. However, another commenter noted that the presence and evolution of market making after the enactment of the Glass-Steagall Act mutes this particular concern. *See* Prof. Richardson.

market making related to near-term customer demand is permitted as contemplated by the statute, the Agencies do not believe the final rule should significantly impact currently-available market-making services.[618]

c. Detailed Explanation of the Market-Making Exemption

1. Requirement To Routinely Stand Ready to Purchase and Sell

a. Proposed Requirement To Hold Self Out

Section ____.4(b)(2)(ii) of the proposed rule would have required the trading desk or other organizational unit that conducts the purchase or sale in reliance on the market-making exemption to hold itself out as being willing to buy and sell, including through entering into long and short positions in, the financial instrument for its own account on a regular or continuous basis.[619] The proposal stated that a banking entity could rely on the proposed exemption only for the type of financial instrument that the entity actually made a market in.[620]

The proposal recognized that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular financial instrument.[621] To account for these variations, the Agencies proposed indicia for assessing compliance with this requirement that differed between relatively liquid markets and less liquid markets. Further, the Agencies recognized that the proposed indicia could not be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making-related activity is conducted.

In particular, the proposal stated that a trading desk or other organizational unit's market making-related activities in relatively liquid markets, such as equity securities or other exchange-traded instruments, should generally include: (i) Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis; (ii) a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; (iii) making continuous quotations that are at or near the market on both sides; and (iv) providing widely accessible and broadly disseminated quotes.[622] With respect to market making in less liquid markets, the proposal noted that the appropriate indicia of market making-related activities will vary, but should generally include: (i) holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;[623] (ii) with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market; and (iii) transaction volumes and risk proportionate to historical customer liquidity and investments needs.[624]

In discussing this proposed requirement, the Agencies stated that *bona fide* market making-related activity may include certain block positioning and anticipatory position-taking. More specifically, the proposal indicated that the *bona fide* market making-related activity described in § ____.4(b)(2)(ii) of the proposed rule would include: (i) block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading;[625] and (ii) taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[626]

b. Comments on the Proposed Requirement To Hold Self Out

Commenters raised many issues regarding § ____.4(b)(2)(ii) of the proposed exemption, which would require a trading desk or other organizational unit to hold itself out as willing to buy and sell the financial instrument for its own account on a regular or continuous basis. As discussed below, some commenters viewed the proposed requirement as too restrictive, while other commenters stated that the requirement was too permissive. Two commenters expressed support for the proposed requirement.[627] A number of commenters provided views on statements in the proposal regarding indicia of *bona fide* market making in more and less liquid markets and the permissibility of block positioning and anticipatory position-taking.

Several commenters represented that the proposed requirement was too restrictive.[628] For example, a number of these commenters expressed concern that the proposed requirement may limit a banking entity's ability to act as a market maker under certain circumstances, including in less liquid markets, for instruments lacking a two-sided market, or in customer-driven, structured transactions.[629] In addition, a few commenters expressed specific concern about how this requirement would impact more limited market-making activity conducted by banks.[630]

[618] Certain non-banking entities, such as some SEC-registered broker-dealers that are not banking entities subject to the final rule, currently engage in market-making activities and, thus, should have the needed infrastructure and may attract additional capital. If the final rule has a marginal impact on banking entities' willingness to engage in market making-related activities, these non-banking entities should be able to respond by increasing their market making-related activities. The Agencies recognize, however, that firms that do not have existing infrastructure or sufficient capital are unlikely to be able to act as market makers shortly after the final rule is implemented. Nevertheless, because some non-bank-affiliated broker-dealers currently operate market-making desks, and because it was the dominant model prior to the Gramm-Leach-Bliley Act, the Agencies believe that non-bank-affiliated financial intermediaries will be able to provide market-making services longer term.

[619] *See* proposed rule § ____.4(b)(2)(ii).

[620] *See* Joint Proposal, 76 FR 68,870 (''Notably, this criterion requires that a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the [financial instrument] involved; simply because a banking entity makes a market in one type of [financial instrument] does not permit it to rely on the market-making exemption for another type of [financial instrument].''); CFTC Proposal, 77 FR 8355–8356.

[621] *See* Joint Proposal, 76 FR 68,870; CFTC Proposal, 77 FR 8356.

[622] *See* Joint Proposal, 76 FR 68,870–68,871; CFTC Proposal, 77 FR 8356. These proposed factors are generally consistent with the indicia used by the SEC to assess whether a broker-dealer is engaged in *bona fide* market making for purposes of Regulation SHO under the Exchange Act. *See* Joint Proposal, 76 FR 68,871 n.148; CFTC Proposal, 77 FR 8356 n.155.

[623] The Agencies noted that, with respect to this factor, the frequency of regular quotations will vary, as moderately illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment. *See* Joint Proposal, 76 FR 68,871 n.149; CFTC Proposal, 77 FR 8356 n.156.

[624] *See* Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8356.

[625] In the preamble to the proposed rule, the Agencies stated that the SEC's definition of ''qualified block positioner'' may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in *bona fide* market making for purposes of § ____.4(b)(2)(ii) of the proposed rule. *See* Joint Proposal, 76 FR 68,871 n.151; CFTC Proposal, 77 FR 8356 n.157.

[626] *See* Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8356–8357.

[627] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[628] *See infra* Part IV.A.3.c.1.c.iii. (addressing these concerns).

[629] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; IHS; SSgA (Feb. 2012).

[630] *See, e.g.,* PNC (stating that the proposed rule needs to account for market making by regional banks on behalf of small and middle-market customers whose securities are less liquid); ABA (stating that the rule should continue to permit

Continued

Many commenters indicated that it was unclear whether this provision would require a trading desk or other organizational unit to regularly or continuously quote every financial instrument in which a market is made, but expressed concern that the proposed language could be interpreted in this manner.[631] These commenters noted that there are thousands of individual instruments within a given asset class, such as corporate bonds, and that it would be burdensome for a market maker to provide quotes in such a large number of instruments on a regular or continuous basis.[632] One of these commenters represented that, because customer demand may be infrequent in a particular instrument, requiring a banking entity to provide regular or continuous quotes in the instrument may not provide a benefit to its customers.[633] A few commenters requested that the Agencies provide further guidance on this issue or modify the proposed standard to state that holding oneself out in a range of similar instruments will be considered to be within the scope of permitted market making-related activities.[634]

To address concerns about the restrictiveness of this requirement, commenters suggested certain modifications. For example, some commenters suggested adding language to the requirement to account for market making in markets that do not typically involve regular or continuous, or two-sided, quoting.[635] In addition, a few commenters requested that the requirement expressly include transactions in new instruments or transactions in instruments that occur infrequently to address situations where a banking entity may not have previously had the opportunity to hold itself out as willing to buy and sell the applicable instrument.[636] Other commenters supported alternative criteria for assessing whether a banking entity is acting as a market maker, such as: (i) a willingness to respond to customer demand by providing prices upon request; [637] (ii) being in the business of providing prices upon request for that financial instrument or other financial instruments in the same or similar asset class or product class; [638] or (iii) a historical test of market-making activity, with compliance judged on the basis of actual trades.[639] Finally, two commenters stated that this requirement should be moved to Appendix B of the rule,[640] which, according to one of these commenters, would provide the Agencies greater flexibility to consider the facts and circumstances of a particular activity.[641]

Other commenters took the view that the proposed requirement was too permissive.[642] For example, one commenter stated that the proposed standard provided too much room for interpretation and would be difficult to measure and monitor. This commenter expressed particular concern that a trading desk or other organizational unit could meet this requirement by regularly or continuously making wide, out of context quotes that do not present any real risk of execution and do not contribute to market liquidity.[643] Some commenters suggested the Agencies place greater restrictions on a banking entity's ability to rely on the market-making exemption in certain illiquid markets, such as assets that cannot be reliably valued, products that do not have a genuine external market, or instruments for which a banking entity does not expect to have customers wishing to both buy and sell.[644] In support of these requests, commenters stated that trading in illiquid products raises certain concerns under the rule, including: a lack of reliable data for purposes of using metrics to monitor a banking entity's market making-related activity (*e.g.,* products whose valuations are determined by an internal model that can be manipulated, rather than an observable market price); [645] relation to the last financial crisis; [646] lack of important benefits to the real economy; [647] similarity to prohibited proprietary trading; [648] and inconsistency with the statute's requirements that market making-related activity must be ''designed not to exceed the reasonably expected near

banks to provide limited liquidity by buying securities that they feel are suitable for their retail and institutional customer base by stating that a bank is ''holding itself out'' when it buys and sells securities that are suitable for its customers).

[631] This issue is further discussed in Part IV.A.3.c.1.c.iii., *infra.*

[632] *See, e.g.,* Goldman (Prop. Trading) (stating that it would be burdensome for a U.S. credit market-making business to be required to produce and disseminate quotes for thousands of individual bond CUSIPs that trade infrequently and noting that a market maker in credit markets will typically disseminate indicative prices for the most liquid instruments but, for the thousands of other instruments that trade infrequently, the market maker will generally provide a price for a trade upon request from another market participant); Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* BDA (Feb. 2012); FTN (stating that in some markets, such as the markets for residential mortgage-backed securities and investment grade corporate debt, a market maker will hold itself out in a subset of instruments (*e.g.,* particular issues in the investment grade corporate debt market with heavy trading volume or that are in the midst of particular credit developments), but will trade in other instruments within the group or sector upon inquiry from customers and other dealers); Oliver Wyman (Feb. 2012) (discussing data regarding the number of U.S. corporate bonds and frequency of trading in such bonds in 2009).

[633] *See* Goldman (Prop. Trading).

[634] *See, e.g.,* RBC (recommending that the Agencies clarify that a trading desk is required to hold itself out as willing to buy and sell a particular type of ''product''); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that the Agencies use the term ''instrument,'' rather than ''covered financial position,'' to provide greater clarity); CIEBA (supporting alternative criteria that would require a banking entity to hold itself out generally as a market maker for the relevant asset class, but not for every instrument it purchases and sells); Goldman (Prop. Trading). One of these commenters recommended that the Agencies recognize and permit the following kinds of activity in related financial instruments: (i) Options market makers should be deemed to be engaged in market making in all put and call series related to a particular underlying security and should be permitted to trade the underlying security regardless of whether such trade qualifies for the hedging exemption; (ii) convertible bond traders should be permitted to trade in the associated equity security; (iii) a market maker in one issuer's bonds should be considered a market maker in similar bonds of other issuers; and (iv) a market maker in standardized interest rate swaps should be considered to be engaged in market making-related activity if it engages in a customized interest rate swap with a customer upon request. *See* RBC.

[635] *See, e.g.,* Morgan Stanley (suggesting that the Agencies add the phrase ''or, in markets where regular or continuous quotes are not typically provided, the trading unit stands ready to provide quotes upon request''); Barclays (suggesting addition of the phrase ''to the extent that two-sided markets are typically made by market makers in a given product,'' as well as changing the reference to ''purchase or sale'' to ''market making-related activity'' to avoid any inference of a trade-by-trade analysis). *See also* Fixed Income Forum/Credit Roundtable. To address concerns about the requirement's application to bespoke products, one commenter suggested that the rule clearly state that a banking entity fulfills this requirement if it markets structured transactions to its client base and stands ready to enter into such transactions with customers, even though transactions may occur on a relatively infrequent basis. *See* JPMC.

[636] *See* Wells Fargo (Prop. Trading); RBC (supporting this approach as an alternative to removing the requirement from the rule, but primarily supporting its removal). *See also* ISDA (Feb. 2012) (stating that the analysis of compliance with the proposed requirement must carefully consider the degree of presence a market maker wishes to have in a given market, which may include being a leader in certain types of instruments, having a secondary presence in others, and potentially leaving or entering other submarkets).

[637] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also suggested that such test be assessed at the ''trading unit'' level. *See id.*

[638] *See* Goldman (Prop. Trading).

[639] *See* FTN.

[640] *See* Flynn & Fusselman; JPMorgan.

[641] *See* JPMC.

[642] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; John Reed. *See infra* note 746 and accompanying text (responding to these comments).

[643] *See* Occupy.

[644] *See* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

[645] *See* AFR *et al.* (Feb. 2012); Occupy.

[646] *See* Occupy.

[647] *See* John Reed.

[648] *See* Johnson & Prof. Stiglitz.

term demands of clients, customers, or counterparties'' and must not result in a material exposure to high-risk assets or high-risk trading strategies.[649]

These commenters also requested that the proposed requirement be modified in certain ways. In particular, several commenters stated that the proposed exemption should only permit market making in assets that can be reliably valued through external market transactions.[650] In order to implement such a limitation, three commenters suggested that the Agencies prohibit banking entities from market making in assets classified as Level 3 under FAS 157.[651] One of these commenters explained that Level 3 assets are generally highly illiquid assets whose fair value cannot be determined using either market prices or models.[652] In addition, a few commenters suggested that banking entities be subject to additional capital charges for market making in illiquid products.[653] Another commenter stated that the Agencies should require all market making-related activity to be conducted on a multilateral organized electronic trading platform or exchange to make it possible to monitor and confirm certain trading data.[654] Two commenters emphasized that their recommended restrictions on market making in illiquid markets should not prohibit banking entities from making markets in corporate bonds.[655]

i. The Proposed Indicia

As noted above, the proposal set forth certain indicia of *bona fide* market making-related activity in liquid and less liquid markets that the Agencies proposed to apply when evaluating whether a banking entity was eligible for the proposed exemption.[656] Several commenters provided their views regarding the effectiveness of the proposed indicia.

With respect to the proposed indicia for liquid markets, a few commenters expressed support for the proposed indicia.[657] One of these commenters stated that while the proposed factors are reasonably consistent with *bona fide* market making, the Agencies should add two other factors: (i) A willingness to transact in reasonable quantities at quoted prices, and (ii) inventory turnover.[658]

Other commenters, however, stated that the proposed use of factors from the SEC's analysis of *bona fide* market making under Regulation SHO was inappropriate in this context. In particular, these commenters represented that *bona fide* market making for purposes of Regulation SHO is a purposefully narrow concept that permits a subset of market makers to qualify for an exception from the ''locate'' requirement in Rule 203 of Regulation SHO. The commenters further expressed the belief that the policy goals of section 13 of the BHC Act do not necessitate a similarly narrow interpretation of market making.[659]

A few commenters expressed particular concern about how the factor regarding patterns of purchases and sales in roughly comparable amounts would apply to market making in exchange-traded funds (''ETFs''). According to these commenters, demonstrating this factor could be difficult because ETF market making involves a pattern of purchases and sales of groups of equivalent securities (*i.e.,* the ETF shares and the basket of securities and cash that is exchanged for them), not a single security. In addition, the commenters were unsure whether this factor could be demonstrated in times of limited trading in ETF shares.[660]

The preamble to the proposed rule also provided certain proposed indicia of *bona fide* market making-related activity in less liquid markets.[661] As discussed above, commenters had differing views about whether the exemption for market making-related activity should permit banking entities to engage in market making in some or all illiquid markets. Thus, with respect to the proposed indicia for market making in less liquid markets, commenters generally stated that the indicia should be broader or narrower, depending on the commenter's overall view on the issue of market making in illiquid markets. One commenter stated that the proposed indicia are effective.[662]

The first proposed factor of market making-related activity in less liquid markets was holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis. As noted above, several commenters expressed concern about a requirement that market makers provide regular quotations in less liquid instruments, including in fixed income markets and bespoke, customized derivatives.[663] With respect to the interaction between the rule language requiring ''regular'' quoting and the proposal's language permitting trading by appointment under certain circumstances, some of these commenters expressed uncertainty about how a market maker trading only by appointment would be able to satisfy the proposed rule's regular quotation

[649] *See* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity must have or reasonably expect at least two customers—one for each side of the trade—and must have a reasonable expectation of the second customer coming to take the position or risk off its books in the ''near term''); AFR *et al.* (Feb. 2012); Public Citizen.

[650] *See* AFR *et al.* (Feb. 2012) (stating that the rule should ban market making in illiquid and opaque securities with no genuine external market, but permit market making in somewhat illiquid securities, such as certain corporate bonds, as long as the securities can be reliably valued with reference to other extremely similar securities that are regularly traded in liquid markets and the financial outcome of the transaction is reasonably predictable); Johnson & Prof. Stiglitz (recommending that permitted market making be limited to assets that can be reliably valued in, at a minimum, a moderately liquid market evidenced by trading within a reasonable period, such as a week, through a real transaction and not simply with interdealer trades); Public Citizen (stating that market making should be limited to assets that can be reliably valued in a market where transactions take place on a weekly basis).

[651] *See* AFR *et al.* (Feb. 2012) (stating that such a limitation would be consistent with the proposed limitation on ''high-risk assets'' and the discussion of this limitation in proposed Appendix C); Public Citizen; Prof. Richardson.

[652] *See* Prof. Richardson.

[653] Two commenters recommended that banking entities be required to treat trading in assets that cannot be reliably valued and that trade only by appointment, such as bespoke derivatives and structured products, as providing an illiquid bespoke loan, which are subject to higher capital charges under the Federal banking agencies' capital rules. *See* Johnson & Prof. Stiglitz; John Reed. Another commenter suggested that, if not directly prohibited, trading in bespoke instruments that cannot be reliably valued should be assessed an appropriate capital charge. *See* Public Citizen.

[654] *See* Occupy. This commenter further suggested that the exemption exclude all activities that include: (i) Assets whose changes in value cannot be mitigated by effective hedges; (ii) new products with rapid growth, including those that do not have a market history; (iii) assets or strategies that include significant imbedded leverage; (iv) assets or strategies that have demonstrated significant historical volatility; (v) assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and (vi) assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties. *See id.*

[655] *See* AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz.

[656] *See supra* Part IV.A.3.c.1.a.

[657] *See* Occupy; AFR *et al.* (Feb. 2012); NYSE Euronext (expressing support for the indicia set forth in the FSOC study, which are substantially the same as the indicia in the proposal); Alfred Brock.

[658] *See* AFR *et al.* (Feb. 2012).

[659] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[660] *See* ICI (Feb. 2012); ICI Global.

[661] *See supra* Part IV.A.3.c.1.a.

[662] *See* Alfred Brock.

[663] *See supra* note 629 accompanying text. With respect to this factor, one commenter requested that the Agencies delete the parenthetical of ''but not necessarily continuous'' from the proposed factor as part of a broader effort to recognize the relative illiquidity of swap markets. *See* ISDA (Feb. 2012).

requirement.[664] In addition, another commenter stated that the proposal's recognition of trading by appointment does not alleviate concerns about applying the ''regular'' quotation requirement to market making in less liquid instruments in markets that are not, as a whole, highly illiquid, such as credit and interest rate markets.[665]

Other commenters expressed concern about only requiring a market maker to provide regular quotations or permitting trading by appointment to qualify for the market-making exemption. With respect to regular quotations, some commenters stated that such a requirement enables evasion of the prohibition on proprietary trading because a proprietary trader may post a quote at a time of little interest in a financial product or may post wide, out of context quotes on a regular basis with no real risk of execution.[666] Several commenters stated that trading only by appointment should not qualify as market making for purposes of the proposed rule.[667] Some of these commenters stated that there is no ''market'' for assets that trade only by appointment, such as customized, structured products and OTC derivatives.[668]

The second proposed criterion for market making-related activity in less liquid markets was, with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market. Two commenters expressed concern about this proposed factor.[669] In particular, one of these commenters stated that the language is fundamentally inconsistent with market making because it contemplates that only taking one side of the market is sufficient, rather than both buying and selling an instrument.[670] The other commenter expressed concern that banking entities would be allowed to accumulate a significant amount of illiquid risk because the indicia for market making-related activity in less liquid markets did not require a market maker to buy and sell in comparable amounts (as required by the indicia for liquid markets).[671]

Finally, the third proposed factor of market making in less liquid markets would consider transaction volumes and risk proportionate to historical customer liquidity and investment needs. A few commenters indicated that there may not be sufficient information available for a banking entity to conduct such an analysis.[672] For example, one commenter stated that historical information may not necessarily be available for new businesses or developing markets in which a market maker may seek to establish trading operations.[673] Another commenter expressed concern that this factor would not help differentiate market making from prohibited proprietary trading because most illiquid markets do not have a source for such historical risk and volume data.[674]

ii. Treatment of Block Positioning Activity

The proposal provided that the activity described in § ____.4(b)(2)(ii) of the proposed rule would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.[675]

A number of commenters supported the general language in the proposal permitting block positioning, but expressed concern about the reference to the definition of ''qualified block positioner'' in SEC Rule 3b–8(c).[676] With respect to using Rule 3b–8(c) as guidance under the proposed rule, these commenters represented that Rule 3b–8(c)'s requirement to resell block positions ''as rapidly as possible'' would cause negative results (*e.g.,* fire sales) or create market uncertainty (*e.g.,* when, if ever, a longer unwind would be permitted).[677] According to one of these commenters, gradually disposing of a large long position purchased from a customer may be the best means of reducing near term price volatility associated with the supply shock of trying to sell the position at once.[678] Another commenter expressed concern about the second requirement of Rule 3b–8(c), which provides that the dealer must determine in the exercise of reasonable diligence that the block cannot be sold to or purchased from others on equivalent or better terms. This commenter stated that this kind of determination would be difficult in less liquid markets because those markets do not have widely disseminated quotes that dealers can use for purposes of comparison.[679]

Beyond the reference to Rule 3b–8(c), a few commenters expressed more general concern about the proposed rule's application to block positioning activity.[680] One commenter noted that the proposal only discussed block positioning in the context of the proposed requirement to hold oneself out, which implies that block positioning activity also must meet the other requirements of the market-making exemption. This commenter requested an explicit recognition that banking entities meet the requirements of the market-making exemption when they enter into block trades for customers, including related trades entered to support the block, such as hedging transactions.[681] Finally, one commenter expressed concern that the inventory metrics in proposed Appendix A would make dealers reluctant to execute large, principal transactions because such trades would have a transparent impact on inventory metrics in the relevant asset class.[682]

iii. Treatment of Anticipatory Market Making

In the proposal, the Agencies proposed that ''*bona fide* market making-related activity may include taking positions in securities in

[664] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA. These commenters requested greater clarity or guidance on the meaning of ''regular'' in the instance of a market maker trading only by appointment. *See id.*

[665] *See* Goldman (Prop. Trading).

[666] *See* Public Citizen; Occupy. One of these commenters further noted that most markets lack a structural framework that would enable monitoring of compliance with this requirement. *See* Occupy.

[667] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; John Reed; Public Citizen.

[668] *See, e.g.,* John Reed; Public Citizen.

[669] *See* AFR *et al.* (Feb. 2012); Occupy.

[670] *See* AFR *et al.* (Feb. 2012)

[671] *See* Occupy.

[672] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy.

[673] *See* Goldman (Prop. Trading).

[674] *See* Occupy.

[675] *See* Joint Proposal, 76 FR 68,871.

[676] *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). *See also infra* note 735 (responding to these comments).

[677] *See* RBC (expressing concern about fire sales); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing concern about fire sales, particularly in less liquid markets where a block position would overwhelm the market and undercut the price a market maker can obtain); Goldman (Prop. Trading) (representing that this requirement could create uncertainty about whether a longer unwind would be permissible and, if so, under what circumstances).

[678] *See* Goldman (Prop. Trading).

[679] *See* RBC.

[680] *See* SIFMA (Asset Mgmt.) (Feb. 2012); Fidelity (requesting that the Agencies explicitly recognize that block trades qualify for the market-making exemption); Oliver Wyman (Feb. 2012).

[681] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[682] *See* Oliver Wyman (Feb. 2012). This commenter estimated that investors trading out of large block positions on their own, without a market maker directly providing liquidity, would have to pay incremental transaction costs between $1.7 and $3.4 billion per year. This commenter estimated a block trading size of $850 billion, based on a haircut of total block trading volume reported for NYSE and Nasdaq. The commenter then estimated, based on market interviews and analysis of standard market impact models provided by dealers, that the market impact of executing large block orders without direct market maker liquidity provision would be the difference between the market impact costs of executing a block trade over a 5-day period versus a 1-day period—which would be approximately 20 to 50 basis points, depending on the size of the trade. *See id.*

anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.'' [683] Many commenters indicated that the language in the proposal is inconsistent with the statute's language regarding near term demands of clients, customers, or counterparties. According to these commenters, the statute's ''designed'' and ''reasonably expected'' language expressly acknowledges that a market maker may need to accumulate inventory before customer demand manifests itself. Commenters further represented that the proposed standard may unduly limit a banking entity's ability to accumulate inventory in anticipation of customer demand.[684]

In addition, two commenters expressed concern that the proposal's language would effectively require a banking entity to engage in impermissible front running.[685] One of these commenters indicated that the Agencies should not restrict anticipatory trading to such a short time period.[686] To the contrary, the other commenter stated that anticipatory accumulation of inventory should be considered to be prohibited proprietary trading.[687] A few commenters noted that the standard in the proposal explicitly refers to securities and requested that the reference be changed to encompass the full scope of financial instruments covered by the rule to avoid ambiguity.[688] Several commenters recommended that the language be eliminated [689] or modified [690] to address the concerns discussed above.

iv. High-Frequency Trading

A few commenters stated that high-frequency trading should be considered prohibited proprietary trading under the rule, not permitted market making-related activity.[691] For example, one commenter stated that the Agencies should not confuse high volume trading and market making. This commenter emphasized that algorithmic traders in general—and high-frequency traders in particular—do not hold themselves out in the manner required by the proposed rule, but instead only offer to buy and sell when they think it is profitable.[692] Another commenter suggested the Agencies impose a resting period on any order placed by a banking entity in reliance on any exemption in the rule by, for example, prohibiting a banking entity from buying and subsequently selling a position within a span of two seconds.[693]

c. Final Requirement To Routinely Stand Ready To Purchase And Sell

Section ____.4(b)(2)(i) of the final rule provides that the trading desk that establishes and manages the financial exposure must routinely stand ready to purchase and sell one or more types of financial instruments related to its financial exposure and be willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments. As discussed in more detail below, the standard of ''routinely'' standing ready to purchase and sell one or more types of financial instruments will be interpreted to account for differences across markets and asset classes. In addition, this requirement provides that a trading desk must be willing and available to provide quotations and transact in the particular types of financial instruments in commercially reasonable amounts and throughout market cycles. Thus, a trading desk's activities would not meet the terms of the market-making exemption if, for example, the trading desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular, intermittent basis.

While this provision of the market-making exemption has some similarity to the requirement to hold oneself out in § ____.4(b)(2)(ii) of the proposed rule, the Agencies have made a number of refinements in response to comments. Specifically, a number of commenters expressed concern that the proposed requirement did not sufficiently account for differences between markets and asset classes and would unduly limit certain types of market making by requiring ''regular or continuous'' quoting in a particular instrument.[694] The explanation of this requirement in the proposal was intended to address many of these concerns. For example, the Agencies stated that the proposed ''indicia cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market-making activity is conducted.'' [695] Nonetheless, the Agencies believe that certain modifications are warranted to clarify the rule and to prevent a potential chilling effect on market making-related activities conducted by banking entities.

Commenters represented that the requirement that a trading desk hold itself out as being willing to buy and sell ''on a regular or continuous basis,'' as was originally proposed, was impossible

[683] Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8356–8357.

[684] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (expressing concern that requiring trades to be related to clear demonstrable trading interest could curtail the market-making function by removing a market maker's discretion to develop inventory to best serve its customers and adversely restrict liquidity); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing general concern that the standard creates limitations on a market maker's inventory). These comments are addressed in Part IV.A.3.c.2., *infra.*

[685] *See* Goldman (Prop. Trading); Occupy. *See also* Public Citizen (expressing general concern that accumulating positions in anticipation of demand opens issues of front running).

[686] *See* Goldman (Prop. Trading).

[687] *See* Occupy.

[688] *See* Goldman (Prop. Trading); ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[689] *See* BoA (stating that a market maker must acquire inventory in advance of express customer demand and customers expect a market maker's inventory to include not only the financial instruments in which customers have previously traded, but also instruments that the banking entity believes they may want to trade); Occupy.

[690] *See* Morgan Stanley (suggesting a new standard providing that a purchase or sale must be ''reasonably consistent with observable customer demand patterns and, in the case of new asset classes or markets, with reasonably expected future developments on the basis of the trading unit's client relationships''); Chamber (Feb. 2012) (requesting that the final rule permit market makers to make individualized assessments of anticipated customer demand based on their expertise and experience in the markets and make trades according to those assessments); Goldman (Prop. Trading) (recommending that the Agencies instead focus on how trading activities are ''designed'' to meet the reasonably expected near term demands of clients over time, rather than whether those demands have actually manifested themselves at a given point in time); ISDA (Feb. 2012) (stating that the Agencies should clarify this language to recognize differences between liquid and illiquid markets and noting that illiquid and low volume markets necessitate that swap dealers take a longer and broader view than dealers in liquid markets).

[691] *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[692] *See* Better Markets (Feb. 2012). *See also infra* note 742 (addressing this issue).

[693] *See* Occupy.

[694] *See supra* Part IV.A.3.c.1.b. (discussing comments on this issue). The Agencies did not intend for the reference to ''covered financial position'' in the proposed rule to imply a single instrument, although commenters contended that the proposal may not have been sufficiently clear on this point.

[695] Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8356.

to meet or impractical in the context of many markets, especially less liquid markets.[696] Accordingly, the final rule requires a trading desk that establishes and manages the financial exposure to ''routinely'' stand ready to trade one or more types of financial instruments related to its financial exposure. As discussed below, the meaning of ''routinely'' will account for the liquidity, maturity, and depth of the market for a type of financial instrument, which should address commenter concern that the proposed standard would not work in less liquid markets and would have a chilling effect on banking entities' ability to act as market makers in less liquid markets. A concept of market making that is applicable across securities, commodity futures, and derivatives markets has not previously been defined by any of the Agencies. Thus, while this standard is based generally on concepts from the securities laws and is consistent with the CFTC's and SEC's description of market making in swaps,[697] the Agencies note that it is not directly based on an existing definition of market making.[698] Instead, the approach taken in the final rule is intended to take into account and accommodate the conditions in the relevant market for the financial instrument in which the banking entity is making a market.

i. Definition of ''Trading Desk''

The Agencies are adopting a market-making exemption with requirements that generally focus on a financial exposure managed by a ''trading desk'' of a banking entity and such trading desk's market-maker inventory. The market-making exemption as originally proposed would have applied to ''a trading desk or other organizational unit'' of a banking entity. In addition, for purposes of the proposed requirement to report and record certain quantitative measurements, the proposal defined the term ''trading unit'' as each of the following units of organization of a banking entity: (i) Each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity; (ii) each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units described in paragraph (i); and (iii) all trading operations, collectively.[699]

The Agencies received few comments regarding the organizational level at which the requirements of the market-making exemption should apply, and many of the commenters that addressed this issue did not describe their suggested approach in detail.[700] One commenter suggested that the market-making exemption apply to each ''trading unit'' of a banking entity, defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity.'' [701] This suggested approach is substantially similar to the second prong of the Agencies' proposed definition of ''trading unit'' in Appendix A of the proposal. The Agencies described this prong as generally including management or reporting divisions, groups, sub-groups, or other intermediate units of organization used by the banking entity to manage one or more discrete trading units (*e.g.,* ''North American Credit Trading,'' ''Global Credit Trading,'' etc.).[702] The Agencies are concerned that this commenter's suggested approach, or any other approach applying the exemption's requirements to a higher level of organization than the trading desk, would impede monitoring of market making-related activity and detection of impermissible proprietary trading by combining a number of different trading strategies and aggregating a larger volume of trading activities.[703] Further, key requirements in the market-making exemption, such as the required limits and risk management procedures, are generally used by banking entities for risk control and applied at the trading desk level. Thus, applying them at a broader organizational level than the trading desk would create a separate system for compliance with this exemption designed to permit a banking entity to aggregate disparate trading activities and apply limits more generally. Applying the conditions of the exemption at a more aggregated level would allow banking entities more flexibility in trading and could result in a higher volume of trading that could contribute modestly to liquidity.[704] Instead of taking that approach, the Agencies have determined to permit a broader range of market making-related activities that can be effectively controlled by building on risk controls used by trading desks for business purposes. This will allow an individual trader to use instruments or strategies within limits established in the compliance program to confidently trade in the type of financial instruments in which his or her trading desk makes a market. The Agencies believe this addresses concerns that uncertainty would negatively impact liquidity. It also addresses concerns that applying the market-making exemption at a higher level of organization would reduce the effectiveness of the requirements in the final rule aimed at ensuring that the quality and character of trading is consistent with market

[696] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; SSgA (Feb. 2012). Some commenters suggested alternative criteria, such as providing prices upon request, using a historical test of market making, or a purely guidance-based approach. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); FTN; Flynn & Fusselman; JPMC. The Agencies are not adopting a requirement that the trading desk only provide prices upon request because the Agencies believe it would be inconsistent with market making in liquid exchange-traded instruments where market makers regularly or continuously post quotes on an exchange. With respect to one commenter's suggested approach of a historical test of market making, this commenter did not provide enough information about how such a test would work for the Agencies' consideration. Finally, the final rule does not adopt a purely guidance-based approach because, as discussed further above, the Agencies believe it could lead to an increased risk of evasion.

[697] *See Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'',* 77 FR 30596, 30609 (May 23, 2012) (describing market making in swaps as ''routinely standing ready to enter into swaps at the request or demand of a counterparty'').

[698] As a result, activity that is considered market making under this final rule may not necessarily be considered market making for purposes of other laws or regulations, such as the U.S. securities laws, the rules and regulations thereunder, or self-regulatory organization rules. In addition, the Agencies note that a banking entity acting as an underwriter would continue to be treated as an underwriter for purposes of the securities laws and the regulations thereunder, including any liability arising under the securities laws as a result of acting in such capacity, regardless of whether it is able to meet the terms of the market-making exemption for its activities. *See* Sens. Merkley & Levin (Feb. 2012).

[699] *See* Joint Proposal, 76 FR 68,957; CFTC Proposal, 77 FR 8436.

[700] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[701] Morgan Stanley.

[702] *See* Joint Proposal, 76 FR 68,957 n.2.

[703] *See, e.g.,* Occupy (expressing concern that, with respect to the proposed definition of ''trading unit,'' an ''oversized'' unit could combine significantly unrelated trading desks, which would impede detection of proprietary trading activity).

[704] The Agencies recognize that the proposed rule's application to a trading desk ''or other organizational unit'' would have provided banking entities with this type of flexibility to determine the level of organization at which the market-making exemption should apply based on the entity's particular business structure and trading strategies, which would likely reduce the burdens of this aspect of the final rule. However, for the reasons noted above regarding application of this exemption to a higher organizational level than the trading desk, the Agencies are not adopting the ''or other organizational unit'' language.

making-related activity and would increase the risk of evasion. Moreover, several provisions of the final rule are intended to account for the liquidity, maturity, and depth of the market for a given type of financial instrument in which the trading desk makes a market. The final rule takes account of these factors to, among other things, respond to commenters' concerns about the proposed rule's potential impact on market making in less liquid markets. Applying these requirements at an organizational level above the trading desk would be more likely to result in aggregation of trading in various types of instruments with differing levels of liquidity, which would make it more difficult for these market factors to be taken into account for purposes of the exemption (for example, these factors are considered for purposes of tailoring the analysis of reasonably expected near term demands of customers and establishing risk, inventory, and duration limits).

Thus, the Agencies continue to believe that certain requirements of the exemption should apply to a relatively granular level of organization within a banking entity (or across two or more affiliated banking entities). These requirements of the final market-making exemption have been formulated to best reflect the nature of activities at the trading desk level of granularity.

As explained below, the Agencies are applying certain requirements to a ''trading desk'' of a banking entity and adopting a definition of this term in the final rule.[705] The definition of ''trading desk'' is similar to the first prong of the proposed definition of ''trading unit.'' The Agencies are not adopting the proposed ''or other organizational unit'' language because the Agencies are concerned that approach would have provided banking entities with too much discretion to independently determine the organizational level at which the requirements should apply, including a more aggregated level of organization, which could lead to evasion of the general prohibition on proprietary trading and the other concerns noted above. The Agencies believe that adopting an approach focused on the trading desk level will allow banking entities and the Agencies to better distinguish between permitted market making-related activities and trading that is prohibited by section 13 of the BHC Act and, thus, will prevent evasion of the statutory requirements, as discussed in more detail below. Further, as discussed below, the Agencies believe that applying requirements at the trading desk level is balanced by the financial exposure-based approach, which will address commenters' concerns about the burdens of trade-by-trade analyses.

In the final rule, trading desk is defined to mean the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed.[706] The geographic location of individual traders is not dispositive for purposes of the analysis of whether the traders may comprise a single trading desk. For instance, a trading desk making markets in U.S. investment grade telecom corporate credits may use trading personnel in both New York (to trade U.S. dollar-denominated bonds issued by U.S.-incorporated telecom companies) and London (to trade Euro-denominated bonds issued by the same type of companies). This approach allows more effective management of risks of trading activity by requiring the establishment of limits, management oversight, and accountability at the level where trading activity actually occurs. It also allows banking entities to tailor the limits and procedures to the type of instruments traded and markets served by each trading desk.

In response to comments, and as discussed below in the context of the ''financial exposure'' definition, a trading desk may manage a financial exposure that includes positions in different affiliated legal entities.[707] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. Using the previous example, the U.S. investment grade telecom corporate credit trading desk may include traders working for or booking into a broker-dealer entity (for corporate bond trades), a security-based swap dealer entity (for single-name CDS trades), and/or a swap dealer entity (for index CDS or interest rate swap hedges). To clarify this issue, the definition of ''trading desk'' specifically provides that the desk can buy or sell financial instruments ''for the trading account of a banking entity or an affiliate thereof.'' Thus, a trading desk need not be constrained to a single legal entity, although it is permissible for a trading desk to only trade for a single legal entity. A trading desk booking positions in different affiliated legal entities must have records that identify all positions included in the trading desk's financial exposure and where such positions are held, as discussed below.[708]

The Agencies believe that establishing a defined organizational level at which many of the market-making exemption's requirements apply will address potential evasion concerns. Applying certain requirements of the market-making exemption at the trading desk level will strengthen their effectiveness and prevent evasion of the exemption by ensuring that the aggregate trading activities of a relatively limited group of traders on a single desk are conducted in a manner that is consistent with the exemption's standards. In particular, because many of the requirements in the market-making exemption look to the specific type(s) of financial instruments in which a market is being made, and such requirements are designed to take into account differences among markets and asset classes, the Agencies believe it is important that these requirements be applied to a discrete and identifiable unit engaged in, and operated by personnel whose responsibilities relate to, making a market in a specific set or type of financial instruments. Further, applying requirements at the trading desk level should facilitate banking entity monitoring and review of compliance with the exemption by limiting the aggregate trading volume that must be reviewed, as well as allowing consideration of the particular facts and circumstances of the desk's trading activities (*e.g.,* the liquidity, maturity, and depth of the market for the relevant types of financial instruments). As discussed above, the Agencies believe that applying the requirements of the market-making exemption to a higher level of organization would reduce the ability to consider the liquidity, maturity, and depth of the market for a type of financial instrument, would impede effective monitoring and compliance reviews, and would increase the risk of evasion.

[705] *See* final rule § ____.3(e)(13).

[706] For example, the Agencies expect a banking entity may determine the foreign exchange options desk to be a trading desk; however, the Agencies do not expect a banking entity to consider an individual Japanese Yen options trader (*i.e.,* the trader in charge of all Yen-based options trades) as a trading desk, unless the banking entity manages its profit and loss, market making, and hedging in Japanese Yen options independently of all other financial instruments.

[707] *See infra* note 724 and accompanying text. Several commenters noted that market-making activities may be conducted across separate affiliated legal entities. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[708] *See infra* note 727 and accompanying text.

ii. Definitions of ''Financial Exposure'' and ''Market-Maker Inventory''

Certain requirements of the proposed market-making exemption referred to a ''purchase or sale of a [financial instrument].'' [709] Even though the Agencies did not intend to require a trade-by-trade review, a significant number of commenters expressed concern that this language could be read to require compliance with the proposed market-making exemption on a transaction-by-transaction basis.[710] In response to these concerns, the Agencies are modifying the exemption to clarify the manner in which compliance with certain provisions will be assessed. In particular, rather than a transaction-by-transaction focus, the market-making exemption in the final rule focuses on two related aspects of market-making activity: A trading desk's ''market-maker inventory'' and its overall ''financial exposure.'' [711]

The Agencies are adopting an approach that focuses on both a trading desk's financial exposure and market-maker inventory in recognition that market making-related activity is best viewed in a holistic manner and that, during a single day, a trading desk may engage in a large number of purchases and sales of financial instruments. While all these transactions must be conducted in compliance with the market-making exemption, the Agencies recognize that they involve financial instruments for which the trading desk acts as market maker (*i.e.,* by standing ready to purchase and sell that type of financial instrument) and instruments that are acquired to manage the risks of positions in financial instruments for which the desk acts as market maker, but in which the desk is not itself a market maker.[712]

The final rule requires that activity by a trading desk under the market-making exemption be evaluated by a banking entity through monitoring and setting limits for the trading desk's market-maker inventory and financial exposure. The market-maker inventory of a trading desk includes the positions in financial instruments, including derivatives, in which the trading desk acts as market maker. The financial exposure of the trading desk includes the aggregate risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk acts as a market maker, but in which the trading desk does not itself make a market, as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker. In addition, the trading desk generally must maintain its market-maker inventory and financial exposure within its market-maker inventory limit and its financial exposure limit, respectively and, to the extent that any limit of the trading desk is exceeded, the trading desk must take action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[713] Thus, if market movements cause a trading desk's financial exposure to exceed one or more of its risk limits, the trading desk must promptly take action to reduce its financial exposure or obtain approval for an increase to its limits through the required escalation procedures, detailed below. A trading desk may not, however, enter into a trade that would cause it to exceed its limits without first receiving approval through its escalation procedures.[714]

Under the final rule, the term market-maker inventory is defined to mean all of the positions, in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section, that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[715] Those financial instruments in which a trading desk acts as market maker must be identified in the trading desk's compliance program under § ____ .4(b)(2)(iii)(A) of the final rule. As used throughout this **SUPPLEMENTARY INFORMATION**, the term ''inventory'' refers to both the retention of financial instruments (*e.g.,* securities) and, in the context of derivatives trading, the risk exposures arising out of market-making related activities.[716] Consistent with the statute, the final rule requires that the market-maker inventory of a trading desk be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

The financial exposure concept is broader in scope than market-maker inventory and reflects the aggregate risks of the financial instruments (as well as any associated loans, spot commodities, or spot foreign exchange or currency) the trading desk manages as part of its market making-related activities.[717] Thus, a trading desk's financial exposure will take into account a trading desk's positions in instruments for which it does not act as a market maker, but which are established as part of its market making-related activities, which includes risk mitigation and hedging. For instance, a trading desk that acts as a market maker in Euro-denominated corporate bonds may, in addition to Euro-denominated bonds, enter into credit default swap transactions on individual European corporate bond issuers or an index of European corporate bond issuers in order to hedge its exposure arising from its corporate bond inventory, in accordance with its documented hedging policies and procedures. Though only the corporate bonds would be considered as part of the trading desk's market-maker inventory, its overall financial exposure would also include the credit default swaps used for hedging purposes.

As noted above, the Agencies believe the extent to which a trading desk is engaged in permitted market making-related activities is best determined by

[709] *See* proposed rule § ____.4(b).

[710] Some commenters also contended that language in proposed Appendix B raised transaction-by-transaction implications. *See supra* notes 517 to 524 and accompanying text (discussing commenters' transaction-by-transaction concerns).

[711] The Agencies are not adopting a transaction-by-transaction approach because the Agencies are concerned that such an approach would be unduly burdensome or impractical and inconsistent with the manner in which *bona fide* market making-related activity is conducted. Additionally, the Agencies are concerned that the burdens of such an approach would cause banking entities to significantly reduce or cease market making-related activities, which would cause negative market impacts harmful to both investors and issuers, as well as the financial system generally.

[712] *See* Joint Proposal, 76 FR 68,870 n.146 (''The Agencies note that a market maker may often make a market in one type of [financial instrument] and hedge its activities using different [financial instruments] in which it does not make a market.''); CFTC Proposal, 77 FR 8356 n.152.

[713] *See* final rule § ____.4(b)(2)(iv).

[714] *See* final rule § ____.4(b)(2)(iii)(E).

[715] *See* final rule § ____.4(b)(5).

[716] As noted in the proposal, certain types of market making-related activities, such as market making in derivatives, involves the retention of principal exposures rather than the retention of actual financial instruments. *See* Joint Proposal, 76 FR 68,869 n.143; CFTC Proposal, 77 FR 8354 n.149. This type of activity would be included under the concept of ''inventory'' in the final rule.

[717] The Agencies recognize that under the statute a banking entity's positions in loans, spot commodities, and spot foreign exchange or currency are not subject to the final rule's restrictions on proprietary trading. Thus, a banking entity's trading in these instruments does not need to comply with the market-making exemption or any other exemption to the prohibition on proprietary trading. A banking entity may, however, include exposures in loans, spot commodities, and spot foreign exchange or currency that are related to the desk's market-making activities in determining the trading desk's financial exposure and in turn, the desk' s financial exposure limits under the market-making exemption. The Agencies believe this will provide a more accurate picture of the trading desk's financial exposure. For example, a market maker in foreign exchange forwards or swaps may mitigate the risks of its market-maker inventory with spot foreign exchange.

evaluating both the financial exposure that results from the desk's trading activity and the amount, types, and risks of the financial instruments in the desk's market-maker inventory. Both concepts are independently valuable and will contribute to the effectiveness of the market-making exemption. Specifically, a trading desk's financial exposure will highlight the net exposure and risks of its positions and, along with an analysis of the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of that exposure consistent with its limits, the extent to which it is appropriately managing the risk of its market-maker inventory consistent with applicable limits, all of which are significant to an analysis of whether a trading desk is engaged in market making-related activities. An assessment of the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory will identify the aggregate amount of the desk's inventory in financial instruments for which it acts as market maker, the types of these financial instruments that the desk holds at a particular time, and the risks arising from such holdings. Importantly, an analysis of a trading desk's market-maker inventory will inform the extent to which this inventory is related to the reasonably expected near term demands of clients, customers, or counterparties.

Because the market-maker inventory concept is more directly related to the financial instruments that a trading desk buys and sells from customers than the financial exposure concept, the Agencies believe that requiring review and analysis of a trading desk's market-maker inventory, as well as its financial exposure, will enhance compliance with the statute's near-term customer demand requirement. While the amount, types, and risks of a trading desk's market-maker inventory are constrained by the near-term customer demand requirement, any other positions in financial instruments managed by the trading desk as part of its market making-related activities (*i.e.,* those reflected in the trading desk's financial exposure, but not included in the trading desk's market-maker inventory) are also constrained because they must be consistent with the market-maker inventory or, if taken for hedging purposes, designed to reduce the risks of the trading desk's market-maker inventory.

The Agencies note that disaggregating the trading desk's market-maker inventory from its other exposures also allows for better identification of the trading desk's hedging positions in instruments for which the trading desk does not make a market. As a result, a banking entity's systems should be able to readily identify and monitor the trading desk's hedging positions that are not in its market-maker inventory. As discussed in Part IV.A.3.c.3., a trading desk must have certain inventory and risk limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its financial exposure that are designed to facilitate the trading desk's compliance with the exemption and that are based on the nature and amount of the trading desk's market making-related activities, including analyses regarding the reasonably expected near term demands of customers.[718]

The final rule also requires these policies and procedures to contain escalation procedures if a trade would exceed the limits set for the trading desk. However, the final rule does not permit a trading desk to exceed the limits solely based on customer demand. Rather, before executing a trade that would exceed the desk's limits or changing the desk's limits, a trading desk must first follow the relevant escalation procedures, which may require additional approval within the banking entity and provide demonstrable analysis that the basis for any temporary or permanent increase in limits is consistent with the reasonably expected near term demands of customers.

Due to these considerations, the Agencies believe the final rule should result in more efficient compliance analyses on the part of both banking entities and Agency supervisors and examiners and should be less costly for banking entities to implement than a transaction-by-transaction or instrument-by-instrument approach. For example, the Agencies believe that some banking entities already compute and monitor most trading desks' financial exposures for risk management or other purposes.[719] The Agencies also believe that focusing on the financial exposure and market-maker inventory of a trading desk, as opposed to each separate individual transaction, is consistent with the statute's goal of reducing proprietary trading risk in the banking system and its exemption for market making-related *activities.* The Agencies recognize that banking entities may not currently disaggregate trading desks' market-maker inventory from their financial exposures and that, to the extent banking entities do not currently separately identify trading desks' market-maker inventory, requiring such disaggregation for purposes of this rule will impose certain costs. In addition, the Agencies understand that an approach focused solely on the aggregate of all the unit's trading positions, as suggested by some commenters, would present fewer burdens.[720] However, for the reasons discussed above, the Agencies believe such disaggregation is necessary to give full effect to the statute's near term customer demand requirement.

The Agencies note that whether a financial instrument or exposure stemming from a derivative is considered to be market-maker inventory is based only on whether the desk makes a market in the financial instrument, regardless of the type of counterparty or the purpose of the transaction. Thus, the Agencies believe that banking entities should be able to develop a standardized methodology for identifying a trading desk's positions and exposures in the financial instruments for which it acts as a market maker. As further discussed in this Part, a trading desk's financial exposure must reflect the aggregate risks managed by the trading desk as part of its market making-related activities,[721] and a banking entity should be able to demonstrate that the financial exposure of a trading desk is related to its market-making activities.

The final rule defines ''financial exposure'' to mean the ''aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.'' [722] In this context, the term ''aggregate'' does not imply that a long exposure in one instrument can be combined with a short exposure in a similar or related

[718] *See infra* Part IV.A.3.c.2.c.; final rule § ____.4(b)(2)(iii)(C).

[719] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that modern trading units generally view individual positions as a bundle of characteristics that contribute to their complete portfolio). *See also* Federal Reserve Board, Trading and Capital-Markets Activities Manual § 2000.1 (Feb. 1998) (''The risk-measurement system should also permit disaggregation of risk by type and by customer, instrument, or business unit to effectively support the management and control of risks.'').

[720] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[721] *See* final rule § ____.4(b)(4).

[722] Final rule § ____.4(b)(4). For example, in the case of derivatives, a trading desk's financial position will be the residual risks of the trading desk's open positions. For instance, an options desk may have thousands of open trades at any given time, including hedges, but the desk will manage, among other risk factors, the trading desk's portfolio delta, gamma, rho, and volatility.

instrument to yield a total exposure of zero. Instead, such a combination may reduce a trading desk's economic exposure to certain risk factors that are common to both instruments, but it would still retain any basis risk between those financial instruments or potentially generate a new risk exposure in the case of purposeful hedging.

With respect to the frequency with which a trading desk should determine its financial exposure and the amount, types, and risks of the financial instruments in its market-maker inventory, a trading desk's financial exposure and market-maker inventory should be evaluated and monitored at a frequency that is appropriate for the trading desk's trading strategies and the characteristics of the financial instruments the desk trades, including historical intraday volatility. For example, a trading desk that repeatedly acquired and then terminated significant financial exposures throughout the day but that had little or no financial exposure at the end of the day should assess its financial exposure based on its intraday activities, not simply its end-of-day financial exposure. The frequency with which a trading desk's financial exposure and market-maker inventory will be monitored and analyzed should be specified in the trading desk's compliance program.

A trading desk's financial exposure reflects its aggregate risk exposures. The types of ''aggregate risks'' identified in the trading desk's financial exposure should reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk acts as market maker or that the desk uses for risk management purposes pursuant to this exemption, including the liquidity, maturity, and depth of the market for the relevant types of financial instruments. Thus, market factors reflected in a trading desk's financial exposure should include all significant and relevant factors associated with the products and instruments in which the desk trades as market maker or for risk management purposes, including basis risk arising from such positions.[723] Similarly, an assessment of the risks of the trading desk's market-maker inventory must reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk makes a market. Importantly, a trading desk's financial exposure and the risks of its market-maker inventory will change based on the desk's trading activity (*e.g.,* buying an instrument that it did not previously hold, increasing its position in an instrument, or decreasing its position in an instrument) as well as changing market conditions related to instruments or positions managed by the trading desk.

Because the final rule defines ''trading desk'' based on operational functionality rather than corporate formality, a trading desk's financial exposure may include positions that are booked in different affiliated legal entities.[724] The Agencies understand that positions may be booked in different legal entities for a variety of reasons, including regulatory reasons. For example, a trading desk that makes a market in corporate bonds may book its corporate bond positions in an SEC-registered broker-dealer and may book index CDS positions acquired for hedging purposes in a CFTC-registered swap dealer. A financial exposure that reflects both the corporate bond position and the index CDS position better reflects the economic reality of the trading desk's risk exposure (*i.e.,* by showing that the risk of the corporate bond position has been reduced by the index CDS position).

In addition, a trading desk engaged in market making-related activities in compliance with the final rule may direct another organizational unit of the banking entity or an affiliate to execute a risk-mitigating transaction on the trading desk's behalf.[725] The other organizational unit may rely on the market-making exemption for these purposes only if: (i) The other organizational unit acts in accordance with the trading desk's risk management policies and procedures established in accordance with § ____.4(b)(2)(iii) of the final rule; and (ii) the resulting risk-mitigating position is attributed to the trading desk's financial exposure (and not the other organizational unit's financial exposure) and is included in the trading desk's daily profit and loss calculation. If another organizational unit of the banking entity or an affiliate establishes a risk-mitigating position for the trading desk on its own accord (*i.e.,* not at the direction of the trading desk) or if the risk-mitigating position is included in the other organizational unit's financial exposure or daily profit and loss calculation, then the other organizational unit must comply with the requirements of the hedging exemption for such activity.[726] It may not rely on the market-making exemption under these circumstances. If a trading desk engages in a risk-mitigating transaction with a second trading desk of the banking entity or an affiliate that is also engaged in permissible market making-related activities, then the risk-mitigating position would be included in the first trading desk's financial exposure and the contra-risk would be included in the second trading desk's market-maker inventory and financial exposure. The Agencies believe the net effect of the final rule is to allow individual trading desks to efficiently manage their own hedging and risk mitigation activities on a holistic basis, while only allowing for external hedging directed by staff outside of the trading desk under the additional requirements of the hedging exemption.

To include in a trading desk's financial exposure either positions held at an affiliated legal entity or positions established by another organizational unit on the trading desk's behalf, a banking entity must be able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section 13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's financial exposure for purposes of the market-making exemption. Similarly, the supervisors and examiners of any Agency that has supervisory authority over the banking entity that holds financial instruments that are being included in another trading desk's financial exposure for purposes of the market-making exemption must have the same level of access to the records of the trading desk.[727] Banking entities should be prepared to provide all records that identify all positions included in a trading desk's financial exposure and where such positions are held.

[723] As discussed in Part IV.A.3.c.3., a banking entity must establish, implement, maintain, and enforce policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell and the products, instruments, or exposures each trading desk may use for risk management purposes. *See* final rule § ____.4(b)(2)(iii).

[724] Other statutory or regulatory requirements, including those based on prudential safety and soundness concerns, may prevent or limit a banking entity from booking hedging positions in a legal entity other than the entity taking the underlying position.

[725] *See infra* Part IV.A.3.c.4.

[726] Under these circumstances, the other organizational unit would also be required to meet the hedging exemption's documentation requirement for the risk-mitigating transaction. *See* final rule § ____.5(c).

[727] A banking entity must be able to provide such records when a related position is held at an affiliate, even if the affiliate and the banking entity are not subject to the same Agency's regulatory jurisdiction.

As an example of how a trading desk's market-maker inventory and financial exposure will be analyzed under the market-making exemption, assume a trading desk makes a market in a variety of U.S. corporate bonds and hedges its aggregated positions with a combination of exposures to corporate bond indexes and specific name CDS in which the desk does not make a market. To qualify for the market-making exemption, the trading desk would have to demonstrate, among other things, that: (i) The desk routinely stands ready to purchase and sell the U.S. corporate bonds, consistent with the requirement of § ____.4(b)(2)(i) of the final rule, and these instruments (or category of instruments) are identified in the trading desk's compliance program; (ii) the trading desk's market-maker inventory in U.S. corporate bonds is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, consistent with the analysis and limits established by the banking entity for the trading desk; (iii) the trading desk's exposures to corporate bond indexes and single name CDS are designed to mitigate the risk of its financial exposure, are consistent with the products, instruments, or exposures and the techniques and strategies that the trading desk may use to manage its risk effectively (and such use continues to be effective), and do not exceed the trading desk's limits on the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; and (iv) the aggregate risks of the trading desk's exposures to U.S. corporate bonds, corporate bond indexes, and single name CDS do not exceed the trading desk's limits on the level of exposures to relevant risk factors arising from its financial exposure.

Our focus on the financial exposure of a trading desk, rather than a trade-by-trade requirement, is designed to give banking entities the flexibility to acquire not only market-maker inventory, but positions that facilitate market making, such as positions that hedge market-maker inventory.[728] As commenters pointed out, a trade-by-trade requirement would view trades in isolation and could fail to recognize that certain trades that are not customer-facing are nevertheless integral to market making and financial intermediation.[729] The Agencies understand that the risk-reducing effects of combining large diverse portfolios could, in certain instances, mask otherwise prohibited proprietary trading.[730] However, the Agencies do not believe that taking a transaction-by-transaction approach is necessary to address this concern. Rather, the Agencies believe that the broader definitions of ''financial exposure'' and ''market-maker inventory'' coupled with the tailored definition of ''trading desk'' facilitates the analysis of aggregate risk exposures and positions in a manner best suited to apply and evaluate the market-making exemption.

In short, this approach is designed to mitigate the costs of a trade-by-trade analysis identified by commenters. The Agencies recognize, however, that this approach is only effective at achieving the goals of the section 13 of the BHC Act—promoting financial intermediation and limiting speculative risks within banking entities—if there are limits on a trading desk's financial exposure. That is, a permissive market-making exemption that gives banking entities maximum discretion in acquiring positions to provide liquidity runs the risk of also allowing banking entities to engage in speculative trades. As discussed more fully in the following Parts of this **SUPPLEMENTARY INFORMATION**, the final market-making exemption provides a number of controls on a trading desk's financial exposure. These controls include, among others, a provision requiring that a trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers and that any other financial instruments managed by the trading desk be designed to mitigate the risk of such desk's market-maker inventory. In addition, the final market-making exemption requires the trading desk's compliance program to include appropriate risk and inventory limits tied to the near term demand requirement, as well as escalation procedures if a trade would exceed such limits. The compliance program, which includes internal controls and independent testing, is designed to prevent instances where transactions not related to providing financial intermediation services are part of a desk's financial exposure.

iii. Routinely Standing Ready To Buy and Sell

The requirement to routinely stand ready to buy and sell a type of financial instrument in the final rule recognizes that market making-related activities differ based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument. For example, a trading desk acting as a market maker in highly liquid markets would engage in more regular quoting activity than a market maker in less liquid markets. Moreover, the Agencies recognize that the maturity and depth of the market also play a role in determining the character of a market maker's activity.

As noted above, the standard of ''routinely'' standing ready to buy and sell will differ across markets and asset classes based on the liquidity, maturity, and depth of the market for the type of financial instrument. For instance, a trading desk that is a market maker in liquid equity securities generally should engage in very regular or continuous quoting and trading activities on both sides of the market. In less liquid markets, a trading desk should engage in regular quoting activity across the relevant type(s) of financial instruments, although such quoting may be less frequent than in liquid equity markets.[731] Consistent with the CFTC's and SEC's interpretation of market making in swaps and security-based swaps for purposes of the definitions of ''swap dealer'' and ''security-based swap dealer,'' ''routinely'' in the swap market context means that the trading desk should stand ready to enter into swaps or security-based swaps at the request or demand of a counterparty more frequently than occasionally.[732] The Agencies note that a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or it may routinely stand ready to enter into derivatives on either side of the market and then enter into one or more offsetting positions in the derivatives market or another market, particularly in the case of relatively less liquid derivatives. While a trading desk may respond to requests to trade certain

[728] The Agencies believe it is appropriate to apply the requirements of the exemption to the financial exposure of a ''trading desk,'' rather than the portfolio of a higher level of organization, for the reasons discussed above, including our concern that aggregating a large number of disparate positions and exposures across a range of trading desks could increase the risk of evasion. *See supra* Part IV.A.3.c.1.c.i. (discussing the determination to apply requirements at the trading desk level).

[729] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[730] *See, e.g.,* Occupy.

[731] Indeed, in the most specialized situations, such quotations may only be provided upon request. *See infra* note 735 and accompanying text (discussing permissible block positioning).

[732] The Agencies will consider factors similar to those identified by the CFTC and SEC in connection with this standard. *See Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'',* 77 FR 30596, 30609 (May 23, 2012)

products, such as custom swaps, even if it does not normally quote in the particular product, the trading desk should hedge against the resulting exposure in accordance with its financial exposure and hedging limits.[733] Further, the Agencies continue to recognize that market makers in highly illiquid markets may trade only intermittently or at the request of particular customers, which is sometimes referred to as trading by appointment.[734] A trading desk's block positioning activity would also meet the terms of this requirement provided that, from time to time, the desk engages in block trades (*i.e.,* trades of a large quantity or with a high dollar value) with customers.[735]

Regardless of the liquidity, maturity, and depth of the market for a particular type of financial instrument, a trading desk should have a pattern of providing price indications on either side of the market and a pattern of trading with customers on each side of the market. In particular, in the case of relatively illiquid derivatives or structured instruments, it would not be sufficient to demonstrate that a trading desk on occasion creates a customized instrument or provides a price quote in response to a customer request. Instead, the trading desk would need to be able to demonstrate a pattern of taking these actions in response to demand from multiple customers with respect to both long and short risk exposures in identified types of instruments.

This requirement of the final rule applies to a trading desk's activity in one or more ''types'' of financial instruments.[736] The Agencies recognize that, in some markets, such as the corporate bond market, a market maker may regularly quote a subset of instruments (generally the more liquid instruments), but may not provide regular quotes in other related but less liquid instruments that the market maker is willing and available to trade. Instead, the market maker would provide a price for those instruments upon request.[737] The trading desk's activity, in the aggregate for a particular type of financial instrument, indicates whether it is engaged in activity that is consistent with § ____.4(b)(2)(i) of the final rule.

Notably, this requirement provides that the types of financial instruments for which the trading desk routinely stands ready to purchase and sell must be related to its authorized market-maker inventory and it authorized financial exposure. Thus, the types of financial instruments for which the desk routinely stands ready to buy and sell should compose a significant portion of its overall financial exposure. The only other financial instruments contributing to the trading desk's overall financial exposure should be those designed to hedge or mitigate the risk of the financial instruments for which the trading desk is making a market. It would not be consistent with the market-making exemption for a trading desk to hold only positions in, or be exposed to, financial instruments for which the trading desk is not a market maker.[738]

A trading desk's routine presence in the market for a particular type of financial instrument would not, on its own, be sufficient grounds for relying on the market-making exemption. This is because the frequency at which a trading desk is active in a particular market would not, on its own, distinguish between permitted market making-related activity and impermissible proprietary trading. In response to comments, the final rule provides that a trading desk also must be willing and available to quote, buy and sell, or otherwise enter into long and short positions in the relevant type(s) of financial instruments for its

[733] The Agencies recognize that, as noted by commenters, preventing a banking entity from conducting customized transactions with customers may impact customers' risk exposures or transaction costs. *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies are not prohibiting this activity under the final rule, as discussed in this Part.

[734] The Agencies have considered comments on the issue of whether trading by appointment should be permitted under the final market-making exemption. The Agencies believe it is appropriate to permit trading by appointment to the extent that there is customer demand for liquidity in the relevant products.

[735] As noted in the preamble to the proposed rule, the size of a block will vary among different asset classes. The Agencies also stated in the proposal that the SEC's definition of ''qualified block positioner'' in Rule 3b–8(c) under the Exchange Act may serve as guidance for determining whether block positioning activity qualifies for the market-making exemption. In referencing that rule as guidance, the Agencies did not intend to imply that a banking entity engaged in block positioning activity would be required to meet all terms of the ''qualified block positioner'' definition at all times. Nonetheless, a number of commenters indicated that it was unclear when a banking entity would need to act as a qualified block positioner in accordance with Rule 3b–8(c) and expressed concern that uncertainty could have a chilling effect on a banking entity's willingness to facilitate customer block trades. *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). For example, a few commenters stated that certain requirements in Rule 3b–8(c) could cause fire sales or general market uncertainty. *See id.* After considering comments, the Agencies have decided that the reference to Rule 3b–8(c) is unnecessary for purposes of the final rule. In particular, the Agencies believe that the requirements in the market-making exemption provide sufficient safeguards, and the additional requirements of the ''qualified block positioner'' definition may present unnecessary burdens or redundancies with the rule, as adopted. For example, the Agencies believe that there is some overlap between § ____.4(b)(2)(ii) of the exemption, which provides that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and Rule 3b–8(c)(iii), which requires the sale of the shares comprising the block as rapidly as possible commensurate with the circumstances. In other words, the market-making exemption would require a banking entity to appropriately manage its inventory when engaged in block positioning activity, but would not speak directly to the timing element given the diversity of markets to which the exemption applies.

As noted above, one commenter analyzed the potential market impact of a complete restriction on a market maker's ability to provide direct liquidity to help a customer execute a large block trade. *See supra* note 682 and accompanying text. Because the Agencies are not restricting a banking entity's ability to engage in block positioning in the manner suggested by this commenter, the Agencies do not believe that the final rule will cause the cited market impact of incremental transaction costs between $1.7 and $3.4 billion per year. The Agencies address this commenter's concern about the impact of inventory metrics on a banking entity's willingness to engage in block trading in Part IV.C.3. (discussing the metrics requirement in the final rule and noting that metrics will not be used to determine compliance with the rule but, rather, will be monitored for patterns over time to identify activities that may warrant further review).

One commenter appeared to request that block trading activity not be subject to all requirements of the market-making exemption. *See* SIFMA (Asset Mgmt.) (Feb. 2012). Any activity conducted in reliance on the market-making exemption, including block trading activity, must meet the requirements of the market-making exemption. The Agencies believe the requirements in the final rule are workable for block positioning activity and do not believe it would be appropriate to subject block positioning to lesser requirements than general market-making activity. For example, trading in large block sizes can expose a trading desk to greater risk than market making in smaller sizes, particularly absent risk management requirements. Thus, the Agencies believe it is important for block positioning activity to be subject to the same requirements, including the requirements to establish risk limits and risk management procedures, as general market-making activity.

[736] This approach is generally consistent with commenters' requested clarification that a trading desk's quoting activity will not be assessed on an instrument-by-instrument basis, but rather across a range of similar instruments for which the trading desk acts as a market maker. *See, e.g.,* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA; Goldman (Prop. Trading).

[737] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[738] The Agencies recognize that there could be limited circumstances under which a trading desk's financial exposure does not relate to the types of financial instruments that it is standing ready to buy and sell for a short period of time. However, the Agencies would expect for such occurrences to be minimal. For example, this scenario could occur if a trading desk unwinds a hedge position after the market-making position has already been unwound or if a trading desk acquires an anticipatory hedge position prior to acquiring a market-making position. As discussed more thoroughly in Part IV.A.3.c.3., a banking entity must establish written policies and procedures, internal controls, analysis, and independent testing that establish appropriate parameters around such activities.

own account in commercially reasonable amounts and throughout market cycles.[739] Importantly, a trading desk would not meet the terms of this requirement if it provides wide quotations relative to prevailing market conditions and is not engaged in other activity that evidences a willingness or availability to provide intermediation services.[740] Under these circumstances, a trading desk would not be standing ready to purchase and sell because it is not genuinely quoting or trading with customers.

In the context of this requirement, ''commercially reasonable amounts'' means that the desk generally must be willing to quote and trade in sizes requested by other market participants.[741] For trading desks that engage in block trading, this would include block trades requested by customers, and this language is not meant to restrict a trading desk from acting as a block positioner. Further, a trading desk must act as a market maker on an appropriate basis throughout market cycles and not only when it is most favorable for it to do so.[742] For example, a trading desk should be facilitating customer needs in both upward and downward moving markets.

As discussed further in Part IV.A.3.c.3., the financial instruments the trading desk stands ready to buy and sell must be identified in the trading desk's compliance program.[743] Certain requirements in the final exemption apply to the amount, types, and risks of these financial instruments that a trading desk can hold in its market-maker inventory, including the near term customer demand requirement[744] and the need to have certain risk and inventory limits.[745]

In response to the proposed requirement that a trading desk or other organizational unit hold itself out, some commenters requested that the Agencies limit the availability of the market-making exemption to trading in particular asset classes or trading on particular venues (*e.g.,* organized trading platforms). The Agencies are not limiting the availability of the market-making exemption in the manner requested by these commenters.[746] Provided there is customer demand for liquidity in a type of financial instrument, the Agencies do not believe the availability of the market-making exemption should depend on the liquidity of that type of financial instrument or the ability to trade such instruments on an organized trading platform. The Agencies see no basis in the statutory text for either approach and believe that the likely harms to investors seeking to trade affected instruments (*e.g.,* reduced ability to purchase or sell a particular instrument, potentially higher transaction costs) and market quality (*e.g.,* reduced liquidity) that would arise under such an approach would not be justified,[747] particularly in light of the minimal benefits that might result from restricting or eliminating a banking entity's ability to hold less liquid assets in connection with its market making-related activities. The Agencies believe these commenters' concerns are adequately addressed by the final rule's requirements in the market-making exemption that are designed to ensure that a trading desk cannot hold risk in excess of what is appropriate to provide intermediation services designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

In response to comments on the proposed interpretation regarding anticipatory position-taking,[748] the Agencies note that the near term demand requirement in the final rule addresses when a trading desk may take positions in anticipation of reasonably expected near term customer demand.[749] The Agencies believe this approach is generally consistent with the comments the Agencies received on this issue.[750] In addition, the Agencies note that modifications to the proposed near term demand requirement in the final rule also address commenters concerns on this issue.[751]

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Consistent with the statute, the proposed rule required that the trading desk or other organizational unit's market making-related activities be, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[752] This requirement is intended to prevent a trading desk from taking a speculative proprietary position that is unrelated to customer needs as part of the desk's

[739] *See, e.g.,* Occupy; Better Markets (Feb. 2012).

[740] One commenter expressed concern that a banking entity may be able to rely on the market-making exemption when it is providing only wide, out of context quotes. *See* Occupy.

[741] As discussed below, this may include providing quotes in the interdealer trading market.

[742] Algorithmic trading strategies that only trade when market factors are favorable to the strategy's objectives or that otherwise frequently exit the market would not be considered to be standing ready to purchase or sell a type of financial instrument throughout market cycles and, thus, would not qualify for the market-making exemption. The Agencies believe this addresses commenters' concerns about high-frequency trading activities that are only active in the market when it is believed to be profitable, rather than to facilitate customers. *See, e.g.,* Better Markets (Feb. 2012). The Agencies are not, however, prohibiting all high-frequency trading activities under the final rule or otherwise limiting high-frequency trading by banking entities by imposing a resting period on their orders, as requested by certain commenters. *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[743] *See* final rule § ____.4(b)(2)(iii)(A).

[744] *See* final rule § ____.4(b)(2)(ii).

[745] *See* final rule § ____.4(b)(2)(iii)(C).

[746] For example, a few commenters requested that the rule prohibit banking entities from market making in assets classified as Level 3 under FAS 157. *See supra* note 651 and accompanying text. The Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule. *See* Joint Proposal, 76 FR 68,859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR 8344 n.107.

Further, a few commenters suggested that the exemption should only be available for trading on an organized trading facility. This type of limitation would require significant and widespread market structure changes (with associated systems and infrastructure costs) in a relatively short period of time, as market making in certain assets is primarily or wholly conducted in the OTC market, and organized trading platforms may not currently exist for these assets. The Agencies do not believe that the costs of such market structure changes would be warranted for purposes of this rule.

[747] As discussed above, a number of commenters expressed concern about the potential market impacts of the perceived restrictions on market making under the proposed rule, particularly with respect to less liquid markets, such as the corporate bond market. *See, e.g.,* Prof. Duffie; Wellington; BlackRock; ICI.

[748] Joint Proposal, 76 FR 68,871 (stating that ''*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties''); CFTC Proposal, 77 FR 8356–8357; *See also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[749] *See* final rule § ____.4(b)(2)(ii); *infra* Part IV.A.3.c.2.c.

[750] *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[751] For example, some commenters suggested that the final rule allow market makers to make individualized assessments of anticipated customer demand, based on their expertise and experience, and account for differences between liquid and less liquid markets. *See* Chamber (Feb. 2012); ISDA (Feb. 2012). The final rule allows such assessments, based on historical customer demand and other relevant factors, and recognizes that near term demand may differ based on the liquidity, maturity, and depth of the market for a particular type of financial instrument. *See infra* Part IV.A.3.c.2.c.iii.

[752] *See* proposed rule § ____.4(b)(2)(iii).

purported market making-related activities.[753]

In the proposal, the Agencies stated that a banking entity's expectations of near term customer demand should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near term demand of those customers based on particular factors, beyond a general expectation of price appreciation. The Agencies further stated that they would not expect the activities of a trading desk or other organizational unit to qualify for the market-making exemption if the trading desk or other organizational unit is engaged wholly or principally in trading that is not in response to, or driven by, customer demands, regardless of whether those activities promote price transparency or liquidity. The proposal stated that, for example, a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule's market-making exemption.[754]

With respect to market making in a security that is executed on an exchange or other organized trading facility, the proposal provided that a market maker's activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy and the market maker is registered, if the exchange or organized trading facility registers market makers. Under the proposal, activities on an exchange or other organized trading facility that primarily take liquidity, rather than provide liquidity, would not qualify for the market-making exemption, even if conducted by a registered market maker.[755]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

As noted above, the proposed near term customer demand requirement would implement language found in the statute's market-making exemption.[756] Some commenters expressed general support for this requirement.[757] For example, these commenters emphasized that the proposed near term demand requirement is an important component that restricts disguised position-taking or market making in illiquid markets.[758] Several other commenters expressed concern that the proposed requirement is too restrictive [759] because, for example, it may impede a market maker's ability to build or retain inventory [760] or may impact a market maker's willingness to engage in block trading.[761] Comments on particular aspects of this proposed requirement are discussed below, including the proposed interpretation of this requirement in the proposal, the requirement's potential impact on market maker inventory, potential differences in this standard across asset classes, whether it is possible to predict near term customer demand, and whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined for purposes of the exemption.

i. The Proposed Guidance for Determining Compliance With the Near Term Customer Demand Requirement

As discussed in more detail above, the proposal set forth proposed guidance on how a banking entity may comply with the proposed near term customer demand requirement.[762] With respect to the language indicating that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation), one commenter stated that it is unclear how a banking entity would be able to make such determinations in markets where trades occur infrequently and customer demand is hard to predict.[763]

Several commenters expressed concern about the proposal's statement that a trading desk or other organizational unit engaged wholly or principally in trading that is not in response to, or driven by, customer demands (*e.g.,* arbitrage trading with non-customers) would not qualify for the exemption, regardless of whether the activities promote price transparency or liquidity.[764] In particular, commenters stated that it would be difficult for a market-making business to try to divide its activities that are in response to customer demand (*e.g.,* customer intermediation and hedging) from activities that promote price transparency and liquidity (*e.g.,* interdealer trading to test market depth or arbitrage trading) in order to determine their proportionality.[765] Another commenter stated that, as a matter of organizational efficiency, firms will often restrict arbitrage trading strategies to certain specific individual traders within the market-making organization, who may sometimes be referred to as a ''desk,'' and expressed concern that this would be prohibited under the rule.[766]

In response to the proposed interpretation regarding market making on an exchange or other organized trading facility (and certain similar language in proposed Appendix B),[767] several commenters indicated that the reference to passive submission of resting orders may be too restrictive and provided examples of scenarios where market makers may need to use market or marketable limit orders.[768] For

[753] *See* Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8357.

[754] *See id.*

[755] *See* Joint Proposal, 76 FR 68,871–68,872; CFTC Proposal, 77 FR 8357.

[756] *See supra* Part IV.A.3.c.2.a.

[757] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Flynn & Fusselman; Better Markets (Feb. 2012).

[758] *See* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[759] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); T. Rowe Price; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation; CIEBA; Credit Suisse (Seidel); SSgA (Feb. 2012); IAA (stating that the proposed requirement is too subjective and would be difficult to administer in a range of scenarios); Barclays; Prof. Duffie.

[760] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies respond to these comments in Part IV.A.3.c.2.c., *infra.* For a discussion of comments regarding inventory management activity conducted in connection with market making, *See* Part IV.A.3.c.2.b.vi., *infra.*

[761] *See, e.g.,* ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation (noting that a market maker may need to hold significant inventory to accommodate potential block trade requests). Two of these commenters stated that a market maker may provide a worse price or may be unwilling to intermediate a large customer position if the market maker has to determine whether holding such position will meet the near term demand requirement, particularly if the market maker would be required to sell the block position over a short period of time. *See* ACLI (Feb. 2012); MetLife. These comments are addressed in Part IV.A.3.c.2.c.iii., *infra.*

[762] *See supra* Part IV.A.3.c.2.a.

[763] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). Another commenter suggested that the Agencies ''establish clear criteria that reflect appropriate revenue from changes in the bid-ask spread,'' noting that a legitimate market maker should be both selling and buying in a rising market (or, likewise, in a declining market). Public Citizen.

[764] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012); *See also infra* Part IV.A.3.c.2.b.viii. (discussing comments on whether arbitrage trading should be permitted under the market-making exemption under certain circumstances).

[765] *See* Goldman (Prop. Trading); RBC. One of these commenters agreed, however, that a trading desk that is ''wholly'' engaged in trading that is unrelated to customer demand should not qualify for the proposed market-making exemption. *See* Goldman (Prop. Trading).

[766] *See* JPMC.

[767] *See* Joint Proposal, 76 FR 68,871–68,872; CFTC Proposal, 77 FR 8357.

[768] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading);

example, many of these commenters stated that market makers may need to enter market or marketable limit orders to: (i) build or reduce inventory;[769] (ii) address order imbalances on an exchange by, for example, using market orders to lessen volatility and restore pricing equilibrium; (iii) hedge market-making positions; (iv) create markets;[770] (v) test the depth of the markets; (vi) ensure that ETFs, American depositary receipts (''ADRs''), options, and other instruments remain appropriately priced;[771] and (vii) respond to movements in prices in the markets.[772] Two commenters noted that distinctions between limit and market or marketable limit orders may not be workable in the international context, where exchanges may not use the same order types as U.S. trading facilities.[773]

A few commenters also addressed the proposed use of a market maker's exchange registration status as part of the analysis.[774] Two commenters stated that the proposed rule should not require a market maker to be registered with an exchange to qualify for the proposed market-making exemption. According to these commenters, there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices. These commenters indicated that any restrictions or burdens on such trading may decrease liquidity or make it harder to provide customers with the best price for their trade.[775] One commenter, however, stated that the exchange registration requirement is reasonable and further supported adding a requirement that traders demonstrate adherence to the same or commensurate standards in markets where registration is not possible.[776]

Some commenters recommended certain modifications to the proposed analysis. For example, a few commenters requested that the rule presume that a trading unit is engaged in permitted market making-related activity if it is registered as a market maker on a particular exchange or organized trading facility.[777] In support of this recommendation, one commenter represented that it would be warranted because registered market makers directly contribute to maintaining liquid and orderly markets and are subject to extensive regulatory requirements in that capacity.[778] Another commenter suggested that the Agencies instead use metrics to compare, in the aggregate and over time, the liquidity that a market maker makes rather than takes as part of a broader consideration of the market-making character of the relevant trading activity.[779]

ii. Potential Inventory Restrictions and Differences Across Asset Classes

A number of commenters expressed concern that the proposed requirement may unduly restrict a market maker's ability to manage its inventory.[780] Several of these commenters stated that limitations on inventory would be especially problematic for market making in less liquid markets, like the fixed-income market, where customer demand is more intermittent and positions may need to be held for a longer period of time.[781] Some commenters stated that the Agencies' proposed interpretation of this requirement would restrict a market maker's inventory in a manner that is inconsistent with the statute. These commenters indicated that the ''designed'' and ''reasonably expected'' language of the statute seem to recognize that market makers must anticipate customer requests and accumulate sufficient inventory to meet those reasonably expected demands.[782] In addition, one commenter represented that a market maker must have wide latitude and incentives for initiating trades, rather than merely reacting to customer requests for quotes, to properly risk manage its positions or to prepare for anticipated customer demand or supply.[783] Many commenters requested certain modifications to the proposed requirement to limit its impact on market maker inventory.[784]

RBC. Comments on proposed Appendix B are discussed further in Part IV.A.3.c.8.b., *infra.* This issue is addressed in note 939 and its accompanying text, *infra.*

[769] Some commenters stated that market makers may need to use market or marketable limit orders to build inventory in anticipation of customer demand or in connection with positioning a block trade for a customer. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). Two of these commenters noted that these order types may be needed to dispose of positions taken into inventory as part of market making. *See* RBC; Goldman (Prop. Trading).

[770] *See* NYSE Euronext.

[771] *See* Goldman (Prop. Trading).

[772] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[773] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[774] *See* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy. *See also infra* notes 940 to 941 and accompanying text (addressing these comments).

[775] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that trading units may currently register as market makers with particular, primary exchanges on which they trade, but will serve in a market-making capacity on other trading venues from time to time); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

[776] *See* Occupy. In the alternative, this commenter would require all market making to be performed on an exchange or organized trading facility. *See id.*

[777] *See* NYSE Euronext (recognizing that registration status is not necessarily conclusive of engaging in market making-related activities); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that to the extent a trading unit is registered on a particular exchange or organized trading facility for any type of financial instrument, all of its activities on that exchange or organized trading facility should be presumed to be market making); Goldman (Prop. Trading). *See also infra* note 940 (responding to these comments). Two commenters noted that certain exchange rules may require market makers to deal for their own account under certain circumstances in order to maintain fair and orderly markets. *See* NYSE Euronext (discussing NYSE rules); Goldman (Prop. Trading) (discussing NYSE and CBOE rules). For example, according to these commenters, NYSE Rule 104(f)(ii) requires a market maker to maintain fair and orderly markets, which may involve dealing for their own account when there is a lack of price continuity, lack of depth, or if a disparity between supply and demand exists or is reasonably anticipated. *See id.*

[778] *See* Goldman (Prop. Trading). This commenter further stated that trading activities of exchange market makers may be particularly difficult to evaluate with customer-facing metrics (because ''specialist'' market makers may not have ''customers''), so conferring a positive presumption of compliance on such market makers would ensure that they can continue to contribute to liquidity, which benefits customers. This commenter noted that, for example, NYSE designated market makers (''DMMs'') are generally prohibited from dealing with customers and companies must ''wall off'' any trading units that act as DMMs. *See id.* (citing NYSE Rule 98).

[779] *See id.* (stating that spread-related metrics, such as Spread Profit and Loss, may be useful for this purpose).

[780] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). These concerns are addressed in Part IV.A.3.c.2.c., *infra.*

[781] *See, e.g.,* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012); RBC.

[782] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[783] *See* Prof. Duffie. However, another commenter stated that a legitimate market maker should respond to customer demand rather than initiate transactions, which is indicative of prohibited proprietary trading. *See* Public Citizen.

[784] *See* Credit Suisse (Seidel) (suggesting that the rule allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand); Barclays (recommending the rule require that ''the market making-related activity is conducted by each trading unit such that its activities (including the maintenance of inventory) are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties consistent with the market and trading patterns of the relevant product, and consistent with the reasonable judgment of the banking entity where such demand cannot be determined with reasonable accuracy''); CIEBA. In addition, some commenters suggested an interpretation that would provide greater discretion to market makers to enter into trades based on factors such as experience and expertise dealing in the market and market exigencies. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012). Two commenters suggested that the proposed requirement should be interpreted to permit market-making activity as it currently exists. *See*

Continued

Commenters' views on the importance of permitting inventory management activity in connection with market making are discussed below in Part IV.A.3.c.2.b.vi.

Several commenters requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes and implement this requirement flexibly.[785] In particular, many of these commenters emphasized that the concept of ''near term demand'' should be different for less liquid markets, where transactions may occur infrequently, and for liquid markets, where transactions occur more often.[786] One commenter requested that the Agencies add the phrase ''based on the characteristics of the relevant market and asset class'' to the end of the requirement to explicitly acknowledge these differences.[787]

iii. Predicting Near Term Customer Demand

Commenters provided views on whether and, if so how, a banking entity may be able to predict near term customer demand for purposes of the proposed requirement.[788] For example, two commenters suggested ways in which a banking entity could predict near term customer demand.[789] One of these commenters indicated that banking entities should be able to utilize current risk management tools to predict near term customer demand, although these tools may need to be adapted to comply with the rule's requirements. According to this commenter, dealers commonly assess the following factors across product lines, which can relate to expected customer demand: (i) Recent volumes and customer trends; (ii) trading patterns of specific customers; (iii) analysis of whether the firm has an ability to win new customer business; (iv) comparison of the current market conditions to prior similar periods; (v) liquidity of large investors; and (vi) the schedule of maturities in customers' existing positions.[790] Another commenter stated that the reasonableness of a market maker's inventory can be measured by looking to the specifics of the particular market, the size of the customer base being served, and expected customer demand, which banking entities should be required to take into account in both their inventory practices and policies and their actual inventories. This commenter recommended that the rule permit a banking entity to assume a position under the market-making exemption if it can demonstrate a track record or reasonable expectation that it can dispose of a position in the near term.[791]

Some commenters, however, emphasized that reasonably expected near term customer demand cannot always be accurately predicted.[792] Several of these commenters requested the Agencies clarify that banking entities will not be subject to regulatory sanctions if reasonably anticipated near term customer demand does not materialize.[793] One commenter further noted that a banking entity entering a new market, or gaining or losing customers, may need greater flexibility in applying the near term demand requirement because its anticipated demand may fluctuate.[794]

iv. Potential Definitions of ''Client,'' ''Customer,'' or ''Counterparty''

Appendix B of the proposal discussed the proposed meaning of the term ''customer'' in the context of permitted market making-related activity.[795] In addition, the proposal inquired whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined in the rule for purposes of the market-making exemption.[796] Commenters expressed varying views on the proposed interpretations in the proposal and on whether these terms should be defined in the final rule.[797]

With respect to the proposed interpretations of the term ''customer'' in Appendix B, one commenter agreed with the proposed interpretations and expressed the belief that the interpretations will allow interdealer market making where brokers or other dealers act as customers. However, this commenter also requested that the Agencies expressly incorporate providing liquidity to other brokers and dealers into the rule text.[798] Another commenter similarly stated that instead of focusing solely on customer demand, the rule should be clarified to reflect that demand can come from other dealers or future customers.[799]

In response to the proposal's question about whether the terms ''client,'' ''customer,'' and ''counterparty'' should be further defined, a few commenters stated that that the terms should not be defined in the rule.[800] Other

MetLife; ACLI (Feb. 2012). One commenter requested that the proposed requirement be moved to Appendix B of the rule to provide greater flexibility to consider facts and circumstances of a particular activity. *See* JPMC.

[785] *See* CIEBA; Morgan Stanley; RBC; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock. The Agencies respond to these comments in Part IV.A.3.c.2.c.ii., *infra.*

[786] *See* ICI (Feb. 2012); CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); RBC.

[787] *See* Morgan Stanley.

[788] *See* Wellington; MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Chamber (Feb. 2012); FTN; RBC; Alfred Brock. These comments are addressed in Part IV.A.3.c.2.c.iii., *infra.*

[789] *See* Sens. Merkley & Levin (Feb. 2012); FTN.

[790] *See* FTN. The commenter further indicated that errors in estimating customer demand are managed through kick-out rules and oversight by risk managers and committees, with latitude in decisions being closely related to expected or empirical costs of hedging positions until they result in trading with counterparties. *See id.*

[791] *See* Sens. Merkley & Levin (Feb. 2012) (stating that banking entities should be required to collect inventory data, evaluate the data, develop policies on how to handle particular positions, and make regular adjustments to ensure a turnover of assets commensurate with near term demand of customers). This commenter also suggested that the rule specify the types of inventory metrics that should be collected and suggested that the rate of inventory turnover would be helpful. *See id.*

[792] *See* MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012); Alfred Brock. This issue is addressed in Part IV.A.3.c.2.c.iii., *infra.*

[793] *See* ICI (Feb. 2012); CIEBA; RBC; Wellington; Invesco.

[794] *See* CIEBA.

[795] *See* Joint Proposal, 76 FR 68,960; CFTC Proposal, 77 FR 8439. More specifically, Appendix B stated: ''In the context of market making in a security that is executed on an organized trading facility or an exchange, a 'customer' is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a [financial instrument] in an OTC market, a 'customer' generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services.'' *Id.* On this last point, the proposal elaborated that in certain cases, depending on the conventions of the relevant market (*e.g.,* the OTC derivatives market), such a ''customer'' may consider itself or refer to itself more generally as a ''counterparty.'' *See* Joint Proposal, 76 FR 68,960 n.2; CFTC Proposal, 77 FR 8439 n.2.

[796] *See* Joint Proposal, 76 FR 68,874; CFTC Proposal, 77 FR 8359. In particular, Question 99 states: ''Should the terms 'client,' 'customer,' or 'counterparty' be defined for purposes of the market making exemption? If so, how should these terms be defined? For example, would an appropriate definition of 'customer' be: (i) A continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction; (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction; (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions; or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?'' *Id.*

[797] Comments on this issue are addressed in Part IV.A.3.c.2.c.i., *infra.*

[798] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Credit Suisse (Seidel); RBC (requesting that the Agencies recognize ''wholesale'' market making as permissible and representing that ''[i]t is irrelevant to an investor whether market liquidity is provided by a broker-dealer with whom the investor maintains a customer account, or whether that broker-dealer looks to another dealer for market liquidity'').

[799] *See* Comm. on Capital Markets Regulation.

[800] *See* FTN; ISDA (Feb. 2012); Alfred Brock.

commenters indicated that further definition of these terms would be appropriate.[801] Some of these commenters suggested that there should be greater limitations on who can be considered a ''customer'' under the rule.[802] These commenters generally indicated that a ''customer'' should be a person or institution with whom the banking entity has a continuing, or a direct and substantive, relationship prior to the time of the transaction.[803] In the case of a new customer, some of these commenters suggested requiring a relationship initiated by the prospective customer with a view to engaging in transactions.[804] A few commenters indicated that a party should not be considered a client, customer, or counterparty if the banking entity: (i) originates a financial product and then finds a counterparty to take the other side of the transaction;[805] or (ii) engages in transactions driven by algorithmic trading strategies.[806] Three commenters requested more permissive definitions of these terms.[807] According to one of these commenters, because these terms are listed in the disjunctive in the statute, the broadest term—a ''counterparty''—should prevail.[808]

v. Interdealer Trading and Trading for Price Discovery or To Test Market Depth

With respect to interdealer trading, many commenters expressed concern that the proposed rule could be interpreted to restrict a market maker's ability to engage in interdealer trading.[809] As a general matter, commenters attributed these concerns to statements in proposed Appendix B[810] or to the Customer-Facing Trade Ratio metric in proposed Appendix A.[811] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity[812] and suggested ways in which this could be accomplished (*e.g.,* through a definition of ''customer'' or ''counterparty'').[813]

Commenters emphasized that interdealer trading provides certain market benefits, including increased market liquidity;[814] more efficient matching of customer order flow;[815] greater hedging options to reduce risks;[816] enhanced ability to accumulate inventory for current or near term customer demand, work down concentrated positions arising from a customer trade, or otherwise exit a position acquired from a customer;[817] and general price discovery among dealers.[818] Regarding the impact of interdealer trading on a market maker's ability to intermediate customer needs, one commenter studied the potential impact of interdealer trading limits—in combination with inventory limits—on trading in the U.S. corporate bond market. According to this commenter, if interdealer trading had been prohibited and a market maker's inventory had been limited to the average daily volume of the market as a whole, 69 percent of customer trades would have been prevented.[819] Some commenters stated that a banking entity would be less able or willing to provide market-making services to customers if it could not engage in interdealer trading.[820]

[801] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[802] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. One of these commenters also requested that the Agencies remove the terms ''client'' and ''counterparty'' from the proposed near term demand requirement. *See* Occupy.

[803] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. These commenters stated that other banking entities should never be ''customers'' under the rule. *See id.* In addition, one of these commenters would further prevent a banking entity's employees and covered funds from being ''customers'' under the rule. *See* AFR *et al.* (Feb. 2012).

[804] *See* AFR *et al.* (Feb. 2012) (providing a similar definition for the term ''client'' as well); Public Citizen.

[805] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity's activities that involve attempting to sell clients financial instruments that it originated, rather than facilitating a secondary market for client trades in previously existing financial products, should be analyzed under the underwriting exemption, not the market-making exemption; in addition, compiling inventory of financial instruments that the bank originated should be viewed as proprietary trading).

[806] *See* AFR *et al.* (Feb. 2012).

[807] *See* Credit Suisse (Seidel) (stating that ''customer'' should be explicitly defined to include any counterparty to whom a banking entity is providing liquidity); ISDA (Feb. 2012) (recommending that, if the Agencies decide to define these terms, a ''counterparty'' should be defined as the entity on the other side of a transaction, and the terms ''client'' and ''customer'' should not be interpreted to require a relationship beyond the isolated provision of a transaction); Japanese Bankers Ass'n. (requesting that it be clearly noted that interbank participants can be customers for interbank market makers).

[808] *See* ISDA (Feb. 2012). This commenter's primary position was that further definitions are not required and could create additional and unnecessary complexity. *See id.*

[809] *See, e.g.,* JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); MetLife; Credit Suisse (Seidel); BoA; ACLI (Feb. 2012); RBC; AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012). A few commenters noted that the proposed rule would permit a certain amount of interdealer trading. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (citing statements in the proposal providing that a market maker's ''customers'' vary depending on the asset class and market in which intermediation services are provided and interpreting such statements as allowing interdealer market making where brokers or other dealers act as ''customers'' within the proposed construct); Goldman (Prop. Trading) (stating that interdealer trading related to hedging or exiting a customer position would be permitted, but expressing concern that requiring each banking entity to justify each of its interdealer trades as being related to one of its own customers would be burdensome and would reduce the effectiveness of the interdealer market). Commenters' concerns regarding interdealer trading are addressed in Part IV.A.3.c.2.c.i., *infra.*

[810] *See infra* Part IV.A.3.c.8.

[811] *See, e.g.,* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012) (recognizing that the proposed rule did not include specific limits on interdealer trading, but expressing concern that explicit or implicit limits could be established by supervisors during or after the conformance period).

[812] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[813] *See* RBC (suggesting that explicitly incorporating liquidity provision to other brokers and dealers in the market-making exemption would be consistent with the statute's reference to meeting the needs of ''counterparties,'' in addition to the needs of clients and customers); AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction); Goldman (Prop. Trading) (representing that the Agencies could evaluate and monitor the amount of interdealer trading that is consistent with a particular trading unit's market making-related or hedging activity through the customer-facing activity category of metrics); Oliver Wyman (Feb. 2012) (recommending removal or modification of any metrics or principles that would indicate that interdealer trading is not permitted).

[814] *See* Prof. Duffie; MetLife; ACLI (Feb. 2012); BDA (Feb. 2012).

[815] *See* Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); MetLife; ACLI (Feb. 2012). *See also* Thakor Study (stating that, when a market maker provides immediacy to a customer, it relies on being able to unwind its positions at opportune times by trading with other market makers, who may have knowledge about impending orders form their own customers that may induce them to trade with the market maker).

[816] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[817] *See* Goldman (Prop. Trading); Chamber (Feb. 2012). *See also* Prof. Duffie (stating that a market maker acquiring a position from a customer may wish to rebalance its inventory relatively quickly through the interdealer network, which is often more efficient than requesting immediacy from another customer or waiting for another customer who wants to take the opposite side of the trade).

[818] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

[819] *See* Oliver Wyman (Feb. 2012) (basing its finding on data from 2009). This commenter also represented that the natural level of interdealer volume in the U.S. corporate bond market made up 16 percent of total trading volume in 2010. *See id.*

[820] *See* Goldman (Prop. Trading); Morgan Stanley. *See also* BDA (Feb. 2012) (stating that if dealers in the fixed-income market are not able to trade with other dealers to ''cooperate with each other to provide adequate liquidity to the market as a whole,'' an essential source of liquidity will be eliminated from the market and existing values of

Continued

As noted above, a few commenters stated that market makers may use interdealer trading for price discovery purposes.[821] Some commenters separately discussed the importance of this activity and requested that, when conducted in connection with market-making activity, trading for price discovery be considered permitted market making-related activity under the rule.[822] Commenters indicated that price discovery-related trading results in certain market benefits, including enhancing the accuracy of prices for customers,[823] increasing price efficiency, preventing market instability,[824] improving market liquidity, and reducing overall costs for market participants.[825] As a converse, one of these commenters stated that restrictions on such activity could result in market makers setting their prices too high, exposing them to significant risk and causing a reduction of market-making activity or widening of spreads to offset the risk.[826] One commenter further requested that trading to test market depth likewise be permitted under the market-making exemption.[827] This commenter represented that the Agencies would be able to evaluate the extent to which trading for price discovery and market depth are consistent with market making-related activities for a particular market through a combination of customer-facing activity metrics, including the Inventory Risk Turnover metric, and knowledge of a banking entity's trading business developed by regulators as part of the supervisory process.[828]

vi. Inventory Management

Several commenters requested that the rule provide banking entities with greater discretion to manage their inventories in connection with market making-related activity, including acquiring or disposing of positions in anticipation of customer demand.[829] Commenters represented that market makers need to be able to build, manage, and maintain inventories to facilitate customer demand. These commenters further stated that the rule needs to provide some degree of flexibility for inventory management activities, as inventory needs may differ based on market conditions or the characteristics of a particular instrument.[830] A few commenters cited legislative history in support of allowing banking entities to hold and manage inventory in connection with market making-related activities.[831] Several commenters noted benefits that are associated with a market maker's ability to appropriately manage its inventory, including being able to meet reasonably anticipated future client, customer, or counterparty demand;[832] accommodating customer transactions more quickly and at favorable prices; reducing near term price volatility (in the case of selling a customer block position);[833] helping maintain an orderly market and provide the best price to customers (in the case of accumulating long or short positions in anticipation of a large customer sale or purchase);[834] ensuring that markets continue to have sufficient liquidity;[835] fostering a two-way market; and establishing a market-making presence.[836] Some commenters noted that market makers may need to accumulate inventory to meet customer demand for certain products or under certain trading scenarios, such as to create units of structured products (*e.g.,* ETFs and asset-backed securities)[837] and in anticipation of an index rebalance.[838]

Commenters also expressed views with respect to how much discretion a banking entity should have to manage its inventory under the exemption and how to best monitor inventory levels. For example, one commenter recommended that the rule allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand.[839] A few commenters suggested that the Agencies provide banking entities with greater discretion to accumulate inventory, but discourage market makers from holding inventory for long periods of time by imposing increasingly higher capital requirements on aged inventory.[840] One commenter

fixed income securities will decline and become volatile, harming both investors who currently hold such positions and issuers, who will experience increased interest costs).

[821] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

[822] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading). One commenter provided the following example of such activity: If Security A and Security B have some price correlation but neither trades regularly, then a trader may execute a trade in Security A for price discovery purposes, using the price of Security A to make an informed bid-ask market to a customer in Security B. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[823] *See* Goldman (Prop. Trading); Chamber (Feb. 2012) (stating that this type of trading is necessary in more illiquid markets); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[824] *See* Goldman (Prop. Trading).

[825] *See* Chamber (Feb. 2012).

[826] *See id.*

[827] *See* Goldman (Prop. Trading). This commenter represented that market makers often make trades with other dealers to test the depth of the markets at particular price points and to understand where supply and demand exist (although such trading is not conducted exclusively with other dealers). This commenter stated that testing the depth of the market is necessary to provide accurate prices to customers, particularly when customers *See*ks to enter trades in amounts larger than the amounts offered by dealers who have sent indications to inter-dealer brokers. *See id.*

[828] *See id.*

[829] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC. Inventory management is addressed in Part IV.A.3.c.2.c., *infra.*

[830] *See, e.g.,* MFA (stating that it is critical for banking entities to continue to be able to maintain sufficient levels of inventory, which is dynamic in nature and requires some degree of flexibility in application); RBC (requesting that the Agencies explicitly acknowledge that, depending on market conditions or the characteristics of a particular security, it may be appropriate or necessary for a firm to maintain inventories over extended periods of time in the course of market making-related activities).

[831] *See, e.g.,* RBC; NYSE Euronext; Fidelity. These commenters cited a colloquy in the Congressional Record between Senator Bayh and Senator Dodd, in which Senator Bayh stated: ''With respect to [section 13 of the BHC Act], the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market-making activities, provided that activity does not exceed the reasonably expected near-term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market-making function. Without that flexibility, market makers would not be able to provide liquidity to markets.'' 156 Cong. Rec. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh).

[832] *See, e.g.,* RBC.

[833] *See* Goldman (Prop. Trading).

[834] *See id.*

[835] *See* MFA.

[836] *See* RBC.

[837] *See* Goldman (Prop. Trading); BoA.

[838] *See* Oliver Wyman (Feb. 2012). As this commenter explained, some mutual funds and ETFs track major equity indices and, when the composition of an index changes (*e.g.,* due to the addition or removal of a security or to rising or falling values of listed shares), an announcement is made and all funds tracking the index need to rebalance their portfolios. According to the commenter, banking entities may need to step in to provide liquidity for rebalances of less liquid indices because trades executed on the open market would substantially affect share prices. The commenter estimated that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year. This commenter identified the proposed inventory metrics in Appendix A as potentially limiting a banking entity's willingness or ability to facilitate index rebalance trades. *See id.* Two other commenters also discussed the index rebalancing scenario. *See* Prof. Duffie; Thakor Study. Index rebalancing is addressed in note 931, *infra.*

[839] *See* Credit Suisse (Seidel).

[840] *See* CalPERS; Vanguard. These commenters represented that placing increasing capital requirements on aged inventory would ease the rule's impact on investor liquidity, allow banking entities to internalize the cost of continuing to hold a position at the expense of its ability to take on new positions, and potentially decrease the possibility of a firm realizing a loss on a position by decreasing the time such position is held. *See id.* One commenter noted that some banking entities

represented that a trading unit's inventory management practices could be monitored with the Inventory Risk Turnover metric, in conjunction with other metrics.[841]

vii. Acting as an Authorized Participant or Market Maker in Exchange-Traded Funds

With respect to ETF trading, commenters generally requested clarification that a banking entity can serve as an authorized participant (''AP'') to an ETF issuer or can engage in ETF market making under the proposed exemption.[842] According to commenters, APs may engage in the following types of activities with respect to ETFs: (i) trading directly with the ETF issuer to create or redeem ETF shares, which involves trading in ETF shares and the underlying components; [843] (ii) trading to maintain price alignment between the ETF shares and the underlying components; [844] (iii) traditional market-making activity; [845] (iv) ''seeding'' a new ETF by entering into several initial creation transactions with an ETF issuer and holding the ETF shares, possibly for an extended period of time, until the ETF establishes regular trading and liquidity in the secondary markets; [846] (v) ''create to lend'' transactions, where an AP enters a creation transaction with the ETF issuer and lends the ETF shares to an investor; [847] and (vi) hedging.[848] A few commenters noted that an AP may not engage in traditional market-making activity in the relevant ETF and expressed concern that the proposed rule may limit a banking entity's ability to act in an AP capacity.[849] One commenter estimated that APs that are banking entities make up between 20 percent to 100 percent of creation and redemption activity for individual ETFs, with an average of approximately 35 percent of creation and redemption activity across all ETFs attributed to banking entities. This commenter expressed the view that, if the rule limits banking entities' ability to serve as APs, then individual investors' investments in ETFs will become more expensive due to higher premiums and discounts versus the ETF's NAV.[850]

A number of commenters stated that certain requirements of the proposed exemption may limit a banking entity's ability to serve as AP to an ETF, including the proposed near term customer demand requirement,[851] the proposed source of revenue requirement,[852] and language in the proposal regarding arbitrage trading.[853] With respect to the proposed near term customer demand requirement, a few commenters noted that this requirement could prevent an AP from building inventory to assemble creation units.[854] Two other commenters expressed the view that the ETF issuer would be the banking entity's ''counterparty'' when the banking entity trades directly with the ETF issuer, so this trading and inventory accumulation would meet the terms of the proposed requirement.[855] To permit banking entities to act as APs, two commenters suggested that trading in the capacity of an AP should be deemed permitted market making-related activity, regardless of whether the AP is acting as a traditional market maker.[856]

viii. Arbitrage or Other Activities That Promote Price Transparency and Liquidity

In response to a question in the proposal,[857] a number of commenters stated that certain types of arbitrage activity should be permitted under the market-making exemption.[858] For example, some commenters stated that a banking entity's arbitrage activity should be considered market making to the extent the activity is driven by creating markets for customers tied to the price differential (*e.g.,* ''box'' strategies, ''calendar spreads,'' merger arbitrage, ''Cash and Carry,'' or basis trading) [859] or to the extent that demand is predicated on specific price relationships between instruments (*e.g.,* ETFs, ADRs) that market makers must

already use this approach to manage risk on their market-making desks. *See* Vanguard. *See also* Capital Group (suggesting that one way to implement the statutory exemption would be to charge a trader or a trading desk for positions held on its balance sheet beyond set time periods and to increase the charge at set intervals). These comments are addressed in note 923, *infra.*

[841] *See* Goldman (Prop. Trading) (representing that the Inventory Risk Turnover metric will allow the Agencies to evaluate the length of time that a trading unit tends to hold risk positions in inventory and whether that holding time is consistent with market making-related activities in the relevant market).

[842] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (stating that an AP may trade with the ETF issuer in different capacities—in connection with traditional market-making activity, on behalf of customers, or for the AP's own account); ICI Global (discussing non-U.S. ETFs specifically); Vanguard; SSgA (Feb. 2012). One commenter represented that an AP's transactions in ETFs do not create risks associated with proprietary trading because, when an AP trades with an ETF issuer for its own account, the AP typically enters into an offsetting transaction in the underlying portfolio of securities, which cancels out investment risk and limits the AP's exposure to the difference between the market price for ETF shares and the ETF's net asset value (''NAV''). *See* Vanguard.

With respect to market-making activity in an ETF, several commenters noted that market makers play an important role in maintaining price alignment by engaging in arbitrage transactions between the ETF shares and the shares of the underlying components. *See, e.g.,* JPMC; Goldman (Prop. Trading) (making similar statement with respect to ADRs as well); SSgA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC. AP and market maker activity in ETFs are addressed in Part IV.A.3.c.2.c.i., *infra.*

[843] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; ICI (Feb. 2012) ICI Global; Vanguard; SSgA (Feb. 2012).

[844] *See* JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); ICI (Feb. 2012) ICI Global.

[845] *See* ICI Global; ICI (Feb. 2012) SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[846] *See* BoA; ICI (Feb. 2012); ICI Global.

[847] *See* BoA (stating that lending the ETF shares to an investor gives the investor a more efficient way to hedge its exposure to assets correlated with those underlying the ETF).

[848] *See* ICI Global; ICI (Feb. 2012).

[849] *See, e.g.,* Vanguard (noting that APs may not engage in market-making activity in the ETF and expressing concern that if AP activities are not separately permitted, banking entities may exit or not enter the ETF market); SSgA (Feb. 2012) (stating that APs are under no obligation to make markets in ETF shares and requiring such an obligation would discourage banking entities from acting as APs); ICI (Feb. 2012).

[850] *See* SSgA (Feb. 2012). This commenter further stated that as of 2011, an estimated 3.5 million—or 3 percent—of U.S. households owned ETFs and, as of September 2011, ETFs represented assets of approximately $951 billion. *See id.*

[851] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[852] *See* BoA. This commenter noted that the proposed source of revenue requirement could be interpreted to prevent a banking entity acting as AP from entering into creation and redemption transactions, ''*See*ding'' an ETF, engaging in ''create to lend'' transactions, and performing secondary market making in an ETF because all of these activities require an AP to build an inventory—either in ETF shares or the underlying components—which often result in revenue attributable to price movements. *See id.*

[853] Commenters noted that this language would restrict an AP from engaging in price arbitrage to maintain efficient markets in ETFs. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See supra* Part IV.A.3.c.2.a. (discussing the proposal's proposed interpretation regarding arbitrage trading).

[854] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[855] *See* ICI Global; ICI (Feb. 2012).

[856] *See* ICI (Feb. 2012) ICI Global. These commenters provided suggested rule text on this issue and suggested that the Agencies could require a banking entity's compliance policies and internal controls to take a comprehensive approach to the entirety of an AP's trading activity, which would facilitate easy monitoring of the activity to ensure compliance. *See id.*

[857] *See* Joint Proposal, 76 FR 68,873 (question 91) (inquiring whether the proposed exemption should be modified to permit certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency but do not service client, customer, or counterparty demand); CFTC Proposal, 77 FR 8359.

[858] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012). Arbitrage trading is further discussed in Part IV.A.3.c.2.c.i., *infra.*

[859] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

maintain.[860] Similarly, another commenter suggested that arbitrage activity that aligns prices should be permitted, such as index arbitrage, ETF arbitrage, and event arbitrage.[861] One commenter noted that many markets, such as futures and options markets, rely on arbitrage activities of market makers for liquidity purposes and to maintain convergence with underlying instruments for cash-settled options, futures, and index-based products.[862] Commenters stated that arbitrage trading provides certain market benefits, including enhanced price transparency,[863] increased market efficiency,[864] greater market liquidity,[865] and general benefits to customers.[866] A few commenters noted that certain types of hedging activity may appear to have characteristics of arbitrage trading.[867]

Commenters suggested certain methods for permitting and monitoring arbitrage trading under the exemption. For example, one commenter suggested a framework for permitting certain arbitrage within the market-making exemption, with requirements such as: (i) Common personnel with market-making activity; (ii) policies that cover the timing and appropriateness of arbitrage positions; (iii) time limits on arbitrage positions; and (iv) compensation that does not reward successful arbitrage, but instead pools any such revenues with market-making profits and losses.[868] A few commenters represented that, if permitted under the rule, the Agencies would be able to monitor arbitrage activities for patterns of impermissible proprietary trading through the use of metrics, as well as compliance and examination tools.[869]

Other commenters stated that the exemption should not permit certain types of arbitrage. One commenter stated that the rule should ensure that relative value and complex arbitrage strategies cannot be conducted.[870] Another commenter expressed the view that the market-making exemption should not permit any type of arbitrage transactions. This commenter stated that, in the event that liquidity or transparency is inhibited by a lack of arbitrage trading, a market maker should be able to find a customer who would seek to benefit from it.[871]

ix. Primary Dealer Activities

A number of commenters requested that the market-making exemption permit banking entities to meet their primary dealer obligations in foreign jurisdictions, particularly if trading in foreign sovereign debt is not separately exempted in the final rule.[872] According to commenters, a banking entity may be obligated to perform the following activities in its capacity as a primary dealer: undertaking to maintain an orderly market, preventing or correcting any price dislocations,[873] and bidding on each issuance of the relevant jurisdiction's sovereign debt.[874] Commenters expressed concern that a banking entity's trading activity as primary dealer may not comply with the proposed near term customer demand requirement[875] or the proposed source of revenue requirement.[876] To address the first issue, one commenter stated that the final rule should clarify that a banking entity acting as a primary dealer of foreign sovereign debt is engaged in primary dealer activity in response to the near term demands of the sovereign, which should be considered a client, customer, or counterparty of the banking entity.[877] Another commenter suggested that the Agencies permit primary dealer activities through commentary stating that fulfilling primary dealer obligations will not be included in determinations of whether the market-making exemption applies to a trading unit.[878]

x. New or Bespoke Products or Customized Hedging Contracts

Several commenters indicated that the proposed exemption does not adequately address market making in new or bespoke products, including structured, customer-driven transactions, and requested that the rule be modified to clearly permit such activity.[879] Many of these commenters emphasized the role such transactions play in helping customers hedge the unique risks they face.[880] Commenters stated that, as a result, limiting a banking entity's ability to conduct such transactions would subject customers to increased risks and greater transaction costs.[881] One commenter suggested that the Agencies explicitly state that a banking entity's general willingness to engage in bespoke transactions is sufficient to make it a market maker in unique products for purposes of the rule.[882]

Other commenters stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or

[860] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[861] *See* Credit Suisse (Seidel).

[862] *See* RBC.

[863] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[864] *See* Credit Suisse (Seidel); RBC.

[865] *See* RBC.

[866] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; FTN; ISDA (Feb. 2012) (stating that arbitrage activities often yield positions that are ultimately put to use in serving customer demand and representing that the process of consistently trading makes a dealer ready and available to serve customers on a competitive basis).

[867] *See* JPMC (stating that firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and transferred by means of internal transactions to a single utility desk (which hedges all of the risks in the aggregate), and this may optically bear some characteristics of arbitrage, although the commenter requested that such activity be recognized as permitted market making-related activity under the rule); ISDA (Feb. 2012) (stating that in some swaps markets, dealers hedge through multiple instruments, which can give an impression of arbitrage in a function that is risk reducing; for example, a dealer in a broad index equity swap may simultaneously hedge in baskets of stocks, futures, and ETFs). *But See* Sens. Merkley & Levin (Feb. 2012) (''When banks use complex hedging techniques or otherwise engage in trading that is suggestive of arbitrage, regulators should require them to provide evidence and analysis demonstrating what risk is being reduced.'').

[868] *See* FTN.

[869] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). One of these commenters stated that the customer-facing activity category of metrics, as well as other metrics, would be available to evaluate whether the trading unit is engaged in a directly customer-facing business and the extent to which its activities are consistent with the market-making exemption. *See* Goldman (Prop. Trading).

[870] *See* Johnson & Prof. Stiglitz. *See also* AFR *et al.* (Feb. 2012) (noting that arbitrage, spread, or carry trades are a classic type of proprietary trade).

[871] *See* Occupy.

[872] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. *See infra* notes 905 to 906 and accompanying text (addressing these comments).

[873] *See* Goldman (Prop. Trading).

[874] *See* Banco de México.

[875] *See* JPMC; Banco de México. These commenters stated that a primary dealer is required to assume positions in foreign sovereign debt even when near term customer demand is unpredictable. *See id.*

[876] *See* Banco de México (stating that primary dealers need to be able to profit from their positions in sovereign debt, including by holding significant positions in anticipation of future price movements, so that the primary dealer business is financially attractive); IIB/EBF (stating that primary dealers may actively *Seek* to profit from price and interest rate movements based on their debt holdings, which governments support as providing much-needed liquidity for securities that are otherwise purchased largely pursuant to buy-and-hold strategies of institutional investors and other entities *Seeking* safe returns and liquidity buffers).

[877] *See* Goldman (Prop. Trading).

[878] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[879] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). This issue is addressed in Part IV.A.3.c.1.c.iii., *supra,* and Part IV.A.3.c.2.c.iii., *infra.*

[880] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[881] *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[882] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

customized derivatives.[883] For example, one commenter suggested that a banking entity be required to disaggregate such derivatives into liquid risk elements and illiquid risk elements, with liquid risk elements qualifying for the market-making exemption and illiquid risk elements having to be conducted on a riskless principal basis under § __ .6(b)(1)(ii) of the proposed rule. According to this commenter, such an approach would not impact the end user customer.[884] Another commenter stated that a banking entity making a market in bespoke instruments should be required both to hold itself out in accordance with § __.4(b)(2)(ii) of the proposed rule and to demonstrate the purchase and the sale of such an instrument.[885]

c. Final Near Term Customer Demand Requirement

Consistent with the statute, § __ .4(b)(2)(ii) of the final rule's market-making exemption requires that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on certain market factors and analysis.[886] As discussed above in Part IV.A.3.c.1.c.ii., the trading desk's market-maker inventory consists of positions in financial instruments in which the trading desk stands ready to purchase and sell consistent with the final rule.[887] The final rule requires the financial instruments to be identified in the trading desk's compliance program. Thus, this requirement focuses on a trading desk's positions in financial instruments for which it acts as market maker. These positions of a trading desk are more directly related to the demands of customers than positions in financial instruments used for risk management purposes, but in which the trading desk does not make a market. As noted above, a position or exposure that is included in a trading desk's market-maker inventory will remain in its market-maker inventory for as long as the position or exposure is managed by the trading desk. As a result, the trading desk must continue to account for that position or exposure, together with other positions and exposures in its market-maker inventory, in determining whether the amount, types, and risks of its market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

While the near term customer demand requirement directly applies only to the trading desk's market-maker inventory, this does not mean a trading desk may establish other positions, outside its market-maker inventory, that exceed what is needed to manage the risks of the trading desk's market making-related activities and inventory. Instead, a trading desk must have limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its aggregate financial exposure that are based on the factors set forth in the near term customer demand requirement, as well as other relevant considerations regarding the nature and amount of the trading desk's market making-related activities. A banking entity must establish, implement, maintain, and enforce a limit structure, as well as other compliance program elements (*e.g.,* those specifying the instruments a trading desk trades as a market maker or may use for risk management purposes and providing for specific risk management procedures), for each trading desk that are designed to prevent the trading desk from engaging in trading activity that is unrelated to making a market in a particular type of financial instrument or managing the risks associated with making a market in that type of financial instrument.[888]

To clarify the application of this standard in response to comments,[889] the final rule provides two factors for assessing whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties. Specifically, the following must be considered under the revised standard: (i) The liquidity, maturity, and depth of the market for the relevant type of financial instrument(s),[890] and (ii) demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments in which the trading desk makes a market, including through block trades. Under the final rule, a banking entity must account for these considerations when establishing risk and inventory limits for each trading desk.[891]

For purposes of this provision, ''demonstrable analysis'' means that the analysis for determining the amount, types, and risks of financial instruments a trading desk may manage in its market-maker inventory, in accordance with the near term demand requirement, must be based on factors that can be demonstrated in a way that makes the analysis reviewable. This may include, among other things, the normal trading records of the trading desk and market information that is readily available and retrievable. If the analysis cannot be supported by the banking entity's books and records and available market data, on their own, then the other factors utilized must be identified and documented and the analysis of those factors together with the facts gathered from the trading and market records must be identified in a way that makes it possible to test the analysis.

Importantly, a determination of whether a trading desk's market-maker inventory is appropriate under this requirement will take into account reasonably expected near term customer demand, including historical levels of customer demand, expectations based on market factors, and current demand. For example, at any particular time, a trading desk may acquire a position in a financial instrument in response to a customer's request to sell the financial instrument or in response to reasonably expected customer buying interest for such instrument in the near term.[892] In addition, as discussed below, this requirement is not intended to impede a trading desk's ability to engage in

[883] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[884] *See* AFR *et al.* (Feb. 2012).

[885] *See* Public Citizen.

[886] The final rule includes certain refinements to the proposed standard, which would have required that the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § __.4(b)(2)(iii).

[887] *See supra* Part IV.A.3.c.1.c.ii.; final rule § __.4(b)(5).

[888] *See infra* Part IV.A.3.c.3. (discussing the compliance program requirements); final rule § __.4(b)(2)(iii).

[889] *See supra* Part IV.A.3.c.2.b.i.

[890] This language has been added to the final rule to respond to commenters' concerns that the proposed near term demand requirement would be unworkable in less liquid markets or would otherwise restrict a market maker's ability to hold and manage its inventory in less liquid markets. *See supra* Part IV.A.3.c.2.b.ii. In addition, this provision is substantially similar to one commenter's suggested approach of adding the phrase ''based on the characteristics of the relevant market and asset class'' to the proposed requirement, but the Agencies have added more specificity about the relevant characteristics that should be taken into consideration. *See* Morgan Stanley.

[891] *See infra* Part IV.A.3.c.3.

[892] As discussed further below, acquiring a position in a financial instrument in response to reasonably expected customer demand would not include creating a structured product for which there is no current customer demand and, instead, soliciting customer demand during or after its creation. *See infra* note 938 and accompanying text; Sens. Merkley & Levin (Feb. 2012).

certain market making-related activities that are consistent with and needed to facilitate permissible trading with its clients, customers, or counterparties, such as inventory management and interdealer trading. These activities must, however, be consistent with the analysis conducted under the final rule and the trading desk's limits discussed below.[893] Moreover, as explained below, the banking entity must also have in place escalation procedures to address, analyze, and document trades made in response to customer requests that would exceed one of a trading desk's limits.

The near term demand requirement is an ongoing requirement that applies to the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory. For instance, a trading desk may acquire exposures as a result of entering into market-making transactions with customers that are within the desk's market-marker inventory and financial exposure limits. Even if the trading desk is appropriately managing the risks of its market-maker inventory, its market-maker inventory still must be consistent with the analysis of the reasonably expected near term demands of clients, customers, and counterparties and the liquidity, maturity and depth of the market for the relevant instruments in the inventory. Moreover, the trading desk must take action to ensure that its financial exposure does not exceed its financial exposure limits.[894] A trading desk may not maintain an exposure in its market-maker inventory, irrespective of customer demand, simply because the exposure is hedged and the resulting financial exposure is below the desk's financial exposure limit. In addition, the amount, types, and risks of financial instruments in a trading desk's market-maker inventory would not be consistent with permitted market-making activities if, for example, the trading desk has a pattern or practice of retaining exposures in its market-maker inventory, while refusing to engage in customer transactions when there is customer demand for those exposures at commercially reasonable prices.

The following is an example of the interplay between a trading desk's market-maker inventory and financial exposure. An airline company customer may seek to hedge its long-term exposure to price fluctuations in jet fuel by asking a banking entity to create a structured ten-year, $1 billion jet fuel swap for which there is no liquid market. A trading desk that makes a market in energy swaps may service its customer's needs by executing a custom jet fuel swap with the customer and holding the swap in its market-maker inventory, if the resulting transaction does not cause the trading desk to exceed its market-maker inventory limit on the applicable class of instrument, or the trading desk has received approval to increase the limit in accordance with the authorization and escalation procedures under paragraph (b)(2)(iii)(E). In keeping with the market-making exemption as provided in the final rule, the trading desk would be required to hedge the risk from this swap, either individually or as part of a set of aggregated positions, if the trade would result in a financial exposure that exceeds the desk's financial exposure limits. The trading desk may hedge the risk of the swap, for example, by entering into one or more futures or swap positions that are identified as permissible hedging products, instruments, or exposures in the trading desk's compliance program and that analysis, including correlation analysis as appropriate, indicates would demonstrably reduce or otherwise significantly mitigate risks associated with the financial exposure from its market-making activities. Alternatively, if the trading desk also acts as a market maker in crude oil futures, then the desk's exposures arising from its market-making activities may naturally hedge the jet fuel swap (*i.e.,* it may reduce its financial exposure levels resulting from such instruments).[895] The trading desk must continue to appropriately manage risks of its financial exposure over time in accordance with its financial exposure limits.

As discussed above, several commenters expressed concern that the near-term customer demand requirement is too restrictive and that it could impede a market maker's ability to build or retain inventory, particularly in less liquid markets where demand is intermittent.[896] Because customer demand in illiquid markets can be difficult to predict with precision, market-maker inventory may not closely track customer order flow. The Agencies acknowledge that market makers will face costs associated with demonstrating that market-maker inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers, as required by the statute and the final rule because this is an analysis that banking entities may not currently undertake. However, the final rule includes certain modifications to the proposed rule that are intended to reduce the negative impacts cited by commenters, such as limitations on inventory management activity and potential restrictions on market making in less liquid instruments, which the Agencies believe should reduce the perceived burdens of the proposed near term demand requirement. For example, the final rule recognizes that liquidity, maturity, and depth of the market vary across asset classes. The Agencies expect that the express recognition of these differences in the rule should avoid unduly impeding a market maker's ability to build or retain inventory. More specifically, the Agencies recognize the relationship between market-maker inventory and customer order flow can vary across asset classes and that an inflexible standard for demonstrating that inventory does not exceed reasonably expected near term demand could provide an incentive to stop making markets in illiquid asset classes.

i. Definition of ''Client,'' ''Customer,'' and ''Counterparty''

In response to comments requesting further definition of the terms ''client,'' ''customer,'' and ''counterparty'' for purposes of this standard,[897] the Agencies have defined these terms in the final rule. In particular, the final rule defines ''client,'' ''customer,'' and ''counterparty'' as, on a collective or individual basis, ''market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services.'' [898] However, for purposes of the analysis supporting the market-maker inventory held to meet the reasonably expected near-term demands of clients, customers and counterparties, a client, customer, or counterparty of the trading desk does not include a trading desk or other organizational unit of another entity if that entity has $50 billion or more in total trading assets and liabilities, measured in accordance with § ____.20(d)(1),[899] unless the

[893] The formation of structured finance products and securitizations is discussed in detail in Part IV.B.2.b. of this **SUPPLEMENTARY INFORMATION.**

[894] *See* final rule § __.4(b)(2)(iii)(B), (C).

[895] This natural hedge with futures would introduce basis risk which, like other risks of the trading desk, must be managed within the desk's limits.

[896] *See* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012) RBC.

[897] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[898] Final rule § ____.4(b)(3).

[899] *See* final rule § ____.4(b)(3)(i). The Agencies are using a $50 billion threshold for these purposes in recognition that firms engaged in substantial trading activity do not typically act as customers to

trading desk documents how and why such trading desk or other organizational unit should be treated as a customer or the transactions are conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.[900]

The Agencies believe this definition is generally consistent with the proposed interpretation of ''customer'' in the proposal. The proposal generally provided that, for purposes of market making on an exchange or other organized trading facility, a customer is any person on behalf of whom a buy or sell order has been submitted. In the context of the over-the-counter market, a customer was generally considered to be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship for such services.[901] The definition of client, customer, and counterparty in the final rule recognizes that, in the context of market making in a financial instrument that is executed on an exchange or other organized trading facility, a client, customer, or counterparty would be any person whose buy or sell order executes against the banking entity's quotation posted on the exchange or other organized trading facility.[902] Under these circumstances, the person would be trading with the banking entity in response to the banking entity's quotations and obtaining the banking entity's market making-related services. In the context of market making in a financial instrument in the OTC market, a client, customer, or counterparty generally would be a person that makes use of the banking entity's intermediation services, either by requesting such services (possibly via a request-for-quote on an established trading facility) or entering into a continuing relationship with the banking entity with respect to such services. For purposes of determining the reasonably expected near-term demands of customers, a client, customer, or counterparty generally would not include a trading desk or other organizational unit of another entity that has $50 billion or more in total trading assets except if the trading desk has a documented reason for treating the trading desk or other organizational unit of such entity as a customer or the trading desk's transactions are executed anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants. The Agencies believe that this exclusion balances commenters' suggested alternatives of either defining as a client, customer, or counterparty anyone who is on the other side of a market maker's trade [903] or preventing any banking entity from being a client, customer, or counterparty.[904] The Agencies believe that the first alternative is overly broad and would not meaningfully distinguish between permitted market making-related activity and impermissible proprietary trading. For example, the Agencies are concerned that such an approach would allow a trading desk to maintain an outsized inventory and to justify such inventory levels as being tangentially related to expected market-wide demand. On the other hand, preventing any banking entity from being a client, customer, or counterparty under the final rule would result in an overly narrow definition that would significantly impact banking entities' ability to provide and access market making-related services. For example, most banks look to market makers to provide liquidity in connection with their investment portfolios.

The Agencies further note that, with respect to a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of the market-making exemption as well as the underwriting exemption.[905] The Agencies believe this interpretation, together with the modifications in the rule that eliminate the requirement to distinguish between revenues from spreads and price appreciation and the recognition that the market-making exemption extends to market making-related activities appropriately captures the unique relationship between a primary dealer and the sovereign government. Thus, generally a banking entity may rely on the market-making exemption for its activities as primary dealer (or functional equivalent) to the extent those activities are outside of the underwriting exemption.[906]

For exchange-traded funds (''ETFs'') (and related structures), Authorized Participants (''APs'') are generally the conduit for market participants seeking to create or redeem shares of the fund

other market makers, while smaller regional firms may *See*k liquidity from larger firms as part of their market making-related activities.

[900] *See* final rule § ____.4(b)(3)(i)(A), (B). In Appendix C of the proposed rule, a trading unit engaged in market making-related activities would have been required to describe how it identifies its customers for purposes of the Customer-Facing Trading Ratio, if applicable, including documentation explaining when, how, and why a broker-dealer, swap dealer, security-based swap dealer, or any other entity engaged in market making-related activities, or any affiliate thereof, is considered to be a customer of the trading unit. *See* Joint Proposal, 76 FR 68,964. While the proposed approach would not have necessarily prevented any of these entities from being considered a customer of the trading desk, it would have required enhanced documentation and justification for treating any of these entities as a customer. The final rule's exclusion from the definition of client, customer, and counterparty is similar to the proposed approach, but is more narrowly focused on firms that have $50 billion or more trading assets and liabilities because, as noted above, the Agencies believe firms engaged in such substantial trading activity are less likely to act as customers to market makers than smaller regional firms.

[901] *See* Joint Proposal, 76 FR 68,960; CFTC Proposal, 77 FR 8439.

[902] *See, e.g.,* Goldman (Prop. Trading) (explaining generally how exchange-based market makers operate).

[903] *See* ISDA (Feb. 2012). In addition, a number of commenters suggested that the rule should not limit broker-dealers from being customers of a market maker. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC; Comm. on Capital Markets Regulation.

[904] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[905] A primary dealer is a firm that trades a sovereign government's obligations directly with the sovereign (in many cases, with the sovereign's central bank) as well as with other customers through market making. The sovereign government may impose conditions on a primary dealer or require that it engage in certain trading in the relevant government obligations (*e.g.,* participate in auctions for the government obligation or maintain a liquid secondary market in the government obligations). Further, a sovereign government may limit the number of primary dealers that are authorized to trade with the sovereign. A number of countries use a primary dealer system, including Australia, Brazil, Canada, China-Hong Kong, France, Germany, Greece, India, Indonesia, Ireland, Italy, Japan, Mexico, Netherlands, Portugal, South Africa, South Korea, Spain, Turkey, the U.K., and the U.S. *See, e.g.,* Oliver Wyman (Feb. 2012). The Agencies note that this standard would similarly apply to the relationship between a banking entity and a sovereign that does not have a formal primary dealer system, provided the sovereign's process functions like a primary dealer framework.

[906] *See* Goldman (Prop. Trading). *See also supra* Part IV.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity). Each suggestion regarding the treatment of primary dealer activity has not been incorporated into the rule. Specifically, the exemption for market making as applied to a primary dealer does not extend without limitation to primary dealer activities that are not conducted under the conditions of one of the exemptions. These interpretations would be inconsistent with Congressional intent for the statute, to limit permissible market-making activity through the statute's near term demand requirement and, thus, does not permit trading without limitation. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. Rather, recognizing that market making by primary dealers is a key function, the limits and other conditions of the rule are flexible enough to permit necessary market making-related activities.

(or equivalent structure).[907] For example, an AP may buy ETF shares from market participants who would like to redeem those shares for cash or a basket of instruments upon which the ETF is based. To provide this service, the AP may in turn redeem these shares from the ETF itself. Similarly, an AP may receive cash or financial instruments from a market participant seeking to purchase ETF shares, in which case the AP may use that cash or set of financial instruments to create shares from the ETF. In either case, for the purpose of the market-making exemption, such market participants as well as the ETF itself would be considered clients, customers, or counterparties of the AP.[908] The inventory of ETF shares or underlying instruments held by the AP can therefore be evaluated under the criteria of the market-making exemption, such as how these holdings relate to reasonably expected near term customer demand.[909] These criteria can be similarly applied to other activities of the AP, such as building inventory to ''seed'' a new ETF or engaging in ETF-loan related transactions.[910] The Agencies recognize that banking entities currently conduct a substantial amount of AP creation and redemption activity in the ETF market and, thus, if the rule were to prevent or restrict a banking entity from acting as an AP for an ETF, then the rule would impact the functioning of the ETF market.[911]

Some firms, whether or not an AP in a given ETF, may also actively engage in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another. Sometimes these firms will register as market makers on an exchange for a given ETF, but other times they may not register as market maker. Regardless of whether or not the firm is registered as a market maker on any given exchange, this activity not only provides liquidity for ETFs, but also, and very importantly, helps keep the market price of an ETF in line with the NAV of the fund. The market-making exemption can be used to evaluate trading that is intended to maintain price continuity between these exchangeable instruments by considering how the firm quotes, maintains risk and exposure limits, manages its inventory and risk, and, in the case of APs, exercises its ability to create and redeem shares from the fund. Because customers take positions in ETFs with an expectation that the price relationship will be maintained, such trading can be considered to be market making-related activity.[912]

After considering comments, the Agencies continue to take the view that a trading desk would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading or other trading that is not in response to, or driven by, the demands of clients, customers, or counterparties.[913] The Agencies believe this activity, which is not in response to or driven by customer demand, is inconsistent with the Congressional intent that market making-related activity be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. For example, a trading desk would not be permitted to engage in general statistical arbitrage trading between instruments that have some degree of correlation but where neither instrument has the capability of being exchanged, converted, or exercised for or into the other instrument. A trading desk may, however, act as market maker to a customer engaged in a statistical arbitrage trading strategy. Furthermore as suggested by some commenters,[914] trading activity used by a market maker to maintain a price relationship that is expected and relied upon by clients, customers, and counterparties is permitted as it is related to the demands of clients, customers, or counterparties because the relevant instrument has the capability of being exchanged,

[907] ETF sponsors enter into relationships with one or more financial institutions that become APs for the ETF. Only APs are permitted to purchase and redeem shares directly from the ETF, and they can do so only in large aggregations or blocks that are commonly called ''creation units.'' In response to a question in the proposal, a number of commenters expressed concern that the proposed market-making exemption may not permit certain AP and market maker activities in ETFs and requested clarification that these activities would be permitted under the market-making exemption. *See* Joint Proposal, 76 FR 68,873 (question 91) (''Do particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed in the proposal? If so, how could the proposal better address those instruments, markets or market features?''); CFTC Proposal, 77 FR 8359 (question 91); *supra* Part IV.A.3.c.2.b.vii. (discussing comments on this issue).

[908] This is consistent with two commenters' request that an ETF issuer be considered a ''counterparty'' of the banking entity when it trades directly with the ETF issuer as an AP. *See* ICI Global; ICI (Feb. 2012). Further, this approach is intended to address commenters' concerns that the near term demand requirement may limit a banking entity's ability to act as AP for an ETF. *See* BoA; Vanguard. The Agencies believe that one commenter's concern about the impact of the proposed source of revenue requirement on AP activity should be addressed by the replacement of this proposed requirement with a metric-based focus on when a trading desk generates revenue from its trading activity. *See* BoA; *infra* Part IV.A.3.c.7.c. (discussing the new approach to assessing a trading desk's pattern of profit and loss).

[909] This does not imply that the AP must perfectly predict future customer demand, but rather that there is a demonstrable, statistical, or historical basis for the size of the inventory held, as more fully discussed below. Consider, for example, a fixed-income ETF with $500 million in assets. If, on a typical day, an AP generates requests for $10 to $20 million of creations or redemptions, then an inventory of $10 to $20 million in bonds upon which the ETF is based (or some small multiple thereof) could be construed as consistent with reasonably expected near term customer demand. On the other hand, if under the same circumstances an AP holds $1 billion of these bonds solely in its capacity as an AP for this ETF, it would be more difficult to justify this as needed for reasonably expected near term customer demand and may be indicative of an AP engaging in prohibited proprietary trading.

[910] In ETF loan transactions (also referred to as ''create-to-lend'' transactions), an AP borrows the underlying instruments that form the creation basket of an ETF, submits the borrowed instruments to the ETF agent in exchange for a creation unit of ETF shares, and lends the resulting ETF shares to a customer that wants to borrow the ETF. At the end of the ETF loan, the borrower returns the ETF shares to the AP, and the AP redeems the ETF shares with the ETF agent in exchange for the underlying instruments that form the creation basket. The AP may return the underlying instruments to the parties from whom it borrowed them or may use them for another loan, as long as the AP is not obligated to return them at that time. For the term of the ETF loan transaction, the AP hedges against market risk arising from any rebalancing of the ETF, which would change the amount or type of underlying instruments the AP would receive in exchange for the ETF compared to the underlying instruments the AP borrowed and submitted to the ETF agent to create the ETF shares. *See* David J. Abner, *The ETF Handbook,* Ch. 12 (2010); Jean M. McLoughlin, Davis Polk & Wardwell LLP, to Division of Corporation Finance, U.S. Securities and Exchange Commission, dated Jan. 23, 2013, available at *http://www.sec.gov/divisions/corpfin/cf-noaction/2013/davis-polk-wardwell-llp-012813–16a.pdf.*

[911] *See* SSgA (Feb. 2012).

[912] A number of commenters expressed concern that the proposed rule would limit market making or AP activity in ETFs because market makers and APs engage in trading to maintain a price relationship between ETFs and their underlying components, which promotes ETF market efficiency. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); Credit Suisse (Prop. Trading).

[913] Some commenters suggested that a range of arbitrage trading should be permitted under the market-making exemption. *See, e.g.,* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC. Other commenters, however, stated that arbitrage trading should be prohibited under the final rule. *See* AFR *et al.* (Feb. 2012); Volcker; Occupy. In response to commenters representing that it would be difficult to comply with this standard because it requires a trading desk to determine the proportionality of its activities in response to customer demand compared to its activities that are not in response to customer demand, the Agencies believe that the statute requires a banking entity to distinguish between market making-related activities that are designed not to exceed the reasonably expected near term demands of customers and impermissible proprietary trading. *See* Goldman (Prop. Trading); RBC.

[914] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

converted, or exercised for or into another instrument.[915]

The Agencies recognize that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of its inventory management activities and that interdealer trading provides certain market benefits, such as more efficient matching of customer order flow, greater hedging options to reduce risk, and enhanced ability to accumulate or exit customer-related positions.[916] The final rule does not prohibit a trading desk from using the market-making exemption to engage in interdealer trading that is consistent with and related to facilitating permissible trading with the trading desk's clients, customers, or counterparties.[917] However, in determining the reasonably expected near term demands of clients, customers, or counterparties, a trading desk generally may not account for the expected trading interests of a trading desk or other organizational unit of an entity with aggregate trading assets and liabilities of $50 billion or greater (except if the trading desk documents why and how a particular trading desk or other organizational unit at such a firm should be considered a customer or the trading desk or conduct market-making activity anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants).[918]

A trading desk may engage in interdealer trading to: Establish or acquire a position to meet the reasonably expected near term demands of its clients, customers, or counterparties, including current demand; unwind or sell positions acquired from clients, customers, or counterparties; or engage in risk-mitigating or inventory management transactions.[919] The Agencies believe that allowing a trading desk to continue to engage in customer-related interdealer trading is appropriate because it can help a trading desk appropriately manage its inventory and risk levels and can effectively allow clients, customers, or counterparties to access a larger pool of liquidity. While the Agencies recognize that effective intermediation of client, customer, or counterparty trading may require a trading desk to engage in a certain amount of interdealer trading, this is an activity that will bear some scrutiny by the Agencies and should be monitored by banking entities to ensure it reflects market-making activities and not impermissible proprietary trading.

ii. Impact of the Liquidity, Maturity, and Depth of the Market on the Analysis

Several commenters expressed concern about the potential impact of the proposed near term demand requirement on market making in less liquid markets and requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes.[920] The Agencies understand that reasonably expected near term customer demand may vary based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument(s) in which the trading desk acts as market maker.[921] As a result, the final rule recognizes that these factors impact the analysis of reasonably expected near term demands of clients, customers, or counterparties and the amount, types, and risks of market-maker inventory needed to meet such demand.[922] In particular, customer demand is likely to be more frequent in more liquid markets than in less liquid or illiquid markets. As a result, market makers in more liquid cash-based markets, such as liquid equity securities, should generally have higher rates of inventory turnover and less aged inventory than market makers in less liquid or illiquid markets.[923] Market makers in less liquid cash-based markets are more likely to hold a particular position for a longer period of time due to intermittent customer demand. In the derivatives markets, market makers carry open positions and manage various risk factors, such as exposure to different points on a yield curve. These exposures are analogous to inventory in the cash-based markets. Further, it may be more difficult to reasonably predict near term customer demand in less mature markets due to, among other things, a lack of historical experience with client, customer, or counterparty demands for the relevant product. Under these circumstances, the Agencies encourage banking entities to consider their experience with similar products or other relevant factors.[924]

iii. Demonstrable Analysis of Certain Factors

In the proposal, the Agencies stated that permitted market making includes taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or

[915] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Credit Suisse (Seidel). For example, customers have an expectation of general price alignment under these circumstances, both at the time they decide to invest in the instrument and for the remaining time they hold the instrument. To the contrary, general statistical arbitrage does not maintain a price relationship between related instruments that is expected and relied upon by customers and, thus, is not permitted under the market-making exemption. Firms engage in general statistical arbitrage to profit from differences in market prices between instruments, assets, or price or risk elements associated with instruments or assets that are thought to be statistically related, but which do not have a direct relationship of being exchangeable, convertible, or exercisable for the other.

[916] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Prof. Duffie; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[917] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity. *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012). One of these commenters analyzed the potential market impact of preventing interdealer trading, combined with inventory limits. *See* Oliver Wyman (Feb. 2012). Because the final rule does not prohibit interdealer trading or limit inventory in the manner this commenter assumed for purposes of its analysis, the Agencies do not believe the final rule will have the market impact cited by this commenter.

[918] *See* AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction).

[919] Provided it is consistent with the requirements of the market-making exemption, including the near term customer demand requirement, a trading desk may trade for purposes of determining how to price a financial instrument a customer *See*ks to trade with the trading desk or to determine the depth of the market for a financial instrument a customer *See*ks to trade with the trading desk. *See* Goldman (Prop. Trading).

[920] *See* CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); Morgan Stanley; RBC; ICI (Feb. 2012) ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock.

[921] *See supra* Part IV.A.3.c.2.b.ii. (discussing comments on this issue).

[922] *See* final rule § ____.4(b)(2)(ii)(A).

[923] The final rule does not impose additional capital requirements on aged inventory to discourage a trading desk from retaining positions in inventory, as suggested by some commenters. *See* CalPERS; Vanguard. The Agencies believe the final rule already limit a trading desk's ability to hold inventory over an extended period and do not *See* a need at this time to include additional capital requirements in the final rule. For example, a trading desk must have written policies and procedures relating to its inventory and must be able to demonstrate, as needed, its analysis of why the levels of its market-maker inventory are necessary to meet, or is a result of meeting, customer demand. *See* final rule § ____.4(b)(2)(ii), (iii)(C).

[924] The Agencies agree, as suggested by one commenter, it may be appropriate for a market maker in a new asset class or market to look to reasonably expected future developments on the basis of the trading desk's customer relationships. *See* Morgan Stanley. As discussed further below, the Agencies recognize that a trading desk could encounter similar issues if it is a new entrant in an existing market.

selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[925] A number of commenters expressed concern about this proposed interpretation's impact on market makers' inventory management activity and represented that it was inconsistent with the statute's near term demand standard, which permits market-making activity that is ''designed'' not to exceed the ''reasonably expected'' near term demands of customers.[926] In response to comments, the Agencies are permitting a trading desk to take positions in reasonable expectation of customer demand in the near term based on a demonstrable analysis that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

The proposal also stated that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation). Several commenters stated that it was unclear how such determinations should be made and expressed concern that near term customer demand cannot always be accurately predicted,[927] particularly in markets where trades occur infrequently and customer demand is hard to predict[928] or when a banking entity is entering a new market.[929] To address these comments, the Agencies are providing additional information about how a banking entity can comply with the statute's near term customer demand requirement, including a new requirement that a banking entity conduct a demonstrable assessment of reasonably expected near term customer demand and several examples of factors that may be relevant for conducting such an assessment. The Agencies believe it is important to require such demonstrable analysis to allow determinations of reasonably expected near term demand and associated inventory levels to be monitored and tested to ensure compliance with the statute and the final rule.

The final rule provides that, to help determine the appropriate amount, types, and risks of the financial instruments in the trading desk's market-maker inventory and to ensure that such inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of client, customers, or counterparties, a banking entity must conduct demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with financial instruments in which the trading desk makes a market, including through block trades. This analysis should not be static or fixed solely on current market or other factors. Instead, an appropriately conducted analysis under this provision will be both backward- and forward-looking by taking into account relevant historical trends in customer demand[930] and any events that are reasonably expected to occur in the near term that would likely impact demand.[931] Depending on the facts and circumstances, it may be proper for a banking entity to weigh these factors differently when conducting an analysis under this provision. For example, historical trends in customer demand may be less relevant when a trading desk is experiencing or expects to experience a change in the pattern of customer needs (*e.g.,* requests for block positioning), adjustments to its business model (*e.g.,* efforts to expand or contract its market shares), or changes in market conditions.[932] On the other hand, absent these types of current or anticipated events, the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory should be relatively consistent with such trading desk's historical profile of market-maker inventory.[933]

Moreover, the demonstrable analysis required under § ____.4(b)(2)(ii)(B) should account for, among other things, how the market factors discussed in § ____.4(b)(2)(ii)(A) impact the amount, types, and risks of market-maker inventory the trading desk may need to facilitate reasonably expected near term demands of clients, customers, or counterparties.[934] Other potential factors that could be used to assess reasonably expected near term customer demand and the appropriate amount, types, and risks of financial instruments in the trading desk's market-maker inventory include, among others: (i) Recent trading volumes and customer trends; (ii) trading patterns of specific customers or other observable customer demand patterns; (iii) analysis of the banking entity's business plan and ability to win new customer business; (iv) evaluation of expected demand under current market conditions

[925] *See* Joint Proposal, 76 FR 68,871; CFTC Proposal, 77 FR 8356–8357.

[926] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[927] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012) Alfred Brock.

[928] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[929] *See* CIEBA.

[930] To determine an appropriate historical dataset, a banking entity should assess the relation between current or reasonably expected near term conditions and demand and those of prior market cycles.

[931] This analysis may, where appropriate, take into account prior and/or anticipated cyclicality to the demands of clients, customers, or counterparties, which may cause variations in the amounts, types, and risks of financial instruments needed to provide intermediation services at different points in a cycle. For example, the final rule recognizes that a trading desk may need to accumulate a larger-than-average amount of inventory in anticipation of an index rebalance. *See supra* note 838 (discussing a comment on this issue). The Agencies are aware that a trading desk engaged in block positioning activity may have a less consistent pattern of inventory because of the need to take on large block positions at the request of customers. *See supra* note 761 and accompanying text (discussing comments on this issue).

Because the final rule does not prevent banking entities from providing direct liquidity for rebalance trades, the Agencies do not believe that the final rule will cause the market impacts that one commenter predicted would occur were such a restriction adopted. *See* Oliver Wyman (Feb. 2012) (estimating that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year).

[932] In addition, the Agencies recognize that a new entrant to a particular market or asset class may not have knowledge of historical customer demand in that market or asset class at the outset. *See supra* note 924 and accompanying text (discussing factors that may be relevant to new market entrants for purposes of determining the reasonably expected near term demands of clients, customers, or counterparties).

[933] One commenter suggested an approach that would allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether inventory can be tied to a particular customer in the near term or to historical trends in customer demand. *See* Credit Suisse (Seidel). The Agencies believe an approach that does not provide for any consideration of historical trends could result in a heightened risk of evasion. At the same time, as discussed above, the Agencies recognize that historical trends may not always determine the amount of inventory a trading desk may need to meet reasonably expected near term demand and it may under certain circumstances be appropriate to build inventory in anticipation of a reasonably expected near term event that would likely impact customer demand. While the Agencies are not requiring that market-maker inventory be tied to a particular customer, The Agencies are requiring that a banking entity analyze and support its expectations for near term customer demand.

[934] The Agencies recognize that a trading desk could acquire either a long or short position in reasonable anticipation of near term demands of clients, customers, or counterparties. In particular, if it is expected that customers will want to buy an instrument in the near term, it may be appropriate for the desk to acquire a long position in such instrument. If it is expected that customers will want to sell the instrument, acquiring a short position may be appropriate under certain circumstances.

compared to prior similar periods; (v) schedule of maturities in customers' existing portfolios; and (vi) expected market events, such as an index rebalancing, and announcements. The Agencies believe that some banking entities already analyze these and other relevant factors as part of their overall risk management processes.[935]

With respect to the creation and distribution of complex structured products, a trading desk may be able to use the market-making exemption to acquire some or all of the risk exposures associated with the product if the trading desk has evidence of customer demand for each of the significant risks associated with the product.[936] To have evidence of customer demand under these circumstances, there must be prior express interest from customers in the specific risk exposures of the product. Without such express interest, a trading desk would not have sufficient information to support the required demonstrable analysis (*e.g.,* information about historical customer demand or other relevant factors).[937] The Agencies are concerned that, absent express interest in each significant risk associated with the product, a trading desk could evade the market-making exemption by structuring a deal with certain risk exposures, or amounts of risk exposures, for which there is no customer demand and that would be retained in the trading desk's inventory, potentially for speculative purposes. Thus, a trading desk would not be engaged in permitted market making-related activity if, for example, it structured a product solely to acquire a desired exposure and not to respond to customer demand.[938] When a trading desk acquires risk exposures in these circumstances, the trading desk would be expected to enter into appropriate hedging transactions or otherwise mitigate the risks of these exposures, consistent with its hedging policies and procedures and risk limits.

With regard to a trading desk that conducts its market-making activities on an exchange or other similar anonymous trading facility, the Agencies continue to believe that market-making activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy or by regularly responding to requests for quotes in markets where resting orders are not generally provided. This ensures that the trading desk has a pattern of providing, rather than taking, liquidity. However, this does not mean that a trading desk acting as a market maker on an exchange or other similar anonymous trading facility is only permitted to use these types of orders in connection with its market making-related activities. The Agencies recognize that it may be appropriate for a trading desk to enter market or marketable limit orders on an exchange or other similar anonymous trading facility, or to request quotes from other market participants, in connection with its market making-related activities for a variety of purposes including, among others, inventory management, addressing order imbalances on an exchange, and hedging.[939] In response to comments, the Agencies are not requiring a banking entity to be registered as a market maker on an exchange or other similar anonymous trading facility, if the exchange or other similar anonymous trading facility registers market makers, for purposes of the final rule.[940] The Agencies recognize, as noted by commenters, that there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices and that requiring registration with each exchange or other trading facility may unnecessarily restrict or impose burdens on exchange market-making activities.[941]

A banking entity is not required to conduct the demonstrable analysis under § ____.4(b)(2)(B) of the final rule on an instrument-by-instrument basis. The Agencies recognize that, in certain cases, customer demand may be for a particular type of exposure, and a customer may be willing to trade any one of a number of instruments that would provide the demanded exposure. Thus, an assessment of the amount, types, and risks of financial instruments that the trading desk may hold in market-maker inventory and that would be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties does not need to be made for each financial instrument in which the trading desk acts as market maker. Instead, the amount and types of financial instruments in the trading desk's market-maker inventory should be consistent with the types of financial instruments in which the desk makes a market and the amount and types of such instruments that the desk's customers are reasonably expected to be interested in trading.

In response to commenters' concern that banking entities may be subject to regulatory sanctions if reasonably expected customer demand does not materialize,[942] the Agencies recognize that predicting the reasonably expected near term demands of clients, customers, or counterparties is inherently subject to changes based on market and other factors that are difficult to predict with certainty. Thus, there may at times be differences between predicted demand and actual demand from clients, customers, or

[935] *See supra* Part IV.A.3.c.2.b.iii. *See* FTN; Morgan Stanley (suggesting a standard that would require a position to be ''reasonably consistent with observable customer demand patterns'').

[936] Complex structured products can contain a combination of several different types of risks, including, among others, market risk, credit risk, volatility risk, and prepayment risk.

[937] In contrast, a trading desk may respond to requests for customized transactions, such as custom swaps, provided that the trading desk is a market maker in the risk exposures underlying the swap or can hedge the underlying risk exposures, consistent with its financial exposure and hedging limits, and otherwise meets the requirements of the market-making exemption. For example, a trading desk may routinely make markets in underlying exposures and, thus, would meet the requirements for engaging in transactions in derivatives that reflect the same exposures. Alternatively, a trading desk might meet the requirements by routinely trading in the derivative and hedging in the underlying exposures. *See supra* Part IV.A.3.c.1.c.iii.

[938] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012).

[939] The Agencies are clarifying this point in response to commenters who expressed concern that the proposal would prevent an exchange market maker from using market or marketable limit orders under these circumstances. *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); RBC.

[940] *See supra* notes 774 to 779 and accompanying text (discussing commenters' response to statements in the proposal requiring exchange registration as a market maker under certain circumstances). Similarly, the final rule does not establish a presumption of compliance with the market-making exemption based on registration as a market maker with an exchange, as requested by a few commenters. *See supra* note 777 and accompanying text. As noted above, activity that is considered market making for purposes of this rule may not be considered market making for purposes of other rules, including self-regulatory organization rules, and vice versa. In addition, exchange requirements for registered market makers are subject to change without consideration of the impact on this rule. Although a banking entity is not required to be an exchange-registered market maker under the final rule, a banking entity must be licensed or registered to engage in market making-related activities in accordance with applicable law. For example, a banking entity would be required to be an SEC-registered broker-dealer to engage in market making-related activities in securities in the U.S. unless the banking entity is exempt from registration or excluded from regulation as a dealer under the Exchange Act. *See infra* Part IV.A.3.c.6.; final rule § ____.4(b)(2)(vi).

[941] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

[942] *See* RBC; CIEBA; Wellington; ICI (Feb. 2012) Invesco.

counterparties. However, assessments of expected near term demand may not be reasonable if, in the aggregate and over longer periods of time, a trading desk exhibits a repeated pattern or practice of significant variation in the amount, types, and risks of financial instruments in its market-maker inventory in excess of what is needed to facilitate near term customer demand.

iv. Relationship to Required Limits

As discussed further below, a banking entity must establish limits for each trading desk on the amount, types, and risks of its market-maker inventory, level of exposures to relevant risk factors arising from its financial exposure, and period of time a financial instrument may be held by a trading desk. These limits must be reasonably designed to ensure compliance with the market-making exemption, including the near term customer demand requirement, and must take into account the nature and amount of the trading desk's market making-related activities. Thus, the limits should account for and generally be consistent with the historical near term demands of the desk's clients, customers, or counterparties and the amount, types, and risks of financial instruments that the trading desk has historically held in market-maker inventory to meet such demands. In addition to the limits that a trading desk selects in managing its positions to ensure compliance with the market-making exemption set out in § ____.4(b), the Agencies are requiring, for banking entities that must report metrics in Appendix A, such limits include, at a minimum, ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics as limits, except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.[943] The Agencies believe that these metrics can be useful for measuring and managing many types of positions and trading activities and therefore can be useful in establishing a minimum set of metrics for which limits should be applied.[944]

As this requirement applies on an ongoing basis, a trade in excess of one or more limits set for a trading desk should not be permitted simply because it responds to customer demand. Rather, a banking entity's compliance program must include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the requirements of this near term demand requirement and with the prudent management of risk by the banking entity, and independent review of such demonstrable analysis and approval.[945] The Agencies expect that a trading desk's escalation procedures will generally explain the circumstances under which a trading desk's limits can be increased, either temporarily or permanently, and that such increases must be consistent with reasonably expected near term demands of the desk's clients, customers, or counterparties and the amount and type of risks to which the trading desk is authorized to be exposed.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

To ensure that a banking entity relying on the market-making exemption had an appropriate framework in place to support its compliance with the exemption, § ____ .4(b)(2)(i) of the proposed rule required a banking entity to establish an internal compliance program, as required by subpart D of the proposal, designed to ensure compliance with the requirements of the market-making exemption.[946]

b. Comments on the Proposed Compliance Program Requirement

A few commenters supported the proposed requirement that a banking entity establish a compliance program under § ____.20 of the proposed rule as effective.[947] For example, one commenter stated that the requirement ''keeps a strong focus on the bank's own workings and allows banks to self-monitor.'' [948] One commenter indicated that a comprehensive compliance program is a ''cornerstone of effective corporate governance,'' but cautioned against placing ''undue reliance'' on compliance programs.[949] As discussed further below in Parts IV.C.1. and IV.C.3., many commenters expressed concern about the potential burdens of the proposed rule's compliance program requirement, as well as the proposed requirement regarding quantitative measurements. According to one commenter, the compliance burdens associated with these requirements may dissuade a banking entity from attempting to comply with the market-making exemption.[950]

c. Final Compliance Program Requirement

Similar to the proposed exemption, the market-making exemption adopted in the final rule requires that a banking entity establish and implement, maintain, and enforce an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing.[951] This provision further requires that the compliance program include particular written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

- The financial instruments each trading desk stands ready to purchase and sell as a market maker;
- The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the required limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;
- Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by the near term customer demand requirement of the final rule, on:
  - The amount, types, and risks of its market-maker inventory;

[943] *See* Appendix A.

[944] The Agencies recognize that for some types of positions or trading strategies, the use of ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics may be ineffective and accordingly limits do not need to be set for those metrics if such ineffectiveness is demonstrated by the banking entity.

[945] *See* final rule § ____.4(b)(2)(iii); *infra* Part IV.A.3.c.3.c. (discussing the meaning of ''independent'' review for purposes of this requirement).

[946] *See* proposed rule § ____.4(b)(2)(i); Joint Proposal, 76 FR 68,870; CFTC Proposal, 77 FR 8355.

[947] *See* Flynn & Fusselman; Morgan Stanley.

[948] *See* Flynn & Fusselman.

[949] *See* Occupy.

[950] *See* ICI (Feb. 2012).

[951] The independent testing standard is discussed in more detail in Part IV.C., which discusses the compliance program requirement in § ____.20 of the final rule.

○ The amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes;

○ Level of exposures to relevant risk factors arising from its financial exposure; and

○ Period of time a financial instrument may be held;

• Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its required limits; and

• Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of § ____.4(b)(2)(ii) of the final rule, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[952]

The compliance program requirement in the proposed market-making exemption did not include specific references to all the compliance program elements now listed in the final rule. Instead, these elements were generally included in the compliance requirements of Appendix C of the proposed rule. The Agencies are moving certain of these requirements into the market-making exemption to ensure that critical components are made part of the compliance program for market making-related activities. Further, placing these requirements within the market-making exemption emphasizes the important role they play in overall compliance with the exemption.[953] Banking entities should note that these compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in market making-related activities under the final rule. Each of the requirements in paragraphs (b)(2)(iii)(A) through (E) must be appropriately tailored to the individual trading activities and strategies of each trading desk on an ongoing basis.

As a threshold issue, the compliance program must identify the products, instruments, and exposures the trading desk may trade as market maker or for risk management purposes.[954] Identifying the relevant instruments in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the exemption by preventing an individual trader on a market-making desk from establishing positions in instruments that are unrelated to the desk's market-making function. Further, this identification of instruments helps form the basis for the specific types of inventory and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, depth, and maturity of the market for the relevant type of financial instrument. The Agencies note that a banking entity should be able to demonstrate the relationship between the instruments in which a trading desk may act as market maker and the instruments the desk may use to manage the risk of its market making-related activities and inventory and why the instruments the desk may use to manage its risk appropriately and effectively mitigate the risk of its market making-related activities without generating an entirely new set of risks that outweigh the risks that are being hedged.

The final rule provides that a banking entity must establish an appropriate risk management framework for each of its trading desks that rely on the market-making exemption.[955] This includes not only the techniques and strategies that a trading desk may use to manage its risk exposures, but also the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposures consistent with its required limits, which are discussed in more detail below. While the Agencies do not expect a trading desk to hedge all of the risks that arise from its market making-related activities, the Agencies do expect each trading desk to take appropriate steps consistent with market-making activities to contain and limit risk exposures (such as by unwinding unneeded positions) and to follow reasonable procedures to monitor the trading desk's risk exposures (*i.e.,* its financial exposure) and hedge risks of its financial exposure to remain within its relevant risk limits.[956]

[952] *See* final rule § ____.4(b)(2)(iii).

[953] The Agencies note that a number of commenters requested that the Agencies place a greater emphasis on inventory limits and risk limits in the final exemption. *See, e.g.,* Citigroup (suggesting that the market-making exemption utilize risk limits that would be set for each trading unit based on expected levels of customer trading—estimated by looking to historical results, target product and customer lists, and target market share—and an appropriate amount of required inventory to support that level of customer trading); Prof. Colesanti *et al.* (suggesting that the exemption include, among other things, a bright-line threshold of the amount of risk that can be retained (which cannot be in excess of the size and type required for market making), positions limits, and limits on holding periods); Sens. Merkley & Levin (Feb. 2012) (suggesting the use of specific parameters for inventory levels, along with a number of other criteria, to establish a safe harbor); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (recommending the use of risk limits in combination with a guidance-based approach); Japanese Bankers Ass'n. (suggesting that the rule set risk allowances for market making-related activities based on required capital for such activities). The Agencies are not establishing specific limits in the final rule, as some commenters appeared to recommend, in recognition of the fact that appropriate limits will differ based on a number of factors, including the size of the market-making operation and the liquidity, depth, and maturity of the market for the particular type(s) of financial instruments in which the trading desk is permitted to trade. *See* Sens. Merkley & Levin (Feb. 2012); Prof. Colesanti *et al.* However, banking entities relying on the market-making exemption must set limits and demonstrate how the specific limits and limit methodologies they have chosen are reasonably designed to limit the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory consistent with the reasonably expected near term demands of the banking entity's clients, customers, and counterparties, subject to the market and conditions discussed above, and to commensurately control the desk's overall financial exposure.

[954] *See* final rule § ____.4(b)(2)(iii)(A) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell in accordance with § ____.4(b)(2)(i) of the final rule); final rule § ____.4(b)(2)(iii)(B) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the products, instruments, or exposures each trading desk may use for risk management purposes).

[955] This standard addresses issues raised by commenters concerning: Certain language in proposed Appendix B regarding market making-related risk management; the market making-related hedging provision in § ____.4(b)(3) of the proposed rule; and, to some extent, the proposed source of revenue requirement in § ____.4(b)(2)(v) of the proposed rule. *See* Joint Proposal, 76 FR 68,960; CFTC Proposal, 77 FR 8439–8440; proposed rule § ____.4(b)(3); Joint Proposal, 76 FR 68,873; CFTC Proposal, 77 FR 8358; Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); Alliance Bernstein; Investure; Invesco; Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); FTN; RBC; NYSE Euronext; MFA. As discussed in more detail above, a number of commenters emphasized that market making-related activities necessarily involve a certain amount of risk-taking to provide ''immediacy'' to customers. *See, e.g.,* Prof. Duffie; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Commenters also represented that the amount of risk a market maker needs to retain may differ across asset classes and markets. *See, e.g.,* Morgan Stanley; Credit Suisse (Seidel). The Agencies believe that the requirement we are adopting better recognizes that appropriate risk management will tailor acceptable position, risk and inventory limits based on the type(s) of financial instruments in which the trading desk is permitted to trade and the liquidity, maturity, and depth of the market for the relevant type of financial instrument.

[956] It may be more efficient for a banking entity to manage some risks at a higher organizational level than the trading desk level. As a result, a banking entity's written policies and procedures may delegate the responsibility to mitigate specific risks of the trading desk's financial exposure to an entity other than the trading desk, including another organizational unit of the banking entity or of an affiliate, provided that such organizational unit of the banking entity or of an affiliate is identified in the banking entity's written policies and procedures. Under these circumstances, the

Continued

As discussed in Part IV.A.3.c.4.c., managing the risks associated with maintaining a market-maker inventory that is appropriate to meet the reasonably expected near-term demands of customers is an important part of market making.[957] The Agencies understand that, in the context of market-making activities, inventory management includes adjustment of the amount and types of market-maker inventory to meet the reasonably expected near term demands of customers.[958] Adjustments of the size and types of a financial exposure are also made to reduce or mitigate the risks associated with financial instruments held as part of a trading desk's market-maker inventory. A common strategy in market making is to establish market-maker inventory in anticipation of reasonably expected customer needs and then to reduce that market-maker inventory over time as customer demand materializes.[959] If customer demand does not materialize, the market maker addresses the risks associated with its market-maker inventory by adjusting the amount or types of financial instruments in its inventory as well as taking steps otherwise to mitigate the risk associated with its inventory.

The Agencies recognize that, to provide effective intermediation services, a trading desk engaged in permitted market making-related activities retains a certain amount of risk arising from the positions it holds in inventory and may hedge certain aspects of that risk. The requirements in the final rule establish controls around a trading desk's risk management activities, yet still recognize that a trading desk engaged in market making-related activities may retain a certain amount of risk in meeting the reasonably expected near term demands of clients, customers, or counterparties. As the Agencies noted in the proposal, where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act.[960] The Agencies emphasize that the only risk management activities that qualify for the market-making exemption—and that are not subject to the hedging exemption—are risk management activities conducted or directed by the trading desk in connection with its market making-related activities and in conformance with the trading desk's risk management policies and procedures.[961] A trading desk engaged in market making-related activities would be required to comply with the hedging exemption or another available exemption for any risk management or other activity that is not in conformance with the trading desk's required market-making risk management policies and procedures.

A banking entity's written policies and procedures, internal controls, analysis, and independent testing identifying and addressing the products, instruments, or exposures and the techniques and strategies that may be used by each trading desk to manage the risks of its market making-related activities and inventory must cover both how the trading desk may establish hedges and how such hedges are removed once the risk they were mitigating is unwound. With respect to establishing positions that hedge or otherwise mitigate the risk(s) of market making-related positions held by the trading desk, the written policies and procedures may consider the natural hedging and diversification that occurs in an aggregation of long and short positions in financial instruments for which the trading desk is a market maker,[962] as it documents its specific risk-mitigating strategies that use instruments for which the desk is a market maker or instruments for which the desk is not a market maker. Further, the written policies and procedures identifying and addressing permissible hedging techniques and strategies must address the circumstances under which the trading desk may be permitted to engage in anticipatory hedging. Like the proposed rule's hedging exemption, a trading desk may establish an anticipatory hedge position before it becomes exposed to a risk that it is highly likely to become exposed to, provided there is a sound risk management rationale for establishing such an anticipatory hedge position.[963] For example, a trading desk may hedge against specific positions promised to customers, such as volume-weighted average price (''VWAP'') orders or large block trades, to facilitate the customer trade.[964] The amount of time that an anticipatory hedge may precede the establishment of the position to be hedged will depend on market factors, such as the liquidity of the hedging position.

Written policies and procedures, internal controls, analysis, and independent testing established pursuant to the final rule identifying and addressing permissible hedging techniques and strategies should be designed to prevent a trading desk from over-hedging its market-maker inventory or financial exposure. Over-hedging would occur if, for example, a trading desk established a position in a financial instrument for the purported purpose of reducing a risk associated with one or more market-making positions when, in fact, that risk had already been mitigated to the full extent possible. Over-hedging results in a new risk exposure that is unrelated to market-making activities and, thus, is not permitted under the market-making exemption.

other organizational unit of the banking entity or of an affiliate must conduct such hedging activity in accordance with the requirements of the hedging exemption in § ____.5 of the final rule, including the documentation requirement in § ____.5(c). As recognized in Part IV.A.4.d.4., hedging activity conducted by a different organizational unit than the unit responsible for the positions being hedged presents a greater risk of evasion. Further, the risks being managed by a higher organizational level than the trading desk may be generated by trading desks engaged in market making-related activity or by trading desks engaged in other permitted activities. Thus, it would be inappropriate for such hedging activity to be conducted in reliance on the market-making exemption.

[957] *See supra* Part IV.A.3.c.2.c. (discussing the final near term demand requirement).

[958] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[959] *See, e.g.,* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[960] *See* Joint Proposal, 76 FR 68,873; CFTC Proposal, 77 FR 8358.

[961] As discussed above, if a trading desk operating under the market-making exemption directs a different organizational unit of the banking entity or an affiliate to establish a hedge position on the desk's behalf, then the other organizational unit may rely on the market-making exemption to establish the hedge position as long as: (i) The other organizational unit's hedging activity is consistent with the trading desk's risk management policies and procedures (*e.g.,* the hedge instrument, technique, and strategy are consistent with those identified in the trading desk's policies and procedures); and (ii) the hedge position is attributed to the financial exposure of the trading desk and is included in the trading desk's daily profit and loss. If a different organizational unit of the banking entity or of an affiliate establishes a hedge for the trading desk's financial exposure based on its own determination, or if such position was not established in accordance with the trading desk's required procedures or was included in that other organizational unit's financial exposure and/or daily profit and loss, then that hedge position must be established in compliance with the hedging exemption in § ____.5 of the rule, including the documentation requirement in § ____.5(c). *See supra* Part IV.A.3.c.1.c.ii.

[962] For example, this may occur if a U.S. corporate bond trading desk acquires a $100 million long position in the corporate bonds of one issuer from clients, customers, or counterparties and separately acquires a $50 million short position in another issuer in the same market sector in reasonable expectation of near term demand of clients, customers, or counterparties. Although both positions were acquired to facilitate customer demand, the positions may also naturally hedge each other, to some extent.

[963] *See* Joint Proposal, 76 FR 68,875; CFTC Proposal, 77 FR 8361.

[964] Two commenters recommended that banking entities be permitted to establish hedges prior to acquiring the underlying risk exposure under these circumstances. *See* Credit Suisse (Seidel); BoA.

A trading desk's financial exposure generally would not be considered to be consistent with market making-related activities to the extent the trading desk is engaged in hedging activities that are inconsistent with the management of identifiable risks in its market-maker inventory or maintains significant hedge positions after the underlying risk(s) of the market-maker inventory have been unwound. A banking entity's written policies and procedures, internal controls, analysis, and independent testing regarding the trading desk's permissible hedging techniques and strategies must be designed to prevent a trading desk from engaging in over-hedging or maintaining hedge positions after they are no longer needed.[965] Further, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities are and continue to be effective, which would include monitoring for and addressing any scenarios where a trading desk may be engaged in over-hedging or maintaining unnecessary hedge positions or new significant risks have been introduced by the hedging activity.

As a result of these limitations, the size and risks of the trading desk's hedging positions are naturally constrained by the size and risks of its market-maker inventory, which must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as well as by the risk limits and controls established under the final rule. This ultimately constrains a trading desk's overall financial exposure since such position can only contain positions, risks, and exposures related to the market-maker inventory that are designed to meet current or near term customer demand and positions, risks and exposures designed to mitigate the risks in accordance with the limits previously established for the trading desk.

The written policies and procedures identifying and addressing a trading desk's hedging techniques and strategies also must describe how and under what timeframe a trading desk must remove hedge positions once the underlying risk exposure is unwound. Similarly, the compliance program established by the banking entity to specify and control the trading desk's hedging activities in accordance with the final rule must be designed to prevent a trading desk from purposefully or inadvertently transforming its positions taken to manage the risk of its market-maker inventory under the exemption into what would otherwise be considered prohibited proprietary trading.

Moreover, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities and inventory—including the instruments, techniques, and strategies used for risk management purposes—are and continue to be effective. This includes ensuring that hedges taken in the context of market making-related activities continue to be effective and that positions taken to manage the risks of the trading desk's market-maker inventory are not purposefully or inadvertently transformed into what would otherwise be considered prohibited proprietary trading. If a banking entity's monitoring procedures find that a trading desk's risk management procedures are not effective, such deficiencies must be promptly escalated and remedied in accordance with the banking entity's escalation procedures. A banking entity's written policies and procedures must set forth the process for determining the circumstances under which a trading desk's risk management strategies may be modified. In addition, risk management techniques and strategies developed and used by a trading desk must be independently tested or verified by management separate from the trading desk.

To control and limit the amount and types of financial instruments and risks that a trading desk may hold in connection with its market making-related activities, a banking entity must establish, implement, maintain, and enforce reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing specific limits on a trading desk's market-maker inventory, risk management positions, and financial exposure. In particular, the compliance program must establish limits for each trading desk, based on the nature and amount of its market making-related activities (including the factors prescribed by the near term customer demand requirement), on the amount, types, and risks of its market-maker inventory, the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes, the level of exposures to relevant risk factors arising from its financial exposure, and the period of time a financial instrument may be held.[966] The limits would be set, as appropriate, and supported by an analysis for specific types of financial instruments, levels of risk, and duration of holdings, which would also be required by the compliance appendix. This approach will build on existing risk management infrastructure for market-making activities that subject traders to a variety of internal, predefined limits.[967] Each of these limits is independent of the others, and a trading desk must maintain its aggregated market-making position within each of these limits, including by taking action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[968] For example, if changing market conditions cause an increase in one or more risks within the trading desk's financial exposure and that increased risk causes the desk to exceed one or more of its limits, the trading desk must take prompt action to reduce its risk exposure (either by hedging the risk or unwinding its existing positions) or receive approval of a temporary or permanent increase to its limit through the required escalation procedures.

The Agencies recognize that trading desks' limits will differ across asset classes and acknowledge that trading desks engaged in market making-related activities in less liquid asset classes, such as corporate bonds, certain derivatives, and securitized products, may require different inventory, risk exposure, and holding period limits than trading desks engaged in market making-related activities in more liquid financial instruments, such as certain listed equity securities. Moreover, the types of risk factors for which limits are established should not be limited solely to market risk factors. Instead, such limits should also account for all risk factors that arise from the types of financial instruments in which the trading desk is permitted to trade. In addition, these limits should be sufficiently granular and focused on the particular types of financial instruments in which the desk may trade. For example, a trading desk that makes a market in derivatives would have exposures to counterparty risk, among others, and would need to have appropriate limits on such risk. Other types of limits that may be relevant for a trading desk include, among others,

[965] *See* final rule § ____.4(b)(2)(iii)(B).

[966] *See* final rule § ____.4(b)(2)(iii)(C).

[967] *See, e.g.,* Citigroup (Feb. 2012) (noting that its suggested approach to implementing the market-making exemption, which would focus on risk limits and risk architecture, would build on existing risk limits and risk management systems already present in institutions).

[968] *See* final rule § ____.4(b)(2)(iv).

position limits, sector limits, and geographic limits.

A banking entity must have a reasonable basis for the limits it establishes for a trading desk and must have a robust procedure for analyzing, establishing, and monitoring limits, as well as appropriate escalation procedures.[969] Among other things, the banking entity's compliance program must provide for: (i) Written policies and procedures and internal controls establishing and monitoring specific limits for each trading desk; and (ii) analysis regarding how and why these limits are determined to be appropriate and consistent with the nature and amount of the desk's market making-related activities, including considerations related to the near term customer demand requirement. In making these determinations, a banking entity should take into account and be consistent with the type(s) of financial instruments the desk is permitted to trade, the desk's trading and risk management activities and strategies, the history and experience of the desk, and the historical profile of the desk's near term customer demand and market and other factors that may impact the reasonably expected near term demands of customers.

The limits established by a banking entity should generally reflect the amount and types of inventory and risk that a trading desk holds to meet the reasonably expected near term demands of clients, customers, or counterparties. As discussed above, while the trading desk's market-maker inventory is directly limited by the reasonably expected near term demands of customers, the positions managed by the trading desk outside of its market-maker inventory are similarly constrained by the near term demand requirement because they must be designed to manage the risks of the market-maker inventory in accordance with the desk's risk management procedures. As a result, the trading desk's risk management positions and aggregate financial exposure are also limited by the current and reasonably expected near term demands of customers. A trading desk's market-maker inventory, risk management positions, or financial exposure would not, however, be permissible under the market-making exemption merely because the market-maker inventory, risk management positions, or financial exposure happens to be within the desk's prescribed limits.[970]

In addition, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits and patterns regarding the portions of the trading desk's limits that are accounted for by the trading desk's activity.[971] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes or modifications to the trading desk's strategy).[972] This process must cover potential scenarios when a trading desk's limits should be raised, as well as potential scenarios when a trading desk's limits should be lowered. For example, if a trading desk experiences reduced customer demand over a period of time, that trading desk's limits should be decreased to address the factors prescribed by the near term demand requirement.

A banking entity's compliance program must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval of any increase to one or more of a trading desk's limits.[973] Thus, in order to increase a limit of a trading desk—on either a temporary or permanent basis—there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, including the factors identified in § ____.4(b)(2)(ii) of the final rule, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § ____.20(b)(6).

As already discussed, commenters have represented that the compliance costs associated with the proposed rule, including the compliance program and metrics requirements, may be significant and ''may dissuade a banking entity from attempting to comply with the market making-related activities exemption.''[974] The Agencies believe that a robust compliance program is necessary to ensure adherence to the rule and to prevent evasion, although, as discussed in Part IV.C.3., the Agencies are adopting a more tailored set of quantitative measurements to better focus on those that are most germane to evaluating market making-related activity. The Agencies acknowledge that the compliance program requirements for the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing, represent a new regulatory requirement for banking entities and the Agencies have thus been mindful that it may impose significant costs and may cause a banking entity to reconsider whether to conduct market making-related activities. Despite the potential costs of the compliance program, the Agencies believe they are warranted to ensure that the goals of the rule and statute will be met, such as promoting the safety and soundness of banking entities and the financial stability of the United States.

4. Market Making-Related Hedging

a. Proposed Treatment of Market Making-Related Hedging

In the proposal, certain hedging transactions related to market making were considered to be made in connection with a banking entity's market making-related activity for purposes of the market-making exemption. The Agencies explained that where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in

[969] *See* final rule § ____.4(b)(2)(iii)(C).

[970] For example, if a U.S. corporate bond trading desk has a prescribed limit of $200 million net exposure to any single sector of related issuers, the desk's limits may permit it to acquire a net economic exposure of $400 million long to issuer ABC and a net economic exposure of $300 million short to issuer XYZ, where ABC and XYZ are in the same sector. This is because the trading desk's net exposure to the sector would only be $100 million, which is within its limits. Even though the net exposure to this sector is within the trading desk's prescribed limits, the desk would still need to be able to demonstrate how its net exposure of $400 million long to issuer ABC and $300 million short to issuer XYZ is related to customer demand.

[971] *See* final rule § ____.4(b)(2)(iii)(D).

[972] For example, a banking entity may determine to permit temporary, short-term increases to a trading desk's risk limits due to an increase in short-term credit spreads or in response to volatility in instruments in which the trading desk makes a market, provided the increased limit is consistent with the reasonably expected near term demands of clients, customers, or counterparties. As noted above, other potential circumstances that could warrant changes to a trading desk's limits include: A change in the pattern of customer needs, adjustments to the market maker's business model (*e.g.,* new entrants or existing market makers trying to expand or contract their market share), or changes in market conditions. *See supra* note 932 and accompanying text.

[973] *See* final rule § ____.4(b)(2)(iii)(E).

[974] *See* ICI (Feb. 2012).

section 13(d)(1)(B) of the BHC Act.[975] To qualify for the market-making exemption, a hedging transaction would have been required to meet certain requirements under § ____.4(b)(3) of the proposed rule. This provision required that the purchase or sale of a financial instrument: (i) Be conducted to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption; and (ii) meet the criteria specified in § ____.5(b) of the proposed hedging exemption and, where applicable, § ____.5(c) of the proposal.[976] In the proposal, the Agencies noted that a market maker may often make a market in one type of financial instrument and hedge its activities using different financial instruments in which it does not make a market. The Agencies stated that this type of hedging transaction would meet the terms of the market-making exemption if the hedging transaction met the requirements of § ____.4(b)(3) of the proposed rule.[977]

b. Comments on the Proposed Treatment of Market Making-Related Hedging

Several commenters recommended that the proposed market-making exemption be modified to establish a more permissive standard for market maker hedging.[978] A few of these commenters stated that, rather than applying the standards of the risk-mitigating hedging exemption to market maker hedging, a market maker's hedge position should be permitted as long as it is designed to mitigate the risk associated with positions acquired through permitted market making-related activities.[979] Other commenters emphasized the need for flexibility to permit a market maker to choose the most effective hedge.[980] In general, these commenters expressed concern that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers.[981] For example, one commenter stated that ''[t]he ability of market makers to freely offset or hedge positions is what, in most cases, makes them willing to buy and sell [financial instruments] to and from customers, clients or counterparties,'' so ''[a]ny impediment to hedging market making-related positions will decrease the willingness of banking entities to make markets and, accordingly, reduce liquidity in the marketplace.'' [982]

In addition, some commenters expressed concern that certain requirements in the proposed hedging exemption may result in a reduction in market-making activities under certain circumstances.[983] For example, one commenter expressed concern that the proposed hedging exemption would require a banking entity to identify and tag hedging transactions when hedges in a particular asset class take place alongside a trading desk's customer flow trading and inventory management in that same asset class.[984] Further, a few commenters represented that the proposed reasonable correlation requirement in the hedging exemption could impact market making by discouraging market makers from entering into customer transactions that do not have a direct hedge [985] or making it more difficult for market makers to cost-effectively hedge the fixed income securities they hold in inventory, including hedging such inventory positions on a portfolio basis.[986]

One commenter, however, stated that the proposed approach is effective.[987] Another commenter indicated that it is confusing to include hedging within the market-making exemption and suggested that a market maker be required to rely on the hedging exemption under § ____.5 of the proposed rule for its hedging activity.[988]

As noted above in the discussion of comments on the proposed source of revenue requirement, a number of commenters expressed concern that the proposed rule assumed that there are effective, or perfect, hedges for all market making-related positions.[989] Another commenter stated that market makers should be required to hedge whenever an inventory imbalance arises, and the absence of a hedge in such circumstances may evidence prohibited proprietary trading.[990]

c. Treatment of Market Making-Related Hedging in the Final Rule

Unlike the proposed rule, the final rule does not require that market making-related hedging activities separately comply with the requirements found in the risk-mitigating hedging exemption if conducted or directed by the same trading desk conducting the market-making activity. Instead, the Agencies are including requirements for market making-related hedging activities within the market-making exemption in response to comments.[991] As discussed above, a trading desk's compliance program must include written policies and procedures, internal controls, independent testing and analysis identifying and addressing the products, instruments, exposures, techniques, and strategies a trading desk may use to manage the risks of its market making-related activities, as well as the actions the trading desk will take to demonstrably reduce or otherwise significant mitigate the risks of its financial exposure consistent with its required limits.[992] The Agencies believe this approach addresses commenters' concerns that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers because it allows banking entities to determine how best to manage the risks of trading desks' market making-related activities through reasonable policies and procedures, internal controls, independent testing, and analysis, rather than requiring compliance with the specific requirements of the hedging exemption.[993] Further, this approach addresses commenters' concerns about the impact of certain requirements of the hedging exemption on market making-related activities.[994]

The Agencies believe it is consistent with the statute's reference to ''market making-related'' activities to permit

[975] *See* Joint Proposal, 76 FR 68,873; CFTC Proposal, 77 FR 8358.

[976] *See* proposed rule § ____.4(b)(3); Joint Proposal, 76 FR 68,873; CFTC Proposal, 77 FR 8358.

[977] *See* Joint Proposal, 76 FR 68,870 n.146; CFTC Proposal, 77 FR 8356 n.152.

[978] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA. These comments are addressed in Part IV.A.3.c.4.c., *infra.*

[979] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* FTN (stating that the principal requirement for such hedges should be that they reduce the risk of market making).

[980] *See* NYSE Euronext (stating that the best hedge sometimes involves a variety of complex and dynamic transactions over the time in which an asset is held, which may fall outside the parameters of the exemption); MFA; JPMC.

[981] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[982] RBC.

[983] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012).

[984] *See* Goldman (Prop. Trading).

[985] *See* BoA.

[986] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[987] *See* Alfred Brock.

[988] *See* Occupy.

[989] *See infra* notes 1068 to 1070 and accompanying text.

[990] *See* Public Citizen.

[991] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA.

[992] *See* final rule § ____.4(b)(2)(iii)(B); *supra* Part IV.A.3.c.3.c.

[993] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[994] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading).

market making-related hedging activities under this exemption. In addition, the Agencies believe it is appropriate to require a trading desk to appropriately manage its risks, consistent with its risk management procedures and limits, because management of risk is a key factor that distinguishes permitted market making-related activity from impermissible proprietary trading. As noted in the proposal, while ''a market maker attempts to eliminate some [of the risks arising from] its retained principal positions and risks by hedging or otherwise managing those risks [ ], a proprietary trader seeks to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains.'' [995]

The Agencies recognize that some banking entities may manage the risks associated with market making at a different level than the individual trading desk.[996] While this risk management activity is not permitted under the market-making exemption, it may be permitted under the hedging exemption, provided the requirements of that exemption are met. Thus, the Agencies believe banking entities will continue to have options available that allow them to efficiently hedge the risks arising from their market-making operations. Nevertheless, the Agencies understand that this rule will result in additional documentation or other potential burdens for market making-related hedging activity that is not conducted by the trading desk responsible for the market-making positions being hedged.[997] As discussed in Part IV.A.4.d.4., hedging conducted by a different organizational unit than the trading desk that is responsible for the underlying positions presents an increased risk of evasion, so the Agencies believe it is appropriate for such hedging activity to be required to comply with the hedging exemption, including the associated documentation requirement.

5. Compensation Requirement

a. Proposed Compensation Requirement

Section ____.4(b)(2)(vii) of the proposed market-making exemption would have required that the compensation arrangements of persons performing market making-related activities at the banking entity be designed not to reward proprietary risk-taking.[998] In the proposal, the Agencies noted that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a financial instrument position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, would be inconsistent with the proposed market-making exemption.

The Agencies stated that under the proposed rule, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking. However, the Agencies noted that a banking entity relying on the proposed market-making exemption would be able to appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained.[999]

b. Comments Regarding the Proposed Compensation Requirement

Several commenters recommended certain revisions to the proposed compensation requirement.[1000] Two commenters stated that the proposed requirement is effective,[1001] while one commenter stated that it should be removed from the rule.[1002] Moreover, in addressing this proposed requirement, commenters provided views on: identifiable characteristics of compensation arrangements that incentivize prohibited proprietary trading,[1003] methods of monitoring compliance with this requirement,[1004] and potential negative incentives or outcomes this requirement could cause.[1005]

With respect to suggested modifications to this requirement, a few commenters suggested that a market maker's compensation should be subject to additional limitations.[1006] For example, two commenters stated that compensation should be restricted to particular sources, such as fees, commissions, and spreads.[1007] One commenter suggested that compensation should not be symmetrical between gains and losses and, further, that trading gains reflecting an unusually high variance in position values should either not be reflected in compensation and bonuses or should be less reflected than other gains and losses.[1008] Another commenter recommended that the Agencies remove ''designed'' from the rule text and provide greater clarity about how a banking entity's compensation regime must be structured.[1009] Moreover, a number of commenters stated that compensation should be vested for a period of time, such as until the trader's market making positions have been fully unwound and are no longer in the banking entity's inventory.[1010] As one commenter explained, such a requirement would discourage traders from carrying inventory and encourage them to get out of positions as soon as possible.[1011] Some commenters also recommended that compensation be risk adjusted.[1012]

A few commenters indicated that the proposed approach may be too restrictive.[1013] Two of these commenters stated that the compensation requirement should instead be set forth as guidance in Appendix B.[1014] In addition, two commenters requested that the Agencies clarify that compensation arrangements must be designed not to reward *prohibited* proprietary risk-taking. These commenters were concerned the proposed approach may restrict a banking entity's ability to provide compensation for permitted activities,

[995] *See* Joint Proposal, 76 FR 68,961.

[996] *See, e.g.,* letter from JPMC (stating that, to minimize risk management costs, firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and passed by means of internal transactions to a single utility desk and suggesting this be recognized as permitted market making-related behavior).

[997] *See* final rule § ____.5(c).

[998] *See* proposed rule § ____.4(b)(2)(vii).

[999] *See* Joint Proposal, 76 FR 68,872; CFTC Proposal, 77 FR 8358.

[1000] *See* Prof. Duffie; SIFMA *et al.* (Prop. Trading) (Feb. 2012); John Reed; Credit Suisse (Seidel); JPMC; Morgan Stanley; Better Markets (Feb. 2012); Johnson & Prof. Stiglitz; Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[1001] *See* FTN; Alfred Brock.

[1002] *See* Japanese Bankers Ass'n.

[1003] *See* Occupy.

[1004] *See* Occupy; Goldman (Prop. Trading).

[1005] *See* AllianceBernstein; Prof. Duffie; Investure; STANY; Chamber (Dec. 2011).

[1006] *See* Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Occupy; John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012). These comments are addressed in note 1027, *infra.*

[1007] *See* Better Markets (Feb. 2012); Public Citizen.

[1008] *See* AFR *et al.* (Feb. 2012)

[1009] *See* Occupy.

[1010] *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie (''A trader's incentives for risk taking can be held in check by vesting incentive-based compensation over a substantial period of time. Pending compensation can thus be forfeited if a trader's negligence causes substantial losses or if his or her employer fails.''); Sens. Merkley & Levin (Feb. 2012).

[1011] *See* John Reed.

[1012] *See* Johnson & Prof. Stiglitz; John Reed; Sens. Merkley & Levin (Feb. 2012).

[1013] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Morgan Stanley.

[1014] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

which also involve proprietary trading.[1015]

Two commenters discussed identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading.[1016] For example, one commenter stated that rewarding pure profit and loss, without consideration for the risk that was assumed to capture it, is an identifiable characteristic of an arrangement that incentivizes proprietary risk-taking.[1017] For purposes of monitoring and ensuring compliance with this requirement, one commenter noted that existing Board regulations for systemically important banking entities require comprehensive firm-wide policies that determine compensation. This commenter stated that those regulations, along with appropriately calibrated metrics, should ensure that compensation arrangements are not designed to reward prohibited proprietary risk-taking.[1018] For similar purposes, another commenter suggested that compensation incentives should be based on a metric that meaningfully accounts for the risk underlying profitability.[1019]

Certain commenters expressed concern that the proposed compensation requirement could incentivize market makers to act in a way that would not be beneficial to customers or market liquidity.[1020] For example, two commenters expressed concern that the requirement could cause market makers to widen their spreads or charge higher fees because their personal compensation depends on these factors.[1021] One commenter stated that the proposed requirement could dampen traders' incentives and discretion and may make market makers less likely to accept trades involving significant increases in risk or profit.[1022] Another commenter expressed the view that profitability-based compensation arrangements encourage traders to exercise due care because such arrangements create incentives to avoid losses.[1023] Finally, one commenter stated that compliance with the proposed requirement may be difficult or impossible if the Agencies do not take into account the incentive-based compensation rulemaking.[1024]

c. Final Compensation Requirement

Similar to the proposed rule, the market-making exemption requires that the compensation arrangements of persons performing the banking entity's market making-related activities, as described in the exemption, are designed not to reward or incentivize prohibited proprietary trading.[1025] The language of the final compensation requirement has been modified in response to comments expressing concern about the proposed language regarding ''proprietary risk-taking.'' [1026] The Agencies note that the Agencies do not intend to preclude an employee of a market-making desk from being compensated for successful market making, which involves some risk-taking.

The Agencies continue to hold the view that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a position held in inventory, rather than use of that inventory to successfully provide effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed retained principal risk, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not prohibited proprietary trading.[1027] For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the market-making exemption.

6. Registration Requirement

a. Proposed Registration Requirement

Under § ____.4(b)(2)(iv) of the proposed rule, a banking entity relying on the market-making exemption with respect to trading in securities or certain derivatives would be required to be appropriately registered as a securities dealer, swap dealer, or security-based swap dealer, or exempt from registration or excluded from regulation as such type of dealer, under applicable securities or commodities laws. Further, if the banking entity was engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States in a manner for which no U.S. registration is required, the banking entity would be required to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.[1028]

b. Comments on the Proposed Registration Requirement

A few commenters stated that the proposed dealer registration requirement is effective.[1029] However, a number of commenters opposed the proposed dealer registration requirement in whole or in part.[1030] Commenters' primary concern with the requirement appeared to be its application to market making-related activities outside of the United States for which no U.S. registration is required.[1031] For example, several commenters stated that many non-U.S. markets do not provide substantive regulation of dealers for all asset classes.[1032] In addition, two

[1015] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies respond to these comments in note 1026 and its accompanying text, *infra.*

[1016] *See* Occupy; Alfred Brock.

[1017] *See* Occupy. The Agencies respond to this comment in Part IV.A.3.c.5.c., *infra.*

[1018] *See* Goldman (Prop. Trading).

[1019] *See* Occupy.

[1020] *See* AllianceBernstein; Investure; Prof. Duffie; STANY. This issue is addressed in note 1027, *infra.*

[1021] *See* AllianceBernstein; Investure.

[1022] *See* Prof. Duffie.

[1023] *See* STANY.

[1024] *See* Chamber (Dec. 2011).

[1025] *See* final rule § ____.4(b)(2)(v).

[1026] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1027] Because the Agencies are not limiting a market maker's compensation to specific sources, such as fees, commissions, and bid-ask spreads, as recommended by a few commenters, the Agencies do not believe the compensation requirement in the final rule will incentivize market makers to widen their quoted spreads or charge higher fees and commissions, as suggested by certain other commenters. *See* Better Markets (Feb. 2012); Public Citizen; AllianceBernstein; Investure. In addition, the Agencies note that an approach requiring revenue from fees, commissions, and bid-ask spreads to be fully distinguished from revenue from price appreciation can raise certain practical difficulties, as discussed in Part IV.A.3.c.7. The Agencies also are not requiring compensation to be vested for a period of time, as recommended by some commenters to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement. *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012).

[1028] *See* proposed rule § ____.4(b)(2)(iv); Joint Proposal, 76 FR 68,872; CFTC Proposal, 77 FR 8357–8358.

[1029] *See* Occupy; Alfred Brock.

[1030] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that if the requirement is not removed from the rule, then it should only be an indicative factor of market making); Morgan Stanley; Goldman (Prop. Trading); ISDA (Feb. 2012).

[1031] *See* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012); JPMC. This issue is addressed in note 1044 and its accompanying text, *infra.*

[1032] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

commenters stated that booking entities may be able to rely on intra-group exemptions under local law rather than carrying dealer registrations, or a banking entity may execute customer trades through an international dealer but book the position in a non-dealer entity for capital adequacy and risk management purposes.[1033] Several of these commenters requested, at a minimum, that the dealer registration requirement not apply to dealers in non-U.S. jurisdictions.[1034]

In addition, with respect to the provisions that would generally require a banking entity to be a form of SEC- or CFTC-registered dealer for market-making activities in securities or derivatives in the United States, a few commenters stated that these provisions should be removed from the rule.[1035] These commenters represented that removing these provisions would be appropriate for several reasons. For example, one commenter stated that dealer registration does not help distinguish between market making and speculative trading.[1036] Another commenter indicated that effective market making often requires a banking entity to trade on several exchange and platforms in a variety of markets, including through legal entities other than SEC- or CFTC-registered dealer entities.[1037] One commenter expressed general concern that the proposed requirement may result in the market-making exemption being unavailable for market making in exchange-traded futures and options because those markets do not have a corollary to dealer registration requirements in securities, swaps, and security-based swaps markets.[1038]

Some commenters expressed particular concern about the provisions that would generally require registration as a swap dealer or a security-based swap dealer.[1039] For example, one commenter expressed concern that these provisions may require banking regulators to redundantly enforce CFTC and SEC registration requirements. Moreover, according to this commenter, the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' do not focus on the market making core of the swap dealing business.[1040] Another commenter stated that incorporating the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' is contrary to the Administrative Procedure Act.[1041]

c. Final Registration Requirement

The final requirement of the market-making exemption provides that the banking entity must be licensed or registered to engage in market making-related activity in accordance with applicable law.[1042] The Agencies have considered comments regarding the dealer registration requirement in the proposed rule.[1043] In response to comments, the Agencies have narrowed the scope of the proposed requirement's application to banking entities engaged in market making-related activity in foreign jurisdictions.[1044] Rather than requiring these banking entities to be subject to substantive regulation of their dealing business in the relevant foreign jurisdiction, the final rule only require a banking entity to be a registered dealer in a foreign jurisdiction to the extent required by applicable foreign law. The Agencies have also simplified the language of the proposed requirement, although the Agencies have not modified the scope of the requirement with respect to U.S. dealer registration requirements.

This provision is not intended to expand the scope of licensing or registration requirements under relevant U.S. or foreign law that are applicable to a banking entity engaged in market-making activities. Instead, this provision recognizes that compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.[1045] For example, a U.S. banking entity would be expected to be an SEC-registered dealer to rely on the market-making exemption for trading in securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances, or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[1046] Similarly, a U.S. banking entity is expected to be a CFTC-registered swap dealer or SEC-registered security-based swap dealer to rely on the market-making exemption for trading in swaps or security-based swaps, respectively,[1047] unless the banking entity is exempt from registration or excluded from regulation as a swap dealer or security-based swap dealer.[1048] In response to comments on whether this provision should generally require registration as a swap dealer or security-based swap dealer to make a market in swaps or security-based swaps,[1049] the Agencies continue to

[1033] *See* JPMC; Goldman (Prop. Trading).

[1034] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Morgan Stanley (requesting the addition of the phrase ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions).

[1035] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). Rather than remove the requirement entirely, one commenter recommended that the Agencies move the dealer registration requirement to proposed Appendix B, which would allow the Agencies to take into account the facts and circumstances of a particular trading activity. *See* JPMC.

[1036] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1037] *See* Goldman (Prop. Trading).

[1038] *See* CME Group.

[1039] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1040] *See* ISDA (Feb. 2012).

[1041] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1042] *See* final rule § ____.4(b)(2)(vi).

[1043] *See supra* Part IV.A.3.c.5.b. One commenter expressed concern that the instruments listed in § ____.4(b)(2)(iv) of the proposed rule could be interpreted as limiting the availability of the market-making exemption to other instruments, such as exchange-traded futures and options. In response to this comment, the Agencies note that the reference to particular instruments in § ____ .4(b)(2)(iv) was intended to reflect that trading in certain types of instruments gives rise to dealer registration requirements. This provision was not intended to limit the availability of the market-making exemption to certain types of financial instruments. *See* CME Group.

[1044] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley.

[1045] In response to commenters who stated that the dealer registration requirement should be removed from the rule because, among other things, registration as a dealer does not distinguish between permitted market making and impermissible proprietary trading, the Agencies recognize that acting as a registered dealer does not ensure that a banking entity is engaged in permitted market making-related activity. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). However, this requirement recognizes that registration as a dealer is an indicator of market making-related activities in the circumstances in which a person is legally obligated to be a registered dealer to act as a market maker.

[1046] A banking entity relying on the market-making exemption for transactions in security-based swaps would generally be required to be a registered security-based swap dealer and would not be required to be a registered securities dealer. However, a banking entity may be required to be a registered securities dealer if it engages in market-making transactions involving security-based swaps with persons that are not eligible contract participants. The definition of ''dealer'' in section 3(a)(5) of the Exchange Act generally includes ''any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants), for such person's own account.'' 15 U.S.C. 78c(a)(5).

To the extent, if any, that a banking entity relies on the market-making exemption for its trading in municipal securities or government securities, rather than the exemption in § ____.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer.

[1047] As noted above, under certain circumstances, a banking entity acting as market maker in security-based swaps may be required to be a registered securities dealer. *See supra* note 1046.

[1048] For example, a banking entity meeting the conditions of the *de minimis* exception in SEC Rule 3a71–2 under the Exchange Act would not need to be a registered security-based swap dealer to act as a market maker in security-based swaps. *See* 17 CFR 240.3a71–2.

[1049] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

believe that this requirement is appropriate. In general, a person that is engaged in making a market in swaps or security-based swaps or other activity causing oneself to be commonly known in the trade as a market maker in swaps or security-based swaps is required to be a registered swap dealer or registered security-based swap dealer, unless exempt from registration or excluded from regulation as such.[1050] As noted above, compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.

As noted above, the Agencies have determined that, rather than require a banking entity engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States to be subject to substantive regulation of its dealing business in the foreign jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration requirements under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). As a result, this requirement will not impact a banking entity's ability to engage in permitted market making-related activities in a foreign jurisdiction that does not provide for substantive regulation of dealers.[1051]

7. Source of Revenue Analysis

a. Proposed Source of Revenue Requirement

To qualify for the market-making exemption, the proposed rule required that the market making-related activities of the trading desk or other organizational unit be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of financial instrument positions it holds in trading accounts or the hedging of such positions.[1052] This proposed requirement was intended to ensure that activities conducted in reliance on the market-making exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the intermediation and liquidity services a market maker provides to its customers, rather than changes in the market value of the positions or risks held in inventory.[1053]

b. Comments Regarding the Proposed Source of Revenue Requirement

As discussed in more detail below, many commenters expressed concern about the proposed source of revenue requirement. These commenters raised a number of concerns including, among others, the proposed requirement's potential impact on a market maker's inventory or on costs to customers, the difficulty of differentiating revenues from spreads and revenues from price appreciation in certain markets, and the need for market makers to be compensated for providing intermediation services.[1054] Several of these commenters requested that the proposed source of revenue requirement be removed from the rule or modified in certain ways. Some commenters, however, expressed support for the proposed requirement or requested that the Agencies place greater restrictions on a banking entity's permissible sources of revenue under the market-making exemption.[1055]

i. Potential Restrictions on Inventory, Increased Costs for Customers, and Other Changes to Market-Making Services

Many commenters stated that the proposed source of revenue requirement may limit a market maker's ability to hold sufficient inventory to facilitate customer demand.[1056] Several of these commenters expressed particular concern about applying this requirement to less liquid markets or to facilitating large customer positions, where a market maker is more likely to hold inventory for a longer period of time and has increased risk of potential price appreciation (or depreciation).[1057] Further, another commenter questioned how the proposed requirement would apply when unforeseen market pressure or disappearance of customer demand results in a market maker holding a particular position in inventory for longer than expected.[1058] In response to this proposed requirement, a few commenters stated that it is important for market makers to be able to hold a certain amount of inventory to: Provide liquidity (particularly in the face of order imbalances and market volatility),[1059] facilitate large trades, and hedge positions acquired in the course of market making.[1060]

Several commenters expressed concern that the proposed source of revenue requirement may incentivize a market maker to widen its quoted spreads or otherwise impose higher fees to the detriment of its customers.[1061] For example, some commenters stated that the proposed requirement could result in a market maker having to sell a position in its inventory within an artificially prescribed period of time and, as a result, the market maker would pay less to initially acquire the position from a customer.[1062] Other commenters represented that the proposed source of revenue requirement would compel market makers to hedge their exposure to price movements, which would likely increase the cost of intermediation.[1063]

Some commenters stated that the proposed source of revenue requirement may make a banking entity less willing to make markets in instruments that it may not be able to resell immediately or in the short term.[1064] One commenter indicated that this concern may be heightened in times of market stress.[1065] Further, a few commenters expressed the view that the proposed requirement would cause banking entities to exit the

[1050] *See* 7 U.S.C. 1a(49)(A); 15 U.S.C. 78c(a)(71)(A).

[1051] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley. This is consistent with one commenter's suggestion that the Agencies add ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions. *See* Morgan Stanley.

[1052] *See* proposed rule § ____.4(b)(2)(v).

[1053] *See* Joint Proposal, 76 FR 68,872; CFTC Proposal, 77 FR 8358.

[1054] These concerns are addressed in Part IV.A.3.c.7.c., *infra.*

[1055] *See infra* note 1103 (responding to these comments).

[1056] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); T. Rowe Price; PUC Texas; SSgA (Feb. 2012); ICI (Feb. 2012) Invesco; MetLife; MFA.

[1057] *See, e.g.,* Morgan Stanley; BoA; BlackRock; T. Rowe Price; Goldman (Prop. Trading); NYSE Euronext (suggesting that principal trading by market makers in large sizes is essential in some securities, such as an AP's trading in ETFs); Prof. Duffie; SSgA (Feb. 2012); CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); MFA. To explain its concern, one commenter stated that bid-ask spreads are useful to capture the concept of market-making revenues when a market maker is intermediating on a close to real-time basis between balanced customer buying and selling interest for the same instrument, but such close-in-time intermediation does not occur in many large or illiquid assets, where demand gaps may be present for days, weeks, or months. *See* Morgan Stanley.

[1058] *See* Capital Group.

[1059] *See* NYSE Euronext; CIEBA (stating that if the rule discourages market makers from holding inventory, there will be reduced liquidity for investors and issuers).

[1060] *See* NYSE Euronext. For a more in-depth discussion of comments regarding the benefits of permitting market makers to hold and manage inventory, *See* Part IV.A.3.c.2.b.vi., *infra.*

[1061] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA.

[1062] *See* MetLife; ACLI (Feb. 2012); ICI (Feb. 2012) SSgA (Feb. 2012).

[1063] *See* SSgA (Feb. 2012); PUC Texas.

[1064] *See* ICI (Feb. 2012) SSgA (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); BoA.

[1065] *See* CIEBA (arguing that banking entities may be reluctant to provide liquidity when markets are declining and there are more sellers than buyers because it would be necessary to hold positions in inventory to avoid losses).

market-making business due to restrictions on their ability to make a profit from market-making activities.[1066] Moreover, in one commenter's opinion, the proposed requirement would effectively compel market makers to trade on an agency basis.[1067]

ii. Certain Price Appreciation-Related Profits Are an Inevitable or Important Component of Market Making

A number of commenters indicated that market makers will inevitably make some profit from price appreciation of certain inventory positions because changes in market values cannot be precisely predicted or hedged.[1068] In particular, several commenters emphasized that matched or perfect hedges are generally unavailable for most types of positions.[1069] According to one commenter, a provision that effectively requires a market-making business to hedge all of its principal positions would discourage essential market-making activity. The commenter explained that effective hedges may be unavailable in less liquid markets and hedging can be costly, especially in relation to the relative risk of a trade and hedge effectiveness.[1070] A few commenters further indicated that making some profit from price appreciation is a natural part of market making or is necessary to compensate a market maker for its willingness to take a position, and its associated risk (*e.g.,* the risk of market changes or decreased value), from a customer.[1071]

iii. Concerns Regarding the Workability of the Proposed Standard in Certain Markets or Asset Classes

Some commenters represented that it would be difficult or burdensome to identify revenue attributable to the bid-ask spread versus revenue arising from price appreciation, either as a general matter or for specific markets.[1072] For example, one commenter expressed the opinion that the difference between the bid-ask spread and price appreciation is ''metaphysical'' in some sense,[1073] while another stated that it is almost impossible to objectively identify a bid-ask spread or to capture profit and loss solely from a bid-ask spread in most markets.[1074] Other commenters represented that it is particularly difficult to make this distinction when trades occur infrequently or where prices are not transparent, such as in the fixed-income market where no spread is published.[1075]

Many commenters expressed particular concern about the proposed requirement's application to specific markets, including: The fixed-income markets;[1076] the markets for commodities, derivatives, securitized products, and emerging market securities;[1077] equity and physical commodity derivatives markets;[1078] and customized swaps used by customers of banking entities for hedging purposes.[1079] Another commenter expressed general concern about extremely volatile markets, where market makers often see large upward or downward price swings over time.[1080]

Two commenters emphasized that the revenues a market maker generates from hedging the positions it holds in inventory are equivalent to spreads in many markets. These commenters explained that, under these circumstances, a market maker generates revenue from the difference between the customer price for the position and the banking entity's price for the hedge. The commenters noted that proposed Appendix B expressly recognizes this in the case of derivatives and recommended that Appendix B's guidance on this point apply equally to certain non-derivative positions.[1081]

A few commenters questioned how this requirement would work in the context of block trading or otherwise facilitating large trades, where a market maker may charge a premium or discount for taking on a large position

[1066] *See* Credit Suisse (Seidel) (arguing that banking entities are likely to cease being market makers if they are: (i) Unable to take into account the likely direction of a financial instrument, or (ii) forced to take losses if a financial instrument moves against them, but cannot take gains if the instrument's price moves in their favor); STANY (contending that banking entities cannot afford to maintain unprofitable or marginally profitable operations in highly competitive markets, so this requirement would cause banking entities to eliminate a majority of their market-making functions).

[1067] *See* IR&M (arguing that domestic corporate and securitized credit markets are too large and heterogeneous to be served appropriately by a primarily agency-based trading model).

[1068] *See* Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas (contending that it is impossible to predict the behavior of even the most highly correlated hedge in comparison to the underlying position); CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco.

[1069] *See* Morgan Stanley; Credit Suisse (Seidel); SSgA (Feb. 2012); PUC Texas; Wellington; AllianceBernstein; Investure.

[1070] *See* Wellington. Moreover, one commenter stated that, as a general matter, market makers need to be compensated for bearing risk related to providing immediacy to a customer. This commenter stated that ''[t]he greater the inventory risk faced by the market maker, the higher the expected return (compensation) that the market maker needs,'' to compensate the market maker for bearing the risk and reward its specialization skills in that market (*e.g.,* its knowledge about market conditions and early indicators that may imply future price movements in a particular direction). This commenter did not, however, discuss the source of revenue requirement in the proposed rule. *See* Thakor Study.

[1071] *See* Capital Group; Prof. Duffie; Investure; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); RBC; PNC.

[1072] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group.

[1073] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1074] *See* Citigroup (Feb. 2012). *See also* Barclays (arguing that a bid-ask spread cannot be defined on a consistent basis with respect to many instruments).

[1075] *See* Goldman (Prop. Trading); BoA; Morgan Stanley (''Observable, actionable, bid/ask spreads exist in only a small subset of institutional products and markets. Indicative bid/ask spreads may be observable for certain products, but this pricing would typically be specific to small size standard lot trades and would not represent a spread applicable to larger and/or more illiquid trades. End-of-day valuations for assets are calculated, but they are not an effective proxy for real-time bid/ask spreads because of intra-day price movements.''); RBC; Capital Group (arguing that bid-ask spreads in fixed-income markets are not always quantifiable or well defined and can fluctuate widely within a trading day because of small or odd lot trades, price discovery activity, a lack of availability to cover shorts, or external factors not directly related to the security being traded).

[1076] *See* Capital Group; CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012). These commenters stated that the requirement may be problematic for the fixed-income markets because, for example, market makers must hold inventory in these markets for a longer period of time than in more liquid markets. *See id.*

[1077] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that these markets are characterized by even less liquidity and less frequent trading than the U.S. corporate bond market). This commenter also stated that in markets where trades are large and less frequent, such as the market for customized securitized products, appreciation in price of one position may be a predominate contributor to the overall profit and loss of the trading unit. *See id.*

[1078] *See* BoA. According to this commenter, the distinction between capturing a spread and price appreciation is fundamentally flawed in some markets, like equity derivatives, because the market does not trade based on movements of a particular security or underlying instrument. This commenter indicated that expected returns are instead based on the bid-ask spread the market maker charges for implied volatility as reflected in options premiums and hedging of the positions. *See id.*

[1079] *See* CIEBA (stating that because it would be difficult for a market maker to enter promptly into an offsetting swap, the market maker would not be able to generate income from the spread).

[1080] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter questioned whether proposed Appendix B's reference to ''unexpected market disruptions'' as an explanatory fact and circumstance was intended to permit such market making. *See id.*

[1081] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). In its discussion of ''customer revenues,'' Appendix B states: ''In the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract.'' Joint Proposal, 76 FR 68,960; CFTC Proposal, 77 FR 8440. *See also* RBC (requesting clarification on how the proposed standard would apply if a market maker took an offsetting position in a different instrument (*e.g.,* a different bond) and inquiring whether, if the trader took the offsetting position, its revenue gain is attributable to price appreciation of the two offsetting positions or from the bid-ask spread in the respective bonds).

to provide ''immediacy'' to its customer.[1082] One commenter further explained that explicitly quoted bid-ask spreads are only valid for indicated trade sizes that are modest enough to have negligible market impact, and such spreads cannot be used for purposes of a significantly larger trade.[1083]

iv. Suggested Modifications to the Proposed Requirement

To address some or all of the concerns discussed above, many commenters recommended that the source of revenue requirement be modified [1084] or removed from the rule entirely.[1085] With respect to suggested changes, some commenters stated that the Agencies should modify the rule text,[1086] use a metrics-based approach to focus on customer revenues,[1087] or replace the proposed requirement with guidance.[1088] Some commenters requested that the Agencies modify the focus of the requirement so that, for example, dealers' market-making activities in illiquid securities can function as close to normal as possible [1089] or market makers can take short-term positions that may ultimately result in a profit or loss.[1090] As discussed below, some commenters stated that the Agencies should modify the proposed requirement to place greater restrictions on market maker revenue.

v. General Support for the Proposed Requirement or for Placing Greater Restrictions on a Market Maker's Sources of Revenue

Some commenters expressed support for the proposed source of revenue requirement or stated that the requirement should be more restrictive.[1091] For example, one of these commenters stated that a real market maker's trading book should be fully hedged, so it should not generate profits in excess of fees and commissions except in times of rare and extraordinary market conditions.[1092] According to another commenter, the final rule should make it clear that banking entities seeking to rely on the market-making exemption may not generally seek to profit from price movements in their inventories, although their activities may give rise to modest and relatively stable profits arising from their limited inventory.[1093] One commenter recommended that the proposed requirement be interpreted to limit market making in illiquid positions because a banking entity cannot have the required revenue motivation when it enters into a position for which there is no readily discernible exit price.[1094]

Further, some commenters suggested that the Agencies remove the word ''primarily'' from the provision to limit banking entities to specified sources of revenue.[1095] In addition, one of these commenters requested that the Agencies restrict a market maker's revenue to fees and commissions and remove the allowance for revenue from bid-ask spreads because generating bid-ask revenues relies exclusively on changes in market values of positions held in inventory.[1096] For enforcement purposes, a few commenters suggested that the Agencies require banking entities to disgorge any profit obtained from price appreciation.[1097]

c. Final Rule's Approach to Assessing Revenues

Unlike the proposed rule, the final rule does not include a requirement that a trading desk's market making-related activity be designed to generate revenue primarily from fees, commissions, bid-ask spreads, or other income not attributable to appreciation in the value of a financial instrument or hedging.[1098] The revenue requirement was one of the most commented upon aspects of the market-making exemption in the proposal.[1099]

The Agencies believe that an analysis of patterns of revenue generation and profitability can help inform a judgment regarding whether trading activity is consistent with the intermediation and liquidity services that a market maker provides to its customers in the context of the liquidity, maturity, and depth of the relevant market, as opposed to prohibited proprietary trading activities. To facilitate this type of analysis, the Agencies have included a metrics data reporting requirement that is refined from the proposed metric regarding profits and losses. The Comprehensive Profit and Loss Attribution metric collects information regarding the daily fluctuation in the value of a trading desk's positions to various sources, along with its volatility, including: (i) Profit and loss attributable to current positions that were also held by the banking entity as of the end of the prior day (''existing positions); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions.[1100]

This quantitative measurement has certain conceptual similarities to the proposed source of revenue requirement in § ____.4(b)(2)(v) of the proposed rule

[1082] *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading). *See also* Thakor Study (discussing market makers' role of providing ''immediacy'' in general).

[1083] *See* CIEBA.

[1084] *See, e.g.,* JPMC; Barclays; Goldman (Prop. Trading); BoA; CFA Inst.; ICI (Feb. 2012) Flynn & Fusselman.

[1085] *See, e.g.,* CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); Capital Group; RBC. In addition to the concerns discussed above, one commenter stated that the proposed requirement may set limits on the values of certain metrics, and it would be inappropriate to prejudge the appropriate results of such metrics at this time. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1086] *See, e.g.,* Barclays. This commenter provided alternative rule text stating that ''market making-related activity is conducted by each trading unit such that its activities are reasonably designed to generate revenues primarily from fees, commissions, bid-ask spreads, or other income attributable to satisfying reasonably expected customer demand.'' *See id.*

[1087] *See* Goldman (Prop. Trading) (suggesting that the Agencies use a metrics-based approach to focus on customer revenues, as measured by Spread Profit and Loss (when it is feasible to calculate) or other metrics, especially because a proprietary trading desk would not be expected to earn any revenues this way). This commenter also indicated that the ''primarily'' standard in the proposed rule is problematic and can be read to mean ''more than 50%,'' which is different from Appendix B's acknowledgment that the proportion of customer revenues relative to total revenues will vary by asset class. *See id.*

[1088] *See* BoA (recommending that the guidance state that the Agencies would consider the design and mix of such revenues as an indicator of potentially prohibited proprietary trading, but only for those markets for which revenues are quantifiable based on publicly available data, such as segments of certain highly liquid equity markets).

[1089] *See* CFA Inst.

[1090] *See* ICI (Feb. 2012).

[1091] *See* Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); FTN; Public Citizen; Occupy; Alfred Brock.

[1092] *See* Better Markets (Feb. 2012). *See also* Public Citizen (arguing that the imperfection of a hedge should signal potential disqualification of the underlying position from the market-making exemption).

[1093] *See* Sens. Merkley & Levin (Feb. 2012). This commenter further suggested that the rule identify certain red flags and metrics that could be used to monitor this requirement, such as: (i) Failure to obtain relatively low ratios of revenue-to-risk, low volatility, and relatively high turnover; (ii) significant revenues from price appreciation relative to the value of securities being traded; (iii) volatile revenues from price appreciation; or (iv) revenue from price appreciation growing out of proportion to the risk undertaken with the security. *See id.*

[1094] *See* AFR *et al.* (Feb. 2012).

[1095] *See* Occupy; Better Markets (Feb. 2012). *See supra* note 1103 (addressing these comments).

[1096] *See* Occupy.

[1097] *See* Occupy; Public Citizen.

[1098] *See* proposed rule § ____.4(b)(2)(v).

[1099] *See infra* Part IV.A.3.c.7.b.

[1100] *See* Appendix A of the final rule (describing the Comprehensive Profit and Loss Attribution metric). This approach is generally consistent with one commenter's suggested metrics-based approach to focus on customer-related revenues. *See* Goldman (Prop. Trading); *See also* Sens. Merkley & Levin (Feb. 2012) (suggesting the use of metrics to monitor a firm's source of revenue); proposed Appendix A.

and certain of the proposed quantitative measurements.[1101] However, in response to comments on those provisions, the Agencies have determined to modify the focus from particular revenue sources (*e.g.,* fees, commissions, bid-ask spreads, and price appreciation) to when the trading desk generates revenue from its positions. The Agencies recognize that when the trading desk is engaged in market making-related activities, the day one profit and loss component of the Comprehensive Profit and Loss Attribution metric may reflect customer-generated revenues, like fees, commissions, and spreads (including embedded premiums or discounts), as well as that day's changes in market value. Thereafter, profit and loss associated with the position carried in the trading desk's book may reflect changes in market price until the position is sold or unwound. The Agencies also recognize that the metric contains a residual component for profit and loss that cannot be specifically attributed to existing positions or new positions.

The Agencies believe that evaluation of the Comprehensive Profit and Loss Attribution metric could provide valuable information regarding patterns of revenue generation by market-making trading desks involved in market-making activities that may warrant further review of the desk's activities, while eliminating the requirement from the proposal that the trading desk demonstrate that its primary source of revenue, under all circumstances, is fees, commissions and bid/ask spreads. This modified focus will reduce the burden associated with the proposed source of revenue requirement and better account for the varying depth and liquidity of markets.[1102] In addition, the Agencies believe these modifications appropriately address commenters' concerns about the proposed source of revenue requirement and reduce the potential for negative market impacts of the proposed requirement cited by commenters, such as incentives to widen spreads or disincentives to engage in market making in less liquid markets.[1103]

The Agencies recognize that this analysis is only informative over time, and should not be determinative of an analysis of whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. The Agencies believe this quantitative measurement provides appropriate flexibility to obtain information on market-maker revenues, which is designed to address commenters' concerns about the proposal's source of revenue requirement (*e.g.,* the burdens associated with differentiating spread revenue from price appreciation revenue) while also helping assess patterns of revenue generation that may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation.

8. Appendix B of the Proposed Rule

a. Proposed Appendix B Requirement

The proposed market-making exemption would have required that the market making-related activities of the trading desk or other organizational unit of the banking entity be consistent with the commentary in proposed Appendix B.[1104] In this proposed Appendix, the Agencies provided overviews of permitted market making-related activity and prohibited proprietary trading activity.[1105]

The proposed Appendix also set forth various factors that the Agencies proposed to use to help distinguish prohibited proprietary trading from permitted market making-related activity. More specifically, proposed Appendix B set forth six factors that, absent explanatory facts and circumstances, would cause particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity. The proposed factors focused on: (i) Retaining risk in excess of the size and type required to provide intermediation services to customers (''risk management factor''); (ii) primarily generating revenues from price movements of retained principal positions and risks, rather than customer revenues (''source of revenues factor''); (iii) generating only very small or very large amounts of revenue per unit of risk, not demonstrating consistent profitability, or demonstrating high earnings volatility (''revenues relative to risk factor''); (iv) not trading through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making desk to provide liquidity services, or retaining principal positions in excess of reasonably expected near term customer demands (''customer-facing activity factor''); (v) routinely paying rather than earning fees, commissions, or spreads (''payment of fees, commissions, and spreads factor''); and (vi) providing compensation incentives to employees that primarily reward proprietary risk-

[1101] *See supra* Part IV.A.3.c.7. and *infra* Part IV.C.3.

[1102] The Agencies understand that some commenters interpreted the proposed requirement as requiring that both the bid-ask spread for a financial instrument and the revenue a market maker acquired from such bid-ask spread through a customer trade be identifiable on a close-to-real-time basis and readily distinguishable from any additional revenue gained from price appreciation (both on the day of the transaction and for the rest of the holding period). *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group. We recognize that such a requirement would be unduly burdensome. In fact, the proposal noted that bid-ask spreads or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable in certain asset classes for purposes of the proposed Spread Profit and Loss metric in Appendix A of the proposal. *See* Joint Proposal, 76 FR 68,958–68,959; CFTC Proposal, 77 FR 8438. Moreover, the burden associated with the proposed requirement should be further reduced because we are not adopting a stand-alone requirement regarding a trading desk's source of revenue. Instead, when and how a trading desk generates profit and loss from its trading activities is a factor that must be considered for purposes of the near term customer demand requirement. It is not a dispositive factor for determining compliance with the exemption.

Further, some commenters expressed concern that the proposed requirement suggested market makers were not permitted to profit from price appreciation, but rather only from observable spreads or explicit fees or commissions. *See, e.g.,* Wellington, Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco. The Agencies confirm that the intent of the market-making exemption is not to preclude a trading desk from generating any revenue from price appreciation. Because this approach clarifies that a trading desk's source of revenue is not limited to its quoted spread, the Agencies believe this quantitative measurement will address commenters concerns that the proposed source of revenue requirement could create incentives for market makers to widen their spreads, result in higher transaction costs, require market makers to hedge any exposure to price movements, or discourage a trading desk from making a market in instruments that it may not be able to sell immediately. *See* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA; SIFMA (Asset Mgmt.) (Feb. 2012). The modifications to this provision are designed to better reflect when, on average and across many transactions, profits are gained rather than how they are gained, similar to the way some firms measure their profit and loss today. *See, e.g.,* Goldman (Prop. Trading).

[1103] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA. The Agencies are not adopting an approach that limits a market maker to specified revenue sources (*e.g.,* fees, commissions, and spreads), as suggested by some commenters, due to the considerations discussed above. *See* Occupy; Better Markets (Feb. 2012). In response to the proposed source of revenue requirement, some commenters noted that a market maker may charge a premium or discount for taking on a large position from a customer. *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading).

[1104] *See* proposed rule § ____.4(b)(2)(vi).

[1105] *See* Joint Proposal, 76 FR 68,873, 68,960–68,961; CFTC Proposal, 77 FR 8358, 8439–8440.

taking (''compensation incentives factor'').[1106]

b. Comments on Proposed Appendix B

Commenters expressed differing views about the accuracy of the commentary in proposed Appendix B and the appropriateness of including such commentary in the rule. For example, some commenters stated that the description of market making-related activity in the proposed appendix is accurate [1107] or appropriately accounts for differences among asset classes.[1108] Other commenters indicated that the appendix is too strict or narrow.[1109] Some commenters recommended that the Agencies revise proposed Appendix B's approach by, for example, placing greater focus on what market making is rather than what it is not,[1110] providing presumptions of activity that will be treated as permitted market making-related activity,[1111] re-formulating the appendix as nonbinding guidance,[1112] or moving certain requirements of the proposed exemption to the appendix.[1113] One commenter suggested the Agencies remove Appendix B from the rule and instead use the conformance period to analyze and develop a body of supervisory guidance that appropriately characterizes the nature of market making-related activity.[1114]

A few commenters expressed concern about the appendix's facts-and-circumstances-based approach to distinguishing between prohibited proprietary trading and permitted market making-related activity and stated that such an approach will make it more difficult or burdensome for banking entities to comply with the proposed rule [1115] or will generate regulatory uncertainty.[1116] As discussed below, other commenters opposed proposed Appendix B because of its level of granularity [1117] or due to perceived restrictions on interdealer trading or generating revenue from retained principal positions or risks in the proposed appendix.[1118] A number of commenters expressed concern about the complexity or prescriptiveness of the six proposed factors for distinguishing permitted market making-related activity from prohibited proprietary trading.[1119]

With respect to the level of granularity of proposed Appendix B, a number of commenters expressed concern that the reference to a ''single significant transaction'' indicated that the Agencies will review compliance with the proposed market-making exemption on a trade-by-trade basis and stated that assessing compliance at the level of individual transactions would be unworkable.[1120] One of these commenters further stated that assessing compliance at this level of granularity would reduce a market maker's willingness to execute a customer sell order as principal due to concern that the market maker may not be able to immediately resell such position. The commenter noted that this chilling effect would be heightened in declining markets.[1121]

A few commenters interpreted certain statements in proposed Appendix B as limiting interdealer trading and expressed concerns regarding potential limitations on this activity.[1122] These commenters emphasized that market makers may need to trade with non-customers to: (i) Provide liquidity to other dealers and, indirectly, their customers, or to otherwise allow customers to access a larger pool of liquidity; [1123] (ii) conduct price discovery to inform the prices a market maker can offer to customers; [1124] (iii) unwind or sell positions acquired from customers; [1125] (iv) establish or acquire positions to meet reasonably expected near term customer demand; [1126] (v) hedge; [1127] and (vi) sell a financial instrument when there are more buyers than sellers for the instrument at that time.[1128] Further, one of these commenters expressed the view that the proposed appendix's statements are inconsistent with the statutory market-making exemption's reference to ''counterparties.'' [1129]

[1106] *See* Joint Proposal, 76 FR 68,873, 68,961–68,963; CFTC Proposal, 77 FR 8358, 8440–8442.

[1107] *See* MetLife; ACLI (Feb. 2012).

[1108] *See* Alfred Brock. *But See, e.g.,* Occupy (stating that the proposed commentary only accounts for the most liquid and transparent markets and fails to accurately describe market making in most illiquid or OTC markets).

[1109] *See* Morgan Stanley; IIF; Sumitomo Trust; ISDA (Apr. 2012); BDA (Feb. 2012) (Oct. 2012) (stating that proposed Appendix B places too great of a focus on derivatives trading and does not reflect how principal trading operations in equity and fixed income markets are structured). One of these commenters requested that the appendix be modified to account for certain activities conducted in connection with market making in swaps. This commenter indicated that a swap dealer may not regularly enjoy a dominant flow of customer revenues and may consistently need to make revenue from its book management. In addition, the commenter stated that the appendix should recognize that making a two-way market may be a dominant theme, but there are certain to be frequent occasions when, as a matter of market or internal circumstances, a market maker is unavailable to trade. *See* ISDA (Apr. 2012).

[1110] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1111] *See* Sens. Merkley & Levin (Feb. 2012). This commenter stated that, for example, Appendix B could deem market making involving widely-traded stocks and bonds issued by well-established corporations, government securities, or highly liquid asset-backed securities as the type of plain vanilla, low risk capital activities that are presumptively permitted, provided the activity is within certain, specified parameters for inventory levels, revenue-to-risk metrics, volatility, and hedging. *See id.*

[1112] *See* Morgan Stanley; Flynn & Fusselman.

[1113] *See* JPMC. In support of such an approach, the commenter argued that sometimes proposed § ____.4(b) and Appendix B addressed the same topic and, when this occurs, it is unclear whether compliance with Appendix B constitutes compliance with § ____.4(b) or if additional compliance steps are required. *See id.*

[1114] *See* Morgan Stanley.

[1115] *See* NYSE Euronext; Morgan Stanley.

[1116] *See* IAA.

[1117] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[1118] *See* Morgan Stanley; Chamber (Feb. 2012); Goldman (Prop. Trading).

[1119] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Chamber (Feb. 2012); ICFR; Morgan Stanley; Goldman (Prop. Trading); Occupy; Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011); Public Citizen; NYSE Euronext. *But See* Alfred Brock (stating that the proposed factors are effective).

[1120] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). In particular, proposed Appendix B provided that ''The particular types of trading activity described in this appendix may involve the aggregate trading activities of a single trading unit, a significant number or series of transactions occurring at one or more trading units, or a single significant transaction, among other potential scenarios.'' Joint Proposal, 76 FR 68,961; CFTC Proposal, 77 FR 8441. The Agencies address commenters' trade-by-trade concerns in Part IV.A.3.c.1.c.ii., *infra.*

[1121] *See* Goldman (Prop. Trading).

[1122] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012). Specifically, commenters cited statements in proposed Appendix B indicating that market makers ''typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions.'' On this issue, the appendix further stated that ''a market maker generally only transacts with non-customers to the extent necessary to hedge or otherwise manage the risks of its market making-related activities, including managing its risk with respect to movements of the price of retained principal positions and risks, to acquire positions in amounts consistent with reasonably expected near term demand of its customers, or to sell positions acquired from its customers.'' The appendix recognized, however, that the ''appropriate proportion of a market maker's transactions that are with customers versus non-customers varies depending on the type of positions involved and the extent to which the positions are typically hedged in non-customer transactions.'' Joint Proposal, 76 FR 68,961; CFTC Proposal, 77 FR 8440. Commenters' concerns regarding interdealer trading are addressed in Part IV.A.3.c.2.c.i., *infra.*

[1123] *See* Morgan Stanley; Goldman (Prop. Trading).

[1124] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012).

[1125] *See* Morgan Stanley; Chamber (Feb. 2012) (stating that market makers in the corporate bond, interest rate derivative, and natural gas derivative markets frequently trade with other dealers to work down a concentrated position originating with a customer trade).

[1126] *See* Morgan Stanley; Chamber (Feb. 2012).

[1127] *See* Goldman (Prop. Trading).

[1128] *See* Chamber (Feb. 2012).

[1129] *See* Goldman (Prop. Trading).

In addition, a few commenters expressed concern about statements in proposed Appendix B about a market maker's source of revenue.[1130] According to one commenter, the statement that profit and loss generated by inventory appreciation or depreciation must be ''incidental'' to customer revenues is inconsistent with market making-related activity in less liquid assets and larger transactions because market makers often must retain principal positions for longer periods of time in such circumstances and are unable to perfectly hedge these positions.[1131] As discussed above with respect to the source of revenue requirement in § ____.4(b)(v) of the proposed rule, a few commenters requested that Appendix B's discussion of ''customer revenues'' be modified to state that revenues from hedging will be considered to be customer revenues in certain contexts beyond derivatives contracts.[1132]

A number of commenters discussed the six proposed factors in Appendix B that, absent explanatory facts and circumstances, would have caused a particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity.[1133] With respect to the proposed factors, one commenter indicated that they are appropriate,[1134] while another commenter stated that they are complex and their effectiveness is uncertain.[1135] Another commenter expressed the view that ''[w]hile each of the selected factors provides evidence of 'proprietary trading,' warrants regulatory attention, and justifies a shift in the burden of proof, some require subjective judgments, are subject to gaming or data manipulation, and invite excessive reliance on circumstantial evidence and lawyers' opinions.'' [1136]

In response to the proposed risk management factor,[1137] one commenter expressed concern that it could prevent a market maker from warehousing positions in anticipation of predictable but unrealized customer demands and, further, could penalize a market maker that misestimated expected demand. This commenter expressed the view that such an outcome would be contrary to the statute and would harm market liquidity.[1138] Another commenter requested that this presumption be removed because in less liquid markets, such as markets for corporate bonds, equity derivatives, securitized products, emerging markets, foreign exchange forwards, and fund-linked products, a market maker needs to act as principal to facilitate client requests and, as a result, will be exposed to risk.[1139]

Two commenters expressed concern about the proposed source of revenue factor.[1140] One commenter stated that this factor does not accurately reflect how market making occurs in a majority of markets and asset classes.[1141] The other commenter expressed concern that this factor shifted the emphasis of § ____ .4(b)(v) of the proposed rule, which required that market making-related activities be ''designed'' to generate revenue primarily from certain sources, to the actual outcome of activities.[1142]

With respect to the proposed revenues relative to risk factor, one commenter supported this aspect of the proposal.[1143] Some commenters, however, expressed concern about using these factors to differentiate permitted market making-related activity from prohibited proprietary trading.[1144] These commenters stated that volatile risk-taking and revenue can be a natural result of principal market-making activity.[1145] One commenter noted that customer flows are often ''lumpy'' due to, for example, a market maker's facilitation of large trades.[1146]

A few commenters indicated that the analysis in the proposed customer-facing activity factor may not accurately reflect how market making occurs in certain markets and asset classes due to potential limitations on interdealer trading.[1147] According to another commenter, however, a banking entity's non-customer facing trades should be required to be matched with existing customer counterparties.[1148] With respect to the near term customer demand component of this factor, one commenter expressed concern that it goes farther than the statute's activity-based ''design'' test by analyzing whether a trading unit's inventory has exceeded reasonably expected near term customer demand at any particular point in time.[1149]

Some commenters expressed concern about the payment of fees, commissions, and spreads factor.[1150] One commenter appeared to support this proposed factor.[1151] According to one commenter, this factor fails to recognize that market makers routinely pay a variety of fees in connection with their market making-related activity, including, for example, fees to access liquidity on another market to satisfy customer demand, transaction fees as a matter of course, and fees in connection with hedging transactions. This commenter also indicated that, because spreads in current, rapidly-moving markets are volatile, short-term measurements of profit compared to spread revenue is problematic, particularly for less liquid

[1130] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). On this issue, Appendix B stated that certain types of ''customer revenues'' provide the primary source of a market maker's profitability and, while a market maker also incurs losses or generates profits as price movements occur in its retained principal positions and risks, ''such losses or profits are incidental to customer revenues and significantly limited by the banking entity's hedging activities.'' Joint Proposal, 76 FR 68,960; CFTC Proposal, 77 FR 8440. The Agencies address commenters' concerns about proposed requirements regarding a market maker's source of revenue in Part IV.A.3.c.7.c., *infra.*

[1131] *See* Morgan Stanley.

[1132] *See supra* note 1081 and accompanying text.

[1133] *See supra* note 1106 and accompanying text.

[1134] *See* Alfred Brock.

[1135] *See* Japanese Bankers Ass'n.

[1136] Sens. Merkley & Levin (Feb. 2012).

[1137] The proposed appendix stated that the Agencies would use certain quantitative measurements required in proposed Appendix A to help assess the extent to which a trading unit's risks are potentially being retained in excess amounts, including VaR, Stress VaR, VaR Exceedance, and Risk Factor Sensitivities. *See* Joint Proposal, 76 FR 68,961–68,962; CFTC Proposal, 77 FR 8441. One commenter questioned whether, assuming such metrics are effective and the activity does not exceed the banking entity's expressed risk appetite, it is necessary to place greater restrictions on risk-taking, based on the Agencies' judgment of the level of risk necessary for *bona fide* market making. *See* ICFR.

[1138] *See* Chamber (Feb. 2012).

[1139] *See* Credit Suisse (Seidel).

[1140] *See* Goldman (Prop. Trading); Morgan Stanley.

[1141] *See* Morgan Stanley.

[1142] *See* Goldman (Prop. Trading). This commenter suggested that the Agencies remove any negative presumptions based on revenues and instead use revenue metrics, such as Spread Profit and Loss (when it is feasible to calculate) or other metrics for purposes of monitoring a banking entity's trading activity. *See id.*

[1143] *See* Occupy (stating that these factors are important and will provide invaluable information about the nature of the banking entity's trading activity).

[1144] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1145] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011). For example, one commenter stated that because markets and trading volumes are volatile, consistent profitability and low earnings volatility are outside a market maker's control. In support of this statement, the commenter indicated that: (i) customer trading activity varies significantly with market conditions, which results in volatility in a market maker's earnings and profitability; and (ii) a market maker will experience volatility associated with changes in the value of its inventory positions, and principal risk is a necessary feature of market making. *See* Morgan Stanley.

[1146] *See* Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1147] *See* Morgan Stanley; Goldman (Prop. Trading).

[1148] *See* Public Citizen.

[1149] *See* Oliver Wyman (Feb. 2012).

[1150] *See* NYSE Euronext; Morgan Stanley.

[1151] *See* Public Citizen.

stocks.[1152] Another commenter stated that this factor reflects a bias toward agency trading and principal market making in highly liquid, exchange-traded markets and does not reflect the nature of principal market making in most markets.[1153] One commenter recommended that the rule require that a trader who pays a fee be prepared to document the chain of custody to show that the instrument is shortly re-sold to an interested customer.[1154]

Regarding the proposed compensation incentives factor, one commenter requested that the Agencies make clear that explanatory facts and circumstances cannot justify a trading unit providing compensation incentives that primarily reward proprietary risk-taking to employees engaged in market making. In addition, the commenter recommended that the Agencies delete the word ''primarily'' from this factor.[1155]

c. Determination To Not Adopt Proposed Appendix B

To improve clarity, the final rule establishes particular criteria for the exemption and does not incorporate the commentary in proposed Appendix B regarding the identification of permitted market making-related activities. This **SUPPLEMENTARY INFORMATION** provides guidance on the standards for compliance with the market-making exemption.

9. Use of Quantitative Measurements

Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review.[1156] The Agencies will not use quantitative measurements as a dispositive tool for differentiating between permitted market making-related activities and prohibited proprietary trading. Like the framework the Agencies have developed for the market-making exemption, the Agencies recognize that there may be differences in the quantitative measurements across markets and asset classes.

4. Section ____.5: Permitted Risk-Mitigating Hedging Activities

Section ____.5 of the proposed rule implemented section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on proprietary trading for certain risk-mitigating hedging activities.[1157] Section 13(d)(1)(C) provides an exemption for risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings (the ''hedging exemption''). Section ____.5 of the final rule implements the hedging exemption with a number of modifications from the proposed rule to respond to commenters' concerns as described more fully below.

a. Summary of Proposal's Approach to Implementing the Hedging Exemption

The proposed rule would have required seven criteria to be met in order for a banking entity's activity to qualify for the hedging exemption. First, §§ ____.5(b)(1) and ____.5(b)(2)(i) of the proposed rule generally required that the banking entity establish an internal compliance program that is designed to ensure the banking entity's compliance with the requirements of the hedging limitations, including reasonably designed written policies and procedures, internal controls, and independent testing, and that a transaction for which the banking entity is relying on the hedging exemption be made in accordance with the compliance program established under § ____.5(b)(1). Next, § ____.5(b)(2)(ii) of the proposed rule required that the transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity. Moreover, § ____.5(b)(2)(iii) of the proposed rule required that the transaction be reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate. Furthermore, § ____.5(b)(2)(iv) of the proposed rule required that the hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction. Section ____.5(b)(2)(v) of the proposed rule required that any hedge position established in reliance on the hedging exemption be subject to continuing review, monitoring and management. Finally, § ____.5(b)(2)(vi) of the proposed rule required that the compensation arrangements of persons performing the risk-mitigating hedging activities be designed not to reward proprietary risk-taking. Additionally, § ____.5(c) of the proposed rule required the banking entity to document certain hedging transactions at the time the hedge is established.

b. Manner of Evaluating Compliance With the Hedging Exemption

A number of commenters expressed concern that the final rule required application of the hedging exemption on a trade-by-trade basis.[1158] One commenter argued that the text of the proposed rule seemed to require a trade-by-trade analysis because each ''purchase or sale'' or ''hedge'' was subject to the requirements.[1159] The final rule modifies the proposal by generally replacing references to a ''purchase or sale'' in the § ____.5(b) requirements with ''risk-mitigating hedging activity.'' The Agencies believe this approach is consistent with the statute, which refers to ''risk-mitigating hedging activity.''[1160]

Section 13(d)(1)(C) of the BHC Act specifically authorizes risk-mitigating hedging activities in connection with and related to ''individual or aggregated positions, contracts or other holdings.''[1161] Thus, the statute does not require that exempt hedging be conducted on a trade-by-trade basis, and permits hedging of aggregated positions. The Agencies recognized this in the proposed rule, and the final rule continues to permit hedging activities in connection with and related to individual or aggregated positions.

The statute also requires that, to be exempt under section 13(d)(1)(C), hedging activities be risk-mitigating. The final rule incorporates this statutory requirement. As explained in more detail below, the final rule requires that, in order to qualify for the exemption for

[1152] *See* NYSE Euronext.

[1153] *See* Morgan Stanley.

[1154] *See* Public Citizen.

[1155] *See* Occupy. This commenter also stated that the commentary in Appendix B stating that a banking entity may give some consideration of profitable hedging activities in determining compensation would provide inappropriate incentives. *See id.*

[1156] *See infra* Part IV.C.3.; final rule Appendix A.

[1157] *See* 12 U.S.C. 1851(d)(1)(C); proposed rule § ____.5.

[1158] *See* Ass'n. of Institutional Investors (Feb. 2012); *See also* Barclays; ICI (Feb. 2012); Investure; MetLife; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley; Fixed Income Forum/Credit Roundtable; Fidelity; FTN.

[1159] *See* Barclays.

[1160] *See* 12 U.S.C. 1851(d)(1)(C) (stating that ''risk-mitigating hedging activities'' are permitted under certain circumstances).

[1161] *See* 12 U.S.C. 1851(d)(1)(C).

risk-mitigating hedging activities: The banking entity implement, maintain, and enforce an internal compliance program, including policies and procedures that govern and control these hedging activities; the hedging activity be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates specific, identifiable risks; the hedging activity not give rise to significant new risks that are left unhedged; the hedging activity be subject to continuing review, monitoring and management to address risk that might develop over time; and the compensation arrangements for persons performing risk-mitigating hedging activities be designed not to reward or incentivize prohibited proprietary trading. These requirements are designed to focus the exemption on hedging activities that are designed to reduce risk and that also demonstrably reduce risk, in accordance with the requirement under section 13(d)(1)(C) that hedging activities be risk-mitigating to be exempt. Additionally, the final rule imposes a documentation requirement on certain types of hedges.

Consistent with the other exemptions from the ban on proprietary trading for market-making and underwriting, the Agencies intend to evaluate whether an activity complies with the hedging exemption under the final rule based on the totality of circumstances involving the products, techniques, and strategies used by a banking entity as part of its hedging activity.[1162]

c. Comments on the Proposed Rule and Approach to Implementing the Hedging Exemption

Commenters expressed a variety of views on the proposal's hedging exemption. A few commenters offered specific suggestions described more fully below regarding how, in their view, the hedging exemption should be strengthened to ensure proper oversight of hedging activities.[1163] These commenters expressed concern that the proposal's exemption was too broad and argued that all proprietary trading could be designated as a hedge under the proposal and thereby evade the prohibition of section 13.[1164]

By contrast, a number of other commenters argued that the proposal imposed burdensome requirements that were not required by statute, would limit the ability of banking entities to hedge in a prudent and cost-effective manner, and would reduce market liquidity.[1165] These commenters argued that implementation of the requirements of the proposal would decrease safety and soundness of banking entities and the financial system by reducing cost-effective risk management options. Some commenters emphasized that the ability of banking entities to hedge their positions and manage risks taken in connection with their permissible activities is a critical element of liquid and efficient markets, and that the cumulative impact of the proposal would inhibit this risk-mitigation by raising transaction costs and suppressing essential and beneficial hedging activities.[1166]

A number of commenters expressed concern that the proposal's hedging exemption did not permit the full breadth of transactions in which banking entities engage to hedge or mitigate risks, such as portfolio hedging,[1167] dynamic hedging,[1168] anticipatory hedging,[1169] or scenario hedging.[1170] Some commenters stated that restrictions on a banking entity's ability to hedge may have a chilling effect on its willingness to engage in other permitted activities, such as market making.[1171] In addition, many of these commenters stated that, if a banking entity is limited in its ability to hedge its market-making inventory, it may be less willing or able to assume risk on behalf of customers or provide financial products to customers that are used for hedging purposes. As a result, according to these commenters, it will be more difficult for customers to hedge their risks and customers may be forced to retain risk.[1172]

Another commenter contended that the proposal represented an inappropriate ''one-size-fits-all'' approach to hedging that did not properly take into account the way banking entities and especially market intermediaries operate, particularly in less-liquid markets.[1173] Two commenters requested that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of the proposed exemption and, in particular, that a banking entity is not obligated to choose the ''best hedge'' and may use the cheapest instrument available.[1174] One commenter suggested uncertainty about the permissibility of a situation where gains on a hedge position exceed losses on the underlying position. The commenter suggested that uncertainty may lead banking entities to not use the most cost-effective hedge, which would make hedging less efficient and raise costs for banking entities and customers.[1175] However, another commenter expressed concern about banking entities relying on the cheapest satisfactory hedge. The commenter explained that such hedges lead to more complicated risk profiles and require banking entities to engage in additional transactions to hedge the exposures resulting from the imperfect, cheapest hedge.[1176]

A few commenters suggested the hedging exemption be modified in favor of a simpler requirement that banking entities adopt risk limits and policies and procedures commensurate with qualitative guidance issued by the Agencies.[1177] Many of these commenters also expressed concerns that the proposed rule's hedging exemption would not allow so-called asset-liability management (''ALM'') activities.[1178] Some commenters proposed that the risk-mitigating hedging exemption reference a set of relevant descriptive factors rather than

[1162] *See* Part IV.A.4.b., *infra.*

[1163] *See, e.g.,* AFR *et al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1164] *See, e.g.,* Occupy.

[1165] *See, e.g.,* Australian Bankers' Ass'n (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* Stephen Roach.

[1166] *See* Credit Suisse (Seidel); ICI (Feb. 2012); Wells Fargo (Prop. Trading); *See also* Banco de México; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA.

[1167] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA; HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1168] *See* Goldman (Prop. Trading); BoA.

[1169] *See* Barclays; State Street (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1170] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Markets Regulation. Each of these types of activities is discussed further below. *See infra* Part IV.A.4.d.2.

[1171] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1172] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Credit Suisse (Seidel).

[1173] *See* Barclays.

[1174] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel).

[1175] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1176] *See* Occupy.

[1177] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* Stephen Roach.

[1178] A detailed discussion of ALM activities is provided in Part IV.A.1.d.2 of this **SUPPLEMENTARY INFORMATION** relating to the definition of trading account. As explained in that part, the final rule does not allow use of the hedging exemption for ALM activities that are outside of the hedging activities specifically permitted by the final rule.

specific prescriptive requirements.[1179] Other alternative frameworks suggested by commenters include: (i) Reformulating the proposed requirements as supervisory guidance; [1180] (ii) establishing a safe harbor,[1181] presumption of compliance,[1182] or bright line test; [1183] or (iii) a principles-based approach that would require a banking entity to document its risk-mitigating hedging strategies for submission to its regulator.[1184]

d. Final Rule

The final rule provides a multi-faceted approach to implementing the hedging exemption that seeks to ensure that hedging activity is designed to be risk-reducing in nature and not designed to mask prohibited proprietary trading.[1185] The final rule includes a number of modifications in response to comments.

This multi-faceted approach is intended to permit hedging activities that are risk-mitigating and to limit potential abuse of the hedging exemption while not unduly constraining the important risk-management function that is served by a banking entity's hedging activities. This approach is also intended to ensure that any banking entity relying on the hedging exemption has in place appropriate internal control processes to support its compliance with the terms of the exemption. While commenters proposed a number of alternative frameworks for the hedging exemption, the Agencies believe the final rule's multi-faceted approach most effectively balances commenter concerns with statutory purpose. In response to commenter requests to reformulate the proposed rule as supervisory guidance,[1186] including the suggestion that the Agencies simply require banking entities to adopt risk limits and policies and procedures commensurate with qualitative Agency guidance,[1187] the Agencies believe that such an approach would provide less clarity than the adopted approach. Although a purely guidance-based approach could provide greater flexibility, it would also provide less specificity, which could make it difficult for banking entity personnel and the Agencies to determine whether an activity complies with the rule and could lead to an increased risk of evasion of the statutory requirements. Further, while a bright-line or safe harbor approach to the hedging exemption would generally provide a high degree of certainty about whether an activity qualifies for the exemption, it would also provide less flexibility to recognize the differences in hedging activity across markets and asset classes.[1188] In addition, the use of any bright-line approach would more likely be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the hedging exemption. Similarly, the Agencies decline to establish a presumption of compliance because, in light of the constant innovation of trading activities and the differences in hedging activity across markets and asset classes, establishing appropriate parameters for a presumption of compliance with the hedging exemption would potentially be less capable of recognizing these legitimate differences than our current approach.[1189] Moreover, the Agencies decline to follow a principles-based approach requiring a banking entity to document its hedging strategies for submission to its regulator.[1190] The Agencies believe that evaluating each banking entity's trading activity based on an individualized set of documented hedging strategies could be unnecessarily burdensome and result in unintended competitive impacts since banking entities would not be subject to one uniform rule. The Agencies believe the multi-faceted approach adopted in the final rule establishes a consistent framework applicable to all banking entities that will reduce the potential for such adverse impacts.

Further, the Agencies believe the scope of the final hedging exemption is appropriate because it permits risk-mitigating hedging activities, as mandated by section 13 of the BHC Act,[1191] while requiring a robust compliance program and other internal controls to help ensure that only genuine risk-mitigating hedges can be used in reliance on the exemption.[1192] In response to concerns that the proposed hedging exemption would reduce legitimate hedging activity and thus impact market liquidity and the banking entity's willingness to engage in permissible customer-related activity,[1193] the Agencies note that the requirements of the final hedging exemption are designed to permit banking entities to properly mitigate specific risk exposures, consistent with the statute. In addition, hedging related to market-making activity conducted by a market-making desk is subject to the requirements of the market-making exemption, which are designed to permit banking entities to continue providing valuable intermediation and liquidity services, including related risk-management activity.[1194] Thus, the final hedging exemption will not negatively impact the safety and soundness of banking entities or the financial system or have a chilling effect on a banking entity's willingness to engage in other permitted activities, such as market making.[1195]

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

[1179] *See* BoA; JPMC; Morgan Stanley.

[1180] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI.

[1181] *See* Prof. Richardson; ABA (Keating).

[1182] *See* Barclays; BoA; ISDA (Feb. 2012).

[1183] *See* Johnson & Prof. Stiglitz.

[1184] *See* HSBC.

[1185] *See* final rule § ____.5.

[1186] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI (Feb. 2012); BoA; Morgan Stanley.

[1187] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* Stephen Roach.

[1188] Some commenters requested that the Agencies establish a safe harbor. *See* Prof. Richardson; ABA (Keating). One commenter requested that the Agencies adopt a bright-line test. *See* Johnson & Prof. Stiglitz.

[1189] A few commenters requested that the Agencies establish a presumption of compliance. *See* Barclays; BoA; ISDA (Feb. 2012).

[1190] One commenter suggested this principles-based approach. *See* HSBC.

[1191] Section 13(d)(1)(C) of the BHC Act permits ''risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.'' 12 U.S.C. 1851(d)(1)(C).

[1192] Some commenters were concerned that the proposed hedging exemption was too broad and that all proprietary trading could be designated as a hedge. *See, e.g.,* Occupy.

[1193] *See, e.g.,* Australian Bankers Ass'n. (Feb. 2012).; BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1194] *See supra* Part IV.A.3.c.4.

[1195] Some commenters believed that restrictions on hedging would have a chilling effect on banking entities' willingness to engage in market making, and may result in customers experiencing difficulty in hedging their risks or force customers to retain risk. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA; IHS.

1. Compliance Program Requirement

The first criterion of the proposed hedging exemption required a banking entity to establish an internal compliance program designed to ensure the banking entity's compliance with the requirements of the hedging exemption and conduct its hedging activities in compliance with that program. While the compliance program under the proposal was expected to be appropriate for the size, scope, and complexity of each banking entity's activities and structure, the proposal would have required each banking entity with significant trading activities to implement robust, detailed hedging policies and procedures and related internal controls and independent testing designed to prevent prohibited proprietary trading in the context of permitted hedging activity.[1196] These enhanced programs for banking entities with large trading activity were expected to include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader designed to ensure that hedging strategies mitigated risk and were not for the purpose of engaging in prohibited proprietary trading.

Commenters, including industry groups, generally expressed support for requiring policies and procedures to monitor the safety and soundness, as well as appropriateness, of hedging activity.[1197] Some of these commenters advocated that the final rule presume that a banking entity is in compliance with the hedging exemption if the banking entity's hedging activity is done in accordance with the written policies and procedures required under its compliance program.[1198] One commenter represented that the proposed compliance framework was burdensome and complex.[1199]

Other commenters expressed concerns that the hedging exemption would be too limiting and burdensome for community and regional banks.[1200] Some commenters argued that foreign banking entities should not be subject to the requirements of the hedging exemption for transactions that do not introduce risk into the U.S. financial system.[1201] Other commenters stated that coordinated hedging through and by affiliates should qualify as permitted risk-mitigating hedging activity.[1202]

Some commenters urged the Agencies to adopt detailed limitations on hedging activities. For example, one commenter urged that all hedging trades be labeled as such at the inception of the trade and detailed information regarding the trader, manager, and supervisor authorizing the trade be kept and reviewed.[1203] Another commenter suggested that the hedging exemption contain a requirement that the banking entity employee who approves a hedge affirmatively certify that the hedge conforms to the requirements of the rule and has not been put in place for the direct or indirect purpose or effect of generating speculative profits.[1204] A few commenters requested limitations on instruments that can be used for hedging purposes.[1205]

The final rule retains the proposal's requirement that a banking entity establish an internal compliance program that is designed to ensure the banking entity limits its hedging activities to hedging that is risk-mitigating.[1206] The final rule largely retains the proposal's approach to the compliance program requirement, except to the extent that, as requested by some commenters,[1207] the final rule modifies the proposal to provide additional detail regarding the elements that must be included in a compliance program. Similar to the proposal, the final rule contemplates that the scope and detail of a compliance program will reflect the size, activities, and complexity of banking entities in order to ensure that banking entities engaged in more active trading have enhanced compliance programs without imposing undue burden on smaller organizations and entities that engage in little or no trading activity.[1208] The final rule also requires, like the proposal, that the banking entity implement, maintain, and enforce the program.[1209]

In response to commenter concerns about ensuring the appropriate level of senior management involvement in establishing these policies,[1210] the final rule requires that the written policies and procedures be developed and implemented by a banking entity at the appropriate level of organization and expressly address the banking entity's requirements for escalation procedures, supervision, and governance related to hedging activities.[1211]

Like the proposal, the final rule specifies that a banking entity's compliance regime must include reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a trading desk may use in its risk-mitigating hedging activities.[1212] The

[1196] These aspects of the compliance program requirement are described in further detail in Part IV.C. of this **SUPPLEMENTARY INFORMATION**.

[1197] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1198] *See* BoA; Barclays; HSBC; JPMC; Morgan Stanley; *See also* Goldman (Prop. Trading); RBC; Barclays; ICI (Feb. 2012); ISDA (Apr. 2012); PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See* the discussion of why the Agencies decline to take a presumption of compliance approach above.

[1199] *See* Barclays.

[1200] *See* ICBA; M&T Bank.

[1201] *See, e.g.,* Bank of Canada; Allen & Overy (on behalf of Canadian Banks). Additionally, foreign banking entities engaged in hedging activity may be able to rely on the exemption for trading activity conducted by foreign banking entities in lieu of the hedging exemption, provided they meet the requirements of the exemption for trading by foreign banking entities under § ____.6(e) of the final rule. *See infra* Part IV.A.8.

[1202] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1203] *See* Sens. Merkley & Levin (Feb. 2012).

[1204] *See* Better Markets (Feb. 2012).

[1205] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras.

[1206] *See* final rule § ____.5(b)(1). The final rule retains the proposal's requirement that the compliance program include, among other things, written hedging policies.

[1207] *See, e.g.,* BoA; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1208] *See* final rule § ____.20(a) (stating that ''[t]he terms, scope and detail of [the] compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity''). The Agencies believe this helps address some commenters' concern that the hedging exemption would be too limiting and burdensome for community and regional banks. *See* ICBA; M&T Bank.

[1209] Many of these policies and procedures were contained as part of the proposed rule's compliance program requirements under Appendix C. They have been moved, and in some cases modified, in order to more clearly demonstrate how they are incorporated into the requirements of the hedging exemption.

[1210] *See* Better Markets (Feb. 2012). The final rule does not require affirmative certification of each hedge, as suggested by this commenter, because the Agencies believe it would unnecessarily slow legitimate transactions. The Agencies believe the final rule's required management framework and escalation procedures achieve the same objective as the commenter's suggested approach, while imposing fewer burdens on legitimate risk-mitigating hedging activity.

[1211] *See* final rule §§ ____.20(b), ____.5(b). This approach builds on the proposal's requirement that senior management and intermediate managers be accountable for the effective implementation of the compliance program.

[1212] This approach is generally consistent with some commenters' suggested approach of limiting the instruments that can be used for hedging purposes; although the final rules provide banking entities with discretion to determine the types of positions, contracts, or other holdings that will mitigate specific risks of individual or aggregated holdings and thus may be used for risk-mitigating hedging activity. *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras. In response to one commenter's request that the final rule require all hedges to be labeled at inception and certain detailed information be documented for each hedge, the Agencies note that the final rules continue to require detailed documentation for hedging activity that presents a heightened risk of evasion. *See* Sens. Merkley & Levin (Feb. 2012); final rule § ____.5(c); *infra* Part IV.A.4.d.4. The Agencies believe a documentation requirement targeted at these

focus on policies and procedures governing risk identification and mitigation, analysis and testing of position limits and hedging strategies, and internal controls and ongoing monitoring is expected to limit use of the hedging exception to risk-mitigating hedging. The final rule adds to the proposed compliance program approach by requiring that the banking entity's written policies and procedures include position and aging limits with respect to such positions, contracts, or other holdings.[1213] The final rule, similar to the proposed rule, also requires that the compliance program contain internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures.[1214] Further, the final rule retains the proposed requirement that the compliance program provide for the conduct of analysis and independent testing designed to ensure that the positions, techniques, and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged.[1215]

The final rule also adds that correlation analysis be undertaken as part of the analysis of the hedging positions, techniques, and strategies that may be used. This provision effectively changes the requirement in the proposed rule that the hedge must maintain correlation into a requirement that correlation be analyzed as part of the compliance program before a hedging activity is undertaken. This provision incorporates the concept in the proposed rule that a hedge should be correlated (negatively, when sign is considered) to the risk being hedged. However, the Agencies recognize that some effective hedging activities, such as deep out-of-the-money puts and calls, may not be exhibit a strong linear correlation to the risks being hedged and also that correlation over a period of time between two financial positions does not necessarily mean one position will in fact reduce or mitigate a risk of the other. Rather, the Agencies expect the banking entity to undertake a correlation analysis that will, in many but not all instances, provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce. It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods. Rather, the nature and extent of the correlation analysis undertaken would be dependent on the facts and circumstances of the hedge and the underlying risks targeted. If correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation.

Moreover, the final rule requires hedging activity conducted in reliance on the hedging exemption be subject to continuing review, monitoring, and management that is consistent with the banking entity's written hedging policies and procedures and is designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, the specific, identifiable risks that develop over time from hedging activity and underlying positions.[1216] This ongoing review should consider market developments, changes in positions or the configuration of aggregated positions, changes in counterparty risk, and other facts and circumstances related to the risks associated with the underlying and hedging positions, contracts, or other holdings.

The Agencies believe that requiring banking entities to develop and follow detailed compliance policies and procedures related to risk-mitigating hedging activity will help both banking entities and examiners understand the risks to which banking entities are exposed and how these risks are managed in a safe and sound manner. With this increased understanding, banking entities and examiners will be better able to evaluate whether banking entities are engaged in legitimate, risk-reducing hedging activity, rather than impermissible proprietary trading. While the Agencies recognize there are certain costs associated with this compliance program requirement,[1217] we believe this provision is necessary to ensure compliance with the statute and the final rule. As discussed in Part IV.C.1., the Agencies have modified the proposed compliance program structure to reduce burdens on small banking entities.[1218]

The Agencies note that hedging may occur across affiliates under the hedging exemption.[1219] To ensure that hedging across trading desks or hedging done at a level of the organization outside of the trading desk does not result in prohibited proprietary trading, the final rule imposes enhanced documentation requirements on these activities, which are discussed more fully below. The Agencies also note that nothing in the final rule limits or restricts the ability of the appropriate supervisory agency of a banking entity to place limits on interaffiliate hedging in a manner consistent with their safety and soundness authority to the extent the agency has such authority.[1220] Additionally, nothing in the final rule limits or modifies the applicability of CFTC regulations with respect to the clearing of interaffiliate swaps.[1221]

2. Hedging of Specific Risks and Demonstrable Reduction of Risk

Section ____.5(b)(2)(ii) of the proposed rule required that a qualifying transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity.[1222] This criterion

scenarios balances the need to prevent evasion of the general prohibition on proprietary trading with the concern that documentation requirements can slow or impede legitimate risk-mitigating activity in the normal course.

[1213] *See* final rule § ____.5(b)(1)(i). Some commenters expressed support for the use of risk limits in determining whether trading activity qualifies for the hedging exemption. *See, e.g.,* Barclays; Credit Suisse (Seidel); ICI (Feb. 2012); Morgan Stanley.

[1214] *See* final rule § ____.5(b)(1)(ii).

[1215] *See* final rule § ____.5(b)(1)(iii). The final rule's requirement to demonstrably reduce or otherwise significantly mitigate is discussed in greater detail below.

[1216] The proposal also contained a continuing review, monitoring, and management requirement. *See* proposed rule § ____.5(b)(2)(v). The final rule modifies the proposed requirement, however, by removing the ''reasonable correlation'' requirement and instead requiring that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks. Correlation analysis is, however, a necessary component of the analysis element in the compliance program requirement of the hedging exemption in the final rule. *See* final rule § ____ .5(b). This change is discussed below.

[1217] *See* Barclays.

[1218] *See infra* Part IV.C.1. Some commenters expressed concern that the compliance program requirement would place undue burden on regional or community banks. *See* ICBA; M&T Bank.

[1219] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1220] In addition, section 608 of the Dodd-Frank Act added credit exposure arising from securities borrowing and lending or a derivative transaction with an affiliate to the list of covered transactions subject to the restrictions of section 23A of the FR Act, in each case to the extent that such transaction causes a bank to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7) and (8). As a consequence, interaffiliate hedging activity within a banking entity may be subject to limitation or restriction under section 23A of the FR Act.

[1221] *See* 17 CFR 50.52.

[1222] *See* proposed rule § ____.5(b)(2)(ii); *See also* Joint Proposal, 76 FR 68,875.

implemented the essential element of the hedging exemption that the transaction be risk-mitigating.

Some commenters expressed support for this provision, particularly the requirement that a banking entity be able to tie a hedge to a specific risk.[1223] One of these commenters stated that a demonstrated reduction in risk should be a key indicator of whether a hedge is in fact permitted.[1224] However, some commenters argued that the list of risks eligible to be hedged under the proposed rule, which included risks arising from aggregated positions, could justify transactions that should be viewed as prohibited proprietary trading.[1225] Another commenter contended that the term ''basis risk'' was undefined and could heighten the potential that this exemption would be used to evade the prohibition on proprietary trading.[1226]

Other commenters argued that requiring a banking entity to specify the particular risk being hedged discourages effective hedging and increases the risk at banking entities. These commenters contended that hedging activities must address constantly changing positions and market conditions.[1227] Another commenter argued that this requirement could render a banking entity's hedges impermissible if those hedges do not succeed in fully hedging or mitigating an identified risk as determined by a post hoc analysis and could prevent banking entities from entering into hedging transactions in anticipation of risks that the banking entity expects will arise (or increase).[1228] Certain commenters requested that the hedging exemption provide a safe harbor for positions that satisfy FASB ASC Topic 815 (formerly FAS 133) hedging accounting standards, which provides that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts, as assets or liabilities in the statement of financial position and measure them at fair value.[1229] Another commenter suggested that scenario hedges could be identifiable and subject to review by the Agencies using VaR, Stress VaR, and VaR Exceedance, as well as revenue metrics.[1230]

The Agencies have considered these comments carefully in light of the statute. Section 13(d)(1)(C) of the BHC Act provides an exemption from the prohibition on proprietary trading only for hedging activity that is ''designed to reduce the specific risks to the banking entity in connection with and related to'' individual or aggregated positions, contracts, or other holdings of the banking entity.[1231] Thus, while the statute permits hedging of individual or aggregated positions (as discussed more fully below), the statute requires that, to be exempt from the prohibition on proprietary trading, hedging transactions be designed to reduce specific risks.[1232] Moreover, it requires that these specific risks be in connection with or related to the individual or aggregated positions, contracts, or other holdings of the banking entity.

The final rule implements these requirements. To ensure that exempt hedging activities are designed to reduce specific risks, the final rule requires that the hedging activity at inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified individual or aggregated positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1233] Hedging activities and limits should be based on analysis conducted by the banking entity of the appropriateness of hedging instruments, strategies, techniques, and limits. As discussed above, this analysis must include analysis of correlation between the hedge and the specific identifiable risk or risks that the hedge is designed to reduce or significantly mitigate.[1234]

This language retains the focus of the statute and the proposed rule on reducing or mitigating specific and identified risks.[1235] As discussed more fully above, banking entities are required to describe in their compliance policies and procedures the types of strategies, techniques, and positions that may be used for hedging.

The final rule does not prescribe the hedging strategy that a banking entity must employ. While one commenter urged that the final rule require each banking entity to adopt the ''best hedge'' for every transaction,[1236] the Agencies believe that the complexity of positions, market conditions at the time of a transaction, availability of hedging transactions, costs of hedging, and other circumstances at the time of the transaction make a requirement that a banking entity always adopt the ''best hedge'' impractical, unworkable, and subjective.

Nonetheless, the statute requires that, to be exempt under section 13(d)(1)(C), hedging activity must be risk-mitigating. To ensure that only risk-mitigating hedging is permitted under this exemption, the final rule requires that in its written policies and procedures the banking entity identify the instruments and positions that may be used in hedging, the techniques and strategies the banking entity deems appropriate for its hedging activities, as well as position limits and aging limits on hedging positions. These written policies and procedures also must specify the escalation and approval procedures that apply if a trader seeks to conduct hedging activities beyond the limits, position types, strategies, or techniques authorized for the trader's activities.[1237]

[1223] *See* AFR (June 2013); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1224] *See* Sens. Merkley & Levin (Feb. 2012).

[1225] *See* Public Citizen; *See also* Occupy.

[1226] *See* Occupy.

[1227] *See, e.g.,* Japanese Bankers Ass'n.

[1228] *See* Barclays.

[1229] *See* ABA (Keating); Wells Fargo (Prop. Trading). Although certain accounting standards, such as FASB ASC Topic 815 hedge accounting standards, address circumstances in which a transaction may be considered a hedge of another transaction, the final rule does not refer to or expressly rely on these accounting standards because such standards: (i) Are designed for financial statement purposes, not to identify proprietary trading; and (ii) change often and are likely to change in the future without consideration of the potential impact on section 13 of the BHC Act.

[1230] *See* JPMC.

[1231] 12 U.S.C. 1851(d)(1)(C).

[1232] Some commenters expressed support for the requirement that a banking entity tie a hedge to a specific risk. *See* AFR (June 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1233] *See* final rule § ____.5(b)(2)(ii).

[1234] *See* final rule § ____.5(b)(1)(iii).

[1235] Some commenters represented that the proposed list of risks eligible to be hedged could justify transactions that should be considered proprietary trading. *See* Public Citizen; Occupy. One commenter was concerned about the proposed inclusion of ''basis risk'' in this list. *See* Occupy. As noted in the proposal, the Agencies believe the inclusion of a list of eligible risks, including basis risk, helps implement the essential element of the statutory hedging exemption—*i.e.,* that the transaction is risk-reducing in connection with a specific risk. *See* Joint Proposal, 76 FR 68,875. *See also* 12 U.S.C. 1851(d)(1)(C). Further, the Agencies believe the other requirements of the final hedging exemption, including requirements regarding internal controls and a compliance program, help to ensure that only legitimate hedging activity qualifies for the exemption.

[1236] *See, e.g.,* Occupy.

[1237] A banking entity must satisfy the enhanced documentation requirements of § ____.5(c) if it engages in hedging activity utilizing positions, contracts, or holdings that were not identified in its written policies and procedures.

As noted above, commenters were concerned that risks associated with permitted activities and holdings change over time, making a determination regarding the effectiveness of hedging activities in reducing risk dependent on the time when risk is measured. To address this, the final rule requires that the exempt hedging activity be designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, risk at the inception of the hedge. As explained more fully below, because risks and the effectiveness of a hedging strategy may change over time, the final rule also requires the banking entity to implement a program to review, monitor, and manage its hedging activity over the period of time the hedging activity occurs in a manner designed to reduce or significantly mitigate and demonstrably reduce or otherwise significantly mitigate new or changing risks that may develop over time from both the banking entity's hedging activities and the underlying positions. Many commenters expressed concern that the proposed ongoing review, monitoring, and management requirement would limit a banking entity's ability to engage in aggregated position hedging.[1238] One commenter stated that because aggregated position hedging may result in modification of hedging exposures across a variety of underlying risks, even as the overall risk profile of a banking entity is reduced, it would become impossible to subsequently review, monitor, and manage individual hedging transactions for compliance.[1239] The Agencies note that the final rule, like the statute, requires that the hedging activity relate to individual or aggregated positions, contracts or other holdings being hedged, and accordingly, the review, monitoring and management requirement would not limit the extent of permitted hedging provided for in section 13(d)(1)(C) as implied by some commenters. Further, the final rule recognizes that the determination of whether hedging activity demonstrably reduces or otherwise significantly mitigates risks that may develop over time should be ''based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof.'' [1240]

A number of other commenters argued that a legitimate risk-reducing hedge may introduce new risks at inception.[1241] A few commenters contended that a requirement that no new risks be associated with a hedge would be inconsistent with prudent risk management and greatly reduce the ability of banking entities to reduce overall risk through hedging.[1242] A few commenters stated that the proposed requirement does not recognize that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner.[1243] With respect to the timing of the initial hedge and any additional transactions necessary to reduce significant exposures arising from it, one of these commenters represented that requiring contemporaneous hedges is impracticable, would raise transaction costs, and would make hedging uneconomic.[1244] Another commenter stated that this requirement could have a chilling effect on risk managers' willingness to engage in otherwise permitted hedging activity.[1245]

Other commenters stated that a position that does not fully offset the risk of an underlying position is not in fact a hedge.[1246] These commenters believed that the introduction of new risks at inception of a transaction indicated that the transaction was impermissible proprietary trading and not a hedge.[1247]

The Agencies recognize that prudent risk-reducing hedging activities by banking entities are important to the efficiency of the financial system.[1248] The Agencies further recognize that hedges are generally imperfect; consequently, hedging activities can introduce new and sometimes significant risks, such as credit risk, basis risk, or new market risk, especially when hedging illiquid positions.[1249] However, the Agencies also recognize that hedging activities present an opportunity to engage in impermissible proprietary trading designed to profit from exposure to these types of risks.

To address these competing concerns, the final rule substantially retains the proposed requirement that, at the inception of the hedging activity, the risk-reducing hedging activity does not give rise to significant new or additional risk that is not itself contemporaneously hedged. This approach is designed to allow banking entities to continue to engage in prudent risk-mitigating activities while ensuring that the hedging exemption is not used to engage in prohibited proprietary trading by taking on prohibited short-term exposures under the guise of hedging.[1250] As noted in the proposal, however, the Agencies recognize that exposure to new risks may result from legitimate hedging transactions; [1251] this provision only prohibits the introduction of additional significant exposures through the hedging transaction unless those additional exposures are contemporaneously hedged.

As noted above, the final rule recognizes that whether hedging activity will demonstrably reduce risk must be based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1252] The Agencies believe this approach balances commenters' request that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of

[1238] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1239] *See* Barclays.

[1240] Final rule § ____.5(b)(2)(iv)(B). The Agencies believe this provision addresses some commenters' concern that the ongoing review, monitoring, and management requirement would limit hedging of aggregated positions, and that such ongoing review of individual hedge transactions with a variety of underlying risks would be impossible. *See* SIFMA (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1241] *See* ABA (Keating); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* AFR *et al.* (Feb. 2012).

[1242] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1243] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays.

[1244] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1245] *See* BoA.

[1246] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; AFR (Nov. 2012).

[1247] *See* Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012).

[1248] *See* FSOC study (stating that ''[p]rudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability'').

[1249] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1250] Some commenters stated that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner, and requiring contemporaneous hedges would raise transaction costs and the potential for hedges to become uneconomical. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays. As noted in the proposal, the Agencies believe that requiring a contemporaneous hedge of any significant new risk that arises at the inception of a hedge is appropriate because a transaction that creates significant new risk exposure that is not itself hedged at the same time would appear to be indicative of prohibited proprietary trading. *See* Joint Proposal, 76 FR 68,876. Thus, the Agencies believe this requirement is necessary to prevent evasion of the general prohibition on proprietary trading. In response to commenters' concerns about transaction costs and uneconomical hedging, the Agencies note that this provision only requires additional hedging of ''significant'' new or additional risk and does not apply to any risk exposure arising from a hedge.

[1251] *See* Joint Proposal, 76 FR 68,876.

[1252] *See* final rule § ____.5(b)(2)(ii).

the proposed exemption [1253] with concerns that allowing banking entities to rely on the cheapest satisfactory hedge will lead to additional hedging transactions.[1254] The Agencies expect that hedging strategies and techniques, as well as assessments of risk, will vary across positions, markets, activities and banking entities, and that a ''one-size-fits-all'' approach would not accommodate all types of appropriate hedging activity.[1255]

By its terms, section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .'' [1256] The preamble to the proposed rule made clear that, consistent with the statutory reference to mitigating risks of *individual or aggregated* positions, this criterion permits hedging of risks associated with aggregated positions.[1257] This approach is consistent with prudent risk-management and safe and sound banking practice.[1258]

The proposed rule explained that, to be exempt under this provision, hedging activities must reduce risk with respect to ''positions, contracts, or other holdings of the banking entity.'' The proposal also required that a banking entity relying on the exemption be prepared to identify the specific position or risks associated with aggregated positions being hedged and demonstrate that the hedging transaction was risk-reducing in the aggregate, as measured by appropriate risk management tools.

Some commenters were of the view that the hedging exemption applied to aggregated positions or portfolio hedging and was consistent with prudent risk-management practices. These commenters argued that permitting a banking entity to hedge aggregate positions and risks arising from a portfolio of assets would be more efficient from both a procedural and business standpoint.[1259]

By contrast, other commenters argued that portfolio-based hedging could be used to mask prohibited proprietary trading.[1260] One commenter contended that the statute provides no basis for portfolio hedging, and another commenter similarly suggested that portfolio hedging should be prohibited.[1261] Another commenter suggested adopting limits that would prevent the use of the hedging exemption to conduct proprietary activity at one desk as a theoretical ''hedge for proprietary trading at another desk.'' [1262] Among the limits suggested by these commenters were a requirement that a banking entity have a well-defined compliance program, the formation of central ''risk management'' groups to perform and monitor hedges of aggregated positions, and a requirement that the banking entity demonstrate the capacity to measure aggregate risk across the institution with precision using proven models.[1263] A few commenters suggested that the presence of portfolio hedging should be viewed as an indicator of imperfections in hedging at the desk level and be a flag used by examiners to identify and review the integrity of specific hedges.[1264]

The final rule, like the proposed rule, implements the statutory language providing for risk-mitigating hedging activities related to individual or aggregated positions. For example, activity permitted under the hedging exemption would include the hedging of one or more specific risks arising from identified positions, contracts, or other holdings, such as the hedging of the aggregate risk of identified positions of one or more trading desks. Further, the final rule requires that these hedging activities be risk-reducing with respect to the identified positions, contracts, or other holdings being hedged and that the risk reduction be demonstrable. Specifically, the final rule requires, among other things: That the banking entity has a robust compliance program reasonably designed to ensure compliance with the exemption; that each hedge is subject to continuing review, monitoring and management designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time related to the hedging activity and the underlying positions, contracts, or other holdings of the banking entity; and that the banking entity meet a documentation requirement for hedges not established by the trading desk responsible for the underlying position or for hedges effected through a financial instrument, technique or strategy that is not specifically identified in the trading desk's written policies and procedures. The Agencies believe this approach addresses concerns that a banking entity could use the hedging exemption to conduct proprietary activity at one desk as a theoretical hedge for proprietary trading at another desk in a manner consistent with the statute.[1265] Further, the Agencies believe the adopted exemption allows banking entities to engage in hedging of aggregated positions [1266] while helping to ensure that such hedging activities are truly risk-mitigating.[1267]

As noted above, several commenters questioned whether the hedging exemption should apply to ''portfolio'' hedging and whether portfolio hedging may create the potential for abuse of the hedging exemption. The term ''portfolio hedging'' is not used in the statute. The language of section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .'' [1268] After consideration of the comments regarding portfolio hedging, and in light of the statutory language, the Agencies are of the view that the statutory language is clear on its face that a banking entity may engage in risk-mitigating hedging in connection with aggregated positions of the banking entity. The permitted hedging activity, when involving more than one position, contract, or other holding, must be in

[1253] *See* SIFMA (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1254] *See* Occupy.

[1255] *See* Barclays.

[1256] 12 U.S.C. 1851(d)(1)(C).

[1257] *See* Joint Proposal, 76 FR 68,875.

[1258] *See, e.g.,* Australian Bankers' Ass'n. (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1259] *See, e.g.* ABA (Keating); Ass'n. of Institutional Investors (Sept. 2012); BoA; *See also* Barclays (expressing concern that the proposed rule could result in regulatory review of individual hedging trades for compliance on a *post hoc* basis); HSBC; ISDA (Apr. 2012); ICI (Feb. 2012); PNC; MetLife; RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1260] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen; Johnson & Prof. Stiglitz.

[1261] *See* Sens. Merkley & Levin (Feb. 2012) (commenting that the use of the term ''aggregate'' positions was intended to note that firms do not have to hedge on a trade-by-trade basis but could not hedge on a portfolio basis); Johnson & Prof. Stiglitz.

[1262] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1263] *See, e.g.,* Occupy; Public Citizen.

[1264] *See* Public Citizen; Occupy; AFR *et al.* (Feb. 2012).

[1265] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1266] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1267] The Agencies believe certain limits suggested by commenters, such as the formation of central ''risk management'' groups to monitor hedges of aggregated positions, are unnecessary given the aforementioned limits in the final rule. *See* Occupy; Public Citizen.

[1268] *See* 12 U.S.C. 1851(d)(1)(C).

connection with or related to aggregated positions of the banking entity.

Moreover, hedging of aggregated positions under this exemption must be related to identifiable risks related to specific positions, contracts, or other holdings of the banking entity. Hedging activity must mitigate one or more specific risks arising from an identified position or aggregation of positions. The risks in this context are not intended to be more generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modeling or other considerations. For example, the hedging activity cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.[1269] Rather, the hedging exemption permits the banking entity to engage in trading activity designed to reduce or otherwise mitigate specific, identifiable risks related to identified individual or aggregated positions that the banking entity it otherwise lawfully permitted to have.

When undertaking a hedge to mitigate the risk of an aggregation of positions, the banking entity must be able to specifically identify the risk factors arising from this set of positions. In identifying the aggregate set of positions that is being hedged for purposes of § ____.5(b)(2)(ii) and, where applicable, § ____.5(c)(2)(i), the banking entity needs to identify the positions being hedged with sufficient specificity so that at any point in time, the specific financial instrument positions or components of financial instrument positions held by the banking entity that comprise the set of positions being hedged can be clearly identified.

The proposal would have permitted a series of hedging transactions designed to rebalance hedging position(s) based on changes resulting from permissible activities or from a change in the price or other characteristic of the individual or aggregated positions, contracts, or other holdings being hedged.[1270] The Agencies recognized that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.[1271]

Some commenters questioned the risk-mitigating nature of a hedge if, at inception, that hedge contained component risks that must be dynamically managed throughout the life of the hedge. These commenters stated that hedges that do not continuously match the risk of underlying positions are not in fact risk-mitigating hedges in the first place.[1272]

On the other hand, other commenters argued that banking entities must be permitted to engage in dynamic hedging activity, such as in response to market conditions which are unforeseeable or out of the control of the banking entity,[1273] and expressed concern that the limitations of the proposed rule, especially the requirement that hedging transactions ''maintain a reasonable level of correlation,'' might impede truly risk-reducing hedging activity.[1274]

A number of commenters asserted that there could be confusion over the meaning of ''reasonable correlation,'' which was used in the proposal as part of explaining what type of activity would qualify for the hedging exemption. Some commenters urged requiring that there be a ''high'' or ''strong'' correlation between the hedge and the risk of the underlying asset.[1275]

Other commenters indicated that uncertainty about the meaning of reasonable correlation could limit valid risk-mitigating hedging activities because the level of correlation between a hedge and the risk of the position or aggregated positions being hedged changes over time as a result of changes in market factors and conditions.[1276] Some commenters represented that the proposed provision would cause certain administrative burdens [1277] or may result in a reduction in market-making activities in certain asset classes.[1278] A few commenters expressed concern that the reasonable correlation requirement could render a banking entity's hedges impermissible if they do not succeed in being reasonably correlated to the relevant risk or risks based on an after-the-fact analysis that incorporates market developments that could not have been foreseen at the time the hedge was placed. These commenters tended to favor a different approach or a type of safe harbor based on an initial determination of correlation.[1279] Some commenters argued the focus of the hedging exemption should be on risk reduction and not on reasonable correlation.[1280] One commenter suggested that risk management metrics such as VaR and risk factor sensitivities could be the focus for permitted hedging instead of requirements like reasonable correlation under the proposal.[1281]

In consideration of commenter concerns about the proposed reasonable correlation requirement, the final rule modifies the proposal in the following key respects. First, the final rule modifies the requirement of ''reasonable correlation'' by providing that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks.[1282] This change is

[1269] The Agencies believe that it would be inconsistent with Congressional intent to permit some or all of these activities under the hedging exemption, regardless of whether certain metrics could be useful for monitoring such activity. *See* JPMC.

[1270] *See* proposed rule § ____.5(b)(2)(ii) (requiring that the hedging transaction ''hedges or otherwise mitigates one or more specific risks . . . arising in connection with and related to individual or aggregated positions, contracts, or other holdings of [the] banking entity''). The proposal noted that this requirement would include, for example, dynamic hedging. *See* Joint Proposal, 76 FR 68,875.

[1271] The proposal noted that this corresponding modification to the hedge should also be reasonably correlated to the material changes in risk that are intended to be hedged or otherwise mitigated, as required by § ____.5(b)(2)(iii) of the proposed rule.

[1272] *See* AFR *et al.* (Feb. 2012); Public Citizen; *See also* Better Markets (Feb. 2012), Sens. Merkley & Levin (Feb. 2012).

[1273] *See* Japanese Bankers Ass'n.

[1274] *See, e.g.,* BoA; Barclays; ISDA (Apr. 2012); PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1275] *See, e.g.,* Occupy; Public Citizen; AFR *et. al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1276] *See* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; *See also* Chamber (Feb. 2012).

[1277] *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1278] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012). As discussed above, market-maker hedging at the trading desk level is no longer subject to the hedging exemption and is instead subject to the requirements of the market-making exemption, which is designed to permit banking entities to continue providing legitimate market-making services, including managing the risk of market-making activity. *See also supra* Part IV.A.3.c.4. of this **SUPPLEMENTARY INFORMATION.**

[1279] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* FTN; BoA.

[1280] *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *See also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1281] *See* Goldman (Prop. Trading). Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review. *See infra* Part IV.C.3.; final rule Appendix A. The Agencies do not intend to use quantitative measurements as a dispositive tool for differentiating between permitted hedging activities and prohibited proprietary trading.

[1282] Some commenters stated that the hedging exemption should focus on risk reduction, not reasonable correlation. *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy. One of these commenters noted that demonstrated risk reduction

Continued

designed to reinforce that hedging activity should be demonstrably risk reducing or mitigating rather than simply correlated to risk. This change acknowledges that hedges need not simply be correlated to underlying positions, and that hedging activities should be consciously designed to reduce or mitigate identifiable risks, not simply the result of pairing correlated positions, as some commenters suggested.[1283] As discussed above, the Agencies do, however, recognize that correlation is often a critical element of demonstrating that a hedging activity reduces the risks it is designed to address. Accordingly, the final rule requires that banking entities conduct correlation analysis as part of the required compliance program in order to utilize the hedging exemption.[1284] The Agencies believe this change better allows consideration of the facts and circumstances of the particular hedging activity as part of the correlation analysis and therefore addresses commenters' concerns that the proposed reasonable correlation requirement could cause administrative burdens, impede legitimate hedging activity,[1285] and require an after-the-fact analysis.[1286]

Second, the final rule provides that the determination of whether an activity or strategy is risk-reducing or mitigating must, in the first instance, be made at the inception of the hedging activity. A trade that is not risk-reducing at its inception is not viewed as a hedge for purposes of the exemption in § ____ .5.[1287]

Third, the final rule requires that the banking entity conduct analysis and independent testing designed to ensure that the positions, techniques, and strategies used for hedging are reasonably designed to reduce or otherwise mitigate the risk being hedged. As noted above, such analysis and testing must include correlation analysis. Evidence of negative correlation may be a strong indicator that a given hedging position or strategy is risk-reducing. Moreover, positive correlation, in some instances, may be an indicator that a hedging position or strategy is not designed to be risk-mitigating. The type of analysis and factors considered in the analysis should take account of the facts and circumstances, including type of position being hedged, market conditions, depth and liquidity of the market for the underlying and hedging position, and type of risk being hedged.

The Agencies recognize that markets and risks are dynamic and that the risks from a permissible position or aggregated positions may change over time, new risks may emerge in the positions underlying the hedge and in the hedging position, new risks may emerge from the hedging strategy over time, and hedges may become less effective over time in addressing the related risk.[1288] The final rule, like the proposal, continues to allow dynamic hedging. Additionally, the final rule requires the banking entity to engage in ongoing review, monitoring, and management of its positions and related hedging activity to reduce or otherwise significantly mitigate the risks that develop over time. This ongoing hedging activity must be designed to reduce or otherwise significantly mitigate, and must demonstrably reduce or otherwise significantly mitigate, the material changes in risk that develop over time from the positions, contracts, or other holdings intended to be hedged or otherwise mitigated in the same way, as required for the initial hedging activity. Moreover, the banking entity is required under the final rule to support its decisions regarding appropriate hedging positions, strategies and techniques for its ongoing hedging activity in the same manner as for its initial hedging activities. In this manner, the final rule permits a banking entity to engage in effective management of its risks throughout changing market conditions[1289] while also seeking to prohibit the banking entity from taking large proprietary positions through action or inaction related to an otherwise permissible hedge.[1290]

As explained above, the final rule requires a banking entity relying on the hedging exemption to be able to demonstrate that the banking entity is exposed to the specific risks being hedged at the inception of the hedge and any adjustments thereto. However, in the proposal, the Agencies requested comment on whether the hedging exemption should be available in certain cases where hedging activity begins before the banking entity becomes exposed to the underlying risk. The Agencies proposed that the hedging exemption would be available in certain cases where the hedge is established ''slightly'' before the banking entity becomes exposed to the underlying risk if such anticipatory hedging activity: (i) Was consistent with appropriate risk management practices; (ii) otherwise met the terms of the hedging exemption; and (iii) did not involve the potential for speculative profit. For example, a banking entity that was contractually obligated or otherwise highly likely to become exposed to a particular risk could engage in hedging that risk in advance of actual exposure.[1291]

A number of commenters argued that anticipatory hedging is a necessary and prudent activity and that the final rule should permit anticipatory hedging more broadly than did the proposed rule.[1292] In particular, commenters were concerned that permitting hedging activity only if it occurs ''slightly'' before a risk is taken could limit hedging activities that are crucial to risk management.[1293] Commenters expressed concern that the proposed approach would, among other things, make it difficult for banking entities to accommodate customer requests for transactions with specific price or size executions[1294] and limit dynamic hedging activities that are important to sound risk management.[1295] In addition, a number of commenters requested that the rule permit banking entities to engage in scenario hedging, a form of

should be a key requirement. *See* Sens. Merkley & Levin (Feb. 2012).

[1283] *See* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *See also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1284] *See* final rule § ____.5(b)(1)(iii).

[1285] Some commenters expressed concern that the proposed ''reasonable correlation'' requirement might impede truly risk-reducing activity. *See, e.g.,* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); ISDA (Apr. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY. Some of these commenters stated that the proposed requirement would cause administrative burdens. *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1286] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012; *See also* FTN.

[1287] By contrast, the proposed requirement did not specify that the hedging activity reduce risk ''at the inception of the hedge.'' *See* proposed rule § ____.5(b)(2)(ii).

[1288] Some commenters noted that hedging activities must address constantly changing positions and market conditions and expressed concern about requiring a banking entity to identify the particular risk being hedged. *See* Japanese Bankers Ass'n.; Barclays.

[1289] A few commenters expressed concern that the proposed ''reasonable correlation'' requirement would render hedges impermissible if not reasonably correlated to the relevant risk(s) based on a *post hoc* analysis. *See, e.g.,* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1290] Some commenters questioned the risk-mitigating nature of a hedge if, at inception, it contained risks that must be dynamically managed throughout the life of the hedge. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

[1291] *See* Joint Proposal, 76 FR 68,875.

[1292] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1293] *See* BoA; Credit Suisse (Seidel); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC *et al.*; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1294] *See* Credit Suisse (Seidel); BoA.

[1295] *See* PNC *et al.*

anticipatory hedging that addresses potential exposures to ''tail risks.''[1296]

Some commenters expressed concern about the proposed criterion that the hedging activity not involve the potential for speculative profit.[1297] These commenters argued that the proper focus of the hedging exemption should be on the purpose of the transaction, and whether the hedge is correlated to the underlying risks being hedged (in other words, whether the hedge is effective in mitigating risk).[1298] By contrast, another commenter urged the Agencies to adopt a specific metric to track realized profits on hedging activities as an indicator of prohibited arbitrage trading.[1299]

Like the proposal, the final rule does not prohibit anticipatory hedging. However, in response to commenter concerns that the proposal would limit a banking entity's ability to respond to customer requests and engage in prudent risk management, the final rule does not retain the proposed requirement discussed above that an anticipatory hedge be established ''slightly'' before the banking entity becomes exposed to the underlying risk and meet certain conditions. To address commenter concerns with the statutory mandate, several parts of the final rule are designed to ensure that all hedging activities, including anticipatory hedging activities, are designed to be risk reducing and not impermissible proprietary trading activities. For example, the final rule retains the proposed requirement that a banking entity have reasonably designed policies and procedures indicating the positions, techniques and strategies that each trading desk may use for hedging. These policies and procedures should specifically address when anticipatory hedging is appropriate and what policies and procedures apply to anticipatory hedging.

The final rule also requires that a banking entity relying on the hedging exemption be able to demonstrate that the hedging activity is designed to reduce or significantly mitigate, and does demonstrably reduce or otherwise significantly mitigate, specific, identifiable risks in connection with individual or aggregated positions of the banking entity.[1300] Importantly, to use the hedging exemption, the final rule requires that the banking entity subject its hedging activity to continuing review, monitoring, and management that is designed to reduce or significantly mitigate specific, identifiable risks, and that demonstrably reduces or otherwise significantly mitigates identifiable risks, in connection with individual or aggregated positions of the banking entity.[1301] The final rule also requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in § ____.5(b)(2) and is not prohibited proprietary trading. If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, under these provisions, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce the risk associated with that position as soon as reasonably practicable after it is determined that the anticipated risk will not materialize. This requirement focuses on the purpose of the hedge as a trade designed to reduce anticipated risk and not for other purposes. The Agencies will (and expect that banking entities also will) monitor the activities of banking entities to identify prohibited trading activity that is disguised as anticipatory hedging.

As noted above, one commenter suggested the Agencies adopt a metric to monitor the profitability of a banking entity's hedging activity.[1302] We are not adopting such a metric because we do not believe it would be useful to monitor the profit and loss associated with hedging activity in isolation without considering the profit and loss associated with the individual or aggregated positions being hedged. For example, the commenter's suggested metric would not appear to provide information about whether the gains arising from hedging positions offset or mitigate losses from individual or aggregated positions being hedged.

3. Compensation

The proposed rule required that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward proprietary risk-taking.[1303] In the proposal, the Agencies stated that hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.[1304]

Commenters generally supported this requirement and indicated that its inclusion was very important and valuable.[1305] Some commenters argued that the final rule should limit compensation based on profits derived from hedging transactions, even if those hedging transactions were in fact risk-mitigating hedges, and urged that employees be compensated instead based on success in risk mitigation at the end of the life of the hedge.[1306] In contrast, other commenters argued that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking.[1307]

After considering comments received on the compensation requirements of the proposed hedging exemption, the final rule substantially retains the proposed requirement that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward prohibited proprietary trading. The final

[1296] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Market Regulation. As discussed above, hedging activity relying on this exemption cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.

[1297] *See* ABA (Keating); CH/ABASA; *See also* Credit Suisse (Seidel); PNC; PNC *et al.*; SIFMA *et al.* (Prop. Trading) (Feb. 2012). One commenter argued that anticipatory hedging should not be permitted because it represents illegal front running. *See* Occupy. The Agencies note that not all anticipatory hedging would constitute illegal front running. Any activity that is illegal under another provision of law, such as front running under section 10(b) of the Exchange Act, remains illegal; and section 13 of the BHC Act and any implementing rules thereunder do not represent a grant of authority to engage in any such activity. *See* 15 U.S.C. 78j.

[1298] As discussed above, the final hedging exemption replaces the ''reasonable correlation'' concept with the requirement that hedging activity ''demonstrably reduce or otherwise significantly mitigate'' specific, identifiable risks.

[1299] *See* AFR *et al.* (Feb. 2012); *See also* Part IV.C.3.d., *infra*.

[1300] This requirement modifies proposed rule §§ ____.5(b)(2)(ii) and (iii). As discussed above, the addition of ''demonstrably reduces or significantly mitigates'' language replaces the proposed ''reasonable correlation'' requirement.

[1301] The proposed rule contained a similar provision, except that the proposed provision also required that the continuing review maintain a reasonable level of correlation between the hedge transaction and the risk being hedged. *See* proposed rule § ____.5(b)(2)(v). As discussed above, the proposed ''reasonable correlation'' requirement was removed from that provision and instead a requirement has been added to the compliance program provision that correlation analysis be undertaken when analyzing hedging positions, techniques, and strategies before they are implemented.

[1302] *See* AFR *et al.* (Feb. 2012).

[1303] *See* proposed rule § ____.5(b)(2)(vi).

[1304] *See* Joint Proposal, 76 FR 68,868.

[1305] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen.

[1306] *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1307] *See* Morgan Stanley.

rule is also modified to make clear that rewarding or incentivizing profit making from prohibited proprietary trading is not permitted.[1308]

The Agencies recognize that compensation, especially incentive compensation, may be both an important motivator for employees as well as a useful indicator of the type of activity that an employee or trading desk is engaged in. For instance, an incentive compensation plan that rewards an employee engaged in activities under the hedging exemption based primarily on whether that employee's positions appreciate in value instead of whether such positions reduce or mitigate risk would appear to be designed to reward prohibited proprietary trading rather than risk-reducing hedging activities.[1309] Similarly, a compensation arrangement that is designed to incentivize an employee to exceed the potential losses associated with the risks of the underlying position rather than reduce risks of underlying positions would appear to reward prohibited proprietary trading rather than risk-mitigating hedging activities. The banking entity should review its compensation arrangements in light of the guidance and rules imposed by the appropriate Federal supervisor for the entity regarding compensation.[1310]

4. Documentation Requirement

Section ____.5(c) of the proposed rule would have imposed a documentation requirement on certain types of hedging transactions. Specifically, for any transaction that a banking entity conducts in reliance on the hedging exemption that involved a hedge established at a level of organization different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the hedging transaction is designed to reduce, the banking entity was required, at a minimum, to document: the risk-mitigating purpose of the transaction; the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce; and the level of organization that is establishing the hedge.[1311] Such documentation was required to be established at the time the hedging transaction is effected. The Agencies expressed concern in the proposal that hedging transactions established at a different level of organization than the positions being hedged may present or reflect heightened potential for prohibited proprietary trading, either at the trading desk level or at the level instituting the hedging transaction. In other words, the further removed hedging activities are from the specific positions, contracts, or other holdings the banking entity intends to hedge, the greater the danger that such activity is not limited to hedging specific risks of individual or aggregated positions, contracts, or other holdings of the banking entity, as required by the rule.

Some commenters argued that the final rule should require comprehensive documentation for all activity conducted pursuant to the hedging exemption, regardless of where it occurs in an organization.[1312] One of these commenters stated that such documentation can be easily and quickly produced by traders and noted that traders already record execution details of every trade.[1313] Several commenters argued that the rule should impose a requirement that banks label all hedges at their inception and provide information regarding the specific risk being offset, the expected duration of the hedge, how it will be monitored, how it will be wound down, and the names of the trader, manager, and supervisor approving the hedge.[1314]

Some commenters requested that the documentation requirement be applied at a higher level of organization,[1315] and some commenters noted that policies and procedures alone would be sufficient to address hedging activity, wherever conducted within the organization.[1316] Two commenters indicated that making the documentation requirement narrower is necessary to avoid impacts or delays in daily trading operations that could lead to a banking entity being exposed to greater risks.[1317] A number of commenters stated that any enhanced documentation requirement would be burdensome and costly, and would impede rapid and effective risk mitigation, whether done at a trading desk or elsewhere in the banking entity.[1318]

At least one commenter also argued that a banking entity should be permitted to consolidate some or all of its hedging activity into a trading desk that is not responsible for the underlying positions without triggering a requirement that all hedges undertaken by a trading desk be documented solely because the hedges are not undertaken by the trading desk that originated the underlying position.[1319]

The final rule substantially retains the proposed requirement for enhanced documentation for hedging activity conducted under the hedging exemption if the hedging is not conducted by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings, the risks of which the hedging activity is designed to reduce. The final rule clarifies that a banking entity must prepare enhanced documentation if a trading desk establishes a hedging position and is not the trading desk that established the underlying positions, contracts, or other holdings. The final rule also requires enhanced documentation for hedges established to hedge aggregated positions across two or more desks. This change in the final rule clarifies that the level of the organization at which the trading desk exists is important for determining whether the trading desk established or is responsible for the underlying positions, contracts, or other holdings. The final rule recognizes that a trading desk may be responsible for hedging aggregated positions of that desk and other desks, business units, or affiliates. In that case, the trading desk putting on the hedge is at least one step removed from some of the positions being hedged. Accordingly, the final rule provides that the documentation requirements in § ____.5 apply if a trading desk is hedging aggregated positions that include positions from more than one trading desk.

[1308] One commenter stated that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking, rather than apply to hedging activities. *See* Morgan Stanley.

[1309] Thus, the Agencies agree with one commenter who stated that compensation for hedging should not be based purely on profits derived from hedging. However, the final rule does not require compensation vesting, as suggested by this commenter, because the Agencies believe the final hedging exemption includes sufficient requirements to ensure that only risk-mitigating hedging is permitted under the exemption without a compensation vesting provision. *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1310] *See* 12 U.S.C. 5641.

[1311] For example, as explained under the proposal, a hedge would be established at a different level of organization of the banking entity if multiple market-making desks were exposed to similar risks and, to hedge such risks, a hedge was established at the direction of a supervisor or risk manager responsible for more than one desk rather than at each of the market-making desks that established the initial positions, contracts, or other holdings. *See* Joint Proposal, 76 FR 68,876 n.161.

[1312] *See* AFR (June 2013); Occupy.

[1313] *See* Occupy.

[1314] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR (June 2013).

[1315] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; *See also* Japanese Bankers Ass'n.

[1316] *See* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1317] *See* JPMC; Barclays.

[1318] *See* Barclays; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* Japanese Bankers Ass'n.

[1319] *See* JPMC.

The final rule adds to the proposal by requiring enhanced documentation for hedges established by the specific trading desk establishing or directly responsible for the underlying positions, contracts, or other holdings, the risks of which the purchases or sales are designed to reduce, if the hedge is effected through a financial instrument, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures as a product, instrument, exposure, technique, or strategy that the trading desk may use for hedging.[1320] The Agencies note that this documentation requirement does not apply to hedging activity conducted by a trading desk in connection with the market making-related activities of that desk or by a trading desk that conducts hedging activities related to the other permissible trading activities of that desk so long as the hedging activity is conducted in accordance with the compliance program for that trading desk.

The Agencies continue to believe that, for the reasons stated in the proposal, it is appropriate to retain documentation of hedging transactions conducted by those other than the traders responsible for the underlying position in order to permit evaluation of the activity. In order to reduce the burden of the documentation requirement while still giving effect to the rule's purpose, the final rule requires limited documentation for hedging activity that is subject to a documentation requirement, consisting of: (1) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings that the purchase or sale is designed to reduce; (2) the specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and (3) the trading desk or other business unit that is establishing and responsible for the hedge transaction. As in the proposal, this documentation must be established contemporaneously with the hedging transaction. Documentation would be contemporaneous if it is completed reasonably promptly after a trade is executed. The banking entity is required to retain records for no less than 5 years (or such longer period as may be required under other law) in a form that allows the banking entity to promptly produce such records to the Agency on request.[1321] While the Agencies recognize this documentation requirement may result in certain costs, the Agencies believe this requirement is necessary to prevent evasion of the statute and final rule.

5. Section ____.6(a)–(b): Permitted Trading in Certain Government and Municipal Obligations

Section ____.6 of the proposed rule permitted a banking entity to engage in trading activities that were authorized by section 13(d)(1) of the BHC Act,[1322] including trading in certain government obligations, trading on behalf of customers, trading by insurance companies, and trading outside of the United States by certain foreign banking entities.[1323] Section ____.6 of the final rule generally incorporates these same statutory exemptions. However, the final rule has been modified in some ways in response to comments received on the proposal.

a. Permitted Trading in U.S. Government Obligations

Section 13(d)(1)(A) permits trading in various U.S. government, U.S. agency and municipal securities.[1324] Section ____.6(a) of the proposed rule, which implemented section 13(d)(1)(A) of the BHC Act, permitted the purchase or sale of a financial instrument that is an obligation of the United States or any agency thereof or an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*).[1325] The proposal did not contain an exemption for trading in derivatives referencing exempt U.S. government and agency securities, but requested comment on whether the final rule should contain an exemption for proprietary trading in options or other derivatives referencing an exempt government obligation.[1326]

Commenters were generally supportive of the manner in which the proposal implemented the exemption for permitted trading in U.S. government and U.S. agency obligations.[1327] Many commenters argued that the exemption for permissible proprietary trading in government obligations should be expanded, however, to include trading in derivatives on government obligations.[1328] These commenters asserted that failure to provide an exemption would adversely impact liquidity in the underlying government obligations themselves and increase borrowing costs to governments.[1329] Several commenters asserted that U.S. government and agency obligations and derivatives on those instruments are substitutes and pose the same investment risks and opportunities.[1330] According to some commenters, the significant connections between these markets and the interchangeable nature of these instruments significantly contribute to price discovery, in particular, in the cash market for U.S. Treasury obligations.[1331] Commenters also argued that trading in Treasury futures and options improves liquidity in Treasury securities markets by providing an outlet to relieve any supply and demand imbalances in spot obligations. Many commenters argued that the authority to engage in trading in derivatives on U.S. government, agency, and municipal obligations is inherent in the statutory exceptions granted by section 13(d)(1)(A) to trade in the underlying obligation.[1332] To the extent there is any doubt about the scope of those exemptions, commenters urged the Agencies to use the exemptive

[1320] One commenter suggested that the rule require documentation when a banking entity needs to engage in new types of hedging transactions that are not covered by its hedging policies, although this commenter's suggested approach would only apply when a hedge is conducted two levels above the level at which the risk arose. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies agree that documentation is needed when a trading desk is acting outside of its hedging policies and procedures. However, the final rule does not limit this documentation requirement to circumstances when the hedge is conducted two organizational levels above the trading desk. Such an approach would be less effective than the adopted approach at addressing evasion concerns.

[1321] *See* final rule § ____5(c)(3).

[1322] *See* proposed rule § ____.6.

[1323] *See* 12 U.S.C. 1851(d)(1)(A), (C), (F), and (H).

[1324] 12 U.S.C. 1851(d)(1)(A).

[1325] The Agencies proposed that United States ''agencies'' for this purpose would include those agencies described in section 201.108(b) of the Board's Regulation A. *See* 12 CFR 201.108(b). The Agencies also noted that the terms of the exemption would encompass the purchase or sale of enumerated government obligations on a forward basis (*e.g.,* in a to-be-announced market). In addition, this would include pass-through or participation certificates that are issued and guaranteed by a government-sponsored entity (*e.g.,* the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with its securitization activities.

[1326] *See* Joint Proposal, 76 FR 68,878.

[1327] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1328] *See* BoA; CalPERS; Credit Suisse (Seidel); CME Group; Fixed Income Forum/Credit Roundtable; FIA; JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1329] *See* BoA; FIA; HSBC; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading).

[1330] *See* Barclays; Credit Suisse (Seidel); Fixed Income Forum/Credit Roundtable; FIA.

[1331] *See* Barclays; CME Group; Fixed Income Forum/Credit Roundtable; *See also* UBS.

[1332] *See* CME Group; *See also* Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

authority under section 13(d)(1)(J) if necessary to permit proprietary trading in derivatives on government obligations.[1333] Two commenters opposed providing an exemption for proprietary trading in derivatives on exempt government obligations.[1334]

The final rule has not been modified to permit a banking entity to engage in proprietary trading of derivatives on U.S. government and agency obligations.

The Agencies note that the cash market for exempt government obligations is already one of the most liquid markets in the world, and the final rule will permit banking entities to participate fully in these cash markets. In addition, the final rule permits banking entities to make a market in U.S. government securities and in derivatives on those securities. Moreover, the final rule allows banking entities to continue to use U.S. government obligations and derivatives on those obligations in risk-mitigating hedging activities permitted by the rule. Further, proprietary trading in derivatives on such obligations will continue by entities other than banking entities.

Proprietary trading of derivatives on U.S. government obligations is not necessary to promote and protect the safety and soundness of a banking entity or the financial stability of the United States. Commenters offered no compelling reasons why derivatives on exempt government obligations pose little or no risk to the financial system as compared to derivatives on other financial products for which proprietary trading is generally prohibited and did not indicate how proprietary trading in derivatives of U.S. government and agency obligations by banking entities would promote the safety and soundness of those entities or the financial stability of the United States. For these reasons, the Agencies have not determined to provide an exemption for proprietary trading in derivatives on exempt government obligations.

The Agencies believe banking entities will continue to provide significant support and liquidity to the U.S. government and agency security markets through permitted trading in the cash exempt government obligations markets, making markets in government obligation derivatives and through derivatives trading for hedging purposes. The final rule adopts the same approach as the proposed rule for the exemption for permitted trading in U.S. government and U.S. agency obligations. In response to commenters, the Agencies are clarifying how banking entities would be permitted to use Treasury derivatives on Treasury securities when relying on the exemptions for market-making related activities and risk-mitigating hedging activities. The Agencies agree with commenters that some Treasury derivatives are close economic substitutes for Treasury securities and provide many of the same economic exposures.[1335] The Agencies also understand that the markets for Treasury securities and Treasury futures are fully integrated, and that trading in these derivative instruments is essential to ensuring the continued smooth functioning of market-making related activities in Treasury securities. Treasury derivatives are frequently used by market makers to hedge their market-making related positions across many different types of fixed-income securities. Under the final rule, market makers will generally be able to continue their practice of using Treasury futures to hedge their activities as block positioners off exchanges. Additionally, when engaging in permitted market-making related or risk-mitigating hedging activities in accordance with the requirements in §§ ____.4(b) or ____.(5), the final rule permits banking entities to acquire a short or long position in Treasury futures through manual trading or automated processes. For example, a banking entity would be permitted to use Treasury futures to hedge the duration risk (*i.e.,* the measure of a bond's price sensitivity to interest rates movements) associated with the banking entity's market-making in Treasury securities or other fixed-income products, provided that the banking entity complies with the market-making requirements in § ____.4(b). In their market making, banking entities also frequently trade Treasury futures (and acquire a corresponding long or short position) in reasonable anticipation of the near-term demands of their clients, customers, and counterparties. For example, banking entities may acquire a long or short position in Treasury futures to hedge anticipated market risk when they reasonably expect clients, customers, or counterparties will seek to establish long or short positions in on- or off-the-run Treasury securities. Similarly, banking entities could acquire a long or short position in the ''Treasury basis'' to hedge the anticipated basis risk associated with making markets for clients, customers, or counterparties that are reasonably expected to engage in basis trading of the price spread between Treasury futures and Treasury securities. A banking entity can also use Treasury futures (or other derivatives on exempt government obligations) to hedge other risks such as the aggregated interest rate risk for specifically identified loans as well as other financial instruments such as asset-backed securities, corporate bonds, and interest rate swaps. Therefore, depending on the relevant facts and circumstances, banking entities would be permitted to acquire a very large long or short position in Treasury derivatives provided that they comply with the requirements in §§ ____.4(b) or ____.(5). The Agencies also understand that banking entities that have been designated as ''primary dealers'' by the Federal Reserve Bank of New York are required to underwrite issuances of Treasury securities. This necessitates the banking entities to frequently establish very large short positions in Treasury futures to order to hedge the duration risk associated with potentially owning a large volume of Treasury securities. As described below,[1336] the Agencies note that, with respect to a banking entity that acts as a primary dealer for Treasury securities, the U.S. government will be considered a client, customer, or counterparty of the banking entity for purposes of the market-making exemption.[1337] We believe this interpretation appropriately captures the unique relationship between a primary dealer and the government. Moreover, this interpretation clarifies that a banking entity may rely on the market-making exemption for its activities as primary dealer to the extent those activities are outside the scope of the underwriting exemption.[1338]

The final rule also includes an exemption for obligations of or guaranteed by the United States or an agency of the United States. An obligation guaranteed by the U.S. or an agency of the U.S. is, in effect, an obligation of the U.S. or that agency.

The final rule also includes an exemption for an obligation of the FDIC, or any entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act (''FDI Act'') or Title II of the Dodd-Frank

[1333] *See* Barclays; CME Group; JPMC.

[1334] *See* Occupy; Alfred Brock.

[1335] *See infra* note 1330.

[1336] *See infra* Part IV.A.3.c.2.c.i.

[1337] *See supra* note 905 (explaining the functions of primary dealers).

[1338] *See supra* Part IV.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity, as well as one commenter's request for such an interpretation).

Act.[1339] These FDIC receivership and conservatorship operations are authorized under the FDI Act and Title II of the Dodd-Frank Act and are designed to lower the FDIC's resolution costs. The Agencies believe that an exemption for these types of obligations would promote and protect the safety and soundness of banking entities and the financial stability of the United States because they facilitate the FDIC's ability to conduct receivership and conservatorship operations in an orderly manner, thereby limiting risks to the financial system generally that might otherwise occur if the FDIC was restricted in its ability to conduct these operations.

b. Permitted Trading in Foreign Government Obligations

The proposed rule did not contain an exemption for trading in obligations of foreign sovereign entities. As part of the proposal, however, the Agencies specifically requested comment on whether proprietary trading in the obligations of foreign governments would promote and protect the safety and soundness of banking entities and the financial stability of the United States under section 13(d)(1)(J) of the BHC Act.[1340]

The treatment of proprietary trading in foreign sovereign obligations prompted a significant number of comments. Many commenters, including foreign governments, foreign and domestic banking entities, and various trade groups, argued that the final rule should permit trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments.[1341] Representatives from foreign governments such as Canada, Germany, Luxembourg, Japan, Australia, and Mexico specifically requested an exemption for trading in obligations of their governments and argued that an exemption was necessary and appropriate to maintain and promote financial stability in their markets.[1342] Some commenters also requested an exemption for trading in obligations of multinational central banks, such as Eurobonds issued or guaranteed by the European Central Bank.[1343]

Many commenters argued that the same rationale for the statutory exemption for proprietary trading in U.S. government obligations supported exempting proprietary trading in foreign sovereign debt and related obligations.[1344] Commenters contended that lack of an express exemption for trading in foreign sovereign obligations could critically impact the functioning of money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations.[1345] These commenters also contended that an exemption for proprietary trading in foreign sovereign debt would promote and protect the safety and soundness and the financial stability of the United States by avoiding the possible negative effects of a contraction of government bond market liquidity.[1346]

Commenters also contended that in some foreign markets, local regulations or market practice require U.S. banking entities operating in those jurisdictions to hold, trade or support government issuance of local sovereign securities. They also indicated that these instruments are traded in the United States or on U.S. markets.[1347] In addition, a number of commenters contended that U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the United States by U.S. primary dealers and alleged that restricting these trading activities would have a significant negative impact on the ability of foreign governments to implement their monetary policy and on liquidity for such securities in many foreign markets.[1348] A few commenters further argued that banking entities use foreign sovereign debt, particularly debt of their home country and of the country in which they are operating, to manage their risk by posting sovereign securities as collateral in foreign jurisdictions, to manage international rate and foreign exchange risk (particularly in local operations), and for liquidity and asset-liability management purposes in different countries.[1349] Similarly, commenters expressed concern that the lack of an exemption for trading in foreign government obligations could adversely interact with other banking regulations, such as liquidity requirements under the Basel III capital rules that encourage financial institutions to hold large concentrations of sovereign bonds to match foreign currency denominated obligations.[1350] Commenters also expressed particular concern that the limitations and obligations of section 13 of the BHC Act would likely be problematic and unduly burdensome if banking entities were able to trade in foreign sovereign obligations only under the market making or other proposed exemptions from the proprietary trading prohibition.[1351] One commenter expressed the view that lack of an exemption for proprietary trading in foreign government obligations together with the proposed exemption for trading that occurs solely outside the U.S. may cause foreign banks to close their U.S. branches to avoid being subject to section 13 of the BHC Act and any final rule thereunder.[1352]

[1339] *See* final rule § ____.6(a)(4).

[1340] *See* Joint Proposal, 76 FR 68,878.

[1341] *See, e.g.,* Allen & Overy (Gov't Obligations); Allen & Overy (Canadian Banks); BoA; Australian Bankers Ass'n. (Feb. 2012); AFMA; Banco de México; Bank of Canada; Ass'n of German Banks; BAROC; Barclays; BEC (citing the National Institute of Banking and Finance); British Bankers' Ass'n.; BaFin/Deutsche Bundesbank; Chamber (Feb. 2012); Mexican Banking Comm'n.; French Treasury *et al.;* EFAMA; ECOFIN; EBF; French Banking Fed'n.; FSA (Apr. 2012); FIA; Goldman (Prop. Trading); HSBC; Hong Kong Inv. Funds Association; IIB/EBF; ICFR; ICSA; IRSG; Japanese Bankers Ass'n.; Ass'n. of Banks in Malaysia; OSFI; British Columbia; Québec; Sumitomo Trust; TMA Hong Kong; UBS; Union Asset.

[1342] *See, e.g.,* Allen & Overy (Gov't Obligations); Bank of Canada; British Columbia; Ontario; IIAC; Quebec; IRSG; IIB/EBF; Mitsubishi; Gov't of Japan/Bank of Japan; Australian Bankers Ass'n (Feb. 2012); AFMA; Banco de México; Ass'n. of German Banks; ALFI; Embassy of Switzerland.

[1343] *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't Obligations).

[1344] *See* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; BaFIN/Deutsche Bundesbank; EFAMA; Union Asset; TMA Hong Kong; ICI (Feb. 2012) (arguing that such an exemption would be consistent with Congressional intent to limit the extra-territorial application of U.S. law).

[1345] *See* Banco de México; Barclays; BoA; Gov't of Japan/Bank of Japan; IIAC; OSFI.

[1346] *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Banco de México; Ass'n. of German Banks; Barclays; Mexican Banking Comm'n.; EFAMA; EBF; French Banking Fed'n.; Goldman (Prop. Trading); HSBC; IIB/EBF; HSBC; ICSA; T. Rowe Price; UBS; Union Asset; IRSG; EBF; Mitsubishi (citing Japanese Bankers Ass'n. and IIB); Wells Fargo (Prop. Trading); ICI Global.

[1347] *See* Allen & Overy (Gov't. Obligations) (contending that ''even if not primary dealers, banking entities or their branches or agencies acting in certain foreign jurisdictions, such as Singapore and India, are still required to hold or transact in local sovereign debt under local law''); BoA; Barclays; Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1348] *See* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup; Goldman (Prop. Trading); IIB/EBF; *See also* JPMC (suggesting that, at a minimum, the Agencies should make clear that all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities are protected by the market-making-related permitted activity); SIFMA *et al.* (Prop. Trading) (Feb. 2012). As discussed in Parts IV.A.2.c.2.c. and IV.A.2.c.2.b.ix of this **SUPPLEMENTARY INFORMATION,** the Agencies believe primary dealing activities would generally qualify under the scope of the market-making or underwriting exemption.

[1349] *See* Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1350] *See* Allen & Overy (Gov't. Obligations); BoA.

[1351] *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1352] *See* Comm. on Capital Markets Regulation.

According to some commenters, providing an exemption only for proprietary trading in U.S. government obligations, without a similar exemption for foreign government obligations, would be discriminatory and inconsistent with longstanding principles of national treatment and with U.S. treaty obligations, such as obligations under the World Trade Organization framework or bilateral trade agreements.[1353] In addition, several commenters argued that not exempting proprietary trading of foreign sovereign debt may encourage foreign regulators to enact similar regulations to the detriment of U.S. financial institutions operating abroad.[1354] However, another commenter disagreed that the failure to exempt trading in foreign government obligations would violate trade agreements or that the proposal discriminated in any way against foreign banking entities' ability to compete with U.S. banking entities in the U.S.[1355]

Based on these concerns, some commenters suggested that the Agencies exempt proprietary trading by foreign banking entities in obligations of their home or host country.[1356] Other commenters suggested allowing trading in foreign government obligations that meet some condition on quality (*e.g.,* OECD-member country obligations, government bonds eligible as collateral for Federal Reserve advances, sovereign bonds issued by G–20 countries, or other highly liquid or rated instruments).[1357] One commenter indicated that in their view, provided appropriate risk-management procedures are followed, investing in non-U.S. government securities is as low risk as investing in U.S. government securities despite current price volatility in certain types of sovereign debt.[1358] Some commenters also suggested the final rule give deference to home country regulation and permit foreign banking entities to engage in proprietary trading in any government obligation to the extent that such trading is permitted by the entity's primary regulator.[1359]

By contrast, other commenters argued that proprietary trading in foreign sovereign obligations represents a risky activity and that there is no effective way to draw the line between safe and unsafe foreign debt.[1360] Two of these commenters pointed to several publicly reported instances where proprietary trading in foreign sovereign obligations resulted in significant losses to certain firms. These commenters argued that restricting proprietary trading in foreign sovereign debt would not cause reduced liquidity in government bond markets since banking entities would still be permitted to make a market in and underwrite foreign government obligations.[1361] A few commenters suggested that, if the final rule exempted proprietary trading in foreign sovereign debt, foreign governments should commit to pay for any damage to the U.S. financial system related to proprietary trading in their obligations pursuant to such exemption.[1362]

The Agencies carefully considered all the comments related to proprietary trading in foreign sovereign debt in light of the language, purpose and standards for exempting activity contained in section 13 of the BHC Act. Under section 13(d)(1)(J), the Agencies may grant an exemption from the prohibitions of the section for any activity that the Agencies determine would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The Agencies note as an initial matter that section 13 permits banking entities—both inside the United States and outside the United States—to make markets in and to underwrite all types of securities, including all types of foreign sovereign debt. The final rule implements the statutory market-making and underwriting exemptions, and thus, the key role of banking entities in facilitating trading and liquidity in foreign government debt through market-making and underwriting is maintained. This includes underwriting and marketmaking as a primary dealer in foreign sovereign obligations. Banking entities may also hold foreign sovereign debt in their long-term investment book. In addition, the final rule does not prevent foreign banking entities from engaging in proprietary trading outside of the United States in any type of sovereign debt.[1363] Moreover, the Agencies continue to believe that positions, including positions in foreign government obligations, acquired or taken for the *bona fide* purpose of liquidity management and in accordance with a documented liquidity management plan that is consistent with the relevant Agency's supervisory requirements, guidance and expectations regarding liquidity management are not covered by the prohibitions in section 13.[1364] The final rule continues to incorporate this view.[1365]

The issue raised by commenters, therefore, is the extent to which proprietary trading in foreign sovereign obligations by U.S. banking entities anywhere in the world and by foreign banking entities in the United States is consistent with promoting and protecting the safety and soundness of the banking entity and the financial stability of the United States. Taking into account the information provided by commenters, the Agencies' understanding of market operations, and the purpose and language of section 13, the Agencies have determined to grant a limited exemption to the prohibition on proprietary trading for trading in foreign sovereign obligations under certain circumstances.

This exemption, which is contained in § ____.6(b) of the final rule, permits the U.S. operations of foreign banking entities to engage in proprietary trading in the United States in the foreign sovereign debt of the foreign sovereign under whose laws the banking entity—or the banking entity that controls it—is organized (hereinafter, the ''home country''), and any multinational central bank of which the foreign sovereign is a member so long as the purchase or sale as principal is not made by an insured depository institution.[1366]

[1353] *See* Allen & Overy (Gov't. Obligations); Banco de México; IIB/EBF; Ass'n. of Banks in Malaysia.

[1354] *See* Sumitomo Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Govt. Obligations); BoA; ICI Global; RBC; ICFR; ICI (Feb. 2012); Bank of Canada; Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); Chamber (Feb. 2012); BAROC. *See also* IIB/EBF.

[1355] *See* Sens. Merkley &Levin (Feb. 2012).

[1356] *See* Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS; *See also* BAROC.

[1357] *See* BoA; Cadwalader (on behalf of Singapore Banks); IIB/EBF; Norinchukin; OSFI; Cadwalader (on behalf of Thai Banks); Ass'n. of Banks in Malaysia; UBS; *See also* BAROC; ICFR; Japanese Bankers Ass'n.; JPMC; Québec.

[1358] *See, e.g.,* Allen & Overy (Gov't Obligations).

[1359] *See* Allen & Overy (Gov't. Obligations); HSBC.

[1360] *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1361] *See* Prof. Johnson; Better Markets (Feb. 2012).

[1362] *See* Better Markets (Feb. 2012); *See also* Prof. Johnson.

[1363] *See* final rule § ____.6(e).

[1364] *See* Joint Proposal, 76 FR 68,862.

[1365] *See* final rule § ____.3(d)(3).

[1366] *See* final rule § ____.6(b). Some commenters requested an exemption for trading in obligations of multinational central banks. *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't. Obligations). In the case of a foreign banking entity that is owned or controlled by a second foreign banking entity domiciled in a country other than the home country of the first foreign banking entity, the final rule would permit the eligible U.S. operations of the first foreign banking entity to engage in proprietary trading only in the sovereign debt of the first foreign banking entity's home country, and would permit the U.S. operations of the second foreign banking entity to engage in proprietary trading only in the sovereign debt of the home country of the second foreign banking entity. As noted earlier, other provisions of the final rule make clear that the rule does not restrict the proprietary trading outside of the United States of

Similar to the exemption for proprietary trading in U.S. government obligations, the permitted trading activity in the U.S. by the eligible U.S. operations of a foreign banking entity would extend to obligations of political subdivisions of the foreign banking entity's home country.[1367]

Permitting the eligible U.S. operations of a foreign banking entity to engage in proprietary trading in the United States in the foreign sovereign obligations of the foreign entity's home country allows these U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations.[1368] At the same time, the risk of these trading activities is largely determined by the foreign sovereign that charters the foreign bank. By not permitting proprietary trading in foreign sovereign debt in insured depository institutions (other than in accordance with the limitations in other exemptions), the exemption limits the direct risks of these activities to insured depository institutions in keeping with the statute.[1369] Thus, the Agencies have determined that this limited exemption for proprietary trading in foreign sovereign obligations promotes and protects the safety and soundness of banking entities and also promotes and protects the financial stability of the United States.

The Agencies have also determined to permit a foreign bank or foreign broker-dealer regulated as a securities dealer and controlled by a U.S. banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized (hereinafter, the ''home country''), including obligations of an agency or political subdivision of that foreign sovereign.[1370] This limited exemption is necessary to allow U.S. banking organizations to continue to own and acquire foreign banking organizations and broker-dealers without requiring those foreign banking organizations and broker-dealers to discontinue proprietary trading in the sovereign debt of the foreign banking entity's home country.[1371] The Agencies have determined that this limited exemption will promote the safety and soundness of banking entities and the financial stability of the United States by allowing U.S. banking entities to continue to be affiliated with and operate foreign banking entities and benefit from international diversification and participation in global financial markets.[1372] However, the Agencies intend to monitor activity of banking entities under this exemption to ensure that U.S. banking entities are not seeking to evade the restrictions of section 13 by using an affiliated foreign bank or broker-dealer to engage in proprietary trading in foreign sovereign debt on behalf of or for the benefit of other parts of the U.S. banking entity.

Apart from this limited exemption, the Agencies have not extended this exemption to proprietary trading in foreign sovereign debt by U.S. banking entities for several reasons. First, section 13 was primarily concerned with the risks posed to the U.S. financial system by proprietary trading activities. This risk is most directly transmitted by U.S. banking entities, and while commenters alleged that prohibiting U.S. banking entities from engaging in proprietary trading in debt of foreign sovereigns would harm liquidity in those markets, the evidence provided by commenters did not sufficiently indicate that permitting U.S. banking entities to engage in proprietary trading (as opposed to market-making or underwriting) in debt of foreign sovereigns contributed in any significant degree to the liquidity of markets in foreign sovereign instruments.[1373] Thus, expanding the exemption to permit U.S. banking entities to engage in proprietary trading in debt of foreign sovereigns would likely increase the risks to these entities and the U.S. financial system without a significant concomitant and offsetting benefit. As explained above, these U.S. entities are permitted by the final rule to continue to engage fully in market-making in and underwriting of debt of foreign sovereigns anywhere in the world. The only restriction placed on these entities is on the otherwise impermissible proprietary trading in these instruments for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements.

The Agencies recognize that, depending on the extent to which banking entities subject to the rule have contributed to the liquidity of trading markets for foreign sovereign debt, the lack of an exemption for proprietary trading in foreign sovereign debt could result in certain negative impacts on the markets for such debt. In general, the Agencies believe these concerns should be mitigated somewhat by the refined exemptions for market making, underwriting and permitted trading activity of foreign banking entities; however, those exemptions do not address certain of the collateral, capital, and other operational issues identified by commenters.[1374] Foreign sovereign

either foreign banking organization in debt of any foreign sovereign.

[1367] *See* Part IV.A.5.c., *infra.* Many commenters requested an exemption for trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Bank of Canada; Ass'n. of German Banks; BAROC; Barclays.

[1368] As part of this exemption, for example, the U.S. operations of a European bank would be able to trade in obligations issued by the European Central Bank. Many commenters represented that the same rationale for exempting trading in U.S. government obligations supports exempting trading in foreign sovereign debt. *See, e.g.,* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; EFAMA; ICI (Feb. 2012).

[1369] The Agencies believe this approach appropriately balances commenter concerns that proprietary trading in foreign sovereign obligations represents a risky activity and the interest in preserving the ability of U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations. *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1370] *See* final rule § ____.6(c). Many commenters requested an exemption for trading in foreign sovereign debt, and some commenters suggested exempting proprietary trading by foreign banking entities in obligations of their home country. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; FSA (Apr. 2012); Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS.

[1371] Commenters argued that in some foreign markets, U.S. banks operating in those jurisdictions are required by local regulation or market practice to trade in local sovereign securities. *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Ass'n. of German Banks; Barclays; EBF; Goldman (Prop. Trading); UBS.

[1372] Some commenters represented that the limitations and obligations of section 13 would be problematic and unduly burdensome on banking entities because they would only be able to trade in foreign sovereign obligations under existing exemptions, such as the market-making exemption. *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1373] *See, e.g.,* BoA; Citigroup; Goldman (Prop. Trading); IIB/EBF; Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012).; Banco de México; Barclays. The Agencies recognize some commenters' representation that restricting trading in foreign sovereign debt would not necessarily cause reduced liquidity in government bond markets because banking entities would still be able to make a market in and underwrite foreign government obligations. *See* Prof. Johnson; Better Markets (Feb. 2012).

[1374] Representatives from foreign governments stated that an exemption allowing trading in obligations of their governments is necessary to maintain financial stability in their markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Bank of Canada; IRSG; IIB/EBF; Gov't of Japan/Bank of Japan; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Ass'n. of German Banks; ALFI. Commenters argued that exempting trading in foreign sovereign debt would avoid the possible negative impacts of a contraction of government bond market liquidity. *See, e.g.,* BoA; Citigroup;

Continued

debt of home and host countries generally serves these purposes. Due to the relationships among global financial markets, permitting trading that supports these essential functions promotes the financial stability and the safety and soundness of banking entities.[1375] In contrast, a broad exemption for proprietary trading in all foreign sovereign debt without the limitations contained in the underwriting, market making and hedging exemptions could lead to more complicated risk profiles and significant unhedged risk exposures that section 13 of the BHC Act is designed to address. Thus, the Agencies believe use of section 13(d)(1)(J) exemptive authority to permit proprietary trading in foreign government obligations in certain limited circumstances is appropriate.

The Agencies decline to follow commenters' suggested alternative of allowing trading in foreign government obligations if the obligations meet a particular condition on quality, such as obligations of OECD member countries.[1376] The Agencies do not believe such an approach responds to the statutory purpose of limiting risks posed to the U.S. financial system by proprietary trading activities as directly as our current approach, which is structured to limit the exposure of banking entities, including insured depository institutions, to the risks of foreign sovereign debt. Additionally, the Agencies decline to permit proprietary trading in any obligation permitted under the laws of the foreign banking entity's home country,[1377] because such an approach could result in unintended competitive impacts since banking entities would not be subject to one uniform standard inside the United States. Further, unlike some commenters, the Agencies do not believe it is appropriate to require foreign governments to commit to paying for any damage to the U.S. financial system resulting from the foreign sovereign debt exemption.[1378]

The proposal also did not contain an exemption for trading in derivatives on foreign government obligations. Many commenters who recommended providing an exemption for proprietary trading in foreign government obligations also requested that the exemption be extended to derivatives on foreign government obligations.[1379] Two of these commenters urged that trading in derivatives on foreign sovereign obligations should be exempt for the same reason that trading in derivatives on U.S. government obligations is exempt because such trading supports liquidity and price stability in the market for the underlying government obligations.[1380] One commenter recommended that the Agencies use the authority in section 13(d)(1)(J) to grant an exemption for proprietary trading in derivatives on foreign government obligations.[1381]

The final rule has not been modified in § ____.6(b) to permit a banking entity to engage in proprietary trading in derivatives on foreign government obligations. As noted above, the Agencies have determined not to permit proprietary trading in derivatives on U.S. exempt government obligations under section 13(d) and, for the same reasons, have determined not to extend the permitted activities to include proprietary trading in derivatives on foreign government obligations.

c. Permitted Trading in Municipal Securities

Section ____.6(a) of the proposed rule implemented an exemption to the prohibition against proprietary trading under section 13(d)(1)(A) of the BHC Act, which permits trading in certain governmental obligations. This exemption permits the purchase or sale of obligations issued by any State or any political subdivision thereof (the ''municipal securities trading exemption''). The proposed rule included both general obligation bonds and limited obligation bonds, such as revenue bonds, within the scope of this municipal securities trading exemption. The proposed rule, however, did not extend to obligations of ''agencies'' of States or political subdivisions thereof.[1382]

Many commenters, including industry participants, trade groups, and Federal and state governmental representatives, argued that the municipal securities trading exemption should be interpreted to permit banking entities to engage in proprietary trading in a broader range of municipal securities, including the following: Obligations issued directly by States and political subdivisions thereof; obligations issued by agencies, constituted authorities, and similar governmental entities acting as instrumentalities on behalf of States and political subdivisions thereof; and obligations issued by such governmental entities that are treated as political subdivisions under various more expansive definitions of political subdivisions under Federal and state laws.[1383] These commenters argued that States and municipalities often issue obligations through agencies and instrumentalities and that these obligations generally have the same level of risk as direct obligations of States and political subdivisions.[1384] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the

Goldman (Feb. 2012); IIB/EBF. Additionally, commenters suggested that failing to provide an exemption for this activity would impact money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations. *See, e.g.,* Barclays; BoA; Gov't of Japan/Bank of Japan; OSFI. A number of commenters also argued that, since U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the U.S. by U.S. primary dealers, the lack of an exemption would have a significant, negative impact on the ability of foreign governments to implement monetary policy and on liquidity in many foreign markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); IIB/EBF. Some commenters argued that banking entities and their customers use foreign sovereign debt to manage their risk by posting collateral in foreign jurisdictions and to manage international rate and foreign exchange risk. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1375] The Agencies generally concur with commenters' concerns that because the lack of an exemption could result in negative consequences—such as harming liquidity in foreign sovereign debt markets, making it more difficult and more costly for foreign governments to fund themselves, or subjecting banking entities to increased concentration risk—systemic risk could increase or there could be spillover effects that would harm global markets, including U.S. markets. *See* IIF; EBF; ICI Global; HSBC; Barclays; ICI (Feb. 2012); IIB/EBF; Union Asset. Additionally, in consideration of one commenter's statements, the Agencies believe that failing to provide this exemption may cause foreign banks to close their U.S. branches, which could harm U.S. markets. *See* Comm. on Capital Markets Regulation.

[1376] *See, e.g.,* BoA; Cadwalader (on behalf of Singapore Banks).; IIB/EBF; OSFI; UBS; BAROC; Japanese Bankers Ass'n.; JPMC.

[1377] Some commenters suggested permitting non-U.S. banking entities to trade in any government obligation to the extent that such trading is permitted by the entity's primary regulator. *See* Allen & Overy (Gov't. Obligations); HSBC.

[1378] *See* Better Markets (Feb. 2012); *See also* Prof. Johnson.

[1379] *See* Barclays; Credit Suisse (Seidel); IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; RBC; Sumitomo Trust; UBS.

[1380] *See* Barclays; FIA.

[1381] *See* Barclays.

[1382] *See* Joint Proposal, 76 FR 68,878 n.165.

[1383] *See, e.g.,* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); BoA; BDA (Feb. 2012); Capital Group; Chamber (Feb. 2012); Citigroup (Jan. 2012); CHFA; Eaton Vance; Fidelity; Fixed Income Forum/Credit Roundtable; HSBC; MEFA; Nuveen Asset Mgmt.; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* MSRB; Fidelity; State of New York; STANY; SIFMA (Municipal Securities) (Feb. 2012); State Street (Feb. 2012); North Carolina; T. Rowe Price; Sumitomo Trust; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1384] *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* North Carolina; Washington State Treasurer; *See also* NABL; Ashurst; BDA (Feb. 2012); Chamber (Feb. 2012); Eaton Vance; Fidelity; MEFA; MSRB; Am. Pub. Power *et al.;* Nuveen Asset Mgmt.; PNC; SIFMA (Municipal Securities) (Feb. 2012); UBS.

terms and purposes of section 13 and would not adversely affect the safety and soundness of banking entities involved in these transactions or create additional risk to the financial stability of the United States.[1385]

Commenters expressed concerns that the proposed rule would result in a bifurcation of the municipal securities market that would achieve no meaningful benefits to the safety and soundness of banking entities, create administrative burdens for determining whether or not a municipal security qualifies for the exemption, result in inconsistent applications across different States, increase costs, and decrease liquidity in the diverse municipal securities market.[1386] Commenters also argued that the market for securities issued by agencies and instrumentalities of States and political subdivisions thereof would be especially disrupted, and would affect about 40 percent of the municipal securities market.[1387]

Commenters recommended that the final rule provide a broad exemption to the prohibition on proprietary trading for municipal securities, based on the definition of ''municipal securities'' used in section 3(a)(29) of the Exchange Act,[1388] which is understood by market participants and by Congress, and has a well-settled meaning and an established body of law. [1389] Other commenters contended that adopting the same definition of municipal securities as used in the Federal securities laws would reduce regulatory burden, remove uncertainty, and lead to consistent treatment of these securities under the banking and securities laws.[1390] According to some commenters, the terms ''agency'' and ''political subdivision'' are used differently under some State laws, and some State laws identify certain agencies as political subdivisions or define political subdivision to include agencies.[1391] Commenters also noted that a number of Federal statutes and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1392] Commenters suggested that the Agencies interpret the term ''political subdivision'' in section 13 more broadly than in the proposal to include a wider range of State and municipal governmental obligations issued by agencies and instrumentalities or, alternatively, that the Agencies use the exemptive authority in section 13(d)(1)(J) if necessary to permit proprietary trading of a broader array of State and municipal obligations.[1393]

On the other hand, one commenter contended that bonds issued by agencies and instrumentalities of States or municipalities pose risks to the banking system because the commenter believed the market for these bonds has not been properly regulated or controlled.[1394] A few commenters also recommended tightening the proposed municipal securities trading exemption to exclude conduit obligations that benefit private businesses and private organizations.[1395] One commenter suggested that the proposed municipal securities trading exemption should not apply to tax-exempt municipal bonds that benefit private businesses (referred to as ''private activity bonds'' in the Internal Revenue Code[1396]) and that allow private businesses to finance private projects at lower interest rates as a result of the exemption from Federal income taxation for the interest received by investors.[1397]

The final rule includes the statutory exemption for proprietary trading of obligations of any State or political subdivision thereof.[1398] In response to the public comments and for the reasons discussed below, this exemption uses the definition of the term ''municipal security'' modeled after the definition of ''municipal securities'' under section 3(a)(29) of the Exchange Act,[1399] but

[1385] *See* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; Wells Fargo (Prop. Trading); *See also* Capital Group (arguing that municipal securities are not generally used as a profit making strategy and thus, including all municipal securities in the exemption by itself should not adversely affect the safety and soundness of banking entities); PNC (arguing that the safe and sound nature of trading in State and municipal agency obligations was ''a fact recognized by Congress in 1999 when it authorized well capitalized national banks to underwrite and deal in, without limit, general obligation, limited obligation and revenue bonds issued by or on behalf of any State, or any public agency or authority of any State or political subdivision of a State''); Sens. Merkley & Levin (Feb. 2012).

[1386] *See, e.g.,* MSRB; City of New York; Am. Pub. Power *et al.;* Wells Fargo; State of New York; Washington State Treasurer; ABA (Keating); Capital Group; North Carolina; Eaton Vance; Port Authority; Connecticut; Citigroup (Jan. 2012); Ashurst; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 2012).

[1387] *See, e.g.,* MSRB (stating that, based on data from Thomson Reuters, 41.4 percent of the municipal securities issued in FY 2011 were issued by agencies and authorities).

[1388] *See* 15 U.S.C. 78c(a)(29).

[1389] *See* ABA (Keating); Ashurst; BoA; Capital Group; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); Eaton Vance; Fidelity; MEFA; MTA–NY; MSRB; Am. Pub. Power *et al.;* NABL; NCSL; State of New York; Nuveen Asset Mgmt.; Port Authority; PNC; SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1390] *See* Ashurst; Citigroup (Jan. 2012) (noting that the National Bank Act explicitly lists State agencies and authorities as examples of political subdivisions); MSRB.

[1391] *See, e.g.,* Citigroup (Jan. 2012).

[1392] *See, e.g.,* MSRB; Citigroup (Jan. 2012). In addition to the Federal securities laws, the National Bank Act explicitly includes agencies and authorities as examples of political subdivisions. *See* 12 U.S.C. 24(seventh) (permitting investments in securities ''issued by or on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or any public agency or authority of any State or political subdivision of a State . . . .''). In addition, a number of banking regulations also include agencies as examples of political subdivisions or define political subdivision to include municipal agencies, authorities, districts, municipal corporations and similar entities. *See, e.g.,* 12 CFR 1.2; 12 CFR 160.30; 12 CFR 161.38; 12 CFR 330.15. Further, for purposes of the tax-exempt bond provisions in the Internal Revenue Code, Treasury regulations treat obligations issued by or ''on behalf of'' States or political subdivisions by ''constituted authorities'' as obligations of such States or political subdivisions, and the Treasury regulations define the term ''political subdivision'' to mean ''any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. . . .'' *See* 26 CFR 1.103–1(b).

[1393] *See* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation; Sens. Merkley & Levin (Feb. 2012); MSRB; Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1394] *See* Occupy.

[1395] *See* AFR *et al.* (Feb. 2012); Occupy.

[1396] *See* 26 U.S.C. 141. In general, the rules applicable to the issuance of tax-exempt private activity bonds under the Internal Revenue Code of 1986, as amended (the ''Code'') are more restrictive than those applicable to traditional governmental bonds issued by States or political subdivisions thereof. Section 146 of the Code imposes an annual State bond volume cap on most tax-exempt private activity bonds that is tied to measures of State populations. Sections 141–150 of the Code impose other additional restrictions on tax-exempt private activity bonds, including, among others, eligible project and use restrictions, bond maturity restrictions, land and existing property financing restrictions, an advance refunding prohibition, and a public approval requirement.

[1397] *See* AFR *et al.* (Feb. 2012).

[1398] *See* final rule § __.6(a)(3).

[1399] Many commenters requested that the final rule use the definition of ''municipal securities'' used in the federal securities laws because, among other reasons, the industry is familiar with that definition and such an approach would promote consistent treatment of these securities under banking and securities laws. *See, e.g.,* ABA (Keating); Ashurst; BoA; Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); NCSL; Port Authority; SIFMA (Municipal Securities) (Feb. 2012); MSRB. Section 3(a)(29) of the Exchange Act defines the term ''municipal securities'' to mean ''securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c)

Continued

with simplifications.[1400] The final rule defines the term ''municipal security'' to mean ''a security which is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.''

The final rule modifies the proposal to permit proprietary trading in obligations issued by agencies and instrumentalities acting on behalf of States and municipalities (*e.g.,* port authority bonds and bonds issued by municipal agencies or corporations).[1401] As noted by commenters, many States and municipalities rely on securities issued by agencies and instrumentalities to fund essential activities, including utility systems, infrastructure projects, affordable housing, hospitals, universities, and other nonprofit institutions.[1402] Both obligations issued directly by States and political subdivisions thereof and obligations issued by an agency or instrumentality of such a State or local governmental entity are ultimately obligations of the State or local governmental entity on whose behalf they act. Moreover, exempting obligations issued by State and municipal agencies and instrumentalities in the same manner as the direct obligations of States and municipalities lessens potential inconsistent treatment of government obligations across States and municipalities that use different funding methods for government projects.[1403]

The Agencies believe that interpreting the language of section 13(d)(1)(A) of the BHC Act to provide an exemption to the prohibition on proprietary trading for obligations issued by States and municipal agencies and instrumentalities as described above is consistent with the terms and purposes of section 13 of the BHC Act.[1404] The Agencies recognize that state and political subdivision agency obligations generally present the same level of risk as direct obligations of States and political subdivisions.[1405] Moreover, the Agencies recognize that other federal laws and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1406] The Agencies decline to exclude from this exemption conduit obligations that benefit private entities, as suggested by some commenters.[1407]

The proposal did not exempt proprietary trading of derivatives on obligations of States and political subdivisions. The proposal solicited comment on whether exempting proprietary trading in options or other derivatives referencing an obligation of a State or political subdivision thereof was consistent with the terms and purpose of the statute.[1408] The Agencies did not receive persuasive information on this topic and, for the same reasons discussed above related to derivatives on U.S. government securities, the Agencies have determined not to provide an exemption for proprietary trading in municipal securities, beyond the underwriting, market-making, hedging and other exemptions provided generally in the rule. The Agencies note that banking entities may trade derivatives on municipal securities under any other available exemption to the prohibition on proprietary trading, providing the requirements of the relevant exemption are met.

d. Determination to Not Exempt Proprietary Trading in Multilateral Development Bank Obligations

The proposal did not exempt proprietary trading in obligations of multilateral banks or derivatives on multilateral development bank obligations but requested comment on this issue.[1409] A number of commenters argued that the final rule should include an exemption for obligations of multilateral development banks.[1410]

The Agencies have not included an exemption to permit banking entities to engage in proprietary trading in obligations of multilateral development banks at this time. The Agencies do not believe that providing an exemption for

does not apply to such security.'' *See* 15 U.S.C. 78c(a)(29).

[1400] The definition of municipal securities in section 3(a)(29) of the Exchange Act has outdated tax references to the prior law under the former Internal Revenue Code of 1954, including particularly references to certain provisions involving the concept of ''industrial development bonds.'' The successor current Internal Revenue Code of 1986, as amended, replaces the prior definition of ''industrial development bonds'' with a revised, more restrictive successor definition of ''private activity bonds'' and related definitions of ''exempt facility bonds'' and ''small issue bonds.'' In recognition of the numerous tax law changes since the last statutory revision of section 3(a)(29) of the Exchange Act in 1970 and the potential attendant confusion, the Agencies determined to use a simpler, streamlined, independent definition of municipal securities for purposes of the municipal securities trading exception. This revised definition is intended to encompass, among others, any securities that are covered by the definition of the term ''municipal securities'' under section 3(a)(29) of the Exchange Act.

[1401] Many commenters requested that the municipal securities trading exemption be interpreted to include a broader range of State and municipal obligations issued by agencies and instrumentalities. *See, e.g.,* ABA (Keating); Ashurst; BoA; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; Sens. Merkley & Levin (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation.

[1402] *See, e.g.,* Citigroup (Jan. 2012); Ashurst; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Chamber (Dec. 2011); BlackRock; Fixed Income Forum/Credit Roundtable.

[1403] Commenters represented that the proposed rule would result in inconsistent applications of the exemption across States and political subdivisions. The Agencies also recognize, as noted by commenters, that the proposed rule would likely have resulted in a bifurcation of the municipal securities market and associated administrative burdens and disruptions. *See, e.g.,* MSRB; Am. Pub. Power *et al.;* Port Authority; Citigroup (Jan. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012).

[1404] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the terms and purposes of section 13. *See, e.g.,* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012).

[1405] Commenters argued that obligations issued by agencies and instrumentalities generally have the same level of risk as direct obligations of States and political subdivisions. *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power et al.; North Carolina. In response to one commenter's concern that the markets for bonds issued by agencies and instrumentalities are not properly regulated, the Agencies note that all types of municipal securities, as defined under the securities laws to include, among others, State direct obligation bonds and agency or instrumentality bonds, are generally subject to the same regulations under the securities laws. Thus, the Agencies do not believe that obligations of agencies and instrumentalities are subject to less effective regulation than obligations of States and political subdivisions. *See* Occupy.

[1406] Commenters noted that a number of federal statutes and regulations define ''political subdivision'' to include municipal agencies and instrumentalities. *See, e.g.,* MSRB; Citigroup (Jan. 2012).

[1407] *See* AFR *et al.* (Feb. 2012); Occupy. The Agencies do not believe it is appropriate to exclude conduit obligations, which are tax-exempt municipal bonds, from this exemption because such obligations are used to finance important projects related to, for example, multi-family housing, healthcare (hospitals and nursing homes), colleges and universities, power and energy companies and resource recovery facilities. *See* U.S. Securities & Exchange Comm'n., Report on the Municipal Securities Market 7 (2012), *available at http://www.sec.gov/news/studies/2012/munireport073112.pdf.*

[1408] *See* Joint Proposal, 76 FR 68,878.

[1409] *See id.*

[1410] Commenters argued that including obligations of multilateral developments banks in a foreign sovereign debt exemption is necessary to avoid endangering international cooperation in financial regulation and potential retaliatory prohibitions against U.S. government obligations. *See* Ass'n. of German Banks; Sumitomo; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Additionally, some commenters represented that an exemption for obligations of international and multilateral development banks is appropriate for many of the same reasons provided for exempting U.S. government obligations and foreign sovereign debt generally. *See* Ass'n. of German Banks; Barclays; Goldman (Prop. Trading); IIB/EBF; ICFR; ICI Global; FIA; Sumitomo Trust; Allen & Overy (Gov't. Obligations); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

trading obligations of multilateral development banks will help enhance the markets for these obligations and therefore promote and protect the safety and soundness of banking entities and U.S. financial stability.

6. Section ____.6(c): Permitted Trading on Behalf of Customers

Section 13(d)(1)(D) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of financial instruments on behalf of customers.[1411] The statute does not define when a transaction or activity is conducted ''on behalf of customers.''

a. Proposed Exemption for Trading on Behalf of Customers

Section ____.6(b) of the proposed rule implemented the exemption for trading on behalf of customers by exempting three types of trading activity. Section ____.6(b)(i) of the proposed rule provided that a purchase or sale of a financial instrument occurred on behalf of customers if the transaction (i) was conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of that customer, and (ii) involved solely financial instruments for which the banking entity's customer, and not the banking entity or any affiliate of the banking entity, was the beneficial owner. This exemption was intended to permit trading activity that a banking entity conducts in the context of providing investment advisory, trust, or fiduciary services to customers provided that the banking entity structures the activity so that the customer, and not the banking entity, benefits from any gains and suffers any losses on the traded positions.

Section ____.6(b)(ii) of the proposed rule exempted the purchase or sale of a covered financial position if the banking entity was acting as riskless principal.[1412] Under the proposed rule, a banking entity qualified as a riskless principal if the banking entity, after having received an order to purchase or sell a covered financial position from a customer, purchased or sold the covered financial position for its own account to offset a contemporaneous sale to or purchase from the customer.[1413]

Section ____.6(b)(iii) of the proposed rule permitted trading by a banking entity that was an insurance company for the separate account of insurance policyholders. Under the proposed rule, only a banking entity that is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator was eligible for this prong of the exemption for trading on behalf of customers. Additionally, the purchase or sale of the covered financial position was exempt only if it was solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company under which all profits and losses arising from the purchase or sale of the financial instrument were allocated to the separate account and inured to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity. These types of transactions are customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets even though the banking entity is treated as the owner of those assets for certain purposes.

b. Comments on the Proposed Rule

Several commenters contended that the Agencies construed the statutory exemption too narrowly by limiting permissible proprietary trading on behalf of customers to only three categories of transactions.[1414] Some of these commenters argued the exemption in the proposal was not consistent with the statutory language or Congressional intent to permit all transactions that are ''on behalf of customers.'' [1415] One of these commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to permit only customer-driven transactions involving securities and not other financial instruments such as foreign exchange forwards and other derivatives.[1416]

Several commenters urged the Agencies to expand the exemption for trading on behalf of customers to permit other categories of customer-driven transactions in which the banking entity may be acting as principal but that serve legitimate customer needs including capital formation. For example, one commenter urged the Agencies to permit customer-driven transactions in which the banking entity has no ready counterparty but that are undertaken at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions.[1417] Other commenters urged the Agencies to exempt transactions where the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction.[1418] Commenters argued that these kinds of transactions are similar in purpose and level of risk to riskless principal transactions.[1419] Commenters also argued that these transactions could be viewed as market-making related activities, but indicated that the potential uncertainty and costs of making that determination would discourage banking entities from taking principal risks to accommodate customer needs.[1420] Commenters also requested that the Agencies expressly permit transactions on behalf of customers to create structured products, as well as for client funding needs, customer clearing, and prime brokerage, if these transactions are included within the trading account.[1421]

In contrast, some commenters supported the proposed approach for implementing the exemption for trading on behalf of customers or urged narrowing the exemption.[1422] One commenter expressed general support for the requirement that all profits (or losses) from the transaction flow to the customer and not the banking entity providing the service for a transaction to be exempt.[1423] One commenter contended that the statute did not permit transactions on behalf of customers to be performed by an investment adviser.[1424] Another commenter argued that the final rule should permit a banking entity to engage in a riskless principal transaction only where the banking entity has already arranged for another customer to be on the other side of the transaction.[1425] Other commenters urged the Agencies to ensure that both parties to the transaction agree

[1411] 12 U.S.C. 1851(d)(1)(D).

[1412] *See* Joint Proposal, 76 FR 68,879.

[1413] This language generally mirrors that used in the Board's Regulation Y, OCC interpretive letters, and the SEC's Rule 3a5–1 under the Exchange Act. *See* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993).

[1414] *See, e.g.,* Am. Express; BoA; ISDA (Apr. 2012); RBC; SIMFA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1415] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1416] *See* Am. Express.

[1417] *See* RBC. The Agencies note that acting as a block positioner is expressly contemplated and included as part of the exemption for market making-related activities under the final rule.

[1418] *See* BoA; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1419] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1420] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1421] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1422] *See, e.g.,* Alfred Brock; ICBA; Occupy.

[1423] *See* ICBA.

[1424] *See* Occupy.

[1425] *See* Public Citizen.

beforehand to the time and price of any relevant trade to ensure that the banking entity solely stands in the middle of the transaction and in fact passes on all gains (or losses) from the transaction to the customers.[1426] Commenters also urged the Agencies to define other key terms used in the exemption. For instance, some commenters requested that the final rule define which entities may qualify as a ''customer'' for purposes of the exemption.[1427]

Some commenters urged the Agencies to provide uniform guidance on how the Agencies will interpret the riskless principal exemption.[1428] One commenter urged the Agencies to clarify how the riskless principal exemption would be implemented with respect to transactions in derivatives, including a hedged derivative transaction executed at the request of a customer.[1429]

Several commenters generally expressed support for the exemption for trading for the separate account of insurance policyholders under the proposed rule.[1430] One commenter requested that the final rule more clearly articulate who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure.[1431]

Several commenters argued that certain types of separate account activities, including the allocation of seed money by an insurance company to a separate account or the offering of certain non-variable separate account contracts by the insurance company, would not appear to be permitted under the proposal.[1432] Commenters also expressed concern that these separate account activities might not satisfy the proposed requirement that all profits and losses arising from the purchase or sale of the financial position inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company.[1433] In addition, commenters argued that under the proposed rule, these activities would appear to fall outside of the exemption for activities in the general account of an insurance company because the proposed rule defined a general account as excluding a separate account.[1434] Commenters urged the Agencies to more closely align the exemptions for trading by an insurance company for the general account and separate account.[1435] According to these commenters, this change would permit insurance companies to continue to engage in the business of insurance by offering the full suite of insurance products to their customers.[1436]

c. Final Exemption for Trading on Behalf of Customers

The Agencies have carefully considered the comments and are adopting the exemption for trading on behalf of customers with several modifications. The Agencies believe that the final rule implements the exemption in section 13(d)(1)(D) in a manner consistent with the legislative intent to allow banking entities to use their own funds to purchase or sell financial instruments when acting on behalf of their customers.[1437] At the same time, the limited activities permitted under the final rule limit the potential for abuse.[1438]

The final rule slightly modifies the proposed rule by providing that a banking entity is not prohibited from trading on behalf of customers when that activity is conducted by the banking entity as trustee or in a similar fiduciary capacity for a customer and so long as the transaction is conducted for the account of, or on behalf of the customer and the banking entity does not have or retain a beneficial ownership of the financial instruments. The final rule removes the proposal's express exemption for investment advisers. After further consideration, the Agencies do not believe an express reference to investment advisers is necessary because investment advisers generally act in a fiduciary capacity on behalf of clients in a manner that is separately covered by other exclusions and exemptions in the final rule. Additionally, the final rule deletes the proposal's express exemption for commodity trading advisors because the legal relationship between a commodity trading advisor and its client depends on the facts and circumstances of each relationship. Therefore, the Agencies determined that it was appropriate to limit the discussion to fiduciary obligations generally and to omit any specific discussion of commodity trading advisors. In order to ensure that a banking entity utilizes this exemption to engage only in transactions for customers and not to conduct its own trading activity, the final rule (consistent with the proposed rule) requires that the purchase or sale of financial instruments be conducted for the account of the customer and that it involve solely financial instruments of which the customer, and not the banking entity, is beneficial owner.[1439] The final rule, like the proposed rule, permits transactions in any financial instrument, including derivatives such as foreign exchange forwards, so long as those transactions are on behalf of customers.[1440]

While some commenters requested that the final rule define ''customer'' for purposes of this exemption,[1441] the Agencies believe the requirements of this exemption address commenters' underlying concerns about what constitutes a ''customer.'' Specifically, the Agencies believe that requiring a transaction relying on this exemption to be conducted in a fiduciary capacity for a customer, to be conducted for the account of the customer, and to involve solely financial instruments of which the customer is beneficial owner address the underlying concerns that a transaction could qualify for this exemption if done on behalf of an indirect customer or on behalf of a customer not served by the banking entity.

The final rule also provides that a banking entity may act as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its

[1426] *See* Occupy; Alfred Brock.

[1427] *See* Occupy; Public Citizen. Conversely, other commenters supported the approach taken in the proposed rule without requesting such a definition. *See* Alfred Brock.

[1428] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1429] *See* Am. Express.

[1430] *See* ACLI; Chris Barnard; NAMIC; Fin. Services Roundtable (Feb. 3, 2012).

[1431] *See* Chris Barnard.

[1432] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1433] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1434] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1435] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1436] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1437] *See* 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''this permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves.'').

[1438] Some commenters urged narrowing the exemption. *See, e.g.,* Alfred Brock; ICBA; Occupy. The Agencies believe the final rule is appropriately narrow to limit potential abuse.

[1439] *See* final rule § ____.6(c)(1)(ii)–(iii). *See also* proposed rule § ____.6(b)(2)(i)(B)–(C).

[1440] Some commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to not permit transactions in foreign exchange forwards and other derivatives. *See* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1441] *See* Occupy; Public Citizen.

own account to offset the contemporaneous sale of the financial instrument to (purchase from) the customer.[1442] Any transaction conducted pursuant to the exemption for riskless principal activity must be customer-driven and may not expose the banking entity to gains (or losses) on the value of the traded instruments as principal.[1443] Importantly, the final rule does not permit a banking entity to purchase (or sell) a financial instrument without first having a customer order to buy (sell) the instrument. While some commenters requested that the Agencies modify the final rule to permit activity without a customer order,[1444] the Agencies are concerned that broadening the exemption in this manner would enable banking entities to evade the requirements of section 13 and engage in prohibited proprietary trading under the guise of trading on behalf of customers.

Several commenters requested that the final rule explain how a banking entity may determine when it is acting as riskless principal.[1445] The Agencies note that riskless principal transactions typically are undertaken as an alternative method of executing orders by customers to buy or sell financial instruments on an agency basis. Acting as riskless principal does not include acting as underwriter or market maker in the particular financial instrument and is generally understood to be equivalent to agency or brokerage transactions in which all of the risks associated with ownership of financial instruments are borne by customers. The Agencies have generally equivalent standards for determining when a banking entity acts as riskless principal and require that the banking entity, after receiving an order to buy (or sell) a financial instrument from a customer, buys (or sells) the instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.[1446] The Agencies intend to determine whether a banking entity acts as riskless principal in accordance with and subject to the requirements of these standards.

Some commenters requested that the final rule permit a greater variety of transactions to be conducted on behalf of customers. Many of these transactions, such as transactions that facilitate customer liquidity needs or block positioning transactions[1447] or transactions in which the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction,[1448] may be permissible under the market-making exemption. To the extent these transactions are conducted by a market maker, the Agencies believe that the restrictions and limits required in connection with market making-related activities are important for limiting the risks to the banking entity from these transactions.[1449] While some commenters requested that clearing and settlement activities and prime brokerage activities be viewed as permitted proprietary trading on behalf of customers,[1450] these transactions are not considered proprietary trading as an initial matter under the final rule.[1451]

Finally, the Agencies have decided to move the exemption for trading activity conducted by an insurance company for a separate account into the provision exempting trading activity in an insurance company's general account in order to better align the two exemptions.[1452] As discussed below in Part IV.A.7., the final rule provides exemptions for trading activity conducted by an insurance company that is a banking entity either in the general account or in a separate account of customers in § ____.6(d). As explained below, the statute specifically exempts trading activity that is conducted by a regulated insurance company engaged in the business of insurance for the general account of the company if conducted in accordance with applicable state law and if not prohibited by the appropriate Federal banking agencies.[1453] Unlike activity for the general account of an insurance company, investments made by regulated insurance companies in separate accounts in accordance with applicable state law are made on behalf of and for the benefit of customers of the insurance company.[1454] Also unlike general accounts (which are supported by all of the assets of the insurance company), a separate account is supported only by the assets in that account and does not have call on the other assets of the company. The customer benefits (or loses) based solely on the performance of the assets in the separate account. These arrangements are the equivalent for insurance companies of fiduciary accounts at banks. For these reasons, the final rule recognizes that separate accounts at regulated insurance companies maintained in accordance with applicable state insurance laws are exempt from the prohibitions in section 13 as acquisitions on behalf of customers.

7. Section ____.6(d): Permitted Trading by a Regulated Insurance Company

Section 13(d)(1)(F) permits a banking entity that is a regulated insurance company acting for its general account,

[1442] *See* final rule § ____.6(c)(2).

[1443] Some commenters urged the Agencies to ensure that the banking entity passes on all gains (or losses) from the transaction to the customers. *See* Occupy; Public Citizen.

[1444] *See* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1445] *See, e.g.,* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1446] *See, e.g.,* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993). One commenter stated that a banking entity should only be allowed to engage in a riskless principal transaction where the banking entity has already arranged for another customer to be on the other side of the transaction. *See* Public Citizen. The Agencies believe that the contemporaneous requirement in the final rule addresses this comment.

[1447] One commenter requested an exemption for transactions at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions. *See* RBC.

[1448] Some commenters requested an exemption for these types of transactions. *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1449] Some commenters stated that the potential uncertainty and costs of determining whether an activity qualifies for the market-making exemption would discourage banking entities from taking principal risks to accommodate customer needs. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies believe that adjustments made to the market-making exemption in the final rule help address this concern. Specifically, the final market-making exemption better accounts for the varying characteristics of market-making across markets and assets classes.

[1450] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1451] *See* final rule § ____.3(d)(4)–(6). *See also infra* Part IV.A.1.d.3–4.

[1452] Some commenters requested that the Agencies more closely align the exemptions for trading by an insurance company for the general account and separate account. *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1453] *See* 12 U.S.C. 1851(d)(1)(F).

[1454] One commenter requested clarification on who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure. *See* Chris Barnard. The Agencies note that the proposed requirement that all profits and losses arising from the purchase or sale of a financial instrument inure to the benefit or detriment of the ''owners of the insurance policies supported by the separate account'' has been removed. *See* proposed rule § ____.6(b)(2)(iii)(C). Instead, the final rule requires that the income, gains, and losses from assets allocated to a separate account be credited to or charged against the account without regard to other income, gains or losses of the insurance company. *See* final rule § ____.2(z) (definition of ''separate account''). Thus, the final rule no longer references ''owners of the insurance policies supported by the separate account.'' The Agencies note, however, that the final rule requires exempted separate account transactions to be ''conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.'' *See* final rule § ____.6(d)(3).

or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions (the ''general account exemption'').[1455] Section 13(d)(1)(D) permits a banking entity to purchase or sell a financial instrument on behalf of customers.[1456] In the proposed rule, the Agencies viewed Section 13(d)(1)(D) as permitting an insurance company to purchase or sell a financial instrument for certain separate accounts (the ''separate account exemption''). The proposal implemented both these exemptions with respect to activities of insurance companies, in each case subject to the restrictions discussed below.[1457]

Section ____.6(c) of the proposed rule implemented the general account exemption by generally restating the statutory requirements of the exemption that:

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

The proposed rule defined the term ''general account'' to include all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law.[1458]

As noted above in Part IV.A.6.a., § ____.6(b)(iii) of the proposed rule provided an exemption for a banking entity that is an insurance company when it acted through a separate account for the benefit of insurance policyholders. The proposed rule defined a ''separate account'' as an account established or maintained by a regulated insurance company subject to regulation by a State insurance regulator or foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[1459]

To limit the potential for abuse of the separate account exemption, the proposed rule included requirements designed to ensure that the separate account trading activity is subject to appropriate regulation and supervision under insurance laws and not structured so as to allow gains or losses from trading activity to inure to the benefit or detriment of the banking entity.[1460] In particular, the proposed rule provided that a purchase or sale of a financial instrument qualified for the separate account exemption only if:

- The banking entity is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;[1461]
- The banking entity purchases or sells the financial instrument solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- All profits and losses arising from the purchase or sale of the financial instrument are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity; and
- The purchase or sale is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

The proposal explained that the proposed separate account exception represented transactions on behalf of customers because the insurance-related transactions are generally customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets, even though the banking entity may be treated as the owner of those assets for certain purposes.

Commenters generally supported the general account exemption and the separate account exemption for regulated insurance companies as consistent with both the statute and Congressional intent to accommodate the business of insurance.[1462] For instance, commenters argued that the statute was designed to appropriately accommodate the business of insurance, subject to regulation in accordance with relevant insurance company investment laws, in recognition that insurance company investment activities are already subject to comprehensive regulation and oversight.[1463]

A few commenters expressed concerns about the definition of ''general account'' and ''separate account.''[1464] One commenter argued the definition of general account was unclear.[1465] A few commenters expressed concern that the proposed definition of separate account inappropriately excluded some separate accounts, such as certain insurance company investment activities such as guaranteed investment contracts, which would also not fall within the proposed definition of general account.[1466] Several commenters argued that the final rule should be modified so that all insurance company investment activity permitted under applicable insurance laws would qualify for either the general account exemption or the separate account exemption.[1467]

Some commenters argued that the prohibition in the proposed definition of separate account against any profits or losses from activity in the account inuring to the benefit (or detriment) of the insurance company would exclude some activity permitted by insurance regulation in separate accounts.[1468] For example, commenters contended that an insurer may allocate its own funds to a separate account as ''seed money'' and

[1455] *See* 12 U.S.C. 1851(d)(1)(F).

[1456] *See* 12 U.S.C. 1851(d)(1)(D).

[1457] *See* proposed rule §§ ____.6(b)(2)(iii), ____.6(c).

[1458] *See* proposed rule § ____.3(c)(6).

[1459] *See* proposed rule § ____.2(z).

[1460] The Agencies noted in the proposal they would not consider profits to inure to the benefit of the banking entity if the banking entity were solely to receive payment, out of separate account profits, of fees unrelated to the investment performance of the separate account.

[1461] The proposed rule provided definitions of the terms ''State insurance regulator'' and ''foreign insurance regulator.'' *See* proposed rule §§ ____.3(c)(4), (13).

[1462] *See, e.g.,* Alfred Brock; Chris Barnard; Fin. Services Roundtable (Feb. 3, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); TIAA–CREF; NAMIC.

[1463] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Country Fin. *et al.;* Sutherland (on behalf of Comm. of Annuity Insurers).

[1464] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); Sutherland (on behalf of Comm. of Annuity Insurers).

[1465] *See* Sutherland (on behalf of Comm. of Annuity Insurers).

[1466] *See* ACLI (Jan. 2012); NAMIC.

[1467] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; *See also* Nationwide.

[1468] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers); *See also* Nationwide.

the profits and losses on those funds inure to the benefit or detriment of the insurance company.[1469]

Some commenters expressed specific concerns about the scope or requirements of the proposal. For instance, one commenter argued that the final rule should provide that a trade is exempt if the trade is made by an affiliate of the insurance company in accordance with state insurance law.[1470] Another commenter urged that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign insurance company was inconsistent with the safety and soundness or financial stability.[1471]

One commenter suggested that insurance company affiliates of banking entities should expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[1472] By contrast, other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities.[1473] These commenters argued that insurance companies are already subject to comprehensive regulation of the kinds and amounts of investments they can make under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits.

After considering the comments received and the language and purpose of the statute, the final rule has been modified to better account for the language of the statute and more appropriately accommodate the business of insurance.

As explained in the proposal, section 13(d)(1)(F) of the BHC Act specifically and broadly exempts the purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company engaged in the business of insurance for the general account of the company (and by an affiliate solely for the general account of the regulated insurance company). Section 13(d)(1)(D) of the statute also specifically exempts the same activity when done on behalf of customers. As explained in the proposal, separate accounts managed and maintained by insurance companies as part of the business of insurance are generally customer-driven and do not expose the banking entity to gains or losses on the value of assets held in the separate account, even though the banking entity may be treated as the owner of the assets for certain purposes. Unlike the general account of the insurance company, separate accounts are managed on behalf of specific customers, much as a bank would manage a trust or fiduciary account.

For these reasons, the final rule retains both the general account exemption and the separate account exemption. The final rule removes any gap between the definition of general account and the definition of separate account by defining the general account to be all of the assets of an insurance company except those allocated to one or more separate accounts.[1474]

The final rule also combines the general account exemption and the separate account exemption into a single section. This makes clear that both exemptions are available only:

- If the insurance company or its affiliate purchases or sells the financial instruments solely for the general account of the insurance company or a separate account of the insurance company;
- The purchases or sales of financial instruments are conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance regarding insurance is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[1475]

Like section 13(d)(1)(F) of the BHC Act, the final rule permits an affiliate of an insurance company to purchase and sell financial instruments in reliance on the general account exemption, so long as that activity is for the general account of the insurance company. Similarly, the final rule implements section 13(d)(1)(D) and permits an affiliate of an insurance company to purchase and sell financial instruments for a separate account of the insurance company, so long as the separate account is established and maintained at the insurance company.

Importantly, the final rule applies only to covered trading activity in a general or separate account of a licensed insurance company engaged in the business of insurance under the supervision of a State or foreign insurance regulator. As in the statute, an affiliate of an insurance company may not rely on this exemption for activity in any account of the affiliate (unless it, too, meets the definition of an insurance company). An affiliate may rely on the exemption to the limited extent that the affiliate is acting solely for the account of the insurance company.[1476]

As noted above, one commenter requested that the final rule impose special data and reporting obligations on insurance companies. Other commenters argued that insurance companies are already subject to comprehensive regulation under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits.

[1469] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012).

[1470] *See* USAA.

[1471] *See* HSBC Life.

[1472] *See* Sens. Merkley & Levin (Feb. 2012).

[1473] *See* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Mutual of Omaha; NAMIC.

[1474] *See* final rule §§ ____.2(p), (bb). Some commenters expressed concerns about the proposed definitions of ''general account'' and ''separate account,'' including that the proposed definition of ''separate account'' excluded some legitimate separate account activities that do not fall within the proposed general account definition. *See, e.g.,* ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers). *See also* proposed rule §§ ____.2(z), ____.3(c)(5).

[1475] The Federal banking agencies have not at this time determined, as part of the final rule, that the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. The Federal banking agencies expect to monitor, in conjunction with the FSOC, the insurance company investment laws, regulations, and written guidance of States or jurisdictions to which exempt transactions are subject and make such determinations in the future, where appropriate. The Agencies believe the final approach addresses one commenter's request that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign company was inconsistent with the safety and soundness or financial stability. *See* HSBC Life.

[1476] Although one commenter requested that the final rule exempt a trade as long as the trade is made by an affiliate of the insurance company in accordance with state insurance law, the Agencies believe the final approach properly implements the statute. *See* USAA.

In accordance with the statute,[1477] the Agencies expect insurance companies to have appropriate compliance programs in place for any activity subject to section 13 of the BHC Act.

The final rule contains a number of other related definitions that are intended to help make clear the limitations of the insurance company exemption, including definitions of foreign insurance regulator and State insurance regulator.

8. Section ____.6(e): Permitted Trading Activities of a Foreign Banking Entity

Section 13(d)(1)(H) of the BHC Act[1478] permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States (the ''foreign trading exemption'').[1479] The statute does not define when a foreign banking entity's trading occurs solely outside of the United States.

The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and activity that constitutes trading solely outside of the United States. The proposed rule effectively precluded a foreign banking entity from engaging in proprietary trading through a transaction that had *any* connection with the United States, including: Trading with any party located in the United States; allowing U.S. personnel of the foreign banking entity to be involved in the purchase or sale; or executing any transaction in the United States (on an exchange or otherwise).[1480]

In general, commenters emphasized the importance of and supported an exemption for foreign trading activities of foreign banking entities. However, a number of commenters expressed concerns that the proposed foreign trading exemption was too narrow and would not be effective in permitting foreign banking entities to engage in foreign trading activities.[1481] For instance, many commenters stated that the proposal's prohibition on trading activities that have any connection to the U.S. was not consistent with the purpose of section 13 of the BHC Act where the risk of the trading activity is taken or held outside of the United States and does not implicate the U.S. safety net.[1482] These commenters argued that, since one of the principal purposes of section 13 of the BHC Act is to limit the risk posed by prohibited proprietary trading to the federal safety net, the safety and soundness of U.S. banking entities, and the financial stability of the United States, the exemption for foreign trading activity should similarly focus on whether the trading activity involves principal risk being taken or held by the foreign banking entity inside the United States.[1483]

Many commenters argued that the proposal's transaction-based approach to implementing the foreign trading exemption would harm U.S. markets and U.S. market participants. For example, some commenters argued that the proposed exemption would cause foreign banks to exit U.S. markets or shrink their U.S.-based operations, thereby resulting in less liquidity and greater fragmentation in markets without producing any significant offsetting benefit.[1484] Commenters also asserted that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities and would lead to foreign firms refusing to trade with U.S. counterparties, including the foreign operations of U.S. entities, to avoid compliance costs associated with relying on another exemption under the proposed rule.[1485] Additionally, commenters argued that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[1486]

a. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(H) provides that, in order to be eligible for the foreign trading exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. The proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

Commenters generally supported this aspect of the proposal.[1487] However, some commenters requested that the final rule be modified to allow U.S. banking entities' affiliates or branches that are physically located outside of the United States (''foreign operations of U.S. banking entities'') to engage in proprietary trading outside of the United States pursuant to this exemption.[1488] These commenters argued that, unless foreign operations of U.S. banking entities are provided similar authority to engage in proprietary trading outside of the United States, foreign operations of U.S. banking entities would be at a competitive disadvantage abroad with respect to foreign banking entities. One commenter also asserted that, unless foreign operations of U.S. banking entities were able to effectively access foreign markets, they could be shut out of those markets and would be unable to effectively manage their risks in a safe and sound manner.[1489]

As noted above, section 13(d)(1)(H) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[1490] Because of this express statutory threshold requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or

[1477] *See* 12 U.S.C. 1851(e)(1) (requiring that the Agencies issue regulations regarding ''internal controls and recordkeeping, in order to insure compliance with this section'').

[1478] Section 13(d)(1)(H) of the BHC Act provides an exemption to the prohibition on proprietary trading for trading conducted by a foreign banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act, if the trading occurs solely outside of the United States, and the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(H).

[1479] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the rule's implementation of section 13(d)(1)(H) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[1480] *See* proposed rule § ____.6(d).

[1481] *See, e.g.,* IIB/EBF; ICI Global; ICI (Feb. 2012); Wells Fargo (Prop. Trading); BoA.

[1482] *See* IIB/EBF; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Seidel); Cadwalader (on behalf of Thai Banks).

[1483] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1484] *See* ICE; ICI Global; BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; IIB/EBF.

[1485] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA; Citigroup (Feb. 2012). As discussed below in Part IV.C. of this **SUPPLEMENTARY INFORMATION,** other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[1486] *See* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Commissioner Barnier; Ass'n. of German Banks; Société Générale; Chamber (Dec. 2012).

[1487] *See* Sens. Merkley & Levin (Feb. 2012) (arguing that the final rule's foreign trading exemption should not exempt foreign affiliates of U.S. banking entities when they engage in trading activity abroad); *See also* Occupy; Alfred Brock.

[1488] *See* Citigroup (Feb. 2012); Sen. Carper; IIF; ABA (Keating); Wells Fargo (Prop. Trading); Abbot Labs. *et al.* (Feb. 14, 2012).

[1489] *See* Citigroup (Feb. 2012).

[1490] *See* 12 U.S.C. 1851(d)(1)(H).

one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its trading activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act.[1491] The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[1492]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[1493] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[1494] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[1495] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[1496] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the exemption for proprietary trading activity of a foreign banking entity.[1497]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not currently subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of this exemption [1498] if the entity, on a fully-consolidated basis, meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[1499] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and section 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States.[1500] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the prohibition on proprietary trading.

b. Permitted Trading Activities of a Foreign Banking Entity

As noted above, the proposed rule laid out a transaction-based approach to implementing the foreign trading exemption and provided that a transaction would be considered to qualify for the exemption only if (i) the transaction was conducted by a banking entity not organized under the laws of the United States or of one or more States; (ii) no party to the transaction was a resident of the United States; (iii) no personnel of the banking entity that was directly involved in the transaction was physically located in the United States; and (iv) the transaction was executed wholly outside the United States.[1501]

Many commenters objected to the proposed exemption, arguing that it was unworkable and would have unintended consequences. For example, commenters argued that prohibiting a foreign banking entity from conducting a proprietary trade with a resident of the United States, including a subsidiary or branch of a U.S. banking entity, wherever located, would likely cause foreign banking entities to be unwilling to enter into permitted trading transactions with foreign subsidiaries or branches of U.S. firms.[1502] In addition,

[1491] *See* final rule § ____.6(e)(1)(ii).

[1492] Section ____.6(e)(2) addresses only when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(H) of the BHC Act, are unable to rely on the foreign trading exemption.

[1493] *See* 12 U.S.C. 1843(c)(9).

[1494] *See* 12 CFR 211.20 *et seq.*

[1495] Commenters noted that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign trading exemption. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. Accordingly, the final rule does not retain the proposal's requirement that the activity be conducted in compliance with subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the exemption in section 13(d)(1)(H) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[1496] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule referenced only the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[1497] This modification to the definition of foreign banking organization is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State a commonwealth, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, or the United States Virgin Islands.

[1498] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[1499] *See* final rule § ____.6(e)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § ____.6(e)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

[1500] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § ____.6(e)(2)(ii)(B).

[1501] *See* proposed rule § ____.6(d).

[1502] *See* BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; Credit Suisse (Seidel); George Osbourne; IIB/EBF.

some commenters represented that it would be difficult to determine and track whether a party is a resident of the United States or that this requirement would require non-U.S. banking entities to inefficiently bifurcate their activities into U.S.-facing and non-U.S.-facing trading desks.[1503] For example, one commenter noted that trading on many exchanges and platforms is anonymous (*i.e.,* each party to the trade is unaware of the identity of the other party to the trade), so a foreign banking entity would likely have to avoid U.S. trading platforms and exchanges entirely to avoid transactions with any resident of the United States.[1504] Further, commenters stated that the proposed rule could deter foreign banking entities from conducting business with U.S. parties outside of the United States, which could also incentivize foreign market centers to limit participation by U.S. parties on their markets.[1505]

Commenters also expressed concern about the requirement that transactions be executed wholly outside of the United States in order to qualify for the proposed foreign trading exemption. Commenters represented that foreign banking entities currently use U.S. trading platforms to trade in certain products (such as U.S.-listed securities or a variety of derivatives contracts), to take advantage of robust U.S. infrastructure, and for time zone reasons.[1506] Commenters indicated that the proposed requirement could harm the competitiveness of U.S. trading platforms and the liquidity available on such facilities.[1507] Some commenters stated that this requirement would effectively result in most foreign banking entities moving their trading operations and personnel outside of the United States and executing transactions on exchanges outside of the United States.[1508] These commenters stated that the relocation of these activities would reduce trading activity in the United States that supports the financial stability and efficiency of U.S. markets. Moreover, these commenters argued that, if foreign banking entities relocate their personnel from the United States to overseas, this would diminish U.S. jobs with no concomitant benefit. They also contended that the proposal was at cross purposes with other parts of the Dodd-Frank Act and would hinder growth of market infrastructure being developed under the requirements of Title VII of that Act, including use of swap execution facilities and security-based swap execution facilities to enhance transparency in the swaps markets and use of central clearinghouses to reduce counterparty risk for the parties to a swap transaction.[1509] For example, one commenter represented that the proposed exemption could make it difficult for non-U.S. swap entities to comply with potential mandatory execution requirements under Title VII of the Dodd-Frank Act and could cause market fragmentation across borders through the creation of parallel execution facilities outside of the United States, which would result in less transparency and greater systemic risk.[1510] In addition, another commenter stated that the proposed requirement would force issuers to dually list their securities to permit trading on non-U.S. exchanges and, further, clearing and settlement systems would have to be set up outside of the United States, which would create inefficiencies, operational risks, and potentially systemic risk by adding needless complexity to the financial system.[1511]

Instead of the proposal's transaction-based approach to implementing the foreign trading exemption, many commenters suggested the final rule adopt a risk-based approach.[1512] These commenters noted that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign trading activity of foreign banking entities.[1513] Commenters also noted that foreign trading activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[1514]

The Agencies have carefully considered these comments and have determined to modify the approach in the final rule. The Agencies believe that the revisions mitigate the potential adverse impacts of the proposed approach while still remaining faithful to the overall purpose of section 13(d)(1)(H). Also, the Agencies believe that section 13(d)(1)(J) of the BHC Act, which authorizes the Agencies to provide an exemption from the prohibition on proprietary trading for any activity the Agencies determine by rule ''would promote and protect the safety and soundness of the banking entity and the financial stability of the United States,'' [1515] supports allowing foreign banking entities to use U.S. infrastructure and trade with certain U.S. counterparties in certain circumstances, which will promote and protect the safety and soundness of banking entities and U.S. financial stability.

Overall, the comments illustrated that both the mechanical steps of the specified transactions to purchase or sell various instruments (*e.g.,* execution, clearing), and the identity of the entity for whose trading account the specified trading is conducted are important.[1516] Consistent with the comments described above, the Agencies believe that the application of section 13(d)(1)(H) and their exemptive authority under section 13(d)(1)(J) should focus on both how the transaction occurs and which entity will bear the risk of those transactions. Although the statute does not define expressly what it means to act ''as a principal'' (acting as principal ordinarily means acting for one's own account), the combination of references to engaging as principal and to a trading account focuses on an entity's incurring risks of profit and loss through taking ownership of securities and other instruments. Thus, the final rule provides an exemption for trading activities of foreign banking entities that addresses both the location of the facilities that effect the acquisition, holding, and disposition of such positions, and the location of the banking entity that incurs such risks through acquisition, holding, and disposition of such positions.

The Agencies believe this approach is consistent with one of the principal purposes of section 13, which is to limit risks that proprietary trading poses to

[1503] *See* Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); IIF; ICE; Banco de México; ICFR; Australian Bankers Ass'n. (Feb. 2012); BAROC.

[1504] *See* ICE.

[1505] *See, e.g.,* RBC.

[1506] *See, e.g.,* IIF; ICE; Société Générale; Mexican Banking Comm'n.; Australian Bankers Ass'n. (Feb. 2012); Banco de México; OSFI. In addition, a few commenters argued that Canadian and Mexican financial firms frequently use U.S. infrastructure to conduct their trading activities in Canada or Mexico. *See, e.g.,* OSFI; Banco de México; Mexican Banking Comm'n.

[1507] *See, e.g.,* ICE; Société Générale (arguing that the requirement would impair capital raising efforts of many U.S. companies); Australian Bankers Ass'n. (Feb. 2012); Canadian Minister of Fin.; Ass'n. of German Banks.

[1508] *See* IIB/EBF.

[1509] *See* Bank of Canada; Banco de México; Allen & Overy (on behalf of Canadian Banks).

[1510] *See* Allen & Overy (on behalf of Candian Banks).

[1511] *See* IIF.

[1512] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1513] *See* IIB/EBF.

[1514] *See* IIB/EBF.

[1515] *See* 12 U.S.C. 1851(d)(1)(J).

the U.S. financial system.[1517] Further, the purpose of section 13(d)(1)(H) is to limit the extraterritorial application of section 13 as it applies to foreign banking entities.[1518]

In addition, prohibiting foreign banking entities from using U.S. infrastructure or trading with all U.S. counterparties could cause certain trading activities to move offshore, with corresponding negative impacts on U.S. market participants, including U.S. banking entities. For example, movement of trading activities offshore, particularly in U.S. financial instruments, could result in bifurcated markets for these instruments that are less efficient and less liquid and could reduce transparency for oversight of trading in these instruments. In addition, reducing access to foreign counterparties for U.S. instruments could concentrate risks in the United States and to its financial system. Moreover, the statute provides separate exemptions for U.S. banking entities to engage in underwriting and market making-related activities, subject to certain requirements, and there is no evidence that limiting the range of potential customers for these entities would further the purposes of the statute. In fact, it is possible that limiting the customer bases of U.S. banking entities, as well as other U.S. firms that are not banking entities, could reduce their ability to effectively manage their inventories and risks and could also result in concentration risk.

These potential effects of the approach taken in the proposal appear to be inconsistent with the statute's goals, including the promotion and protection of the safety and soundness of banking entities and U.S. financial stability. To the contrary, the exemptive approach taken in the final rule appears to be more consistent with the goals of the statute and would promote and protect the safety and soundness of banking entities and U.S. financial stability by limiting the risks of foreign banking entities' proprietary trading activities to the U.S. financial system, while also allowing U.S. markets to continue to operate efficiently in conjunction with foreign markets (rather than creating incentives to establish barriers between U.S. and foreign markets).[1519]

Thus, in response to commenter concerns, the final rule has been modified to better reflect the text and achieve the overall purposes of the statute (by ensuring that the principal risks of proprietary trading by foreign banking entities allowed under the foreign trading exemption remain solely outside of the United States) while mitigating potentially adverse effects on competition.[1520] In order to ensure these risks remain largely outside of the United States, and to limit potential risk that could flow to the U.S. financial system through trades by foreign banking entities with or through U.S. entities, the final rule includes several conditions on the availability of the exemption. Specifically, in addition to limiting the exemption to foreign banking entities, the final rule provides that the exemption for the proprietary trading activity of a foreign banking entity is available only if:

(i) The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;[1521]

(ii) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;

(iii) The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;

(iv) No financing for the banking entity's purchase or sale is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;[1522]

(v) The purchase or sale is not conducted with or through any U.S. entity,[1523] other than:

(A) A purchase or sale with the foreign operations of a U.S. entity, if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale.

The Agencies believe it is appropriate to exercise their exemptive authority under section 13(d)(1)(J) to also allow, under clause (vi) of the final rule, the following types of purchases or sales conducted with a U.S. entity:

(B) A purchase or sale with an unaffiliated market intermediary acting as principal,[1524] provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

(C) A purchase or sale through an unaffiliated market intermediary, provided the purchase or sale is conducted anonymously (i.e. each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale) on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

The requirements are designed to ensure that any foreign banking entity engaging in trading activity under this exemption does so in a manner that ensures the risk, decision-making, arrangement, negotiation, execution and financing of the activity resides solely outside the United States and limits the risk to the U.S. financial system from trades by foreign banking entities with or through U.S. entities.

The final rule specifically recognizes that, for purposes of the exemption for

[1517] *See, e.g.,* 12 U.S.C. 1851(b)(1) (directing the FSOC to study and make recommendations on implementing section 13 so as to, among other things, protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities).

[1518] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the foreign trading exemption ''recognize[s] rules of international comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law.'').

[1519] 12 U.S.C. 1851(d)(1)(J).

[1520] The proposed rule also contained a definition of ''resident of the United States'' that was designed to capture the scope of U.S. counterparties that, if involved in the transaction, would preclude that transaction from being considered to have occurred solely outside the United States. The final rule addresses this point by including a definition, for purposes of § __.6(e) only, of the term ''U.S. entity.''

[1521] Personnel that arrange, negotiate, or execute a purchase or sale conducted under the exemption for trading activity of a foreign banking entity must be located outside of the United States. Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. Personnel in the United States also cannot serve as decision makers in transactions conducted under this exemption. Personnel that engage in back-office functions, such as clearing and settlement of trades, would not be considered to arrange, negotiate, or execute a purchase or sale for purposes of this provision.

[1522] This provision is not intended to restrict the ability of a U.S. branch or affiliate of a foreign banking entity to provide funds collected in the United States to its foreign parent for general purposes.

[1523] ''U.S. entity'' is defined for purposes of this provision as any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State. *See* final rule § ____.6(e)(4).

[1524] This provision would generally allow market intermediaries to engage in market-making, underwriting or similar market intermediation functions.

trading activity of a foreign banking entity, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[1525] This provision helps give effect to the statutory language limiting the foreign trading exemption to activities of foreign banking entities that occur solely outside of the United States by clarifying that the U.S. operations of foreign banking entities may not conduct proprietary trading based on this exemption.

The Agencies have considered whether the concerns raised by commenters that the foreign operations of U.S. banking entities would be disadvantaged in competing outside the United States warrant an exemption under section 13(d)(1)(J) of the BHC Act that extends to foreign operations of U.S. banking entities. The competitiveness of U.S. banking entities outside the United States often improves the potential for the operations of U.S. firms outside the United States to succeed and be profitable, and thereby, often improves the safety and soundness of the entity and financial stability in the United States.

However, Congress has determined to generally prohibit U.S. banking entities (including foreign branches and subsidiaries thereof) from engaging in proprietary trading because of the perceived risks of those activities to banking entities and the U.S. economy.[1526] Allowing U.S. banking entities to conduct, through branches or subsidiaries that are physically located outside the United States, the same proprietary trading activities those U.S. firms are expressly prohibited from conducting directly through their operations located within the United States would subject U.S. banking entities and the U.S. economy to the very risks section 13 is designed to avoid. The risks of proprietary trading would continue to be borne by the U.S. banking entity whether the activity is conducted by the U.S. banking entity through units physically located inside or outside of the United States. Moreover, the robust trading markets that exist overseas could allow U.S. banking entities to shift their prohibited proprietary trading activities to branches or subsidiaries that are physically located outside the United States under such an exemption, without achieving a meaningful elimination of risk. Accordingly, the Agencies have not exercised their authority under section 13(d)(1)(J) at this time to allow U.S. banking entities to conduct otherwise prohibited proprietary trading activities through operations located outside the United States. As a consequence, and consistent with the statutory language and purpose of section 13(d)(1)(H) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under, or directly or indirectly controlled by a banking entity that is organized under, the laws of the United States or of one or more States.[1527]

As discussed above, many commenters requested that the final rule permit a foreign banking entity to engage in proprietary trading transactions with a greater variety of counterparties, including counterparties that are located in or organized and incorporated under the laws of the United States or of one or more States.[1528] These commenters also requested that the final rule not require that any purchase or sale under the exemption be executed wholly outside of the United States.

As described above and in response to commenters' concerns, the final rule provides that a foreign banking entity generally may engage in trading activity under the exemption with U.S. entities, provided the transaction is with the foreign operations of an unaffiliated U.S. firm (whether or not the U.S. firm is a banking entity subject to section 13 of the BHC Act) and does not involve any personnel of the U.S. entity that are in the United States and involved in the arrangement, negotiation, or execution of the transaction. The Agencies have also exercised their exemptive authority under section 13(d)(1)(J) to allow foreign banking entities to engage in a transaction that is either through an unaffiliated market intermediary and executed anonymously on an exchange or similar trading facility (regardless of whether the ultimate counterparty is a U.S. entity or not) or is executed with a U.S. entity that is an unaffiliated market intermediary acting as principal, provided in either case that the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

For purposes of the final rule, market intermediary is defined as an unaffiliated entity, acting as an intermediary, that is: (i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such; (ii) a swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such; (iii) a security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or (iv) a futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.[1529]

These provisions of the final rule, viewed as a whole, prevent the exemption for trading of foreign banking entities from weakening U.S. trading markets and U.S. firms that are either not subject to the provisions of section 13 or that conduct activities in compliance with other parts of section 13. For instance, the final rule permits a foreign banking entity to trade under the exemption with the foreign operations of a U.S. firm, so long as the purchase or sale does not involve any personnel of the U.S. firm who are located in the United States and involved in arranging, negotiating or executing the trade.[1530] Transactions that occur outside of the United States between foreign operations of U.S. entities and foreign banking entities improve access to and functioning of liquid markets without raising the concerns for increased risk to banking entities in the U.S. that motivated enactment of section 13 of the BHC Act. The final rule permits a foreign banking entity to engage in transactions with the foreign operations of both U.S. non-banking and U.S. banking entities. Among other things, this approach will ensure that the foreign operations of

[1525] *See* final rule § ____.6(e)(5).

[1526] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (''However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly.'').

[1527] *See* final rule § ____.6(e)(1)(i).

[1528] A number of commenters also requested that the foreign trading exemption permit proprietary trading of foreign sovereign debt or similar obligations of foreign governments. As discussed in Part IV.A.5.b. of this **SUPPLEMENTARY INFORMATION**, the final rule addresses banking entities' ability to engage in transaction in these types of instruments in § ____.6(b).

[1529] *See* final rule § ____.6(e)(5). For example, under this definition, a bank that is exempt from registration as a swap dealer under the de minimis exception to swap dealer registration requirements could be a market intermediary for transactions in swaps. *See* 17 CFR 1.3(ggg)(4).

[1530] *See* final rule § ____.6(e)(3)(v)(A).

U.S. banking entities continue to be able to access foreign markets.[1531] The language of the exemption expressly requires that trading with the foreign operations of a U.S. entity may not involve the use of personnel of the U.S. entity who are located in the United States for purposes of arranging, negotiating, or executing transactions.

Under the final rule, the exemption in no way exempts the U.S. or foreign operations of the U.S. banking entities from having to comply with the restrictions and limitations of section 13. Thus, the U.S. and foreign operations of a U.S. banking entity that is engaged in permissible market making-related activities or other permitted activities may engage in those transactions with a foreign banking entity that is engaged in proprietary trading in accordance with the exemption under § ____.6(e) of the final rule. Importantly, the final rule does not impose a duty on the foreign banking entity or the U.S. banking entity to ensure that its counterparty is conducting its activity in conformance with section 13 of the BHC Act and the final rule. Rather, that burden is at all times on each party subject to section 13 to ensure that it is conducting its activities in accordance with section 13 and this implementing rule.

The final rule also permits, pursuant to section 13(d)(1)(J), a foreign banking entity to trade through an unaffiliated market intermediary if the trade is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization.[1532] Allowing foreign banking entities to generally conduct anonymous proprietary trades on U.S. exchanges and similar anonymous trading facilities allows these exchanges and facilities—which are generally not subject to section 13 and do not take the risks section 13 is designed to address—to serve the widest possible range of counterparties. This prevents the potential adverse impacts from possible reductions in competitiveness of or liquidity available on these regulated exchanges and facilities, which could also harm other U.S. market participants who trade on these exchanges and facilities. In addition, the Agencies recognize that anonymous trading on exchanges and similar anonymous trading facilities promotes transparency and that prohibiting foreign banking entities from trading on U.S. exchanges and similar anonymous trading facilities under this exemption would likely reduce transparency for trading in U.S. financial instruments. All of these considerations support the Agencies' exercise of their exemptive authority under section 13(d)(1)(J) to allow such trading by foreign banking entities.

The final rule requires that foreign banking entities trade through an unaffiliated market intermediary to access a U.S. exchange or trading facility in recognition that existing laws and regulations generally require this structure.[1533] For purposes of this exemption, an exchange would include, unless the context otherwise requires, any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, and any exchange or security-based swap execution facility, as such terms are defined under the Exchange Act.[1534]

This provision of the final rule requires that foreign banking entities trade anonymously and that the trade be centrally cleared and settled. The Agencies understand that in these circumstances, the foreign banking entity would not have any prior information regarding its counterparty to the trade. Requiring that the trade be executed anonymously preserves the benefits of allowing U.S. entities to participate in such trades, while reducing the potential for evasion of section 13 that could occur if foreign banking entities directly arranged purchases and sales with U.S. entities.[1535] The final rule specifies that a trade is anonymous if each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. That is, it is lack of knowledge of the identity of the counteryparty(ies) to the trade that is relevant. The final rule does not prohibit foreign banking entities from accessing a trading facility through an unaffiliated U.S. market intermediary (which the foreign banking entity would necessarily know), so long as the foreign banking entity is not aware of the identity of the counterparty to the transaction.

Similarly, also pursuant to section 13(d)(1)(J), the final rule allows a foreign banking entity to trade with an unaffiliated market intermediary acting in a principal capacity and effecting a market intermediation function, in a transaction that is not conducted on an exchange or similar anonymous trading facility, as long as the trade is promptly cleared and settled through a clearing agency or derivatives clearing organization. This provision recognizes that not all financial instruments are traded on an exchange or similar anonymous trading facility and, thus, allows foreign banking entities to trade and contribute to market liquidity in all types of U.S. financial instruments without requiring separate market infrastructure to be developed outside the U.S. for such trading activity, which could result in inefficiencies and reduce U.S. market liquidity. Market intermediaries can serve the same general purpose as exchanges or similar trading facilities in intermediating between buyers and sellers, particularly in asset classes that do not generally trade on these exchanges or facilities, although this intermediation function may not be as immediate in the case of market intermediaries.

In either case (*i.e.,* for either an anonymous trade or a trade with an unaffiliated market intermediary), if the U.S. counterparty to the transaction is a banking entity subject to section 13 and these rules, it must comply with an exemption to the prohibition on proprietary trading, such as the market-making exemption or the exemption for riskless principal transactions. Allowing foreign banking entities to trade with unaffiliated U.S. market intermediaries, including banking entities engaged in permitted market making-related activities, expands the range of potential buyers and sellers for which the U.S. entities can trade and may result in more efficient and timely matching of trades, reducing inventory risks to the U.S. market intermediary. At the same time, this exemption does not permit a U.S. market intermediary that is subject to section 13 of the BHC Act to conduct trading activities other than in compliance with the provisions of section 13. Thus, the Agencies believe it is appropriate to allow foreign banking entities to conduct such trading under the exemption in section 13(d)(1)(J).

To reduce risks to U.S. entities and the potential for evasion, the provisions

[1531] The Agencies believe that this provision should address commenters' concerns that the proposed rule could cause foreign banking entities to avoid conducting business with U.S. firms outside the United States or could incentivize foreign market places to restrict access to U.S. firms. *See, e.g.,* RBC.

[1532] Under the final rule, ''anonymous'' means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. *See* final rule § ____.3(e)(1).

[1533] *See, e.g.,* 15 U.S.C. 78f(c)(1) (providing that a national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer).

[1534] *See* final rule § ____.3(e)(6) (defining the term ''exchange''). The rule refers to an ''exchange or similar trading facility.'' A similar trading facility for these purposes may include, for example, an alternative trading system.

[1535] In addition, allowing a foreign banking entity to trade directly with a U.S. end user customer under the foreign trading exemption could give the foreign banking entity a competitive advantage over U.S. banking entities with respect to trading in the United States.

allowing trading with U.S. entities include two additional protections. First, the final rule does not allow a foreign banking entity to trade through an affiliated U.S. entity under the exemption out of concern that it could increase the risk of evasion.[1536] Second, a foreign banking entity's trades conducted through an unaffiliated market intermediary on an exchange or conducted directly with an unaffiliated market intermediary must be promptly cleared and settled through a clearing agency or derivatives clearing organization acting as central counterparty. Consistent with the goals of section 13 to reduce risk to banking entities and the U.S. financial system, this requirement is designed to reduce risk to U.S. entities arising from foreign banking entities' proprietary trading activity, particularly counterparty risk, and preclude foreign banking entities from relying on the exemption for trading that creates exposure of U.S. counterparties pursuant to bilateral, uncleared transactions, which poses heightened counterparty credit risks.[1537] This condition is also consistent with the systemic risk benefits of central clearing and may incentivize the use of central clearing for trading by foreign banking entities and foreign affiliates of U.S. banking entities. The Agencies believe this approach is consistent with and reinforces the goals of the central clearing framework of Title VIII of the Dodd-Frank Act.

The final rule does not allow a foreign banking entity to trade with a broader range of U.S. entities under the exemption because the Agencies are concerned such an approach may result in adverse competitive impacts between U.S. banking entities and foreign banking entities with respect to their trading in the United States, which could harm the safety and soundness of banking entities and U.S. financial stability. For example, such an approach could allow foreign banking entities to act as market makers for U.S. customers under the exemption in § ____.6(e) of the final rule so long as the foreign banking entity held the risk of its market-making trades outside the United States. In turn, this could give foreign banking entities a competitive advantage over U.S. banking entities with respect to U.S. market-making activities because foreign banking entities could trade directly with U.S. non-banking entities without incurring the additional costs, or being subject to the limitations, associated with the market-making or other exemptions under the rule. This competitive disparity in turn could create a significant potential for regulatory arbitrage. The Agencies do not believe this result was intended by the statute. Instead, the final rule seeks to alleviate the concern that an overly broad approach to the exemption (*e.g.,* permitting trading with all U.S. counterparties) may result in competitive impacts and increased risks to the U.S. financial system, while mitigating the concern that an overly narrow approach to the exemption (*e.g.,* prohibiting trading with any U.S. counterparty) may cause market bifurcations, reduce the efficiency and liquidity of markets, and harm U.S. market participants.

9. Section ____.7: Limitations on Permitted Trading Activities

Section ____.8 of the proposed rule implemented section 13(d)(2) of the BHC Act,[1538] which provides that a banking entity may not engage in certain exempt activities (*e.g.,* permitted market making-related activities, risk-mitigating hedging, etc.) if the activity would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[1539] The Agencies sought comment on proposed definitions of the terms ''material conflict of interest,'' ''high-risk asset,'' and ''high-risk trading strategy'' for these purposes.

With respect to general comments regarding the proposed rule, commenters generally agreed on the need to limit banking entities' proprietary trading activities so as to avoid material conflicts of interest and material exposures to high-risk trading strategies and high-risk assets.[1540] One commenter expressed support for the Agencies' proposed approach, stating that the proposed rule was clear and structured in such a manner so that it should remain effective even as financial markets evolve and change.[1541] As discussed in greater detail below, most commenters suggested amendments, clarification, or alternative approaches. For example, some commenters expressed concern regarding the application of the prudential backstops to the activities of foreign banking entities.[1542] The Agencies did not receive any comments on the prohibition against transactions or activities that pose a threat to the safety or soundness of the banking entity or the financial stability of the United States.

As explained in detail below, the Agencies have carefully reviewed comments on the proposed rule's implementation of the prudential backstops under section 13(d)(2) of the BHC Act, including commenters' suggestions for expanding, contracting, or revising the proposed rule. After carefully considering these comments, the Agencies continue to believe the expansive scope of section 13 of the BHC Act supports a similarly inclusive approach focusing on the facts and circumstances of each potential conflict or high-risk activity. Therefore, and in consideration of all issues discussed below, the Agencies are adopting the final rule substantially as proposed.[1543] The Agencies intend to develop additional guidance regarding best practices for addressing potential material conflicts of interest, high-risk assets and trading strategies and practices that pose significant risks to safety and soundness and to the U.S. financial system as the Agencies and banking entities gain experience with implementation of the requirements and

[1536] In addition, allowing a foreign banking entity to trade through or with a U.S. affiliate under the exemption for trading activity of a foreign banking entity could give the foreign banking entity a competitive advantage over U.S. banking entities that are subject to limitations on their trading activities. Thus, the Agencies are not permitting a foreign banking entity to trade through a U.S. affiliate as agent, as requested by some commenters. *See, e.g.,* IIB/EBF. However, the Agencies recognize that, with respect to trading anonymously, there is no way to know the identity of the counterparty to the trade. Thus, a foreign banking entity would not be in violation of this rule if it traded through an unaffiliated market intermediary on an exchange, in accordance with the exemption for trading activity of a foreign banking entity, and the counterparty to its trade happened to be an affiliated entity.

[1537] As discussed above, centralized clearing redistributes counterparty risk among members of a clearing agency or derivatives clearing organization through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. *See supra* note 266 and accompanying text.

[1538] Section ____.8 of the proposed rule regarding limitations on permitted trading activities is consistent with § ____.17 of the proposed rule regarding other limitations on permitted covered funds activities. Accordingly, the discussion regarding proposed rule § ____.8 and final rule § ____.7 in this part also pertain to § ____.17 of the proposed rule and § ____.16 of the final rule. *See also* Part IV.B.6., *infra.*

[1539] *See* 12 U.S.C. 1851(d)(2).

[1540] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Paul Volcker.

[1541] *See* Alfred Brock.

[1542] *See* IIB/EBF; Ass'n. of German Banks.

[1543] The Agencies note that proposed Appendix C, which required banking entities to describe how they comply with these provisions, will be adopted as Appendix B with similar requirements regarding compliance with the limitations on permitted activities.

limitations in section 13 of the BHC Act and this rule, which are all generally designed to limit risky behavior in trading and investment activities.

a. Scope of ''Material Conflict of Interest''

1. Proposed Rule

Section ____.8(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with a permitted trading activity, were prohibited under the proposal.[1544] As noted in the proposal, conflicts of interest may arise in a variety of circumstances related to permitted trading activities. For example, a banking entity may acquire substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its lending, underwriting, investment advisory or other activities which, if improperly transmitted to and used in trading operations, would permit the banking entity to use such information to its customers', clients' or counterparties' disadvantage. Similarly, a banking entity may conduct a transaction that places the banking entity's own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer involved in that transaction. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1545] In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances.[1546]

To address these types of material conflicts of interest, § ____.8(b) of the proposed rule specified that a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest, and subject to specific requirements provided in the proposal, through either (i) timely and effective disclosure, or (ii) information barriers.[1547] Unless the conflict of interest is addressed and mitigated in one of the two ways specified in the proposal, the related transaction, class of transactions or activity would be prohibited under the proposed rule, notwithstanding the fact that it may be otherwise permitted under §§ ____.4 through ____.6 of the proposed rule.[1548]

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

Section ____.8(b)(1) of the proposed rule described the two requirements that must be met in cases where a banking entity addresses and mitigates a material conflict of interest through timely and effective disclosure. First, § ____ .8(b)(1)(A)(i) of the proposed rule required that the banking entity, *prior* to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, make clear, timely and effective disclosure of the conflict or potential conflict of interest, together with any other necessary information. This would also require such disclosure to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1549] Disclosure that is only general or generic, rather than specific to the individual, class, or type of transaction or activity, or that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, would not meet this standard. Second, § ____.8(b)(1)(ii) of the proposed rule required that the disclosure be made explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty that was created or would be created by the conflict or potential conflict.[1550]

The Agencies noted that, in order to provide the requisite opportunity for the client, customer or counterparty to negate or substantially mitigate the disadvantage created by the conflict, the disclosure would need to be provided sufficiently close in time to the client's, customer's, or counterparty's decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and, if necessary, take steps that would negate or substantially mitigate the conflict. Disclosure provided far in advance of a particular transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating the transaction, would not suffice. Conversely, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the fact, would also not suffice under the proposal. The Agencies note that the proposed definition would not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties or that otherwise do not involve ''material'' conflicts of interest as discussed above.

The proposed disclosure standard reflected the fact that some types of conflicts may be appropriately resolved through the disclosure of clear and meaningful information to the client, customer, or counterparty that provides such party with an informed opportunity to consider and negate or substantially mitigate the conflict. However, in the case of a conflict in which a client, customer, or counterparty does not have sufficient information and opportunity to negate or mitigate the materially adverse effect on the client, customer, or counterparty created by the conflict, the existence of that conflict of interest would prevent the banking entity from availing itself of any exemption (*e.g.,* the underwriting or market-making exemptions) with respect to the relevant transaction, class of transactions, or activity. The

[1544] Section ____.17(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with permitted covered fund activities, are prohibited.

[1545] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), *available at http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.*

[1546] *See* Joint Proposal, 76 FR 68,893.

[1547] *See* proposed rule § ____.8(b)(1).

[1548] *See* Joint Proposal, 76 FR 68,893.

[1549] *See id.*

[1550] *See* proposed rule § ____.8(b)(1)(B).

Agencies note that the proposed disclosure provisions were provided solely for purposes of the proposed rule's definition of material conflict of interest, and did not affect a banking entity's obligation to comply with additional or different disclosure or other requirements with respect to a conflict under applicable securities, banking, or other laws (*e.g.,* section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which governs conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities).

Section ____.8(b)(2) of the proposed rule described the requirements that must be met in cases where a banking entity uses information barriers that are reasonably designed to prevent a material conflict of interest from having a materially adverse effect on a client, customer or counterparty. Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among units of the entity. Examples of information barriers include, but are not limited to, restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees. Such information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.[1551]

In order to address and mitigate a conflict of interest through the use of the information barriers pursuant to § ____.8(b)(2) of the proposed rule, a banking entity would be required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. Importantly, the proposed rule also provided that, notwithstanding a banking entity's establishment of such information barriers if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of proposed § ____ .8(b)(1).[1552] This aspect of the proposal was intended to make clear that, in specific cases in which a banking entity has established an information barrier but knows or should reasonably know that it has failed or will fail to prevent a conflict of interest arising from a specific transactions or activity that disadvantages a client, customer, or counterparty, the information barrier is insufficient to address that conflict and the transaction would be prohibited, unless the banking entity is otherwise able to address and mitigate the conflict through timely and effective disclosure under the proposal.[1553]

The proposed definition of material conflict of interest did not address instances in which a banking entity has made a material misrepresentation to its client, customer, or counterparty in connection with a transaction, class of transactions, or activity, as such transactions or activity appears to involve fraud rather than a conflict of interest. This is because such misrepresentations are generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws).[1554] In addition, the Agencies noted that any activity involving a material misrepresentation to, or other fraudulent conduct with respect to, a client, customer, or counterparty would not be permitted under the proposed rule in the first instance.

2. Comments on the Proposed Limitation on Material Conflicts of Interest

Commenters expressed a variety of views regarding the treatment of material conflicts of interest under the proposal, including the manner in which conflicts may be mitigated or eliminated. One commenter believed that the proposed material conflict of interest provisions would be effective.[1555] Another commenter stated that conflicts of interest were unavoidable but that the final rule should ensure that institutional investors have confidence that the banking entities they are dealing with are not operating at a conflict with investors' goals.[1556]

Other commenters expressed differing views on whether the proposed rule's provisions for addressing conflicts of interest through disclosure or information barriers were appropriate. A few commenters stated there is no statutory basis for allowing conflicts of interest in connection with exempted activities even if banking entities provide disclosure or establish information barriers, and the rule should prohibit banking entities from engaging in permitted activities if material conflicts of interest exist.[1557] One commenter believed the definition did not appear to address issues of customer favoritism, in which a bank is financially incentivized to treat one customer more favorably than another (typically less sophisticated) customer.[1558] Some commenters believed that the proposed definition of material conflict of interest was too vague or narrow and suggested it should be strengthened by either expanding the types of transactions that may result in

[1551] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)–(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks). 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; *Amendments to Form ADV,* Investment Advisers Act Release No. 3060 (July 28, 2010), 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1552] *See* proposed rule § ____.8(b)(2).

[1553] *See* Joint Proposal, 76 FR 68,894.

[1554] *See* 12 U.S.C. 1851(g)(3).

[1555] *See* Alfred Brock.

[1556] *See* Paul Volcker.

[1557] *See* Public Citizen; Sens. Merkley & Levin; Occupy; AFR *et al.* (Feb. 2012).

[1558] *See* Public Citizen.

a material conflict of interest or by imposing additional limitations or restrictions on transactions.[1559] For instance, one commenter suggested the final rule consider depositors of a banking entity to be ''customers'' for the purpose of this provision, impose a fiduciary duty on any banking entity conducting an exempt activity pursuant to section 13(d)(1) of the BHC Act, and impose size restrictions on any banking entity engaging in proprietary trading under an exemption. This commenter also stated that a banking entity inherently has a material conflict of interest with its customer when it takes the opposite side of a transaction and, therefore, that the final rule should require a banking entity to disgorge all principal gains from transactions conducted pursuant to any exemption under section 13(d)(1) of the BHC Act, including market-making, trading in U.S. government obligations, insurance company activities and other exempt activities.[1560] In addition, a few commenters stated that, if disclosure or information barriers were permitted to mitigates conflicts under the final rule, clients of the banking entity must be required to acknowledge in writing that they understand the potential conflicts of interest present in order for any disclosure to be effective in mitigating a conflict of interest.[1561]

Some commenters believed that the Agencies should consider issuing additional guidance regarding the definition of material conflicts of interest, high-risk assets, and high-risk trading strategies.[1562] One commenter stated that the final rule should limit the extraterritorial impact of section 13 by only applying the restrictions of section 13(d)(2) of the BHC Act to the U.S. operations or activities of foreign banking entities and that the regulation of safety and soundness of the foreign operations and activities of foreign banking entities should be left to the home country regulator or supervisor of a foreign banking entity.[1563]

Some commenters provided general suggestions on enhancing compliance with the prohibition on material conflicts of interest. A common suggestion among industry participants was to implement the prohibition on material conflicts of interest under these rules in a manner consistent with the implementation of section 621 of Dodd-Frank.[1564] One commenter suggested that trading in government obligations should not be subject to the material conflict of interest provision because government obligations are broadly traded and do not present the types of conflicts addressed by the proposed rule.[1565] In contrast, one commenter stated banking entities should be required to receive pre-trade clearance from the Federal Reserve for trading in certain government obligations like municipal bonds and mortgage-backed securities, due to their role in the 2008 financial crisis.[1566]

a. Disclosure

Some commenters expressed concern about potential difficulties associated with the proposed disclosure provision and provided suggestions to address these difficulties. For example, a few commenters noted the difficulty in determining what constitutes effective disclosure,[1567] especially in relation to the volume of disclosure or the impact of information asymmetry in illiquid markets.[1568] One commenter stated that unless the rule requires full disclosure of a banking entity's trading strategy and the rationale behind it, allowing disclosure will permit the banking entity to protect itself without adequately mitigating the harm of the conflict. This commenter also noted the practical difficulties associated with disclosing anticipated future conflicts and conflicts in the context of block trading.[1569] Another commenter stated market participants understand inherent conflicts of interest and believed disclosure in such situations would be burdensome and unnecessary.[1570] One commenter stated that the rule should require a banking entity to negate, not just permit the client, customer, or counterparty to substantially mitigate, the materially adverse effect of the conflict.[1571]

A few commenters disagreed with the disclosure provision, noting that Congress specifically considered and rejected disclosure as a mitigation method for purposes of section 621 of the Dodd-Frank Act and that this indicates the Agencies should not permit a material conflict of interest to be mitigated through disclosure for purposes of section 13 of the BHC Act.[1572]

Commenters were in disagreement as to the extent and timing of disclosure that should be required under the rule. Some commenters stated the disclosure provisions would slow trading, and suggested the rule require only one-time disclosure at the inception of the business relationship[1573] thnsp; or periodic disclosures to address ongoing conflicts.[1574] One of these commenters noted that extensive trade-by-trade disclosure requirements create the risk of unintended breaches of confidentiality.[1575] Other commenters requested the Agencies provide additional guidance, such as when transaction-specific disclosure is necessary,[1576] whether disclosure should be written,[1577] and what constitutes ''reasonable detail.'' [1578]

In addition, some commenters provided suggestions on whether parties should be required to acknowledge receipt of disclosures [1579] or affirmatively consent to the conflict.[1580] One commenter proposed allowing a majority of a committee of independent board members to approve consent to waivers of conflicts of interest.[1581] One commenter believed disclosure and consent by a sophisticated investor ought to be sufficient to serve as a waiver to most types of conflict of interest.[1582] In contrast, another commenter asserted general disclosure or waivers of conflicts should never be allowed, and the Agencies should not provide *any* additional guidance as to the extent, timing, frequency, or scope of disclosure appropriate in any given situation.[1583] Similarly, one commenter asserted the Agencies should not provide guidance on what issues can be addressed by disclosure, as such guidance would be ''dangerously

[1559] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1560] *See* Occupy.

[1561] *See, e.g.,* Lynda Aiman-Smith; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1562] *See* Rep. Blumenauer *et al.;* Sens. Merkley & Levin (Feb. 2012).

[1563] *See* IIB/EBF; EBF.

[1564] *See* ASF (Conflicts) (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); LSTA (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1565] *See* BDA (Feb. 2012).

[1566] *See* Occupy.

[1567] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR.

[1568] *See* Occupy.

[1569] *See* Public Citizen; *See also* AFR *et al.* (Feb. 2012).

[1570] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1571] *See* Occupy.

[1572] *See, e.g,* Occupy.

[1573] *See* ISDA (Apr. 2012); Arnold & Porter.

[1574] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Apr. 2012).

[1575] *See* ISDA (Apr. 2012).

[1576] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1577] *See* Sens. Merkley & Levin (Feb. 2012); ICFR (questioning the effectiveness of enforcement mechanisms if oral disclosure permitted under the rule); Occupy.

[1578] *See* ICFR.

[1579] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

[1580] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012).

[1581] *See* Arnold & Porter.

[1582] *See* Arnold & Porter.

[1583] *See* Alfred Brock (stating there is no such thing as a ''sophisticated party'').

prescriptive and would introduce moral hazards.'' [1584]

Information Barriers

A few commenters addressed the information barriers provision of the proposed rule. One commenter expressed support for the proposed approach,[1585] while three commenters stated this provision was ineffective.[1586] A few commenters opposed the information barriers provision because they believed information barriers would make conflict mitigation more difficult [1587] or would effectively mandate that no single officer be aware of a banking entity's collective operations.[1588]

A few commenters also requested the Agencies provide guidance regarding the use of information barriers. One commenter requested the Agencies specify the type and nature of information barriers and where they are practical to implement.[1589] Another commenter believed that the Agencies should view information barriers favorably. This commenter stated that information barriers should be permitted for addressing conflicts of interest unless the banking entity knows, or should reasonably know, that the information barrier would not be effective in restricting the spread of information that could lead to the conflict.[1590] To provide greater clarity, another commenter recommended the Agencies provide guidance on certain elements that may be used to determine the reasonableness of information barriers, such as memorialization of procedures and documentation of actions taken pursuant to such procedures.[1591]

3. Final Rule

After considering carefully comments received on the proposal as well as the purpose and language of section 13 of the BHC Act, the Agencies have adopted the final rule largely as proposed. Under the final rule, a banking entity that engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to the transaction, class of transactions, or activity, must address and mitigate the conflict of interest, where possible, through either timely and effective disclosure or informational barriers.[1592] This requirement is in addition to, and does not supplant, any limitations or prohibitions contained in other laws. For example, a material misrepresentation by a banking entity to its client, customer, or counterparty in connection with market-making activities may involve fraud and is generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws) [1593] as well as being prohibited under section 13 of the BHC Act.

The Agencies believe that certain of commenters' suggested modifications to the proposed rule are outside the scope of the Agencies' statutory authority. For example, the Agencies do not believe section 13 of the BHC Act provides statutory authority to directly impose limits on the size of banking entities [1594] or to implement specific fiduciary standards on banking entities.[1595] In addition, the Agencies do not believe it is appropriate to expand the definition of ''customer'' to include individuals and entities that solely make use of the bank's traditional banking services because section 13 is focused on the trading activities and investment in which banking entities may be involved.[1596]

The final rule recognizes that a banking entity may address or substantially mitigate a potential conflict of interest by making adequate disclosures or creating and enforcing informational barriers. Some commenters argued that the legislative history of the Dodd-Frank Act suggests that disclosure or informational barriers are not adequate to address a material conflict of interest.[1597] However, section 13 of the BHC Act directs the Agencies to define ''material conflict of interest'' and gives the Agencies discretion to determine how to define this term for purposes of the rule. Under the final rule, a material conflict of interest exists when the banking entity engages in transactions or activities that cause its interests to be materially adverse to the interests of its client, customer, or counterparty. At the same time, the final rule provides banking entities the opportunity to take certain actions to address the conflict, such that the conflict does not have a materially adverse effect on that client, customer, or counterparty. Under the final rule, a banking entity may address a conflict by establishing, maintaining, and enforcing information barriers reasonably designed to avoid a conflict's materially adverse effect, or by disclosing the conflict in a manner that allows the client, customer, or counterparty to substantially mitigate or negate any materially adverse effect created by the conflict of interest. The Agencies believe that, to the extent the materially adverse effect of a conflict has been substantially mitigated, negated, or avoided, it is appropriate to allow the transaction, class of transaction, or activity under the final rule. Continuing to view the conflict as a material conflict of interest under these circumstances would not appear to benefit the banking entity's client, customer, or counterparty. The disclosure standard under the final rule requires clear and meaningful information be provided to the client, customer, or counterparty in a manner that provides such party the opportunity to negate or substantially mitigate, any materially adverse effects on such party created by the conflict.

Some commenters suggested that obtaining consent to or waiver of disclosed conflicts should be sufficient to comply with the rule.[1598] The Agencies do not believe that consent or waivers alone are sufficient to address material conflicts of interest, and continue to believe that any banking entity using disclosure to address a conflict of interest should be required to provide any client, customer, or counterparty with whom the banking entity has a conflict with the opportunity to negate or substantially mitigate the materially adverse effect of the conflict on the client, customer, or counterparty. The Agencies believe this approach, which applies equally to all

[1584] *See* ICFR.

[1585] *See* Alfred Brock.

[1586] *See* Better Markets (Feb. 2012); Occupy; Public Citizen.

[1587] *See* Occupy.

[1588] *See* Public Citizen (contending that this would undermine the Dodd-Frank Act's requirement to promote sound management, ensure financial stability, and reduce systemic risk).

[1589] *See* AFR *et al.* (Feb. 2012).

[1590] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1591] *See* ISDA (Apr. 2012) (arguing that its suggested guidance was derived from prior SEC and self-regulatory organization guidance on information barriers).

[1592] The Agencies note that the definition of material conflict of interest and the disclosure provisions related to that definition apply solely for purposes of the rule's definition of material conflict of interest, and does not affect the scope of that term in other contexts or a banking entity's obligation to comply with additional or different requirements with respect to a conflict under applicable securities, banking, or other laws (*e.g.,* section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities).

[1593] *See* 12 U.S.C. 1851(g)(3).

[1594] *See* Occupy.

[1595] *See* Occupy.

[1596] *See* Occupy.

[1597] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

[1598] *See, e.g.,* Arnold & Porter.

types of clients, customers, or counterparties, will reduce the potential for unintended or differing impacts on certain types of clients, customers, or counterparties. In response to one commenter's suggestion that the final rules require full negation of the materially adverse effect on the client, customer, or counterparty, the Agencies continue to believe it is appropriate to allow a transaction or activity to continue if the client, customer, or counterparty is provided an opportunity to substantially mitigate the materially adverse effect.[1599] The Agencies are concerned that requiring the conflict's impact to be fully negated under all circumstances could prevent a banking entity from providing a service to a particular customer despite that customer's knowledge of the conflict and ability to substantially reduce the effect of the conflict on that customer.

With regards to commenters' statements that information barriers and disclosure will not work to address the harm caused by conflicts, the Agencies emphasize that under the final rule, like the proposed rule, a banking entity may use disclosure or information barriers to address a conflict only in those instances where the disclosure provides the client, customer, or counterparty with the opportunity to negate or substantially mitigate any materially adverse effect of the conflict on that entity or the information barriers are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. If the banking entity is unable to effectively use disclosure or information barriers in a way that meets the rule's requirements, then the banking entity is prohibited from engaging in the conflicted transaction, class of transaction, or activity. Additionally, the Agencies note that the material conflict of interest provisions in the final rule do not preempt any duties owed to parties outside the transaction, including any duty of confidentiality.[1600]

In response to commenters' statements that the volume of information included in a disclosure or the manner in which the disclosure is presented may make it difficult for a customer to identify and understand the relevant information regarding the conflict,[1601] the Agencies note that the final rule requires disclosure of the conflict or potential conflict be clear, timely, and effective and that the disclosure includes any other necessary information. Disclosure is also required to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1602] Thus, disclosure that is only general or generic, that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, or that is hidden in a large volume of needless information would not meet this standard. The Agencies believe these provisions of the final rule are designed to ensure that customers receive sufficient information about the conflict of interest so that they are well informed and, as required by the rule, able to negate or substantially mitigate any materially adverse effect of the conflict.

In addition to requiring that customers are provided with detailed information about the conflict, the final rule, like the proposal, requires that disclosure is made prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise and is otherwise timely. As a result, under § ____.7(b)(2)(i), disclosure must be provided sufficiently close in time to the client's, customer's, or counterparty's decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and take steps that would negate or substantially mitigate the conflict. This approach is similar to the approach permitted by a variety of consumer protection statutes and regulations for addressing potential conflicts of interest in consumer transactions.[1603]

Some commenters requested that the final rule permit a conflict to be negated or substantially mitigated through generic or periodic disclosures, such as at the beginning of a trading relationship or on an annual basis. Other commenters stated that some conflicts, such as anticipated future conflicts or those that arise in the context of block trading, may require the banking entity to provide disclosure in advance of the actual conflict in order to allow the client, customer, or counterparty the opportunity to mitigate the materially adverse effect.[1604] The Agencies emphasize, however, that disclosure provided far in advance of a particular transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating the transaction, would not suffice. At the same time, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the fact, would also not be permissible disclosure under the final rules. The Agencies believe that, in considering the effectiveness of disclosures, the type, timing and frequency of disclosures depends significantly on the customer relationship, the type of transaction, and the matter that creates the potential conflict. Therefore, while written disclosures may be appropriate in certain circumstances, the Agencies are not requiring banking entities to provide written disclosure,[1605] or obtain documentation showing that disclosure was received,[1606] because the Agencies believe it is more important that disclosure is timely than documented. For example, if disclosure were required

[1599] *See* Occupy.

[1600] *See* ISDA (Apr. 2012).

[1601] *See* Better Markets (Feb. 2012) (suggesting that a disclosure regime can facilitate abuse by enabling market participants to point to obscure and meaningless disclosure as a shield against liability); Occupy (arguing that a large volume of disclosed information can be difficult to understand or can serve to hide relevant information).

[1602] *See* final rule § ____.7(b)(1)(i) and final rule § ____.16(b)(1)(i).

[1603] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)–(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks); 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; *Amendments to Form ADV,* Investment Advisers Act Release No. 3060 (July 28, 2010), 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1604] *See* Public Citizen; *See also* AFR *et al.* (Feb. 2012).

[1605] *See* Sens. Merkley & Levin (Feb. 2012); ICFR; Occupy; Alfred Brock.

[1606] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

to be in writing, this might slow a banking entity's ability to provide the disclosure to the relevant customer, which could impede the customer's ability to consider the disclosed information and take steps to negate or substantially mitigate the conflict's effect on the customer. The Agencies further note that the final rule does not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties.

As noted above, one commenter expressed concern about the burdens of disclosing inherent conflicts and stated such disclosure is unnecessary because market participants understand inherent conflicts of interest.[1607] As noted in the proposal, certain inherent conflicts, such as the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests, would not be deemed a ''material'' conflict of interest with respect to permitted activities.[1608]

The Agencies continue to believe that information barriers can be an effective means of addressing conflicts of interest that may arise through, for example, the spread of information among trading desks engaged in different trading activities that may result in potentially inappropriate informational advantage. The Agencies are not adopting one commenter's suggestion that the final rule specify the particular types of scenarios where information barriers may be effective [1609] because, as discussed below, the Agencies believe banking entities are better positioned to determine when information barriers may be effective given their trading activities and business structure.[1610] In response to one commenter's concern that information barriers may result in the banking entity's management not being aware of the firm's collective operations,[1611] the Agencies note that information barriers do not require this result. Rather, information barriers would be established between relevant personnel or functions while other personnel, including senior managers, internal auditors, and compliance personnel, would have access to each group separated by the barrier.

The final rule continues to recognize that a banking entity may address or substantially mitigate a conflict of interest through use of information barriers. In order to address and mitigate a conflict of interest through the use of the information barriers, a banking entity is required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[1612] Importantly, the final rule also provides that, notwithstanding a banking entity's establishment of such information barriers, if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of § ____.7(b)(2)(i).[1613]

While some commenters requested that the final rule include additional limitations as part of implementing the material conflict of interest provisions in section 13(d)(2), the Agencies do not believe additional restrictions are appropriate at this time. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1614] In all cases, the question of whether a material conflict of interest exists will depend on an evaluation of the specific facts and circumstances. For example, certain simple transactions may implicate conflicts of interest that cannot be mitigated by disclosure or restricted by information barriers. On the other hand, certain highly structured and complex transactions may involve conflicts of interest that can be mitigated by disclosure or restricted by information barriers.

The Agencies believe that conflicts of interest must be determined and addressed in accordance with the specific facts and circumstances presented. One commenter suggested that the proposed rule be modified so that a banking entity could conclusively rely on information barriers unless it knows or has reason to know that policies, procedures, and controls establishing barriers would not be effective in restricting the spread of information.[1615] By focusing on whether a banking entity knows or has reason to know that its policies and procedures would not be effective, rather than on what the banking entity knows or should reasonably know about a conflict of interest that may involve or result in a material adverse effect on a client, customer, or counterparty, the commenter's suggestion has the potential to allow a banking entity to engage in transactions that involve a material conflict of interest. Therefore, the Agencies have determined not to

[1607] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); *but See* Occupy.

[1608] *See* Joint Proposal, 76 FR 68,893. Thus, the Agencies are not adopting one commenter's suggestion that the final rule consider all transactions by a banking entity to involve a material conflict of interest because the banking entity is necessarily on the opposite side of a transaction with its client, customer, or counterparty. *See* Occupy.

[1609] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1610] The Agencies note examples of information barriers that may address or substantially mitigate a material conflict of interest include restrictions on information sharing, limits on types of trading, prohibitions on common officers or employees between functions. Such information barriers have been recognized in Federal securities laws as a means to address or mitigate potential conflicts of interest or other inappropriate activities. *See, e.g.,* 17 U.S.C. 78o(g).

[1611] *See* Public Citizen.

[1612] The Agencies note that a banking entity subject to Appendix B of the final rule must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits conflicts of interest with clients, customers, and counterparties. As part of maintaining and enforcing information barriers, a banking entity should have processes to review, test, and modify information barriers on a continuing basis. In addition, banking entities should have ongoing monitoring to maintain and to enforce information barriers, for example by identifying whether such barriers have not prevented unauthorized information sharing and addressing instances in which the barriers were not effective. This may require both remediating any identified breach as well as updating the information barriers to prevent further breaches, as necessary. Periodic assessment of the effectiveness of information barriers and periodic review of the written policies and procedures are also important to the maintenance and enforcement of effective information barriers and reasonably designed policies and procedures. Such assessments can be done either (i) internally by a qualified employee or (ii) externally by a qualified independent party. *See* Part IV.C.2.e., *infra.*

[1613] If a conflict occurs to the detriment of a client, customer, or counterparty despite an information barrier, the Agencies would also expect the banking entity to review the effectiveness of its information barrier and make adjustments, as necessary, to avoid future occurrences, or review whether such information barrier is appropriate for that type of conflict.

[1614] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), *available at http://hsgac.senate.gov/public/__files/Financial__Crisis/FinancialCrisisReport.pdf.*

[1615] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

adopt the commenter's suggested approach. Similarly, the Agencies are rejecting some commenters' suggestions that the final rule prescribe the method, scope, or specific content of disclosures.[1616] The Agencies believe that specific guidance on disclosure may provide an incentive for banking entities to consider the form of disclosure provided, rather than whether disclosure can address the substance of the conflict as determined by the specific facts and circumstances at hand. Moreover, the Agencies believe banking entities are in the best position to identify and evaluate the conflicts present in their business as well as the most effective method of disclosing such conflicts. Banking entities must tailor their compliance programs to identify, monitor, and evaluate potential conflicts based on their business structure and specific activities and customer relationships.[1617]

Finally, some commenters requested that the final rule specifically address the conflict of interest provisions related to asset-backed securitizations contained in section 621 of the Dodd-Frank Act. As explained below in Part IV.B.1., some securitizations are subject to the final rule, and others such as securitizations of loans are not subject to section 13 of the BHC Act. For any securitization that meets the definition of covered fund under the final rule, relationships with and transactions by a banking entity involving those securitizations remain subject to the requirements of section 13, including the requirements of section 13(d)(2). In addition, the banking entity would be subject to the limitations contained in section 621 of the Dodd-Frank Act and any rules regarding conflicts of interest relating to securitizations implemented under that section. The final rule in no way limits the application of section 621 of that Act with respect to an asset-backed security that is subject to that section.

b. Definition of ''High-Risk Asset'' and ''High-Risk Trading Strategy''

1. Proposed Rule

Section ____.8(c) of the proposed rule defined ''high-risk asset'' and ''high-risk trading strategy'' for purposes of the proposed limitations on permitted trading activities. Proposed § ____ .8(c)(1) defined a ''high-risk asset'' as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. Proposed § ____.8(c)(2) defined a ''high-risk trading strategy'' as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.[1618]

2. Comments on Proposed Limitations on High-Risk Assets and Trading Strategies

With respect to the prohibition on transactions or activities that expose banking entities to high-risk assets or high-risk trading strategies, one commenter stated the provisions were effective,[1619] while other commenters stated the proposed rule was too vague [1620] and implied that banking entities may be required to exit positions in periods of market stress, further reducing liquidity.[1621] A few commenters suggested the Agencies identify and prohibit certain types of high-risk assets or high-risk trading strategies under the rule.[1622] In contrast, one commenter asserted the Agencies should not specify certain classes of assets or trading strategies as ''high risk.'' [1623] A few commenters requested greater clarity on the proposed definitions and suggested the Agencies provide additional guidance.[1624] One of these commenters suggested the Agencies simplify compliance by establishing safe harbors, setting pre-determined risk limits within risk-based approaches, or allowing individual banking entities to set practical risk-based standards that the Agencies can review.[1625]

One commenter suggested integrating the ban on high-risk activities throughout the rule and stated that, given the evolving nature of financial markets, regulators should have the flexibility to update criteria for identifying high-risk assets or high-risk trading strategies.[1626] This commenter stated the definition of high-risk trading strategies was appropriately broad and flexible, but suggested improving the rule by encompassing trading strategies that are so complex the risk or value thereof cannot be reliably and objectively determined.[1627] The commenter also suggested that the quantitative measurements collected under proposed Appendix A could be utilized to help inform whether a high-risk asset or trading strategy exists.[1628]

One commenter stated that in large concentrations, *all* assets can be high risk. This commenter suggested evaluating transactions on a case-by-case basis and believed all activity exempted under section 13(d)(1) of the BHC Act should be viewed as ''high-risk'' absent prior regulatory approval. This commenter further suggested that high-risk assets or trading strategies be defined to include any asset or trading strategy that would have forced a banking entity to exit the market during the 2008 financial crisis, and that leverage, rehypothecation, concentration limits, and high frequency trading should be viewed as indicia of high-risk trading strategies. Finally, this commenter suggested the Agencies require banking entity CEOs to certify that their institution's activities do not result in a material exposure to high-risk assets or high-risk trading strategies.[1629]

3. Final Rule

After considering carefully the comments received, the Agencies have modified the final rule to provide that a high-risk asset means an asset or group of assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Similarly, the final rule defines high-risk trading strategy to include any strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

Importantly, under the final rule, banking entities that engage in activities

[1616] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR; Alfred Brock; Public Citizen; AFR *et al.* (Feb. 2012); Arnold & Porter; Sens. Merkley & Levin (Feb. 2012).

[1617] For a full discussion of the final rule's compliance requirements, including a discussion of the specific compliance requirements applicable to different banking entities, *See* Part IV.C. of this **SUPPLEMENTARY INFORMATION**, *infra*.

[1618] *See* Joint Proposal, 76 FR 68,894. The Agencies noted that a banking entity subject to proposed Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits exposure to high-risk assets and high-risk trading strategies, and identifies a variety of assets and strategies (*e.g.,* assets or strategies with significant embedded leverage). *See* Joint Proposal, 76 FR 68,894 n.215.

[1619] *See* Alfred Brock.

[1620] *See* AFR *et al.* (Feb. 2012); Japanese Bankers Ass'n.; Investure; AllianceBernstein; Comm. on Capital Markets Regulation.

[1621] *See* Obaid Syed.

[1622] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; Occupy.

[1623] *See* Alfred Brock.

[1624] *See* Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen.

[1625] *See* Japanese Bankers Ass'n.

[1626] *See* Sens. Merkley & Levin (Feb. 2012).

[1627] *See* Sens. Merkley & Levin (Feb. 2012).

[1628] *See* Sens. Merkley & Levin (Feb. 2012).

[1629] *See* Occupy.

pursuant to an exemption must have a reasonably designed compliance program in place to monitor and understand whether it is exposed to high-risk assets or trading strategies. For instance, any banking entity engaged in activity pursuant to the market-making exemption in § ____.4(b) must, as part of its compliance program, have reasonably designed written policies and procedures, internal controls, analysis and independent testing regarding the limits for each trading desk, including limits on the level of exposures to relevant risk factors that the trading desk may incur. These policies and procedure and any activity conducted pursuant to the final rule will be evaluated by the Agencies, as appropriate, as part of ensuring the safety and soundness of banking entities and monitoring for exposures to high-risk activities or assets.

While some commenters stated that the definition of high risk asset or trading strategy should be more clearly defined, the Agencies believe that it is appropriate to include a broad definition of these terms that accounts for different facts and circumstances that may impact whether a particular asset or trading strategy is high-risk with respect to a banking entity. As stated by commenters, this framework is effective and flexible enough to be utilized by the Agencies in a variety of contexts. For instance, a trading strategy or asset may be high-risk to one banking entity but not another, or may be high-risk to a banking entity under some market conditions but not others. As part of evaluating whether a banking entity is exposed to a high-risk asset or trading strategy, the Agencies expect that a variety of factors will be considered, such as the presence of excess leverage, rehypothecation or excessively high concentration of assets, or unsafe and unsound trading strategies.

We believe an approach limiting this provision's applicability to certain permitted activities or creating a safe harbor for certain assets or trading strategies would be inconsistent with the statutory language, which prohibits any permitted activity that involves or results in a material exposure to a high-risk asset or high-risk trading strategy.[1630] In addition, the Agencies decline to identify any particular assets or trading strategies as per se high-risk because a determination of the specific risk posed to a banking entity depends on the facts and circumstances.[1631] Certain facts and circumstances may include, but are not limited to, the amount of capital at risk in a transaction, whether or not the transaction can be hedged, the amount of leverage present in the transaction, and the general financial condition of the banking entity engaging in the transaction. In response to one commenter's recommendation that the Agencies adopt a CEO certification requirement specific to the high-risk provisions,[1632] the Agencies believe such a requirement is unnecessary in light of the required management framework in the compliance program provision of § ____.20 of the final rule, as well as the CEO certification requirement included in the final rule.[1633]

c. *Limitations on Permitted Activities That Pose a Threat to Safety and Soundness of the Banking Entity or the Financial Stability of the United States*

Finally, as the Agencies did not receive any comments on the proposed rule's limitations on permitted activities that pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States and the proposed approach mirrored the statutory language, the Agencies have determined no changes to final rule are necessary.

B. Subpart C—Covered Fund Activities and Investments

As noted above and except as otherwise permitted, section 13(a)(1)(B) of the BHC Act generally prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a covered fund.[1634] Section 13(d) of the BHC Act contains certain exemptions to this prohibition. Subpart C of the final rule implements these and other provisions of section 13 related to covered funds. Additionally, subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in subpart D of the final rule, as well as Appendix B, to the extent applicable.

1. Section ____.10: Prohibition on Acquisition or Retention of Ownership Interests in, and Certain Relationships With, a Covered Fund

Section ____.10 of the final rule defines the scope of the prohibition on the acquisition and retention of ownership interests in, and certain relationships with, a covered fund. It also defines a number of key terms, including the definition of covered fund.

The term ''covered fund'' specifies the types of entities to which the prohibition contained in § ____.10(a) applies, unless the activity is specifically permitted under an available exemption contained in subpart C of the final rule.[1635] The final rule modifies the proposed definition of covered fund in a number of key aspects. The Agencies have defined the term ''covered fund'' with reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (''Investment Company Act'') with some additions and subject to a number of exclusions, several of which have been modified from permitted activity exemptions included in the proposal.

The Agencies have tailored the final definition to include entities of the type that the Agencies believe Congress intended to capture in its definition of private equity fund and hedge fund in section 13(h)(2) of the BHC Act by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act. Thus, the final definition focuses on the types of entities formed for the purpose of investing in securities or derivatives for resale or otherwise trading in securities or derivatives, and that are offered and sold in offerings that do not involve a public offering, but typically involve offerings to institutional investors and high-net worth individuals (rather than to retail investors). These types of funds are not subject to all of the securities law protections applicable with respect to funds that are registered with the SEC as investment companies, and the Agencies therefore believe that these types of entities may be more likely to engage in risky investment strategies. At the same time, the Agencies have tailored the definition to exclude entities that have more general corporate purposes and do not present the same risks for banking entities as those associated with the funds described above, as well as certain other entities as further discussed below.

The final rule also contains a revised version of the proposal's treatment of certain foreign funds as covered funds, which has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute, such as certain foreign funds that are established by

[1630] *See* BDA (Feb. 2012); Japanese Bankers Ass'n.

[1631] *See* Occupy.

[1632] *See* Occupy.

[1633] *See* § ____.20 and Appendix B of the final rule, also discussed in Part IV.C., *infra*.

[1634] *See* 12 U.S.C. 1851(a)(1)(B).

[1635] *See* final rule §§ ____.10(b)–(c). The term banking entity is defined in final rule § ____.2(c).

U.S. banking entities and not otherwise subject to the Investment Company Act.

The Agencies have not included all commodity pools within the definition of covered fund as proposed. Instead, and as discussed in more detail below, the Agencies have included only commodity pools for which the commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC's regulations or that could qualify as exempt pools and which have not been publicly offered [1636] to persons who are not qualified eligible persons under section 4.7 of the CFTC's regulations.[1637] Qualified eligible persons are typically institutional investors, banking entities and high net worth individuals (rather than retail investors). This more tailored approach, together with the various exclusions from the covered fund definition in the final rule, is designed to include as covered funds those commodity pools that are similar to funds that rely on section 3(c)(1) or 3(c)(7) while not also including as covered funds entities, like commercial end-users or registered investment companies, whose activities do not implicate the concerns that section 13 was designed to address.

Finally, other related terms, including ''ownership interest,'' ''resident of the United States,'' ''sponsor,'' and ''trustee,'' are also defined in § ____.10(d) of the final rule.[1638] As explained below, these terms are largely defined in the same manner as in the proposal although with certain changes, including changes to help clarify the scope of these definitions as requested by commenters. Some of these terms and related provisions also have been reorganized to improve clarity. As explained in more detail below, the Agencies received a number of comments relating to some of the terms defined in § ____.10. Some comments directly relate to the scope of the proposed rule and the economic effects associated with the prohibitions on covered funds activities and investments, some of which commenters argued did not further the purposes of section 13.[1639] The Agencies have carefully considered these and other comments when defining the key terms used in the statute and in providing certain exclusions to the definition of the term covered fund. The Agencies also have sought to provide guidance below, where appropriate, on how these key terms would operate in order to better enable banking entities to understand their obligations under section 13 and the final rule.

a. Prohibition Regarding Covered Fund Activities and Investments

Section ____.10(a) of the final rule implements section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, directly or indirectly, acquiring or retaining as principal an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless otherwise permitted under subpart C of the final rule.[1640] This provision of the rule reflects the statutory prohibition.

The general prohibition in § ____.10(a) of the proposed rule applied solely to the acquisition or retention of an ownership interest in, or acting as sponsor to, a covered fund, ''as principal.'' [1641] Commenters generally supported this approach, arguing that applying the prohibition related to covered fund activities and investments by a banking entity only to instances where the banking entity acts as principal is consistent with the statutory focus on principal activity.[1642] The final rule takes this approach as discussed below.

The proposed rule and preamble accompanying it described potential exemptions from the definition of ownership interest for a variety of interests, including interests related to employee benefit plans, interests held in the ordinary course of collecting a debt previously contracted, positions as trustee, or interests acquired as agent, broker or custodian. Commenters provided information on each of these types of ownership interests, and generally supported excluding each of these from the section's prohibition on acquiring or retaining an ownership interest in a covered fund.

A significant number of commenters focused on employee benefit plans. Commenters generally argued that the prohibition in section 13(a) of the BHC Act did not encompass interests held on behalf of employees through an employee benefit plan. While the proposed rule did not explicitly cover certain ''qualified plans'' under the Internal Revenue Code, a number of commenters argued that the prohibition should not cover activity or investments related to other types of employee benefit plans that are not a ''qualified plan'' under the Internal Revenue Code.[1643] A significant number of commenters urged exclusion of interests in and relationships with foreign employee benefit plans.[1644] Commenters argued that the risks of investments made through employee benefit plans are borne by the employee beneficiaries of these plans, and any decision to cover employee benefit plans or investments made by these plans under the prohibitions in section 13 of the BHC Act would eliminate or severely restrict the availability of employee programs that are widely offered, regulated and endorsed under a system of Federal, state and foreign laws.[1645]

Commenters also supported the exemption under the proposed rule for holdings in satisfaction of a debt previously contracted in good faith.[1646] This provision of the proposal recognized that banking entities may acquire an ownership interest in or relationship with a covered fund as a result of a counterparty's failure to repay a *bona fide* debt and without an intent to engage in those activities as principal.[1647]

Several commenters urged revision to the proposal to add a specific exclusion for investments held by a banking entity in the capacity of trustee (including as trustee for a charitable trust).[1648] These commenters argued that failing to recognize and exempt these types of activities in the final rule would prevent banking entities that act as trustees from effectively meeting their trust and fiduciary obligations and from providing these services to customers. Commenters also argued that the exemption for trust activities should not be dependent on the duration of the trust because the law governing the duration of trusts is changing and varies across jurisdictions.[1649]

As with the proposed rule, the prohibition in § ____.10(a) of the final rule applies only to the acquisition or retention of an ownership interest in, or sponsorship of, a covered fund as

[1636] *See infra* note 1721 and accompanying text regarding the meaning of the term ''offer'' as used in the final rule's inclusion of certain commodity pools as covered funds.

[1637] *See* final rule § ____.10(b)(1)(ii).

[1638] *See* final rule § ____.10(d)(6), (8), (9), and (10).

[1639] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Goldman (Covered Funds); Rep. Himes; SVB; Scale.

[1640] *See* final rule § ____.10(a).

[1641] *See* proposed rule § ____.10(a); *See also* Joint Proposal, 76 FR 68,896.

[1642] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012).

[1643] *See* Credit Suisse (Williams); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1644] *See, e.g.,* Credit Suisse (Williams); Arnold & Porter; UBS; NAB; Hong Kong Inv. Funds Ass'n; Australian Bankers Ass'n. (Feb. 2012).

[1645] *See, e.g.,* Arnold & Porter.

[1646] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); LSTA (Feb. 2012).

[1647] *See* proposed rule § ____.14(b).

[1648] *See, e.g.,* ABA (Keating).

[1649] *See, e.g.,* ABA (Keating); Arnold & Porter; NAB.

principal. The Agencies continue to believe section 13 of the BHC Act was designed to address the risks attendant to principal activity and not those that are borne by customers of the banking entity or for which the banking entity lacks design or intent to take a proprietary interest as principal.

In order to address commenter concerns regarding the types of activity that are subject to the prohibition, the Agencies have modified and reorganized the final rule to make the scope of acting ''as principal'' clear and more consistent with the proprietary trading restrictions under the final rule.[1650] The final rule provides that the prohibition does not include acquiring or retaining an ownership interest in a covered fund by a banking entity: (1) Acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;[1651] (2) through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof); [1652] (3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the appropriate agency; or (4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.[1653]

Because these activities do not involve the banking entity engaging in an activity intended or designed to take ownership interests in a covered fund as principal, they do not appear to be the types of activities that section 13 of the BHC Act was designed to address. However, the Agencies note that in order to prevent a banking entity from evading the requirements of section 13 and the final rule, the exclusions for these activities do not permit a banking entity to engage in establishing, organizing and offering, or acting as sponsor to a covered fund in a manner other than as permitted elsewhere in the final rule. The Agencies intend to monitor these activities and investments for efforts to evade the restrictions in section 13 of the BHC Act and the final rule on banking entities' investments in and relationships with covered funds.

b. ''Covered Fund'' Definition

Section 13(h)(2) of the BHC Act defines hedge fund and private equity fund to mean an issuer that would be an investment company, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or ''such similar funds'' as the Agencies determine by rule.[1654] Given that the statute defines ''hedge fund'' and ''private equity fund'' without differentiation, the proposed rule and the final rule combine the terms into the definition of a ''covered fund.'' Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act.[1655] The proposal included as a covered fund any entity that would be an investment company but for the exclusion from that definition contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, any foreign entity that would also be an investment company but for those same exclusions were the foreign entity to be organized or offered in the United States, and a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1656] The preamble to the proposal recognized that this definition was broad and specifically requested comment on whether and how the definition of covered fund should be modified for purposes of the final rule.

Commenters contended that the definition of covered fund should not focus exclusively on whether an entity relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Commenters argued that sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act. Under the Investment Company Act, any entity that holds investment securities (*i.e.,* generally all securities other than U.S. government securities) representing at least 40 percent of the entity's total assets would be an investment company.[1657] According to commenters, this definition and the accompanying exclusions are part of a securities law and regulatory framework designed for purposes different than the prudential purpose that underlies section 13 of the BHC Act.[1658]

A number of comments received on the proposal argued that the proposed definition of covered fund was overly broad and would lead to anomalous results inconsistent with the words, structure, and purpose of section 13.[1659] For instance, many commenters asserted that the proposed rule's definition of covered fund would cause a number of commonly used corporate entities that are not traditionally thought of as hedge

[1650] *See* final rule § ____.3(d)(7)(9).

[1651] A banking entity acting as agent, broker, or custodian is not acting ''as principal'' under the final rule so long as the activity is conducted for the account of, or on behalf of, a customer and the banking entity does not have or retain beneficial ownership of such ownership interest, as noted above. This provision is consistent with the final rule's treatment of banking entities acting on behalf of customers as trustee or in a fiduciary capacity.

[1652] The Agencies note that this provision does not permit joint investments between the banking entity and its employees. Rather, this provision is intended to enable banking entities to maintain deferred compensation and other similar plans formed for the benefit of employees. The Agencies recognize that, since it is possible an employee may forfeit its interest in such a plan, the banking entity may have a residual or reversionary interest in the assets referenced under the plan. However, other than such residual or reversionary interests, a banking entity may not rely on this provision to invest in a covered fund.

[1653] *See* final rule § ____.10(a)(2). For instance, as part of engaging in its traditional trust company functions, a bank or savings association typically may act through an entity that is excluded from the definition of investment company under section 3(c)(3) or 3(c)(11). This would be included within the scope of acting on behalf of customers as trustee or in a similar fiduciary capacity, provided that it meets the applicable requirements of the exclusion under the final rule.

[1654] *See* 12 U.S.C. 1851(h)(2).

[1655] 12 U.S.C. 1851(h)(2). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of ''investment company'' for: (1) Any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper); or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. *See* 15 U.S.C. 80a–3(c)(1) and (c)(7).

[1656] *See* proposed rule § ____.10(b)(1).

[1657] 15 U.S.C. 80a–3(a)(1)(A) & (C). The definition of securities is very broad under the Investment Company Act and has been interpreted to include instruments such as loans, that would not be regarded as securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, the determination of what constitutes an ''investment security'' under the Investment Company Act requires complex analysis and consideration of a broad set of facts and circumstances.

[1658] *See, e.g.,* NVCA.

[1659] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.*; Rep. Garrett *et al.*

funds or private equity funds, such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles, to be subject to the covered fund restrictions of section 13. These commenters argued that this interpretation of section 13 would cause a disruption to the operations of banking entities and their closely related affiliates that does not relate to the intent of section 13 and therefore cause an unnecessary burden on banking entities. Commenters argued that the words, structure and purpose of section 13 allow the Agencies to adopt a more tailored definition of covered fund that focuses on vehicles used for investment purposes that were the target of section 13's restrictions.

In particular, commenters requested that the final rule exclude at least the following from the definition of covered fund: U.S. registered investment companies (including mutual funds); the foreign equivalent of U.S. registered investment companies; business development companies; wholly-owned subsidiaries; joint ventures; acquisition vehicles; financial market utilities; foreign pension or retirement funds; insurance company separate accounts; loan securitizations, including asset-backed commercial paper conduits; cash management vehicles or cash collateral pools; credit funds; real estate investment trusts; various securitization vehicles; tender option bond programs; and venture capital funds.[1660] Commenters requested some of these exclusions in order to mitigate the impact of the proposal's inclusion of commodity pools as part of the definition of covered fund.[1661]

Some commenters argued that the proposal failed to distinguish between different types of investment funds.[1662] These commenters expressed the view that the statute provides the Agencies with the discretion to distinguish between investment funds generally and a subset of funds—hedge funds and private equity funds—that may engage in particularly risky trading and investment activities. For example, several commenters argued that the proposed rule's restrictions on covered fund investments should not cover venture capital funds that provide investment capital to new businesses.[1663] Others argued for an exclusion for securitization vehicles such as securitizations that are backed, in whole or in part, by assets that are not loans, including corporate debt repackagings,[1664] CLOs,[1665] ABCP conduits,[1666] insurance-linked securities,[1667] and synthetic securitizations backed by derivatives.[1668]

As a potential solution to some of these concerns, a number of commenters argued that the Agencies should define covered fund by reference to characteristics that are designed to distinguish hedge funds and private equity funds from other types of entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1669] Commenters believed this approach would help exclude some of the corporate vehicles and funds mentioned above that they did not believe were intended by Congress to be included as hedge funds and private equity funds and therefore reduce costs that, in the commenters' view, did not further the purposes of section 13.[1670]

These commenters proposed a number of different potential types of characteristics for defining hedge fund and private equity fund. Some commenters focused on certain structural or investment characteristics found in traditional private equity funds and hedge funds, such as investor redemption rights, performance compensation fees, leverage and the use of short-selling.[1671] Another commenter argued that the characteristics used to define a covered fund should focus on the types of speculative behavior that the statute was intended to address, citing characteristics such as volatility of asset performance and high leverage.[1672]

In contrast to the majority of the commenters, one commenter urged that characteristics be used to expand the proposed definition to include any issuer that exhibits characteristics of proprietary trading that the statute prohibits to be done by a banking entity.[1673] According to this commenter, any fund engaging in more than minimal proprietary trading should be a covered fund and subject to the requirements of section 13.

However, not all commenters supported a characteristics-based definition. One commenter opposed a characteristics-based definition, suggesting that the final rule rely only on the statutory reference to the Investment Company Act, and arguing that using characteristics to define a covered fund (*e.g.,* leverage) could create opportunities for circumvention of the rule.[1674] Commenters that generally supported the proposed definition argued that its broad scope prevented circumvention.[1675]

One commenter argued in favor of broadening the definition of covered fund to include entities that rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) and 3(c)(7), such as section 3(c)(2) (which provides an exclusion for underwriters and brokers) or 3(c)(6) (which provides an exclusion for entities engaged in a business other than investing in

[1660] *See* ABA (Keating); ABA (Abernathy); SIFMA *et al.* (Covered Funds) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); Allen & Overy (on behalf of Canadian Banks); Deutsche Bank (Repackaging Transactions); ICI (Feb. 2012); Putnam; JPMC; GE (Feb. 2012); Chamber (Feb. 2012); Rep. Himes; BOK; Ass'n. of Institutional Investors (Feb. 2012); Wells Fargo (Covered Funds); BoA; NAIB *et al.;* PNC; SunTrust; Nationwide; STANY; BNY Mellon *et al.;* RMA; Goldman (Covered Funds); Japanese Bankers Ass'n; IRSG; ISDA (Feb. 2012); IIB/EBF; Citigroup (Jan. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Eaton Vance; Fidelity; SBIA; River Cities; Ashurst; Sen. Hagan; Sen. Bennet.

[1661] As discussed below, the Agencies have modified the final rule to include only certain commodity pools within the definition of covered fund.

[1662] *See* NVCA; *See also* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating).

[1663] *See, e.g.,* ABA (Keating); ABA (Abernathy); Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Growth Managers; River Cities; SVB; EVCA.

[1664] *See* AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Deutsche Bank (Repackaging Transactions); SIFMA (Securitization) (Feb. 2012).

[1665] *See* SIFMA (Securitization) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); JPMC; LSTA (Feb. 2012).

[1666] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); Eaton Vance; Fidelity; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012); AFME *et al.*

[1667] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1668] *See* AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); ABA (Keating).

[1669] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Credit Suisse (Williams); SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); Allen & Overy (on behalf of Foreign Bank Group).

[1670] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); AFME *et al*; Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Ashurst; Barclays; BDA (Feb. 2012); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Nuveen Asset Mgmt.; PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds).

[1671] *See* Ass'n. of Institutional Investors (Feb. 2012); Barclays; JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* FSOC study at 62–63 (suggesting a characteristics-based approach considering compensation structure; trading/investment strategy; use of leverage; investor composition); ABA (Keating); BNY Mellon *et al.;* Northern Trust, SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); T. Rowe Price; RMA (suggesting use of characteristics derived from the SEC's Form PF for registration of investment advisers of private funds).

[1672] *See* RBC (citing FSOC study).

[1673] *See* Occupy.

[1674] *See* AFR *et al.* (Feb. 2012).

[1675] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Alfred Brock.

securities).[1676] By contrast, other commenters argued that an entity should not be considered a covered fund if the entity relies on an exclusion or exemption contained in the Investment Company Act other than an exclusion contained in section 3(c)(1) or 3(c)(7) under that Act, such as the exclusion contained in section 3(c)(3) for bank collective investment funds.[1677]

The Agencies have carefully considered all of the comments related to the definition of covered fund. While the Agencies believe that the proposal reflected a reasonable interpretation of the statutory provision, on further review and in light of the comments the Agencies have determined to adopt a different approach. The Agencies have revised the final rule to address many of the concerns raised by commenters regarding the scope of the original proposal in a manner the Agencies believe is a better reading of the statutory provision because it is both consistent with the language, purpose and structure of section 13 and avoids unintended consequences of the less precise definitional approach of the proposal.

In the final rule, the Agencies have joined the definitions of ''hedge fund'' and ''private equity fund'' into a single definition ''covered fund'' (as in the statute) and have defined this term as any issuer that would be an investment company as defined in the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act with a number of express exclusions and additions (explained below) as determined by the Agencies. Thus, for example, an entity that invests in securities and relies on any exclusion or exemption from the definition of ''investment company'' under the Investment Company Act other than the exclusion contained in section 3(c)(1) or 3(c)(7) of that Act would not be considered a covered fund so long as it satisfies the conditions of another Investment Company Act exclusion or exemption.[1678] Such an entity would not be an investment company *but for* section 3(c)(1) or 3(c)(7), and the Agencies have modified the final rule to explicitly exclude such an entity.[1679]

The Agencies believe this definition is consistent with the words, structure, purpose and legislative history of section 13 of the BHC Act. As noted above, section 13(h)(2) provides that:

> The terms ''hedge fund'' and ''private equity fund'' mean an issuer that would be an investment company as defined in the [Investment Company Act] (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, *or* such similar funds as the [Agencies] may, by rule, as provided in subsection (b)(2), determine.[1680]

The statutory provision contains two parts: a first part that refers to any issuer that is ''an investment company, as defined in the Investment Company Act, but for section 3(c)(1) and 3(c)(7) of the Act''; and a second part that covers ''such similar funds as the [Agencies] may, by rule . . . determine.'' The proposed rule offered a reading of this provision as a simple concurrent definition with two self-contained, supplementary parts. Under this approach, all entities covered by part one of the definition would be included in the definitions of ''hedge fund'' and ''private equity fund,'' and the role of the Agencies under the second part was limited to considering whether and how to augment the scope of the primary statutory definition.

As noted above, commenters argued that this interpretation led to unintended consequences that were not consistent with other provisions of section 13 or the purposes of section 13, and that other interpretations of the definition of covered fund were consistent with both the words and the purpose of the statute. Also as explained above, commenters offered multiple alternative interpretations of the definition of, the scope of the prohibition on ownership interests in, and relationships with, a covered fund.[1681]

The Agencies believe that the language of section 13(h)(2) can best be interpreted to provide two alternative definitions of the entities to be covered by the statutory terms ''hedge fund'' and ''private equity fund.'' Under this reading, the first part of section 13(h)(2) contains a base definition that references the noted exclusions under the Investment Company Act (the ''default definition''), while the second part grants the Agencies the authority to adopt an alternate definition that is triggered by agency action (the ''tailored definition''). Thus, if the Agencies do not act by rule, the definition is set by reference to the Investment Company Act and the relevant exclusions alone; if the Agencies act by rule, the definitions are set by the Agencies under that rule. As noted above, the Agencies have determined to exercise the authority under the second part of the statute to define ''hedge fund'' and ''private equity fund'' in the final rule.

Relying on the Agencies' authority to adopt an alternative, tailored definition of ''hedge fund'' and ''private equity fund,'' the final rule references funds that are similar to the funds in the base alternative provided in the first alternative definition—that is, an issuer that would be an investment company under the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act. The additions and exclusions from that definition represent further determinations by the Agencies regarding the scope of that definition that were made in the course of a rulemaking conducted in accordance with section 13(b)(2) of the BHC Act.

The Agencies believe that this reading of the statutory provision is consistent with the purpose of section 13. That purpose appears to be to limit the involvement of banking entities in high-risk proprietary trading, as well as their investment in, sponsorship of, and other connections with, entities that engage in investment activities for the benefit of banking entities, institutional investors and high-net worth individuals.[1682] Further, the Agencies believe that the provision permits them to tailor the scope of the definition to funds that engage in the investment activities contemplated by section 13 (as opposed, for example, to vehicles that merely serve to facilitate corporate structures); doing so allows the Agencies to avoid the unintended results, some of which commenters identified, that might

[1676] *See* Occupy (also arguing in favor of including entities that rely on rule 3a–1 (which provides an exemption for issuers that hold less than 45% of their assets in securities excluding government securities) or 3a–6 (which provides an exemption for foreign banks and insurance companies) to avoid being regulated as investment companies under the Investment Company Act).

[1677] *See, e.g.,* ABA (Keating).

[1678] For instance, bank common trust and collective funds that qualify for the exclusion from the definition of investment company pursuant to section 3(c)(3) or 3(c)(11) of the Investment Company Act are not covered funds. *See* 15 U.S.C. 78a–3(c)(3) and (c)(11). These funds are subject to supervision and regulation by a Federal banking agency, thus helping to distinguish them from traditional hedge funds and private equity funds which are generally not themselves subject to such supervision or regulation.

[1679] *See* final rule § ____.10(c)(12).

[1680] *See* 12 U.S.C. 1851(h)(2) (emphasis added).

[1681] In addition to the readings described above, one commenter argued that the section could be read to provide that both the reference to issuers covered by section 3(c)(1) or 3(c)(7) of the Investment Company Act in the first part of section 13(h)(2) and the reference to similar funds in the second part of the section should be read as qualified by the clause ''as the Agencies may by rule . . . determine.'' Under this reading, Congress granted the Agencies authority to determine by rule whether an entity described by the first part would be covered and whether an issuer would be deemed to be a similar fund under the second part. *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1682] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

follow from a definition that is inappropriately imprecise.[1683]

The Agencies also note that nothing in the structure or history of the Dodd-Frank Act suggests that the definition of hedge fund and private equity fund was intended to necessitate a fundamental restructuring of banking entities by disallowing investments in common corporate vehicles such as intermediate holding companies, joint operating companies, acquisition vehicles and similar entities that do not engage in the types of investment activities contemplated by section 13. Moreover, other provisions of the Dodd-Frank Act and existing banking laws and regulations would be undermined or vitiated by a reading that restricts investments in these types of corporate vehicles and structures.[1684]

Based on the interpretive and policy considerations raised by commenters, the language of section 13(h)(2), and the language, structure, and purpose of the Dodd-Frank Act, the Agencies have adopted a tailored definition of covered fund in the final rule that covers issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act with exclusions for certain specific types of issuers in order to focus the covered fund definition on vehicles used for the investment purposes that were the target of section 13. The definition of covered fund under the final rule also includes certain funds organized and offered outside of the United States in order to address foreign fund structures and certain commodity pools that might otherwise allow circumvention of the restrictions of section 13. The Agencies also expect to exercise the statutory anti-evasion authority provided in section 13(e) of the BHC Act and other prudential authorities in order to address instances of evasion.[1685]

As discussed above, an alternative approach to defining a covered fund would be to reference fund characteristics. Commenters arguing for a characteristics-based approach stated that it would more precisely tailor the final rule to the intent of section 13 and limit the potential for undue burden on banking entities. A characteristics-based definition, however, could be less effective than the approach taken in the final rule as a means to prohibit banking entities, either directly or indirectly, from engaging in the covered fund activities limited or proscribed by section 13. A characteristics-based approach also could require more analysis by banking entities to apply those characteristics to every potential covered fund on a case-by-case basis, and create greater opportunity for evasion. As discussed below, the Agencies have sought to address some of the concerns raised by commenters suggesting a characteristics-based approach by tailoring the definition of covered fund to provide exclusions for certain entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and otherwise would be treated as covered funds.

Some commenters discussed the potential cost to banking entities to analyze the covered fund status of certain entities if the Agencies were to define the term covered fund by reference to sections 3(c)(1) and 3(c)(7), arguing that this analysis would be costly.[1686] A characteristics-based approach could mitigate the costs associated with an investment company analysis but, depending on the characteristics, could result in additional compliance costs in some cases to the extent banking entities would be required to implement policies and procedures to prevent potential covered funds from having characteristics that would bring them within the covered fund definition. Furthermore, banking entities may currently rely on section 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid registering various entities under the Investment Company Act, and the costs to analyze the status of these entities under a statutory-based definition of covered fund are generally already included as part of the fund formation process and the costs of determining covered fund status may thus be mitigated, especially given the exclusions provided in the final rule.

The entities excluded from the definition of covered fund are described in detail in section (c) below.

1. Foreign Covered Funds

In order to prevent evasion of the prohibition and purposes of section 13, the proposal included within the definition of covered fund any issuer organized or offered outside of the United States (''foreign covered fund'') that would be a covered fund were it organized or offered in the United States.[1687]

Commenters expressed concern that the proposed treatment of foreign covered funds was overly broad, exceeded the Agencies' statutory authority, was not consistent with principles of national treatment, and violated international treaties.[1688] Commenters expressed concern about the difficulties of applying Investment Company Act concepts to foreign funds that are structured to comply with

[1683] The Agencies believe that the choice of the tailored definition is supported by the legislative history that suggests that Congress may have fore*See*n that its base definition could lead to unintended results and might be overly broad, too narrow, or otherwise off the mark. Part two of the statutory definition was not originally included in the bill reported by the Senate Committee on April 30, 2010. While the addition of part two did not receive specific comment, Rep. Frank, a co-sponsor and principal architect of the Dodd-Frank Act, noted that the default definition ''could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds'' and confirmed that ''[w]e do not want these overdone.'' *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored).

[1684] For example, the Dodd-Frank Act requires banking entities to serve as a source of financial strength to their insured depository institutions and requires certain banking entities to form intermediate holding companies to separate their financial and non-financial activities. *See* Sections 167, 616(d) & 626 of the Dodd-Frank Act. These provisions would be severely undermined if the prohibitions on investments and activities contained in section 13 were applied to ownership of intermediate holding companies. For instance, a bank holding company would not be able to serve as a source of strength to an intermediate holding company (or any subsidiary thereof) that is a covered fund due to the transaction restrictions contained in section 13(f). *See* 12 U.S.C. 1851(f). As another example, the Agencies have made certain modifications to the final rule to make clear that it will not affect the resolution authority of the Federal Deposit Insurance Corporation, including by excluding from the covered fund definition issuers formed by or on behalf of the Corporation for the purpose of facilitating the disposal of assets acquired in the Corporation's capacity as conservator or receiver. *See* § ____.10(c)(13).

[1685] As discussed in Part IV.C.1 of this **SUPPLEMENTARY INFORMATION** regarding the compliance program requirements of the final rule, the Agencies will consider information maintained and provided by banking entities under the compliance program mandate to help monitor potential evasions of the prohibitions and restrictions of section 13. Additionally and consistent with the statute, the final rule permits the Agencies to jointly determine to include within the definition of covered fund any fund excluded from that definition. The Agencies expect that this authority may be used to help address situations of evasion.

[1686] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1687] *See* proposed rule § ____.10(b)(1)(iii).

[1688] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BNY Mellon *et al.;* BlackRock; ABA (Keating); AFTI; AFG; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal *et al.* (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; TCW; Govt. of Japan/Bank of Japan.

regulatory schemes under local laws outside the United States. They also argued that it would be burdensome and costly to require foreign banking entities to interpret and apply U.S. securities laws to foreign structures that are designed primarily to be offered and sold outside the United States.[1689] Commenters also contended that foreign mutual fund equivalents, such as retail Undertakings for Collective Investments in Transferable Securities (''UCITS''),[1690] would be treated as covered funds under the proposal even though they generally are similar to U.S. registered investment companies, which are not covered funds, meaning that under the proposal the scope of foreign funds captured was broader than the scope of domestic funds.[1691] These commenters argued that a foreign fund organized and offered outside of the United States should not be treated as a covered fund simply because the foreign fund may (or could) rely on the exclusion under section 3(c)(1) or 3(c)(7) of the Investment Company Act were it to be offered in the United States.[1692]

Some commenters argued that the proposal did not clearly identify which foreign funds would be covered, thereby creating uncertainty about the scope of funds to which section 13 would apply.[1693] Several commenters argued that the proposal's foreign covered fund definition could be read to include a foreign fund, even if its securities were never offered and sold to U.S. persons, because the fund could theoretically be offered in the United States in reliance on section 3(c)(1) or 3(c)(7).[1694] Commenters argued that the definition of foreign covered fund should be tailored.[1695] Some commenters argued that foreign funds that are not made available for sale in the U.S. or actively marketed to U.S. investors should be specifically excluded from the definition of covered fund.[1696] Several other commenters supported narrowing the definition of foreign covered fund to those foreign funds with characteristics similar to domestic hedge funds or private equity funds.[1697]

After considering the comments in light of the statutory provisions and purpose of section 13, the Agencies have modified the final rule to more effectively tailor the scope of foreign funds that would be covered funds under the rule and better implement the language and purpose of section 13. As noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities, and one of the purposes of section 13 is to reduce the risk to the U.S. financial system of activities with and investments in covered funds. The Agencies proposed to include foreign funds within the definition of covered fund in order to more effectively accomplish the purpose of section 13. In particular, the Agencies were concerned that a definition of covered fund that did not include foreign funds would allow U.S. banking entities to be exposed to risks and engage in covered fund activities outside the United States that are specifically prohibited in the United States. This result would undermine section 13 and pose risks to U.S. banking entities and the stability of the U.S. financial system that section 13 was designed to prevent.

At the same time, section 13 includes other provisions that explicitly limit its extra-territorial application to the activities of foreign banks outside the United States. As explained below, section 13 specifically exempts certain activities in covered funds conducted by foreign banking entities solely outside of the United States.

Based on these considerations and the information provided by commenters, the Agencies have revised the definition of covered fund in the final rule to include certain foreign funds under certain circumstances. The final rule provides that a foreign fund is included within the definition of covered fund only for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State. Under this definition a foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund. Under the rule, a foreign fund is any entity that: (i) is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and (iii) has as its sponsor the U.S. banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by the U.S. banking entity (or an affiliate thereof).[1698] A foreign fund therefore may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.

This approach is designed to include within the definition of covered fund only foreign entities that would pose risks to U.S. banking entities of the type section 13 was designed to address. The Agencies note that any foreign fund, including a foreign fund sponsored or owned by a foreign banking entity, that is offered or sold in the United States in reliance on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act would be included in the definition of covered fund under § ____.10(b)(1)(i) of the final rule unless it meets the requirements of an exclusion from that definition as discussed below.[1699] Thus, the rule is

[1689] *See* JPMC; *See also* Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Govt. of Japan/Bank of Japan.

[1690] UCITS are public limited companies that, under a series of directives issued by the EU Commission, coordinate distribution and management of unit trusts or collective investment schemes in financial instruments on a cross-border basis throughout the European Union on the basis of the authorization of a single member state.

[1691] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); AFG; AFTI; BoA; French Banking Fed'n.; SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* BNY Mellon *et al.;* BlackRock; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal *et al.* (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; HSBC Life; ICSA Ass'n. of Banks in Malaysia (arguing that foreign banking organization would have to determine how a fund would be regulated under U.S. law before making investments in funds in their home markets).

[1692] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); SSgA (Feb. 2012); BoA; Goldman (Covered Funds).

[1693] *See* Australian Bankers Ass'n. (Feb. 2012); BlackRock.

[1694] *See* BlackRock; SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; ABA (Keating); IIB/EBF. These commenters argued that the proposed definition of a covered fund could result in virtually every foreign fund being considered a covered fund, regardless of whether the fund is similar to a hedge fund or private equity fund.

[1695] *See, e.g.,* AGC; Ass'n. of Institutional Investors (Feb. 2012); ABA (Keating); Goldman (Covered Funds); BoA; GE (Feb. 2012); Japanese Bankers Ass'n.; EBF.

[1696] *See* Australian Bankers Ass'n. (Feb. 2012); AFG; BNY Mellon *et al.;* BlackRock; Goldman (Covered Funds); IIB/EBF.

[1697] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; Goldman (Covered Funds); Credit Suisse (Williams); ABA (Keating); IIB/EBF; Barclays; BoA; GE (Feb. 2012) (discussing the uncertainty with respect to foreign-based loan and securitization programs and whether they would be deemed covered funds).

[1698] *See* final rule § ____.10(b)(1)(iii).

[1699] *See also* Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997); Touche

designed to provide parity—and no competitive advantages or disadvantages—between U.S. and non-U.S. funds sold within the United States.

To further ensure that this approach to foreign funds is consistent with the scope of coverage applied within the United States, the final rule excludes from the definition of covered fund any foreign issuer that, were it subject to U.S. securities laws, would be able to rely on an exclusion or exemption from the definition of investment company *other than* the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1700]

As explained below, the final rule also contains an exclusion for foreign public funds.[1701] This is designed to prevent the extension of the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies, which are by statute not covered by section 13.

2. Commodity Pools

Under the proposal, the Agencies proposed to use their authority to expand the definition of covered fund to include a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1702] A commodity pool is defined in the Commodity Exchange Act to mean any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.[1703] The Agencies proposed to include commodity pools in the definition of covered fund because some commodity pools are managed and structured in a manner similar to a covered fund.

Some commenters objected to this expansion of the definition of covered fund as beyond the scope of section 13. Commenters argued that covering commodity pools would extend section 13 of the BHC Act to any entity that engages in a single commodity, futures or swap transaction, including entities that share few, if any, of the characteristics or risk associated with private equity funds or hedge funds.[1704] For example, some commenters argued that many non-bank businesses that are not investment companies but that hedge risks using commodity interests would be treated as covered funds if all commodity pools were covered.[1705] In addition, registered mutual funds, pension funds, and many investment companies that rely on exclusions or exceptions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act would be covered as commodity pools. Commenters argued that the CFTC has ample authority to regulate the activities of commodity pools and commodity pool operators, and nothing in section 13 indicates that Congress intended section 13 to govern commodity pool activities or investments in commodity pools.[1706] Commenters also argued that expanding the definition of covered fund to include commodity pools would have the unintended consequence of limiting all covered transactions between a banking entity sponsor or investor in a commodity pool and the commodity pool itself.[1707] If a commercial end user is a commodity pool for example, this restriction could limit access to credit for that entity.

Commenters that opposed the proposal's inclusion of commodity pools generally asserted that, if commodity pools were nonetheless included as covered funds under the final rule, the definition of commodity pool should be modified so that it would include only those pools that engage ''primarily'' or ''principally'' in commodities trading *and* exhibit characteristics similar to those of conventional hedge funds and private equity funds.[1708] Other commenters urged the Agencies to incorporate the exemptions from the commodity pool operator registration requirements under the Commodity Exchange Act (such as rule 4.13(a)(4)).[1709]

Some commenters supported including commodity pools within the definition of covered fund,[1710] with some suggesting that this approach would be consistent with the goals of the statute.[1711] One commenter asserted that including commodity pools would be necessary to prevent banking entities from indirectly engaging in prohibited proprietary trading through commodity pools.[1712] Another commenter asserted that the inclusion of commodity pools was advisable because the CFTC has in the past viewed many commodity pools as similar to hedge funds.[1713]

After carefully considering these comments, the Agencies have determined not to include all commodity pools as covered funds as proposed. Instead, and taking into account commenters' concerns, the Agencies have taken a more tailored approach that is designed to more accurately identify those commodity pools that are similar to issuers that would be investment companies as defined the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of that Act, consistent with section 13(h)(2) of the BHC Act.

Under the final rule, as a threshold matter, a collective investment vehicle must determine whether it is a ''commodity pool'' as that term is defined in section 1a(10) of the Commodity Exchange Act.[1714] The Agencies note that collective investment vehicles need to make this determination for purposes of complying with the Commodity Exchange Act regardless of whether commodity pools are covered funds. Under section 1a(10), a commodity pool is ''any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests.'' [1715] If a collective investment

Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984).

[1700] *See* final rule § ____.10(b)(2). Because any issuer that offers its securities under the U.S. securities laws that may rely on an exclusion or exemption from the definition of investment company other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be a covered fund, this exclusion is designed to provide equivalent treatment for foreign covered funds.

[1701] *See* § ____.10(c)(1).

[1702] *See* proposal rule § ____.10(b)(1)(ii).

[1703] Commodity interests include: (i) commodity for future delivery, security futures product, or swap; (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under section 4c of the Commodity Exchange Act; or (iv) leveraged transaction authorized under section 23 of the Commodity Exchange Act. *See* Joint Proposal, 76 FR 68,897 n.224 and accompanying text.

[1704] *See, e.g.,* ABA (Keating) (citing *See, e.g.,* CFTC Interpretative Letter No. 86–22, Comm. Fut. L. Rep. (CCH) ¶ 23,280 (Sept. 19, 1986)); SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock; Goldman (Covered Funds); Wells Fargo (Covered Funds); BoA; EFAMA; TCW; ISDA (Feb. 2012); Arnold & Porter; BNY Mellon *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); RMA; IIB/EBF.

[1705] *See* Goldman (Covered Funds); TCW; IIB/EBF.

[1706] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock.

[1707] *See, e.g.,* BoA.

[1708] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); BlackRock; Wells Fargo (Covered Funds); BNY Mellon, *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); ABA (Keating); FIA; IIB/EBF; BoA.

[1709] *See* Credit Suisse (Williams).

[1710] *See* AFR *et al.* (Feb. 2012); Alfred Brock; Occupy; Sens. Merkley & Levin (Feb. 2012).

[1711] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Alfred Brock.

[1712] *See* Sens. Merkley & Levin (Feb. 2012).

[1713] *See* Occupy.

[1714] *See* 7 U.S.C. 1a(10).

[1715] *Id.* The CFTC and its divisions have provided interpretative guidance with respect to the meaning of the definition of commodity pool. *See, e.g.,* 46 FR 26004, 26005 (May 8, 1981) (adopting the CFTC's regulatory definition of commodity pool in 17 CFR 4.10(d), which is substantively identical to the definition in section 1a(10) of the Commodity Exchange Act); 77 FR 11252, 11258 (Feb. 24, 2012) (explaining the need for swaps to be included in the de minimis exclusion and exemption in 17 CFR 4.5 and 4.13); CFTC Staff Letter 12–13 (Oct. 11, 2012) (providing interpretative guidance to equity real estate investment trusts); and CFTC Staff Letters

Continued

vehicle meets that definition, the commodity pool would be considered a covered fund provided it meets one of two alternative tests and does not also qualify for an exclusion from the covered fund definition (*e.g.,* the exclusion for registered investment companies).

First, a commodity pool will be a covered fund if it is an ''exempt pool'' under section 4.7(a)(1)(iii) of the CFTC's regulations,[1716] meaning that it is a commodity pool for which a registered commodity pool operator has elected to claim the exemption provided by section 4.7 of the CFTC's regulations. The Agencies believe that such commodity pools are appropriately considered covered funds because, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools sell their participation units in restricted offerings that are not registered under the Securities Act of 1933 and are offered only to investors who meet certain heightened qualification standards, as discussed above.[1717] The Agencies therefore have determined that they properly are considered ''such similar funds'' as specified in section 13(h)(2) of the BHC Act.

Alternatively, a commodity pool for which exempt pool status under section 4.7 of the CFTC's regulations has not been elected may also be a covered fund if the pool features certain elements that make the pool substantively similar to exempt pools under section 4.7. The Agencies are including the alternative definition of commodity pools that are covered funds because, if the Agencies had included only pools for which exempt pool status had been elected, covered fund status for pools in which banking entities are invested could easily be avoided merely by not electing exempt pool status under section 4.7. The following is a description of the elements of a pool that would cause a pool that is not an exempt pool under section 4.7 to be a covered fund.

The first element is that a commodity pool operator for the pool is registered pursuant to the Commodity Exchange Act in connection with the operation of that commodity pool. This element is present for all pools that are exempt pools under section 4.7 because exempt pool status can only be elected by registered commodity pool operators. This element excludes from the definition of covered fund an entity that is a commodity pool, but for which the pool operator has been either exempted from registration as a commodity pool operator or excluded from the definition of commodity pool operator under the CFTC's regulations or pursuant to a no-action letter issued by CFTC staff.[1718]

The second element under the alternative definition is that substantially all of the commodity pool's participation units are owned only by qualified eligible persons under section 4.7(a)(2) and (a)(3).[1719] This element is consistent with the requirement under section 4.7 that exempt pool status can only be claimed if the participation units in the pool are only offered or sold to qualified eligible persons.[1720] Moreover, the inclusion of this element aligns the elements of the alternative test with features that define funds that rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.

The assessment as to whether the commodity pool in question satisfies this condition must be made at the time that the banking entity is required to make the following determinations: Whether it can obtain new participation units in the commodity pool, whether it can retain previously purchased participation units in the commodity pool, and whether it can act as the commodity pool's sponsor. The Agencies believe this to be appropriate because it would require the banking entity to consider current information regarding the commodity pool and its participants rather than assess the composition of the pool's participants over time even though its investments in or relationships with the pool do not change, which could be difficult depending upon the length of time that the pool has been in operation and the records available at the time of determination.

Finally, the third element under the alternative definition is that the commodity pool participation units have not been publicly offered to persons other than qualified eligible persons. Consistent with CFTC regulations addressing the meaning of ''offer'' in the context of the CFTC's regulations, the term ''offer'' as used in § ____.10(b)(1)(ii)(B) ''has the same meaning as in contract law, such that, if accepted the terms of the offer would form a binding contract.'' [1721] This aspect of the alternative definition is intended to limit the ability for commodity pools to avoid classification as covered funds through an offer, either in the past or currently ongoing, to non-qualified eligible persons ''in name only'' where there is no actual offer to non-qualified eligible persons.

Accordingly, unless the pool operator can show that the pool's participation units have been actively and publicly offered to non-affiliated parties that are not qualified eligible persons whereby such non-qualified eligible persons could in fact purchase a participation unit in the commodity pool, a pool that features the other elements listed in the alternative definition would be a covered fund. Such a showing will not turn solely on whether the commodity pool has filed a registration statement to offer its participation units under the Securities Act of 1933 or whether the commodity pool operator has prepared a disclosure document consistent with the provisions of section 4.24 of the CFTC's regulations.[1722] Rather, the pool operator would need to show that a reasonably active effort, based on the facts and circumstances, has been undertaken by brokers and other sales personnel to publicly offer the pool's participation units to non-affiliated parties that are not qualified eligible persons.

In taking this more tailored approach to commodity pools that will be covered funds, the Agencies are more closely aligning the types of commodity pools that will be covered funds under the final rule with section 13's definition of a hedge fund and private equity fund by reference to section 3(c)(1) or section 3(c)(7), and addressing concerns of commenters that the proposal was

Nos. 12–14 (Oct. 11, 2012) and 12–45 (Dec. 7, 2012) (providing interpretative relief that certain securitization vehicles are not commodity pools).

[1716] 17 CFR 4.7(a)(1)(iii).

[1717] Although section 3(c)(1) itself does not limit the types of investors who may invest in a fund relying on that exclusion, section 3(c)(1) provides that the fund may not conduct a public offering. A fund relying on section 3(c)(1) therefore must offer and sell its interests in offerings that are not registered under the Securities Act of 1933, which offerings generally are limited to persons who meet certain qualification standards.

[1718] *See, e.g.,* CFTC regulations 3.10(c) and 4.13 and CFTC Staff Letters Nos. 12–37 (Nov. 29, 2012) (relief from registration for operators of certain types of family office pools), 12–40 (Dec. 4, 2012) (relief from registration for operators of business development companies that meet certain conditions) and 12–44 (Dec. 7, 2012) (relief from registration for operators of mortgage real estate investment trusts that meet certain conditions). *See also supra* note 1715.

[1719] 17 CFR 4.7(a)(2) and (a)(3).

[1720] Although section 4.7 requires that all participation units be owned by qualified eligible persons, this element of the final rule has been modified to include pools for which ''substantially all'' participation units are owned by qualified eligible persons to prevent avoidance of covered fund status by distributing a small number of participation units to persons who are not qualified eligible persons.

[1721] *See* 77 FR 9734, 9741 (Feb. 17, 2012) (describing the meaning of the term ''offer'' in the context of the business conduct standards for swap dealers and major swap participants with counterparties adopted by the CFTC). The term ''offered'' as used in this section of the final rule is not intended to denote an ''offer'' for purposes of the Securities Act of 1933.

[1722] 17 CFR 4.24 (2013).

overly broad and would lead to outcomes inconsistent with the words, structure, and purpose of section 13.[1723] The Agencies believe that the types of commodity pools described above generally are similar to funds that rely on section 3(c)(1) and 3(c)(7) in that, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools may be owned only by investors who meet certain heightened qualification standards, as discussed above.[1724] Further, the Agencies believe that the final rule's identification of the elements of a commodity pool that is a covered fund are clearly established and readily ascertainable such that once it is determined whether an entity is a commodity pool, an assessment that is already necessary to comply with the Commodity Exchange Act, then the further determination of whether an entity that is a commodity pool is also a covered fund can be made based on readily ascertainable information.

In adopting this approach, the Agencies also are utilizing the current regulatory structure promulgated by the CFTC under the CEA. As the CFTC regulates commodity pools, commodity pool operators, and commodity trading advisors that advise commodity pools, the Agencies believe that it is beneficial to utilize an already established set of rules, regulations, and guidance. The Agencies considered alternative approaches provided by the commenters, but have adopted the approach taken in the final rule for the reasons discussed above and because the Agencies believe that the final rule, by incorporating concepts with which commodity pools and their operators are familiar, more clearly delineates the commodity pools that are covered funds.[1725]

The Agencies believe that the final rule's tailored approach to commodity pools includes in the definition of covered fund commodity pools that are similar to funds that rely on section 3(c)(1) and 3(c)(7). The Agencies also note in this regard that a commodity pool that would be a covered fund even under this tailored approach will not be a covered fund if the pool also qualifies for an exclusion from the covered fund definition, including the exclusion for registered investments companies. Accordingly, this approach excludes from covered funds entities like commercial end users and registered investment companies, whose activities do not implicate the concerns section 13 was designed to address. Rather, the final rule limits the commodity pools that will be included as covered funds to those that are similar to other covered funds except that they are not generally subject to the Investment Company Act of 1940 due to the instruments in which they invest. For all of these reasons, the Agencies believe that the final rule's approach to commodity pools addresses both the Agencies' concerns about the potential for evasion and commenters' concerns about the breadth of the proposed rule, and provides that the commodity pools captured as covered funds are ''such similar funds,'' consistent with section 13(h)(2) of the BHC Act.

The Agencies acknowledge that as a result of including certain commodity pools in the definition of covered fund, the prohibitions under section 13(f) and § ____.14 may result in certain structural changes in the industry. The Agencies note that these changes (*e.g.,* bank-affiliated FCMs may not be able to lend money in certain clearing transactions to affiliated commodity pools that are covered funds) may result in certain changes in the way related entities do business with each other. However, the Agencies believe that because the industry is competitive with a significant number of alternative non-affiliate competitors, the changes would not result in a less competitive landscape for investors in commodity pools.

3. Entities Regulated Under the Investment Company Act

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[1726] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[1727] A few commenters argued that the final rule should specifically provide that all SEC-registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[1728]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[1729]

The Agencies did not intend to include registered investment companies and business development companies as covered funds under the proposal. Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are *excluded* from SEC regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which *are* regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered

[1723] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.;* Rep. Garrett *et al.*

[1724] Funds relying on section 3(c)(7) must be owned exclusively by qualified purchasers, as defined in the Investment Company Act. The Agencies note in this regard that section 4.7 of the CFTC's regulations use substantially the same definition of a qualified purchaser in defining the term qualified eligible person.

[1725] Operators of commodity pools currently must consider whether they are required to register with the CFTC as commodity pool operators, and whether the pools have the characteristics that would make it possible for the operator to claim an exemption under section 4.7. These concepts thus should be familiar to commodity pools and their operators, and including these concepts in the final rule should allow banking entities more easily to determine if a particular commodity pools is a covered fund than if the Agencies were to develop new concepts solely for purposes of the final rule.

[1726] *See* proposed rule § ____.10(b)(1).

[1727] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

[1728] *See* Arnold & Porter; Goldman (Covered Funds); *See also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC; (requesting clarification that registered investment companies are not banking entities); TCW.

[1729] *See* ICI (Feb. 2012); TCW.

funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[1730]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed in more detail below in Part IV.B.1.c.12 of this **SUPPLEMENTARY INFORMATION**.

The Agencies also understand that registered investment companies may establish and hold subsidiary entities that rely on section 3(c)(1) or 3(c)(7) in order to trade in various financial instruments for the registered investment company parent. If a registered investment company were itself a banking entity, section 13 and the final rule would prohibit the registered investment company from sponsoring or investing in such an investment subsidiary. But a registered investment company would only itself be a banking entity if it is an affiliate of an insured depository institution. As explained in the proposal, a registered investment company, such as a mutual fund or exchange traded fund, or an entity that has made an effective election to be regulated as a business development company, would not be an affiliate of a banking entity for purposes of section 13 of that Act solely by virtue of being advised, or organized, sponsored and managed by a banking entity in accordance with the BHC Act (including section 13) and the Board's Regulation Y.[1731]

Under the BHC Act, an entity (including a registered investment company) would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution.[1732] Pursuant to the BHC Act, a company controls another company if: (i) The company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors of trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company.[1733]

The Board's regulations and orders have long recognized that a bank holding company may organize, sponsor, and manage a mutual fund such as a registered investment company, including by serving as investment adviser to registered investment company, without controlling the registered investment company for purposes of the BHC Act.[1734] For example, the Board has permitted a bank holding company to own up to 5 percent of the voting shares of a registered investment company for which the bank holding company provides investment advisory, administrative, and other services, and has a number of director and officer interlocks, without finding that the bank holding company controls the fund.[1735] The Board has also permitted a bank holding company to own less than 25 percent of the voting shares of a registered investment company and provide similar services without finding that the bank holding company controls the fund, so long as the fund limits its investments to those permissible for the holding company to make itself.[1736]

The BHC Act, as amended by the Gramm-Leach-Bliley Act, and the Board's Regulation Y authorize a bank holding company that qualifies as a financial holding company to engage in a broader set of activities, and to have a broader range of relationships or investments with entities, than bank holding companies.[1737] For instance, a financial holding company may engage in, or acquire shares of any company engaged in, any activity that is financial in nature or incidental to such financial activity, including any activity that a bank holding company is permitted to engage in or acquire by regulation or order.[1738] In light of the foregoing, for purposes of section 13 of the BHC Act a financial holding company may own more than 5 percent (and less than 25 percent) of the voting shares of a registered investment company for which the holding company provides investment advisory, administrative, and other services and has a number of director and officer interlocks, without controlling the fund for purposes of the BHC Act.[1739]

So long as a bank holding company or financial holding company complies with these limitations, it would not, absent other facts and circumstances, control a registered investment company and the registered investment company for purposes of section 13 (and any subsidiary thereof) would not itself be a banking entity subject to the restrictions of section 13 of the BHC Act and any final implementing rules (unless the registered investment company itself otherwise controls an insured depository institution). Also consistent with the Board's precedent regarding bank holding company control of and relationships with funds, a seeding vehicle that will become a registered investment company or SEC-regulated business development

[1730] *See* final rule § ____.10(c)(12).

[1731] *See* Joint Proposal, 76 FR 68,856.

[1732] *See* final rule § ____.2(a) (defining ''affiliate'' for purposes of the final rule).

[1733] *See* 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

[1734] *See, e.g.,* 12 CFR 211.10(a)(11); 225.28(b)(6)(i); 225.86(b)(3); *Unicredito,* 86 Fed. Res. Bull. 825 (2000); *Societe Generale,* 84 Fed. Res. Bull. 680 (1998); *Commerzbank AG,* 83 Fed. Res. Bull. 678 (1997); *The Governor and Company of the Bank of Ireland,* 82 Fed. Res. Bull. 1129 (1996); *Mellon Bank Corp.,* 79 Fed. Res. Bull. 626 (1993); *Bayerische Vereinsbank AG,* 73 Fed. Res. Bull. 155 (1987).

[1735] *See, e.g., Societe Generale,* 84 Fed. Res. Bull. 680 (1998) (finding that a bank holding company does not control a mutual fund for which it holds up to 5 percent of the voting shares and also provides investment advisory, administrative and other services, has directors or employees who comprise less than 25 percent of the board of directors of the fund (including the chairman of the board), and has three senior officer interlocks and a number of junior officer interlocks).

[1736] *See* letter dated June 24, 1999, to H. Rodgin Cohen, Esq., Sullivan & Cromwell (First Union Corp.), from Jennifer J. Johnson, Secretary of the Board of Governors of the Federal Reserve System (finding that a bank holding company does not control a mutual fund for which it provides investment advisory and other services and that complies with the limitations of section 4(c)(7) of the BHC Act (12 U.S.C. 1843(c)(7)), so long as (i) the bank holding company reduces its interest in the fund to less than 25 percent of the fund's voting shares after a six-month period, and (ii) a majority of the fund's directors are independent of the bank holding company and the bank holding company cannot select a majority of the board) (''First Union Letter''); H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies); *See also* 12 U.S.C. 1843(k)(1), (6).

[1737] *See, e.g.,* H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies).

[1738] *See* 12 U.S.C. 1843(k)(1); 12 CFR 225.86.

[1739] *See* First Union Letter (June 24, 1999); *See also* 12 CFR 225.86(b)(3) (authorizing a financial holding company to organize, sponsor, and manage a mutual fund so long as (i) the fund does not exercise managerial control over the entities in which the fund invests, and (ii) the financial holding company reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits).

company would not itself be viewed as violating the requirements of section 13 during the seeding period so long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or SEC-regulated business development company within the time period provided by section 13(d)(4) and § ____.12 for seeding a covered fund.[1740]

c. Entities Excluded From Definition of Covered Fund

As noted above, the final rule excludes a number of entities from the definition of covered fund.[1741] As discussed in more detail below, these exclusions more effectively tailor the definition of covered fund to those types of entities that section 13 was designed to focus on. The exclusions thus are designed to provide certainty, mitigate compliance costs and other burdens, and address the potential over-breadth of the covered fund definition and related requirements without such exclusions by permitting banking entities to invest in and have other relationships with entities that do not relate to the statutory purpose of section 13. These exclusions, described in more detail below, take account of information provided by many commenters regarding entities that would likely be included within the proposed definition of a covered fund, but that are not traditionally thought of as hedge funds or private equity funds.[1742] Finally, the Agencies note that providing exclusions from the covered fund definition, rather than providing permitted activity exemptions as proposed in some cases, aligns the final rule with the statute in applying the restrictions imposed by section 13(f) on transactions with covered funds only to transactions with issuers that are defined as covered funds and thus raise the concerns section 13 was designed to address.

The Agencies recognize, however, that the final rule's definition of covered fund does not include certain pooled investment vehicles. For example, the definition of covered fund excludes business development companies, entities that rely on section 3(c)(5)(C), 3(c)(3), or 3(c)(11) of the Investment Company Act, and certain foreign public funds that are subject to home-country regulation. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule.

1. Foreign Public Funds

As discussed above, under the proposal a covered fund was defined to include the foreign equivalent of any covered fund in order to address the potential for circumvention. Many commenters argued that the proposed definition could capture non-U.S. public retail funds, such as UCITS.[1743] These commenters contended that non-U.S. public retail funds should be excluded from the definition of covered fund because they are regulated in their home jurisdiction; commenters noted that similar funds registered in the United States, such as mutual funds, are not covered funds.[1744]

Some commenters were concerned that the proposed definition could inadvertently capture exchange-traded funds trading in foreign jurisdictions,[1745] separate accounts set up to fund foreign pension plans,[1746] non-U.S. issuers of asset-backed securities,[1747] and non-U.S. regulated funds specifically designed for institutional investors.[1748] Commenters also provided several potential effects of capturing foreign public funds under the covered fund definition: U.S. banking entities would incur unnecessary and substantial costs to rebrand and restructure their non-U.S. regulated funds,[1749] banking entities could be eliminated from the potential pool of counterparties, thereby affecting pricing and efficiency,[1750] U.S. banking entities may exit the UCITS market and lose competitiveness,[1751] the growth of mutual fund formation in foreign countries could be limited,[1752] and market liquidity in foreign jurisdictions could be impaired.[1753]

Some commenters supported excluding any foreign public fund that is organized or formed under non-U.S. law, authorized for public sale in the jurisdiction in which it is organized or formed, and regulated as a public investment company in that jurisdiction.[1754] In light of the proposal's broad definition of covered fund, some commenters recommended explicitly excluding non-U.S. regulated funds based on characteristics to distinguish the foreign funds that should be treated as covered funds.[1755] Several commenters recommended excluding non-U.S. funds based upon whether the funds are subject to a regulatory framework comparable to that which is imposed on SEC-registered funds;[1756] one commenter specifically identified European UCITS, Canadian mutual funds, Australian unit trusts, and Japanese investment trusts as examples of regulated funds to be excluded.[1757]

To address these concerns, the final rule generally excludes from the definition of covered fund any issuer

[1740] *See* final rule §§ ____.10(c)(12) and ____.20(e). Under the final rule, these *See*ding vehicles also must comply with the limitations on leverage under the Investment Company Act that apply to registered investment companies and SEC-regulated business development companies. *See* final rule § ____.10(c)(12).

[1741] *See* final rule § ____.10(c).

[1742] *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored); *See also* FSOC study at 61–63.

[1743] As discussed above, the proposed rule generally included in the covered fund definition a foreign fund that, were it organized or offered under the laws of the United States or offered to U.S. residents, would meet the definition of a domestic covered fund (*i.e.,* would need to rely section 3(c)(1) or 3(c)(7) of the Investment Company Act). Many commenters argued that this definition is too broad and could include as covered funds various types of foreign funds, like UCITS, that commenters argued should not be included. *See, e.g.,* JPMC; BlackRock.

[1744] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Hong Kong Inv. Funds Ass'n.; UBS; ICI Global; BlackRock; TCW; State Street (Feb. 2012); SSgA (Feb. 2012); IAA; JPMC; Goldman (Covered Funds); BoA; Credit Suisse (Williams); BNY Mellon, *et al.;* Union Asset; EFAMA; BVI; IRSG, SEB; IIB/EBF; GE (Feb. 2012) (commenting on the overbreadth of the definition because of the effect on foreign issuers of asset-backed securities); Allen & Overy (on behalf of Foreign Bank Group).

[1745] *See* BlackRock; Vanguard.

[1746] *See* BlackRock.

[1747] *See* ASF (Feb. 2012).

[1748] *See* Union Asset; EFAMA; BVI.

[1749] *See* Goldman (Covered Funds).

[1750] *See* AFMA.

[1751] *See* BoA.

[1752] *See* BVI.

[1753] *See* Goldman (Covered Funds).

See AFMA.

See BoA.

[1754] *See* ICI Global; ICI (Feb. 2012); SSgA (Feb. 2012); BNY Mellon *et al.*

[1755] *See* UBS; ICI Global; ICI (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); T. Rowe Price; HSBC Life; Union Asset; EFAMA; BVI; EBF; Hong Kong Inv. Funds Ass'n.; IMA; Ass'n. of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); Credit Suisse (Williams).

[1756] *See* T. Rowe Price; Credit Suisse (Williams); SSgA (Feb. 2012); BNY Mellon *et al.*

[1757] *See* T. Rowe Price.

that is organized or established outside of the United States and the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through one or more public offerings outside of the United States.[1758] Foreign funds that meet these requirements will not be covered funds, except that an additional condition applies to U.S. banking entities[1759] with respect to the foreign public funds they sponsor. The foreign public fund exclusion is only available to a U.S. banking entity with respect to a foreign fund sponsored by the U.S. banking entity if, in addition to the requirements discussed above, the fund's ownership interests are sold predominantly to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.

For purposes of this exclusion, the Agencies note that the reference to retail investors, while not defined, should be construed to refer to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors, professional investors or high net worth investors who may be permitted to invest in complex investments or private placements in various jurisdictions. Retail investors would therefore be expected to be entitled to the full protection of securities laws in the home jurisdiction of the fund, and the Agencies would expect a fund authorized to sell ownership interests to such retail investors to be of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund.

In order to help maintain this distinction and to avoid circumstances that could result in an evasion of section 13 and the final rule, the ownership interests of the fund must be sold predominantly in one or more public offerings outside of the United States to qualify for the exclusion. Given this restriction, a U.S. banking entity therefore could not rely on this exclusion to set up a foreign public fund for the purpose of selling a significant amount of ownership interests in the fund through one or more offerings conducted on an unregistered basis (whether in a foreign jurisdiction or in the United States). The Agencies generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States.

The requirements that a foreign public fund both be authorized for sale to retail investors and sold predominantly in public offerings outside of the United States are based in part on the Agencies' view that foreign funds that meet these requirements generally will be sufficiently similar to U.S. registered investment companies such that it is appropriate to exclude these foreign funds from the covered fund definition. A foreign fund authorized for sale to retail investors that is also publicly offered may, for example, provide greater information than funds that are sold through private offerings like funds that rely on section 3(c)(1) or 3(c)(7). Such foreign funds also may be subject to various restrictions, as deemed appropriate by foreign regulators in light of local conditions and practices, that exceed those applicable to privately offered funds. Foreign regulators may apply these or other enhanced restrictions or other requirements to funds that are offered on a broad basis to the general public for the protection of investors in those jurisdictions.

A foreign fund that purports to publicly offer its shares but in fact offers them on a more limited basis, however, may be less likely to resemble a registered investment company in these and other respects. In order to limit the foreign public fund exclusion to funds that publicly offer their shares on a sufficiently broad basis, the final rule defines the term ''public offering'' for purposes of this exclusion to mean a ''distribution'' (as defined in § ____ .4(a)(3) of subpart B) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that (i) the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; (ii) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and (iii) the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.[1760]

Under the final rule, therefore, a foreign fund's distribution would not be a public offering for purposes of the foreign public fund exclusion if the distribution imposes investor restrictions based on a required minimum level of net worth or net investment assets. This would not be affected by any suitability requirements that may be imposed under applicable local law. In addition, the final rule requires that, in connection with a public offering by a foreign public fund, the offering disclosure documents must be ''publicly available.'' This requirement will provide assurance regarding the transparency for such an offering and will generally be satisfied where the documents are made accessible to all persons in such jurisdiction. Disclosure documents may be made publicly available in a variety of means, such as through a public filing with a regulatory agency or through a Web site that provides broad accessibility to persons in such jurisdiction.

In addition and as discussed above, the final rule also places an additional condition on a U.S. banking entity's ability to rely on the foreign public fund exclusion with respect to the foreign public funds it sponsors. For a U.S. banking entity to rely on the foreign public fund exclusion with respect to a foreign public fund it sponsors, the ownership interests in the fund must be sold predominantly to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity. Consistent with the Agencies' view concerning whether a foreign public fund has been sold predominantly outside of the United States, the Agencies generally expect that a foreign public fund will satisfy this additional condition if 85 percent or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity.

This additional condition reflects the Agencies' view that the foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of section 13 of the BHC Act, including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States. The exclusion is not intended to permit a U.S. banking entity to establish a foreign fund for the purpose of investing in the fund as a means of avoiding the restrictions imposed by section 13. Permitting a U.S. banking entity to invest in a foreign public fund under this exclusion only

[1758] *See* final rule § ____.10(c)(1).

[1759] Although the discussion of this condition generally refers to U.S. banking entities for ease of reading, the condition also applies to foreign affiliates of a U.S. banking entity. *See* final rule § ____.10(c)(1)(ii) (applying this limitation ''[w]ith respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor'').

[1760] *See* final rule § ____.10(c)(1)(iii).

when that fund is sold predominantly to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity permits U.S. banking entities to continue their asset management businesses outside of the United States while also limiting the opportunity for evasion of section 13 as discussed below.

This additional condition only applies to U.S. banking entities with respect to the foreign public funds they sponsor because the Agencies believe that a foreign public fund sponsored by a U.S. banking entity may present heightened risks of evasion. Absent the additional condition, a U.S. banking entity could establish a foreign public fund for the purpose of itself investing substantially in that fund and, through the fund, making investments that the banking entity could not make directly under section 13. The Agencies believe it is less likely that a U.S. banking entity effectively could evade section 13 by investing in third-party foreign public funds that the banking entity does not sponsor. In those cases it is less likely that the U.S. banking entity would be able to control the investments of the fund, and the fund thus likely would be a less effective means for the banking entity to engage in proprietary trading through the fund. The Agencies therefore have declined to apply this additional condition with respect to *any* foreign public fund in which a U.S. banking entity invests but does not act as sponsor.

The Agencies note that the foreign public fund exclusion is not intended to permit a banking entity to sponsor a foreign fund for the purpose of selling ownership interests to any banking entity (affiliated or unaffiliated) that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State (or to a limited group of such banking entities). The Agencies intend to monitor banking entities' investments in foreign public funds to ensure that banking entities do not use the exclusion for foreign public funds in a manner that functions as an evasion of section 13 in this or any other way. The Agencies expect that one area of focus for such monitoring would be significant investments in a foreign public fund, including a fund that is unaffiliated with any banking entity located in or organized under the laws of the United States or of any State, where such investments represent a substantial percentage of the ownership interests in such fund.

In order to conduct this monitoring more effectively, the Agencies also are adopting certain documentation requirements concerning U.S. banking entities' investments in foreign public funds, as discussed in more detail below in Part IV.C.1 of this **SUPPLEMENTARY INFORMATION**. Under the final rule, a U.S. banking entity with more than $10 billion in total consolidated assets will be required to document its investments in foreign public funds, broken out by each foreign public fund and each foreign jurisdiction in which any foreign public fund is organized, if the U.S. banking entity and its affiliates' ownership interests in foreign public funds exceed $50 million at the end of two or more consecutive calendar quarters. This requirement thus is tailored to apply only to U.S. banking entities above a certain size that also have substantial investments in foreign public funds.[1761] The Agencies believe this approach appropriately balances the Agencies' evasion concerns and the burdens that documentation requirements impose.

For all of the reasons discussed above, the Agencies believe that the final rule's approach to foreign public funds is consistent with the final rule's exclusion of registered or otherwise exempt (without reliance on the exemptions in section 3(c)(1) or 3(c)(7)) funds in the United States. It also limits the extraterritorial application of section 13 of the BHC Act and reduces the potential economic and other burdens commenters argued would result for banking entities. The Agencies believe that this exclusion represents an appropriate balancing of considerations that should not significantly increase the risks to the U.S. financial system that section 13 was designed to limit.

2. Wholly-Owned Subsidiaries

Under the proposed rule, a banking entity would have been permitted to invest in or sponsor a wholly-owned subsidiary that relies on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company under that Act if the subsidiary was carried on the balance sheet of its parent and was engaged principally in performing *bona fide* liquidity management activities.[1762]

Commenters argued that, instead of providing a permitted activity exemption for banking entities to invest in or sponsor certain wholly-owned subsidiaries as proposed, all wholly-owned subsidiaries should be excluded from the definition of covered fund under the final rule because wholly-owned subsidiaries are typically used for organizational convenience and generally do not have the characteristics, risks, or purpose of a hedge fund or private equity fund, which involves unaffiliated investors owning interests in the structure for the purpose of sharing in the profits and losses from investment activities.[1763] Commenters explained that publicly traded companies often establish wholly-owned intermediate companies for the purpose of holding securities of operating entities or other corporate vehicles necessary to the business of the entity. Because these intermediate companies invest entirely (or substantially) in the securities of other entities, these intermediate companies may be investment companies for purposes of the Investment Company Act but for the exclusion provided by section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1764]

Commenters contended that requiring banking entities to divest their interests in wholly-owned subsidiaries and cease certain intercompany transactions would have a material adverse effect on the safety, soundness, efficiency and stability of the U.S. and global financial systems, which could in turn have a material adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output.[1765] Commenters also argued that an exclusion for wholly-owned subsidiaries is necessary in order to avoid a conflict with other important requirements in the Dodd-Frank Act. For example, commenters alleged that including wholly-owned subsidiaries within the definition of covered fund for purposes of section 13 would create a conflict with the requirement that a banking entity that is a bank holding company serve as a source of strength to its subsidiaries because the prohibition in section 13(f) on transactions between a banking entity and covered funds owned or sponsored by the banking entity would effectively prohibit the banking entity from providing financial resources to wholly-owned intermediate holding companies and their subsidiaries.[1766] Other commenters argued that banking entities would bear extensive compliance costs and operational burdens and likely would be

[1761] *See* final rule § ____.20(e).

[1762] *See* proposed rule § ____.14(a)(2)(iv); Joint Proposal, 76 FR 68,913.

[1763] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012), JPMC; Goldman (Covered Funds), NAIB *et al.;* GE (Feb. 2012); BoA; Chamber (Feb. 2012); Wells Fargo (Covered Funds); ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); Credit Suisse (Williams); Rep. Himes; BOK.

[1764] *See* 15 U.S.C. 80a–3(a)(1)(A) & (C).

[1765] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1766] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Rep. Himes.

restricted from structuring themselves effectively.[1767]

Commenters proposed several alternatives to address these concerns. For instance, commenters recommended that the final rule exclude all wholly-owned subsidiaries from the definition of covered fund.[1768] Commenters also urged that the final rule include ownership interests held by employees of a banking entity with any ownership interests held directly by the banking entity for purposes of qualifying for any exclusion granted by the rule for wholly-owned subsidiaries.[1769] Another commenter recommended the exclusion of subsidiaries, wholly owned or not, that engage in *bona fide* liquidity management.[1770]

In light of these comments and consistent with the purposes of section 13 and the terms of the Dodd-Frank Act as discussed in more detail above, the Agencies have revised the final rule to exclude wholly-owned subsidiaries from the definition of covered fund, including those not engaged in liquidity management.[1771] A wholly-owned subsidiary, as defined in the final rule, is an entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that (i) up to five percent of the entity's ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity (or an affiliate thereof); and (ii) within the five percent ownership interests described in clause (i), up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.[1772]

Although the final rule includes ownership interests held by certain former directors and employees for purposes of qualifying for the exclusion, the exclusion requires that an interest held by a former (or current) director or employee must actually be held by that person (or by the banking entity) and must have been acquired while employed by or in the service of the banking entity. For example, if a former employee subsequently transfers his/her interest to a third party (other than to immediate family members of the employee or through intestacy of the employee), then the ownership interest would no longer be held by the banking entity or persons whose ownership interests may be aggregated with interests held by the banking entity for purposes of the exclusion for wholly-owned subsidiaries under the final rule.

The final rule also permits up to 0.5 percent of the ownership interest of a wholly-owned subsidiary to be held by a third party if the interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns, and the ownership interest is included when calculating the five percent cap on employee and director ownership. The Agencies understand that it is often important, or in certain circumstances required, under the laws of various jurisdictions for a parent company to establish corporate separation of a subsidiary through the issuance of a small amount of ownership interest to a third party.

The Agencies believe that permitting limited employee and director ownership of a vehicle and accommodating the foreign law requirements discussed above is consistent with a vehicle's treatment as a wholly-owned subsidiary. Under the final rule, the banking entity (or an affiliate thereof) will control the vehicle because it must, as principal, own at least 95% of the vehicle.[1773] These conditions are designed to exclude from the covered fund definition vehicles that are formed for corporate and organizational convenience, as discussed above, and that thus do not engage in the investment activities prohibited by section 13. The exclusion also should reduce the disruption to the operations of banking entities that commenters asserted would result from the proposed rule.[1774]

Importantly, the Agencies note that a wholly-owned subsidiary of a banking entity—although excluded from the definition of covered fund—still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of section 13 of the BHC Act and the final rule.[1775] Accordingly, a wholly-owned subsidiary of a banking entity would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading) and may not engage in activity in violation of the prohibitions of section 13 and the final rule.

3. Joint Ventures

The proposed rule would have permitted a banking entity to invest in or manage a joint venture between the banking entity and any other person, provided that the joint venture was an operating company and did not engage in any activity or any investment not permitted under the proposed rule. As noted in the proposal, many joint ventures rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1776] Joint ventures are a common form of business, especially for firms seeking to enter new lines of business or new markets, or seeking to share complementary business expertise.

Commenters supported this aspect of the proposal and argued that joint ventures do not share the same characteristics as a hedge fund or private equity fund. However, they expressed concern that joint ventures were defined too narrowly under the proposal because the exclusion was limited to joint ventures that were operating companies.[1777] Some

[1767] *See, e.g.,* Goldman (Covered Funds); BoA.

[1768] *See* Rep. Himes; Fin. Services Roundtable (June 14, 2011); SIFMA *et al.* (Covered Funds) (Feb. 2012); BOK; Chamber (Feb. 2012); ABA (Keating); GE (Feb. 2012); Wells Fargo (Covered Funds); Goldman (Covered Funds); Ass'n. of Institutional Investors (Feb. 2012); BoA; NAIB *et al.*

[1769] *See* Wells Fargo (Covered Funds); Credit Suisse (Williams).

[1770] *See* Credit Suisse (Williams).

[1771] Although not a condition of the exclusion, banking entities may use wholly-owned subsidiaries to engage in *bona fide* liquidity management. As discussed below, however, a wholly-owned subsidiary is itself a banking entity, and thus is subject to all of the requirements that apply to banking entities, including the requirements applicable to a banking entity's liquidity management activities under § ____.3(d)(3).

[1772] *See* final rule § ____.10(c)(2).

[1773] *Cf.* Section 2(a)(43) of the Investment Company Act (defining a ''wholly-owned subsidiary'' of a person to mean ''a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person'').

[1774] The Agencies also note that depositors for asset-backed securities offerings are important to the process of securitization. *See, e.g.,* ASF (July 2012) (noting that a depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities). *See also,* Rule 191 under the Securities Act of 1933 (17 CFR 230.191) (depositor as issuer for registered asset-backed securities offerings). Commenters raised a question about the treatment of depositors under the Investment Company Act, and therefore, whether they would technically fall within the definition of covered fund. *See* ASF (July 2012); GE (Aug. 2012). For purposes of the covered fund prohibitions, the Agencies note that depositors may fall within the wholly-owned subsidiary exclusion from the covered fund definition.

[1775] *See* 12 U.S.C. 1851(h)(1) (defining banking entity to include any affiliate or subsidiary of a banking entity).

[1776] *See* Joint Proposal, 76 FR 68,913.

[1777] *See, e.g.,* ABA (Keating); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Aug. 2012); Goldman (Covered Funds); NAIB *et al.;* Rep Himes; Sen. Bennet; *See also* 156 Cong

commenters criticized the lack of guidance regarding the meaning of operating company.[1778] One commenter proposed defining operating company as any company engaged in activities that are permissible for a financial holding company under sections 3 or 4 of the BHC Act, other than a company engaged exclusively in investing in securities of other companies for resale or other disposition.[1779]

Another commenter argued that joint ventures are often used to share risk from non-performing loans, credit card receivables, consumer loans, commercial real estate loans or automobile loans.[1780] According to this commenter, these joint ventures, while not generally viewed as operating companies, promote safety and soundness by allowing a banking entity to limit the size of its exposure to permissible investments or to more efficiently transfer the risk of existing assets to a small number of partners. Commenters stated that banking entities often employ similar types of non-operating company joint ventures to engage in merchant banking activities or other permissible banking activities, and that the final rule should not prevent a banking entity from sharing the risk of a portfolio company investment with third parties.[1781] A number of commenters argued that treating joint ventures as covered funds would create the same inconsistencies with other provisions and principles embodied in the Dodd-Frank Act noted for wholly-owned subsidiaries, were they to be treated as covered funds.[1782] Several commenters argued that the proposed exemption, as drafted, was unworkable because it did not appear to provide an exception to the intercompany limitations on transactions under section 13(f), which prohibits transactions between a banking entity and a related covered fund.[1783]

Commenters proposed several alternatives to address these issues. Several commenters recommended that the final rule eliminate the operating company condition under the proposed exemption.[1784] Other commenters recommended excluding joint ventures that have an unspecified but limited number of partners (such as five or fewer joint venture partners).[1785] One commenter recommended excluding all ''controlled joint ventures'' but did not provide an explanation of how to define that term.[1786] Another commenter suggested defining a joint venture in one of the following ways: (1) Any company with a limited number of co-venturers that is managed pursuant to a shareholders' agreement, as opposed to managed by a general partner;[1787] or (2) a joint venture in which: (a) There are a limited number of unaffiliated partners; (b) the parties operate the venture on a joint basis or in proportion to their relative ownership, including pursuant to a shareholders' agreement; (c) material decisions are made by one party (for example, a general partner); and (d) the joint venture does not engage in any activity or investment not permitted under section 13, other than activities or investments incidental to its permissible business.[1788]

In response to commenter concerns, the final rule excludes joint ventures from the definition of covered fund with some modifications from the proposal to more clearly identify entities that are excluded. Under the final rule, a joint venture is excluded from the definition of covered fund if the joint venture is between the banking entity or any of its affiliates and no more than 10 unaffiliated co-venturers, is in the business of engaging in activities that are permissible for the banking entity other than investing in securities for resale or other disposition, and is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[1789] Banking entities, therefore, will continue to be able to share the risk and cost of financing their banking activities through these types of entities which, as noted by commenters as discussed above, may allow banking entities to more efficiently manage the risk of their operations.

The Agencies have specified a limit on the number of joint venture partners at the request of many commenters that suggested such a limit be added (though typically without suggesting the specific number of partners). The Agencies believe that a limit of 10 partners allows flexibility in structuring larger business ventures without involving such a large number of partners as to suggest the venture is in reality a hedge fund or private equity fund established for investment purposes. The Agencies will monitor joint ventures—and other excluded entities—to ensure that they are not used by banking entities to evade the provisions of section 13.

The final rule's requirement that a joint venture not be an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities prevents a banking entity from relying on this exclusion to evade section 13 of the BHC Act by owning or sponsoring what is or will become a covered fund. Consistent with this restriction and to prevent evasion of section 13, a banking entity may not use a joint venture to engage in merchant banking activities because that involves acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment.[1790]

As with wholly-owned subsidiaries, if a banking entity owns 25 percent or more of the voting securities of the joint venture or otherwise controls an entity that qualifies for the joint venture exclusion, the joint venture would then itself be a banking entity and would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading).

The Agencies note that the statute defines banking entity to include not only insured depository institutions and bank holding companies, but also their affiliates. In the context of a company that owns an insured depository institution but is not a bank holding company or savings and loan holding company, the insured depository institution's affiliates may engage in commercial activities impermissible for banks and bank holding companies. However, section 13 of the BHC Act and the final rule do not authorize a banking entity to engage in otherwise impermissible activities. Because of this, the scope of activities in which a joint venture may engage under the final rule will depend on the status and identity of its co-venturers. For instance, a joint venture between a bank holding

Rec. H5226 (daily ed. June 30, 2010) (statement of Rep. Himes).

[1778] *See, e.g.,* ABA (Keating); NAIB *et al.;* GE (Aug. 2012); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); Wells Fargo (Covered Funds); Credit Suisse (Williams); Goldman (Covered Funds).

[1779] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1780] *See* Goldman (Covered Funds).

[1781] *See* ABA (Keating); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1782] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); Chamber (Feb. 2012).

[1783] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); GE (Feb. 2012); Chamber (Feb. 2012).

[1784] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); Credit Suisse (Williams).

[1785] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[1786] *See* Goldman (Covered Funds).

[1787] *See* ABA (Keating); Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); *See also* GE (Feb. 2012); NAIB *et al.*

[1788] *See* Goldman (Covered Funds).

[1789] *See* final rule § ____.10(c)(3).

[1790] *See* 12 U.S.C. 1843(k)(4)(H).

company and unaffiliated companies may not engage in commercial activities impermissible for a bank holding company.

4. Acquisition Vehicles

Similar to wholly-owned subsidiaries and joint ventures, the proposed rule would have permitted a banking entity to invest in or sponsor an acquisition vehicle provided that the sole purpose and effect of the acquisition vehicle was to effectuate a transaction involving the acquisition or merger of an entity with or into the banking entity or one of its affiliates. As noted in the proposal, banking entities often form corporate vehicles for the purpose of accomplishing a corporate merger or asset acquisition.[1791] Because of the way they are structured, acquisition vehicles may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1792]

Commenters supported the exclusion of acquisition vehicles from the restrictions governing covered funds, and argued that acquisition vehicles do not share the same characteristics as a hedge fund or private equity fund.[1793] However, similar to concerns articulated above with respect to wholly-owned subsidiaries and joint ventures, commenters argued that the proposed rule, as drafted, left uncertain how other provisions of section 13 would apply to these vehicles.[1794]

In light of the comments, the final rule has been modified to exclude acquisition vehicles from the definition of covered fund, rather than provide a permitted activity exemption for banking entities to invest in or sponsor the vehicles, so long as the vehicle is formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction and the vehicle exists only for such period as necessary to effectuate the transaction.[1795] The final rule thus reflects modifications from the exemption for acquisition vehicles in the proposal, which was available for acquisition vehicles where the sole purpose and effect of the entity was to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity.[1796] The Agencies modified the conditions in the final rule, as discussed above, to more clearly reflect the limited activities in which an excluded acquisition vehicle may engage and to exclude acquisition vehicles from the definition of covered fund, rather than only permit banking entities to invest in or sponsor them pursuant to an exemption.

The Agencies also note that an acquisition vehicle that survives a transaction would likely be excluded from the definition of covered fund under the separate exclusion for either joint ventures or wholly-owned subsidiaries described above. An acquisition vehicle that is controlled by a banking entity would be a banking entity itself and would be subject to the restrictions of section 13 and the final rule that apply to a banking entity.

5. Foreign Pension or Retirement Funds

Under the proposed rule, a foreign pension plan that relied on section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company (or that was a commodity pool), would have been a covered fund. Commenters argued that including pension funds within the definition of covered fund would produce many unexpected results for pension plans as well as plan participants.[1797]

Commenters generally argued that foreign pension or retirement funds are established by a foreign company or foreign sovereign for the purpose of providing a specific group of foreign persons with income during retirement or when they reach a certain age or meet certain predetermined criteria and are typically eligible for preferential tax treatment, and are not formed for the same purposes as hedge funds or private equity funds.[1798] Commenters argued that the definition of covered fund should not include certain foreign pension or retirement funds, including managed investment arrangements and wrap platforms, such as so-called ''superannuation funds,'' that are managed by foreign banks as part of providing retirement or pension schemes to foreign citizens pursuant to foreign law and are generally not available for sale to U.S. citizens. Commenters asserted that many foreign banking entities act as sponsor to and organize and offer foreign pension funds abroad as part of a foreign sovereign program to provide retirement, pension, or similar benefits to its citizens or workforce.[1799] These commenters contended that a foreign pension plan might itself rely on the exclusion in section 3(c)(1) or 3(c)(7) in order to avoid being an investment company if it is offered to citizens of the foreign sovereign present in the United States.[1800]

Several commenters argued that foreign pension and retirement plans should be excluded from the definition of covered fund on the same basis as U.S. pension and retirement funds that are ERISA-qualified funds that rely on the exclusion from the definition of investment company provided under section 3(c)(11) of the Investment Company Act.[1801] Commenters alleged that without an exclusion for foreign pension or retirement funds, section 13 of the BHC Act would have an extra-territorial effect on pension or retirement benefits abroad that would be severe and beyond what was contemplated by section 13 of the BHC Act.

In light of comments received on the proposal, the final rule excludes from the definition of covered fund a plan, fund, or program providing pension, retirement, or similar benefits that is: (i) Organized and administered outside of the United States; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and (iii) established for the benefit of citizens or residents of one or more foreign sovereign or any political subdivision thereof.[1802] This is similar to the treatment provided to U.S. pension funds by virtue of the exclusion from the definition of investment company under the Investment Company Act for certain broad-based

[1791] *Cf.* Joint Proposal, 76 FR 68,897.

[1792] *See* Joint Proposal, 76 FR 68,913; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1793] *See, e.g.,* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Feb. 2012); Sen. Bennet; Sen. Carper *et al.*

[1794] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; GE (Feb. 2012).

[1795] *See* final rule § ____.10(c)(4).

[1796] The proposed rule contained an exemption for investments in acquisition vehicles, provided that the ''the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the covered banking entity or one of its affiliates.'' *See* proposed rule § ____.14(a)(2)(ii). The final rule excludes an acquisition vehicle, which is defined as an issuer that is ''[f]ormed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction'' and that ''exists only for such period as necessary to effectuate the transaction.'' *See* final rule § ____.10(c)(4).

[1797] As explained above, commenters also argued that a foreign pension plan should not be considered a banking entity if the plan is sponsored by a banking entity or is established for the benefit of employees of the banking entity. If deemed a banking entity, the pension plan could become subject to the limits on section 13 on investing in covered funds. *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; Credit Suisse (Williams). The final rule addresses these comments with the exclusions described above.

[1798] *See, e.g.,* Allen & Overy (on behalf of Canadian Banks).

[1799] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1800] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

[1801] *See* Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

[1802] *See* final rule § ____.10(c)(5).

employee benefit plans provided by section 3(c)(11) of that Act. The exclusion from the covered fund definition for foreign plans would be available for *bona fide* plans established for the benefit of employees or citizens outside the U.S. even if some of the beneficiaries of the fund reside in the U.S. or subsequently become U.S. residents.

The Agencies believe this exclusion is appropriate in order to facilitate parallel treatment of domestic and foreign pension and retirement funds to the extent possible and to assist in ensuring that section 13 of the BHC Act does not apply to foreign pension, retirement, or similar benefits programs.[1803]

6. Insurance Company Separate Accounts

Under the proposed rule, insurance company separate accounts would have been covered funds to the extent that the separate accounts relied on section 3(c)(1) or 3(c)(7). Such reliance would generally occur in circumstances where policies funded by the separate account are distributed in an unregistered securities offering solely to qualified purchasers or on a limited basis to accredited investors. While the proposed rule did not generally exclude insurance company separate accounts from the definition of covered fund, the proposed rule did provide a limited exemption for investing in or acting as sponsor to separate accounts that were used for the purpose of allowing a banking entity to purchase bank owned life insurance (''BOLI''), subject to certain restrictions.[1804]

Various state or foreign laws allow regulated insurance companies to create separate accounts that are generally not separate legal entities but represent a segregated pool of assets on the balance sheet of the insurance company that support a specific policy claim on the insurance company. These accounts have assets and obligations that are separate from the general account of the insurance company. Insurance companies often utilize these separate accounts to allow policyholders of variable annuity and variable life insurance to allocate premium amounts for the purpose of engaging in various investment strategies that are tailored to the requirements of the individual policyholder. The policyholder, and not the insurance company, primarily benefits from the results of investments in the separate account. These separate accounts are generally investment companies for purposes of the Investment Company Act, unless an exclusion from that definition is applicable,[1805] and, as noted above, may rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

While most commenters supported the proposal's recognition that interests in BOLI separate accounts should be permitted, commenters generally argued that the final rule should also provide a broader exclusion from the definition of covered fund for all insurance company separate accounts. Commenters argued that covering separate accounts could lead to unintended consequences and was inconsistent with the statutory recognition that the business of insurance should continue to be accommodated.[1806] These commenters argued that covering separate accounts within the definition of covered fund would disrupt a substantial portion of customer-driven insurance or retirement planning activity and pose a burden on insurance companies and holders of insurance policies funded by separate accounts, a result commenters alleged Congress did not intend.[1807]

In response to commenter concerns and in order to more appropriately accommodate the business of insurance in a regulated insurance company, the final rule excludes an insurance company separate account from the definition of covered fund under certain circumstances. To prevent this exclusion from being used to evade the restrictions on investments and sponsorship of covered funds by a banking entity, the final rule provides that no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.[1808] In this manner, the final rule appropriately accommodates the business of insurance by permitting an insurance company that is a banking entity to continue to provide its customers with a variety of insurance products through separate account structures in accordance with applicable insurance laws while protecting against the use of separate accounts as a means by which banking entities might take a proprietary or beneficial interest in an account that engages in prohibited proprietary trading and thereby evade the requirements of section 13 of the BHC Act. The exclusion of insurance company separate accounts from the definition of covered fund therefore is designed to reduce the potential burden of the final rule on insurance companies and holders of insurance policies funded by separate accounts while also continuing to prohibit banking entities from taking ownership interests in, and sponsoring or having certain relationships with, entities that engage in investment and trading activities prohibited by section 13.

7. Bank Owned Life Insurance Separate Accounts

As explained above, bank owned life insurance (''BOLI'') is generally offered through a separate account held by an insurance company. In recognition of the fact that banking entities have for many years invested in life insurance policies that covered key employees, in accordance with supervisory policies established by the Federal banking agencies, the proposal contained a provision that would permit banking entities to invest in and sponsor BOLI separate accounts.[1809]

Many commenters supported the exemption in the proposal for BOLI separate accounts, arguing that permitting this kind of activity was appropriate and consistent with safety and soundness as well as financial stability.[1810] Conversely, one commenter objected to the proposed rule's exemption for investments in BOLI separate accounts, contending that such an exemption did not promote and protect the safety and soundness of banking entities or the financial stability of the United States.[1811]

After considering comments received on the proposal, the final rule excludes BOLI separate accounts from the definition of covered fund but maintains the substance of the conditions from the proposal designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that

[1803] Additionally and as discussed above, the prohibitions of section 13 and the final rule do not apply to an ownership interest that is acquired or retained by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of persons who are or were employees of the banking entity.

[1804] *See* proposed rule § ____.14(a)(1).

[1805] *See In re The Prudential Ins. Co. of Am.,* 41 S.E.C. 335, 345 (1963), *aff'd, The Prudential Ins. Co. of Am. v. SEC,* 326 F.2d 383 (3d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[1806] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *See also* STANY.

[1807] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *See also* STANY.

[1808] *See* final rule § ____.10(c)(6).

[1809] *See* proposed rule § ____.14(a)(1).

[1810] *See* ACLI (Jan. 2012); Mass. Mutual; Jones of Northwestern; AALU; BBVA; BoA; Chris Barnard; Clark Consulting (Feb. 7, 2012); Clark Consulting (Feb. 13, 2012); Gagnon of GW Financial.

[1811] *See* Occupy.

section 13 of the BHC Act was designed to address. In particular, in order for a separate account to qualify for the BOLI exclusion from the definition of covered fund, the final rule requires that the separate account be used solely for the purpose of allowing one or more banking entities (which by definition includes their affiliates) to purchase a life insurance policy for which such banking entity(ies) is a beneficiary.[1812] Additionally, if the banking entity is relying on this exclusion, the banking entity that purchases the insurance policy (i) must not control the investment decisions regarding the underlying assets or holdings of the separate account,[1813] and (ii) must participate in the profits and losses of the separate account in compliance with applicable supervisory guidance regarding BOLI.[1814]

When made in the normal course, investments by banking entities in BOLI separate accounts do not involve the types of speculative risks section 13 of the BHC Act was designed to address. Rather, these accounts permit the banking entity to effectively hedge and cover costs of providing benefits to employees through insurance policies related to key employees. Moreover, applying the prohibitions of section 13 to investments in these accounts would eliminate an investment that helps banking entities to efficiently reduce their costs of providing employee benefits, and therefore potentially introduce a burden to banking entities that would not further the statutory purpose of section 13. The Agencies expect this exclusion to be used by banking entities in a manner consistent with safety and soundness.

8. Exclusion for Loan Securitizations and Definition of Loan

a. Definition of Loan

The proposal defined the term ''loan'' for purposes of the restrictions on proprietary trading and the covered funds provisions and, as discussed in more detail below, provided an exemption for loan securitizations in two separate sections of the proposed rule. As proposed, loan was defined as ''any loan, lease, extension of credit, or secured or unsecured receivable.'' [1815] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security issued in connection with a loan securitization or otherwise backed by loans.

Some commenters requested that the Agencies narrow the proposed definition of ''loan.'' [1816] One of these commenters was concerned that the proposed definition could apply to any banking activity and argued that the definition of loan for purposes of the final rule should not include securities.[1817] Another commenter, citing a statement made by Senator Merkley, asserted that Congress did not intend the rule of construction for the sale and securitization of loans in section 13(g)(2) to include ''loans that become financial instruments traded to capture the change in their market value.'' [1818]

Other commenters requested that the Agencies expand the proposed definition of ''loan'' to capture many traditional extensions of credit that the proposal would otherwise exclude.[1819] Examples of traditional credit extensions that commenters requested be specifically included within the definition of ''loan'' included loan participations,[1820] variable funding notes or certificates,[1821] note purchase facilities,[1822] certain forms of revolving credit lines,[1823] corporate bonds,[1824] municipal securities,[1825] securities lending agreements and reverse repurchase agreements,[1826] auto lease securitizations,[1827] and any other type of credit extension that banking entities traditionally have been permitted to issue under their lending authority.[1828]

The definition of ''loan'' in the final rule applies both in the context of the proprietary trading restrictions as well as in determining the scope of the exclusion of loan securitizations and asset-backed commercial paper conduits from the definition of covered fund. The final rule modifies the proposed definition and defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1829] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1830] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading.

The definition of loan in the final rule excludes loans that are securities or derivatives, including securities or derivatives of or based on such instruments. The definition of ''loan''

[1812] *See* final rule § ____.10(c)(7).

[1813] This requirement is not intended to preclude a banking entity from purchasing a life insurance policy from an affiliated insurance company.

[1814] *See, e.g.,* Bank Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance (Dec. 7, 2004).

[1815] *See* proposed rule § ____.2(q).

[1816] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1817] *See* Public Citizen. This commenter argued that the loan definition should be limited to the plain meaning of the term ''loan'' and noted that a loan is not a security. *Id.*

[1818] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1819] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); Goldman (Covered Funds); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One individual commenter supported the proposed definition of loan. *See* Alfred Brock. For example, one commenter requested that definition of ''loan'' be revised to include ''(i) any loan, lease (including any lease residual), extension [of] credit, or secured or unsecured receivables, (ii) any note, bond or security collateralized and payable from pools of loans, leases (including Lease residuals), extensions of credit or secured or unsecured receivables, and (iii) any contractual rights arising from, or security interests or liens, assets, property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the foregoing.'' *See* RBC. Another commenter requested that the definition of ''loan'' be revised to include ''any type of credit extension (including bonds, other [banking entity-eligible] debt securities, asset-backed securities [as defined in their letter], variable funding notes and securities lending agreements, repurchase agreements, reverse repurchase agreements and other similar extensions of credit) that a banking entity could hold or deal in.'' *See* SIFMA (Securitization) (Feb. 2012).

[1820] *See* JPMC.

[1821] *See* ASF (Feb. 2012); Credit Suisse (Williams); JPMC (arguing that such notes operate in economic substance as loans); SIFMA (Securitization) (Feb. 2012).

[1822] *See* ASF (Feb. 2012). This commenter asserted that a note purchase facility is negotiated by the asset-backed commercial paper conduit and allows the asset-backed commercial paper conduit to purchase asset-backed securities issued by an intermediate special purpose vehicle and backed by loans or asset-backed securities backed by loans. *Id.*

[1823] *See* ASF (Feb. 2012).

[1824] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); JPMC.

[1825] *See* ASF (Feb. 2012). This commenter argued that certain municipal securities may be ABS, including revenue bonds that involve the issuance of senior and subordinate bonds. *Id.*

[1826] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1827] *See* SIFMA (Securitization) (Feb. 2012). This commenter contended that because securitization transactions have been viewed by the Agencies and courts as 'legally transparent' (*i.e.,* as simply another way for banking entities to buy and sell the loans or other assets underlying such securities), auto lease securitizations supported by a beneficial interest in a titling trust should be treated as securitizations of the underlying auto leases and should fall within the loan securitization exemption. This commenter also argued that if the definition of ''loan'' is not expanded to include securities, then banking entities could not act as sponsors for auto lease securitizations (including resecuritizations) supported by a beneficial interest in a titling trust.

[1828] *See* Credit Suisse (Williams); Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1829] *See* final rule § ____.2(s).

[1830] 12 U.S.C. 1851(h)(4).

does not specify the type, nature or structure of loans included within the definition, other than by excluding securities and derivatives. In addition, the definition of loan does not limit the scope of parties that may be lenders or borrowers for purposes of the definition. The Agencies note that the parties' characterization of an instrument as a loan is not dispositive of its treatment under the federal securities laws or federal laws applicable to derivatives. The determination of whether a loan is a security or a derivative for purposes of the loan definition is based on the federal securities laws and the Commodity Exchange Act. Whether a loan is a ''note'' or ''evidence of indebtedness'' and therefore a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan.[1831] For example, loans that are structured to provide payments or returns based on, or tied to, the performance of an asset, index or commodity or provide synthetic exposure to the credit of an underlying borrower or an underlying security or index may be securities or derivatives depending on their terms and the circumstances of their creation, use, and distribution.[1832] Regardless of whether a party characterizes the instrument as a loan, these kinds of instruments, which may be called ''structured loans,'' must be evaluated based on the standards associated with evaluating derivatives and securities in order to prevent evasion of the restrictions on proprietary trading and ownership interests in covered funds.

b. Loan Securitizations

An exemption for loan securitizations was contained in two separate sections of the proposed rule. The first, in section ____.13(a), was proposed as part of ''other permitted covered fund activities and investments.'' The second, in § ____.14(d), was proposed as part of ''covered fund activities determined to be permissible.'' These proposed provisions would have acted in concert to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a loan securitization regardless of the relationship that the banking entity had with the securitization. The Agencies have evaluated all comments received on securitizations. These sections of the proposed rule were intended to implement the rule of construction contained in section 13(g)(2) of the BHC Act which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise permitted by law.[1833] The language of the proposed exemption for loan securitizations would have permitted a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which were solely comprised of: (i) Loans (as defined); (ii) rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or rights or assets and (B) are used for hedging purposes with respect to the securitization structure.[1834] The proposed rule in § ____.13(d) was further augmented by the proposed rule in § ____.14(a)(2) so that a banking entity would be permitted to purchase loan securitizations and engage in the sale and securitization of loans. This was accomplished through the authorization in proposed section ____.14(a)(2) of a banking entity's acquisition or retention of an ownership interest in such securitization vehicles that the banking entity did not organize and offer, or for which it did not act as sponsor, provided that the assets or holdings of such vehicles were solely comprised of the instruments or obligations identified in the proposed exemption.

The proposed rules would have allowed a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in certain securitization vehicles (which could be a covered fund for purposes of the proposed rules) that the banking entity organized and offered, or acted as sponsor to, without being subject to the ownership and sponsor limitations contained in the proposed rule.[1835] As noted in the proposing release, the Agencies recognized that by defining ''covered fund'' broadly, and, in particular, by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act, securitization vehicles may be affected by the restrictions and requirements of the proposed rule. The Agencies attempted to mitigate the potential adverse impact on the securitization market by excluding loan securitizations from the restrictions on sponsoring or acquiring and retaining ownership interests in covered funds, consistent with the rule of construction contained in section 13(g)(2) of the BHC Act.[1836] As a result, under the proposal, loan securitizations would not be limited or restricted because banking entities would be able to find investors or buyers for their loans or loan securitizations. The proposing release included several requests for comment on the proposed loan securitization exemption and the application of the covered fund prohibitions to securitizations.

Some commenters supported a narrow exemption for loan securitizations and in some cases suggested that the proposed exemption could be narrowed even further. For example, one commenter argued that the definition of ''loan'' for purposes of the exemption could include any extension of credit and any banking activity.[1837] Also, in response to the proposing release,[1838] some commenters suggested that any exemption for securitizations should seek to prevent evasion of the covered fund prohibitions by issuers with ''hedge-fund or private equity fund-like characteristics'' or issuers with ''hidden proprietary trading operations.'' [1839]

On the other hand, many commenters believed that the proposed exemption

[1831] *See* 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10); *Reves* v. *Ernst & Young,* 494 U.S. 56 (1990); *Trust Company of Louisiana* v. *N.N.P. Inc.,* 104 F.3d 1478 (5th Cir. 1997); *Pollack v. Laidlaw Holdings,* 27 F.3d 808 (2d Cir. 1994); *but See Marine Bank* v. *Weaver,* 455 U.S. 551 (1982) ; *Banco Espanol de Credito* v. *Security Pacific National Bank,* 973 F.2d 51 (2d Cir. 1992); *Bass* v. *Janney Montgomery Scott, Inc.,* 210 F.3d 577 (6th Cir. 2000); *Piaubert* v. *Sefrioui,* 2000 WL 194140 (9th Cir. 2000).

[1832] *Id.*

[1833] *See* 12 U.S.C. 1851(g)(2).

[1834] *See* proposed rule § ____.13(d); Joint Proposal, 76 FR 68,912.

[1835] *Id.*

[1836] *See* Joint Proposal, 76 FR 68,931.

[1837] *See, e.g.,* Public Citizen. This commenter argued that any exemption should prevent evasion, should ensure that each exempted securitization reduces risk and should be designed to only serve client needs. A different commenter recommended a safe harbor available only to a particular pre-specified, transparent and standardized securitization structure, where Agencies would need to justify why the specified structure protects against the systemic risks associated with securitization. *See* AFR (Nov. 2012).

[1838] *See* Request for Comment No. 231 in the Proposing Release (noting that many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (*e.g.,* CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities) and requesting comment on how to prevent hedge funds or private equity funds from structuring around an exemption for asset-backed securities from the covered fund prohibitions).

[1839] *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. *But See* Credit Suisse (Williams) (arguing it would be difficult to use the typical structure and operation of securitizations to avoid the prohibition on proprietary trading because the structures are not set up to engage in the kind of proprietary trading about which Congress was concerned).

from the covered fund prohibitions for loan securitizations should be expanded to cover securitizations generally and not just loan securitizations. These commenters provided various arguments for their request to exempt all securitizations from the covered fund prohibitions, including that the regulation of securitizations was addressed in other areas of the Dodd-Frank Act,[1840] that securitization is essentially a lending activity,[1841] and that securitizations have ''long been recognized as permissible activities for banking entities.'' [1842]

Commenters recommending a broader exclusion for securitizations also provided a wide variety of specific suggestions or concerns. Some commenters suggested that permissible assets for a loan securitization include assets other than loans acquired in the course of collecting a debt previously contracted, restructuring a loan, during a loan work out or during the disposition of a loan or other similar situation.[1843] Commenters noted that, for example, rules 2a–7 and 3a–7 under the Investment Company Act define eligible assets for a securitization as not only including financial assets but also ''any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.'' [1844] Commenters requested that various additional rights or assets be added to the list of permissible assets held by a loan securitization such as cash and cash accounts,[1845] cash equivalents,[1846] and various other high quality short term investments, liquidity agreements or credit enhancements, certain beneficial interests in titling trusts used in lease securitizations or lease residuals.[1847] One commenter suggested that a loan securitization be permitted to include ''any contractual rights arising from or supporting obligations underlying or relating to the loans.'' [1848]

Others requested that loan securitizations also be permitted to hold repurchase agreements or unlimited amounts of various forms of securities, including municipal securities, asset-backed securities, credit-linked notes, trust certificates and ''equity like-rights.'' [1849] Some commenters requested that loan securitizations be permitted to hold a limited amount of certain rights such as securities.[1850] Commenters also had suggestions about the types of derivatives that an exempted securitization vehicle be permitted to hold.[1851] For example, one industry association requested that the loan securitization exemption include securitizations where up to 10 percent of the assets are held in the form of synthetic risk exposure that references ''loans that could otherwise be held directly'' under the proposal in order to achieve risk diversification.[1852] This commenter stated its belief that the rule of construction requires that synthetic exposures be permitted because they are used in certain types of loan securitizations.

In addition to requests that specific types of underlying assets be permitted under the loan securitization exemption, the Agencies also received comments about specific types of asset classes or structures. Some commenters suggested certain asset classes or structures should be an excluded securitization from the covered fund prohibitions including insurance-linked securities, collateralized loan obligations, tender option bonds, asset-backed commercial paper conduits (ABCP conduits), resecuritizations of asset-backed securities, and corporate debt re-packagings.[1853] In some cases, commenters believed that the Agencies should use their authority under section 13(d)(1)(J) of the BHC Act to exempt these types of vehicles. Some commenters identified other vehicles such as credit funds and issuers of covered bonds that they believed should be excluded from the covered fund prohibitions.[1854] On the other hand, the Agencies also received comment letters that argued that certain securitizations should not be exempted from the covered fund prohibitions, including resecuritizations, CDO-squared, and CDO-cubed securitizations because of concern about their complexity and lack of reliable performance data or ability to value those securities.[1855]

Because a loan securitization could still be a covered fund, several commenters expressed concern that the proposed loan securitization exemption, as drafted, did not exempt loan securitizations from the prohibitions of

[1840] *See* AFME *et al.;* Ass'n. of German Banks; Cleary Glottlieb; Credit Suisse (Williams); GE (Feb. 2012); IIB/EBF; RBC; SIFMA (Securitization) (Feb. 2012).

[1841] *See, e.g.,* Credit Suisse (Williams).

[1842] *See* Credit Suisse (Williams); JPMC. These commenters cited the sponsoring of asset-backed commercial paper conduits as an example of permissible bank securitization activity.

[1843] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); JPMC.

[1844] *See* GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012).

[1845] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams) (including cash that did not arise directly from the underlying loans); JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012).

[1846] *See* Cleary Gottlieb; Credit Suisse (Williams).

[1847] *See* JPMC (requesting high quality, highly liquid investments, including Treasury securities and highly rated commercial paper); LSTA (Feb. 2012); LSTA (July 2012) (requesting short-term highly liquid investments such as obligations backed by the full faith and credit of the United States, deposits insured by the Federal Deposit Insurance Corporation, various obligations of U.S. financial institutions and investments in money market funds); ASF (Feb. 2012); Commercial Real Estate Fin. Council; RBC (requesting short-term, high quality investments); Allen & Overy (on behalf of Foreign Bank Group) (requesting short-term eligible investments); Credit Suisse (Williams) (requesting government guaranteed securities, money market funds and other highly credit-worthy and liquid investments); Cleary Gottlieb (requesting money-market interests; SIFMA (Securitization) (Feb. 2012) (requesting associated investments which are customarily employed in securitization transactions). One commenter further noted that such investments are required by securitization documents. *See* Commercial Real Estate Fin. Council.

[1848] RBC. This commenter argued that the loan securitization exemptions as proposed would not permit ''traditional securitizations and securitizations with the characteristics of traditional securitizations'' and ''would effectively eliminate a substantial portion of the very securitization activities carried on by banks that the [loan securitization exemptions] are designed to preserve.''

[1849] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1850] *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; LSTA (Feb. 2012). LSTA (Feb. 2012) specifically requested that entities issuing collateralized loan obligations that are primarily backed by loans or loan participations also be permitted to hold a limited amount of corporate credit obligations. This commenter provided recommendations about such limitations—if the amount of such corporate credit obligations exceeded 10 percent, a CLO would not be able to purchase any assets other than senior, secured syndicated loans and temporary investments (as defined in the letter). If the amount of such assets exceeded 30 percent, the entity should not be able to purchase any assets other than loans.

[1851] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1852] *See* ASF (Feb. 2012). Permissible synthetic exposure would include ''credit default swaps, total return swaps or other agreements referencing corporate loans or corporate bonds pursuant to which the issuer is the seller of credit protection or otherwise 'long' the credit exposure of the reference corporate loan or bond, and receives a yield derived from the yield on the reference corporate loan or bond.''

[1853] *See* AFME *et al.;* ASF (July 2012); GE (Aug. 2012); Capital Group; Goldman (Covered Funds); LSTA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1854] *See* Goldman (Covered Funds) (requesting exclusion for credit funds). AFME *et al.* (requesting exclusion for covered bonds); FSA (Apr. 2012) (requesting exclusion for covered bonds); UKRCBC (requesting exclusion for covered bonds).

[1855] *See* Sens. Merkley & Levin (Feb. 2012). These commenters argued that there should be increased capital charges in line with the complexity of a securitization and using the ''high risk asset limitations on permitted activities to bar any securitization by a bank from using complex structures, re-securitization techniques, synthetic features, or other elements that may increase risk or make a risk analysis less reliable.''

section 13(f) of the BHC Act. As a result, one commenter noted that the proposed loan securitization exemptions would not have their intended result of excluding loan securitizations from the BHC Act restrictions applicable to covered funds.[1856]

Certain securitization transactions may involve the issuance of an intermediate asset-backed security that supports the asset-backed securities that are issued to investors, such as in auto lease securitizations and ABCP conduits. Commenters suggested that the Agencies should look through intermediate securitizations to the assets that support the intermediate asset-backed security to determine if those assets would satisfy the definition of ''loan'' for purposes of the loan securitization exemption. If those assets are loans, these commenters suggested that the entire securitization transaction should be deemed a loan securitization, even if the assets supporting the asset-backed securities issued to investors are not loans.[1857] However, some commenters argued that each step in a multi-step securitization should be viewed separately to ensure compliance with the specific restrictions in the proposal because otherwise a multi-step securitization could include impermissible assets.[1858] Some commenters also raised question about whether depositors would fall within the definition of ''investment company'' under the Investment Company Act and, therefore, may fall within the proposed definition of covered fund.[1859]

After considering carefully the comments received on sections of the proposed rule, the Agencies have determined to adopt a single section in the final provision relating to loan securitizations that would exclude loan securitizations that meet certain criteria contained in the rule from the definition of covered fund. The rule, as adopted, takes into account comments received on each of the conditions specified in the two loan securitization sections of the proposed provisions and has adopted those conditions with some clarifying changes from the proposed language. In addition, in response to comments, as discussed more fully below, the Agencies are adopting additional exclusions from the definition of covered fund for certain types of vehicles if they are backed by the same types of assets as the assets that are permitted to be held in the loan securitization exclusion. These additional exclusions are tailored to vehicles that are very similar to loan securitizations but have particular structural issues, which are described in more detail below.

In light of the comments received on the proposal, the final rule was revised to exclude from the definition of covered fund an issuing entity of asset-backed securities, as defined in Section 3(a)(79) of the Exchange Act,[1860] if the underlying assets or holdings are comprised solely of: (A) loans, (B) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans, (C) certain interest rate or foreign exchange derivatives, and (D) certain special units of beneficial interests and collateral certificates (together, ''loan securitizations'').[1861] In addition, as discussed below, the Agencies are adopting specific exclusions for certain vehicles that issue short term asset-backed securities and for pools of assets that are part of covered bond transactions which pools also meet the conditions delineated above.[1862]

Although commenters argued that various types of assets should be included within the definition of loan or otherwise permitted to be held under the loan securitization exclusion, the loan securitization exclusion in the final rule has not been expanded to be a broad exclusion for all securitization vehicles. Although one commenter suggested that any securitization is essentially a lending activity,[1863] the Agencies believe such an expansion of the exclusion would not be consistent with the rule of construction in section 13(g)(2) of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' The Agencies believe that a broad definition of loan and therefore a broad exemption for transactions that are structured as securitizations of pooled financial assets could undermine the restrictions Congress intended to impose on banking entities' covered fund activities, which could enable market participants to use securitization structures to engage in activities that otherwise are constrained for covered funds. The Agencies believe the purpose underlying section 13 is not to expand the scope of assets in an excluded loan securitization beyond loans as defined in the final rule and the other assets that the Agencies are specifically permitting in a loan securitization.

While not expanding the permitted assets under the loan securitization exclusion, the Agencies have made modifications in response to commenters to ensure that the provisions of the final rule appropriately accommodate the need, in administering a loan securitization transaction on an ongoing basis, to hold various assets other than the loans that support the asset-backed securities. Moreover, the Agencies do not believe that the assets permitted under the loan securitization need to be narrowed further to prevent evasion and hidden proprietary trading as requested by certain commenters because the Agencies believe that the potential for evasion has been adequately addressed through modifications to the definition of loan and more specific limitations on the types of securities and derivatives permitted in an excluded loan securitization. The Agencies have revised the scope of the loan securitization exclusion to accommodate existing market practice for securitizations as discussed by

[1856] *See* AFME *et al.;* SIFMA (May 2012) (arguing that because of the narrowness of the proposed exemption and because it would not exempt securitizations from prohibitions on covered transactions imposed by section 13(f), the rule as proposed ''will effectively prevent banking entities from sponsoring and owning a large variety of asset-backed securities, in contravention of the rule of construction.'')

[1857] *See* AFME *et al.;* ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1858] *See* Occupy; Public Citizen. Occupy contended that the structured security issued in a multi-step securitization can hide underlying risks under layers of structured complexity. *See* Occupy. Public Citizen argued that prohibiting such activity would ensure that securitizations do not become proprietary trading vehicles for banking entities that are effectively off-balance sheet. *See* Public Citizen. *See infra* Part IV.B.1.c.8.b.iv. of this **SUPPLEMENTARY INFORMATION.**

[1859] A depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities. *See* ASF (July 2012); GE (Aug. 2012). For purposes of this rule, the Agencies believe the wholly owned subsidiary exclusion is available for depositors. *See supra* note 1774.

[1860] 15 U.S.C. 78c(a)(79). This definition was added by Section 941 of the Dodd-Frank Act.

[1861] *See* final rule § ____.10(c)(8). Consistent with the proposal, certain securitizations, regardless of asset composition, would not be considered covered funds because the securitization issuer is deemed not to be an investment company under Investment Company Act exclusions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act. For example, this would include issuers that meet the requirements of section 3(c)(5) or rule 3a–7 of the Investment Company Act, and the asset-backed securities of such issuers may be offered in transactions registered under the Securities Act.

[1862] As discussed below, the Agencies are adopting an exclusion from the definition of covered funds for the pools of assets that are involved in the covered bond financings. Although the cover pools must satisfy the same criteria as the excluded loan securitizations, a separate exclusion is needed because the securities involved in the covered bond issuance are not asset-backed securities.

[1863] *See, e.g.,* Credit Suisse (Williams).

commenters while limiting the availability of the exclusion for these particular types of securitization transactions to issuers of asset-backed securities supported by loans.

The Agencies are not adopting specific exclusions for other securitization vehicles identified by commenters, including insurance-linked securities, collateralized loan obligations, and corporate debt re-packagings.[1864] The Agencies believe that providing such exclusions would not be consistent with the rule of construction in section 13(g)(2)of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' These other types of securitization vehicles referenced by commenters are used to securitize exposures to instruments which are not included in the definition of loan as adopted by the final rule. Moreover, the Agencies note in response to commenters that resecuritizations of asset-backed securities and CDO-squared and CDO-cubed securitizations could be used as a means of evading the prohibition on the investment in the ownership interests of covered funds.

As with the proposed rules, the Agencies are excluding certain loan securitizations from the definition of covered fund and therefore the prohibitions applicable to banking entities' involvement in covered funds in order to implement Congressional intent expressed in the rule of construction in section 13(g)(2) of the BHC Act.[1865] The Agencies believe that, as reflected in the rule of construction, the continued ability of banking entities to participate in loan securitizations is important to enable banks of all sizes to be able to continue to provide financing to loan borrowers at competitive prices. Loan securitizations provide an important avenue for banking entities to obtain investor financing for existing loans, which allows such banks greater capacity to continuously provide financing and lending to their customers. The Agencies also believe that loan securitizations that meet the conditions of the rule as adopted do not raise the same types of concerns as other types of securitization vehicles that could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act.

Under the rule as adopted, loan securitizations that meet the conditions of the rule as adopted are excluded from the definition of covered fund and, consequently, banking entities are not restricted as to their ownership of such entities or their ongoing relationships with such entities by the final rule. As the Agencies stated in the proposal, permitting banking entities to acquire or retain an ownership interest in these loan securitizations will allow for a deeper and richer pool of potential participants and a more liquid market for the sale of such securitizations, which in turn should result in the continued availability of funding to individuals and small businesses, as well as provide an efficient allocation of capital and sharing of risk. The Agencies believe that excluding these loan securitizations from the definition of covered fund is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction regarding loan securitizations.[1866]

i. Loans

The first condition of the loan securitization exclusion from the definition of covered fund is that the underlying assets or holdings are comprised of loans. In the proposal, ''loan'' was a defined term for purposes of the restrictions on proprietary trading and the covered funds provisions. As proposed, a loan was defined as a loan, lease, extension of credit, or secured or unsecured receivable.[1867] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans.

As discussed above under ''Definition of Loan,'' the Agencies received comments regarding the loan definition in the securitization context. In particular, one commenter, citing a statement made by Senator Merkley, argued that Congress did not intend the loan securitization exemption to include ''loans that become financial instruments traded to capture the change in their market value.'' [1868]

The Agencies, after considering carefully the comments received, have adopted a definition of loan that is revised from the proposed definition. The final rule defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1869] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1870] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading. Further, for purposes of the loan securitization exclusion, the loan securitization must own the loan directly; a synthetic exposure to a loan, such as through holding a derivative, such as a credit default swap, will not satisfy the conditions for the loan securitization exclusion.[1871] As such, a securitization that owns a tranche of another loan securitization is not itself a loan securitization, even if the ownership of such tranche by a banking entity would otherwise be permissible under the final rule.

As discussed above under ''Definition of Loan,'' the definition of loan in the final rule has not been expanded as requested by some commenters but has been clarified in some respects in response to comments. The final rule explicitly excludes securities or derivatives.[1872] In addition, the definition of loan has not been modified to include repurchase agreements or reverse repurchase agreements regardless of the character of the underlying asset. The Agencies are concerned that parties, under the guise of a ''loan'' might instead create instruments that provide the same exposures to securities and derivatives that otherwise are prohibited by section 13 and might attempt to use the loan securitization exclusion to acquire ownership interests in covered funds holding those types of instruments,

[1864] Commenters' concerns regarding credit funds are discussed below in Part IV.B.1.d.6. of this **SUPPLEMENTARY INFORMATION**.

[1865] As discussed below, the Agencies are excluding those loan securitizations that hold only loans (and certain other assets identified in the final rule), consistent with the rule of construction in section 13(g)(2) of the BHC Act.

[1866] The Agencies note that the loan securitization and other securitization exclusions apply only to the definition of covered fund, and therefore the covered fund-related provisions of the rule, and not to its prohibition on proprietary trading. The Agencies recognize that trading in loans is not subject to the proprietary trading restrictions.

[1867] *See* proposed rule § ____.2(q).

[1868] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1869] *See* § ____.2(r).

[1870] 12 U.S.C. 1851(h)(4).

[1871] Under the final provision, the issuing entity for the SUBIs and collateral certificate may rely on the loan securitization exclusion because of the separate provisions allowing such a holding.

[1872] The determination of whether an instrument falls outside the definition of loan because it is a security or a derivative is based on the federal securities laws and the Commodity Exchange Act. Whether a loan, lease, extension of credit, or secured or unsecured receivable is a note or evidence of indebtedness that is defined as a security under the federal securities laws will depend on the particular facts and circumstances, including the economic terms of the transaction. *See supra* note 1831 and accompanying text.

counter to the terms and the purpose of section 13 of the BHC Act. As the Agencies have noted previously, the rules relating to covered funds and to proprietary trading are not intended to interfere with traditional lending practices or with securitizations of loans generated as a result of such activities. Although the Agencies have revised the definition of loan in response to commenters' concerns as discussed above, the Agencies are not adopting a separate definition of loan for securitization transactions as requested by commenters. The Agencies believe that the definition of loan adopted in the final rule appropriately encompasses the financial instruments that result from lending money to customers.

ii. Contractual Rights or Assets

Under the proposed loan securitization definition, a covered fund that is an issuer of asset-backed securities would have been permitted to hold contractual rights or assets directly arising from those loans supporting the asset-backed securities.[1873] The proposal did not identify or describe such contractual rights or assets.

Commenters requested that the Agencies expand the list of contractual rights and assets that an issuer of asset-backed securities would be permitted to hold under the proposed loan securitization exemption.[1874] Examples of the additional rights and assets requested by commenters include cash and cash accounts;[1875] cash equivalents;[1876] liquidity agreements, including asset purchase agreements, program support facilities and support commitments;[1877] credit enhancements;[1878] asset-backed securities;[1879] municipal securities;[1880] repurchase agreements;[1881] credit-linked notes;[1882] trust certificates;[1883] lease residuals;[1884] debt securities;[1885] and derivatives.[1886] As an alternative, commenters requested that an issuer of asset-backed securities be permitted to hold under the proposed loan securitization exemption certain of such additional rights and/or assets up to a threshold, such as a specified percentage of the assets of such covered fund.[1887]

In response to comments, the final rule modifies the loan securitization exclusion from the proposal to identify the types of contractual rights or assets directly arising from those loans supporting the asset-backed securities that a loan securitization relying on such exclusion may hold. Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold contractual rights or assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans (''servicing assets'').[1888] The servicing assets are permissible in an excluded loan securitization transaction only to the extent that they arise from the structure of the loan securitization or from the loans supporting a loan securitization. If such servicing assets are sold and securitized in a separate transaction, they will not qualify as

[1873] *See* proposed rule § ____.13(d).

[1874] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Vanguard.

[1875] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams).

[1876] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of cash equivalents: government guaranteed securities, money market funds, and ''other highly credit-worthy and liquid investments'' (Credit Suisse (Williams)); and high quality, highly liquid investments, including Treasury securities and highly rated commercial paper (JPMC). In addition, LSTA (Feb. 2012) requested inclusion of the following: (i) Short-term highly liquid investments; (ii) direct obligations of, and obligations fully guaranteed as to full and timely payment by, the United States (or by any agency thereof to the extent such obligations are backed by the full faith and credit of the United States); (iii) demand deposits, time deposits or certificates of deposit that are fully insured by the Federal Deposit Insurance Corporation; (iv) corporate, non-extendable commercial paper; (v) notes that are payable on demand or bankers' acceptances issued by regulated U.S. financial institutions; (vi) investments in money market funds or other regulated investment companies; time deposits having maturities of not more than 90 days; (vii) repurchase obligations with respect to direct obligations and guaranteed obligations of the U.S. entered into with a regulated U.S. financial institution; and (viii) other investments with a maturity one year or less, with the requirement that each of the investments listed have, at the time of the securitization's investment or contractual commitment to invest therein, a rating of the highest required investment category.

[1877] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012).

[1878] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012). For example, SIFMA (Securitization) (Feb. 2012) requested inclusion of third party credit enhancements such as guarantees and letters of credit. Commenters requested inclusion of the following examples of credit enhancements: (i) External credit support of borrower obligations under such loans, including a credit support facilities, third party or parent guarantee, insurance policy, letter of credit or other contractual commitment to make payments or perform other obligations of the borrower under the loans (ASF (Feb. 2012)); and (ii) property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the loans (RBC).

[1879] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of asset-backed securities: (i) SUBI certificates (beneficial interests in titling trusts typically used in lease securitizations) (AFME *et al.;* ASF (Feb. 2012); GE (Aug. 2012); SIFMA (Securitization) (Feb. 2012)); (ii) ownership interests and bonds issued by CLOs (JPMC); a broad array of receivables that support asset-backed commercial paper (ICI (Feb. 2012)); certain notes, certificates or other instruments backed by loans or financial assets that are negotiated by the purchasing asset-backed commercial paper conduit (ASF (Feb. 2012); GE (Feb. 2012)); municipal securities that are technically ABS, including revenue bonds that involve the issuance of senior and subordinate bonds (ASF (Feb. 2012)); ownership interests in credit funds (as defined in their letter) (SIFMA *et al.* (Covered Funds) (Feb. 2012)); any note, bond or security collateralized and payable from pools of loans, leases (including lease residuals), extensions of credit or secured or unsecured receivables (RBC); asset-backed securities issued by intermediate vehicles in a securitization collateralized predominantly by loans and financial assets, and other similar instruments (Credit Suisse (Williams)); and asset-backed securities backed by loans or receivables that are originated by or owned by the sponsor of such securitization or which are issued by an entity that is organized under the direction of the same sponsor as the issuer of the covered fund (ASF (Feb. 2012)).

[1880] *See* ICI (Feb. 2012); Vanguard.

[1881] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1882] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1883] *See* Credit Suisse (Williams).

[1884] *See* ASF (Feb. 2012); GE (Feb. 2012); GE (Aug. 2012); RBC.

[1885] *See* GE (Aug. 2012).

[1886] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of derivatives: (i) Credit derivatives (without explanation) as a means of diversifying the portfolio (Japanese Bankers Association); (ii) synthetic securities that reference corporate credits or other debt (Credit Suisse (Covered Fund)); (iii) credit instruments or other obligations that the banking entity could originate or invest or deal in directly, including tranched or untranched credit linked notes exposed to the credit risk of such reference assets through a credit default swap or other credit derivative entered into by the related ABS Issuer (SIFMA (Securitization) (Feb. 2012)); (iv) any derivatives structured as part of the securitization of loans (without explanation) (Allen & Overy (on behalf of Foreign Bank Group)); (v) hedge agreements (Credit Suisse (Williams)); and (vi) any derivative, including a credit default swap, as and to the extent a banking entity could use such derivative in managing its own investment portfolio (SIFMA (Securitization) (Feb. 2012)).

[1887] *See* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); LSTA (Feb. 2012); LSTA (July 2012).

[1888] *See* final rule § ____.10(c)(8)(i)(B). The use of the term ''servicing assets'' is not meant to imply that servicing assets are limited to those contractual rights or assets related to the servicer and the performance of the servicer's obligations.

permissible holdings for the loan securitization exclusion.[1889]

In adopting this approach, the Agencies considered commenters' concerns and determined to revise the condition to be more consistent with the definition and treatment of servicing assets in other asset-backed securitization regulations, such as the exemption from the definition of ''investment company'' under rule 3a–7 promulgated under the Investment Company Act.[1890]

Although the Agencies have revised the proposal in response to commenters' concerns, the final rule does not permit a loan securitization to hold as servicing assets a number of instruments specifically requested by commenters whether in their entirety or as a percentage of the pool. Under the final rule, servicing assets do not include securities or derivatives other than as specified in the rule.

Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold securities if those securities fall into one of three categories.[1891] First, such loan securitizations may hold securities that are cash equivalents. For purposes of the exclusion for loan securitizations, the Agencies interpret ''cash equivalents'' to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities.[1892] Depending on the specific funding needs of a particular securitization, ''cash equivalents'' might include deposits insured by the Federal Deposit Insurance Corporation, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper.[1893] Second, such loan securitizations may hold securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities. Finally, such loan securitizations may hold securities that qualify as SUBIs or collateral certificates subject to the provisions set forth in the rule for such intermediate asset-backed securities.

The Agencies have specifically limited the types of securities held as eligible assets in a loan securitization that may be excluded from the definition of covered fund under the final rule, even in limited amounts, in order to assure that the types of securities are cash equivalents or otherwise related to the loan securitization and to prevent the possible misuse of the loan securitization exclusion to circumvent the restrictions on proprietary trading, investments in covered funds and prohibitions in section 13(f) of the BHC Act.[1894] The Agencies believe that types of securities other than those specifically included in the final rule could be misused in such manner, because without limitations on the types of securities in which an excluded loan securitization may invest, a banking entity could structure an excluded loan securitization with provisions to engage in activities that are outside the scope of the definition of loan as adopted and also to engage in impermissible proprietary trading. Further, the Agencies do not believe that the use of thresholds with respect to such other types of securities as an alternative is appropriate because similarly, such a securitization would then involve a securitization of non-loan assets, outside the scope of what the Agencies believe the rule of construction was intended to cover. By placing restrictions on the securities permitted to be held by an excluded loan securitization, the potential for evasion is reduced. Loan securitizations are intended, as contemplated by the rule of construction, to permit banks to continue to engage in securitizations of loans. Including all types of securities within the scope of permitted assets in an excluded loan securitization would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

iii. Derivatives

Under the proposed loan securitization definition, an exempted loan securitization would be permitted to hold interest rate or foreign exchange derivatives that materially relate to the terms of any loans supporting the asset-backed securities and any contractual rights or assets directly arising from such loans so long as such derivatives are used for hedging purposes with respect to the securitization structure.[1895] The Agencies indicated in the proposing release that the proposed loan securitization definition would not allow an exempted loan securitization to use credit default swaps.[1896]

Commenters criticized the proposed limitations on the use of derivatives included in the proposed loan securitization definition.[1897] In particular, one commenter indicated that the use of credit derivatives such as credit default swaps is important in loan securitizations to provide diversification of assets.[1898] Another commenter noted the use of such instruments to manage risks with respect to corporate loan and debt books by accessing capital from a broad group of capital markets investors and facilitates making markets.[1899] In contrast, two commenters generally supported the limitations on the use of derivatives under the proposed loan securitization definition and indicated that excluding credit default swaps from the loan securitization definition was appropriate.[1900]

[1889] For example, under the final rule, mortgage insurance policies supporting the mortgages in a loan securitization are servicing assets permissible for purposes of § ____.10(c)(8)(i)(B). However, a separate securitization of the payments on those mortgage insurance policies would not qualify for the loan securitization exclusion.

[1890] The Agencies believe that for purposes of the final rule, in the context of securitization, such related or incidental assets in a loan securitization should support or further, and therefore, be secondary to the loans held by the securitization vehicle.

[1891] *See* final rule § ____.10(c)(8)(iii).

[1892] If either the loans supporting the loan securitization or the asset-backed securities issued by the loan securitization are denominated in a foreign currency, for purposes of the exclusion a loan securitization would be permitted to hold foreign currency, cash equivalents denominated in foreign currency and foreign exchange derivatives that comply with § ____.10(c)(8)(iv).

[1893] Servicing assets should not introduce significant additional risks to the transaction, including foreign currency risk or maturity risk. For instance, funds on deposit in an account that is swept on a monthly basis should not be invested in securities that mature in 90 days.

[1894] Commenters expressed concerns about the use of securitization vehicles for evasion. *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1895] *See* Joint Proposal, 76 FR 68,912.

[1896] *Id.*

[1897] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012) (requesting that an excluded loan securitization be permitted to hold up to 10% of its assets in the form of synthetic risk exposure to loans); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012) (for CLOs); SIFMA (Securitization) (Feb. 2012).

[1898] *See* Japanese Bankers Ass'n. This commenter indicated that credit derivatives are important in securitizations to provide diversification when the desired mix of assets cannot be achieved.

[1899] *See* ASF (Feb. 2012). This commenter argued that for some loan securitizations, investors may *See*k a broader pool of credit exposures than the bank has available or can obtain to securitize in order to achieve risk diversification.

[1900] *See* AFR *et al.* (Feb. 2012); Public Citizen. One of these commenters stated that the credit default exclusion was appropriate because ''synthetic securitizations and resecuritizations were a key contributor to financial contagion during the crisis.'' *See* AFR *et al.* (Feb. 2012). Another commenter argued that the loan securitization definition should not permit the use of derivatives. *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity. This commenter also argued that the inclusion of derivatives in the loan securitization definition exceeded the Agencies' statutory authority. *Id.* Two senators

With respect to the use of derivatives, the Agencies are adopting the loan securitization exclusion substantially as proposed with certain modifications to reflect a restructuring of this provision in order to more closely align the permissible uses of derivatives under the loan securitization exclusion with the loans, the asset-backed securities, or the contractual rights and other assets that a loan securitization relying on the loan securitization exclusion may hold. As adopted, for a loan securitization to be eligible for the loan securitization exclusion, the loan securitization may hold only interest rate or foreign exchange derivatives that meet the following requirements: (i) The written terms of the derivatives directly relate to either the loans or the asset-backed securities that such loan securitization may hold under the other provisions of the loan securitization exclusion; and (ii) the derivatives reduce interest rate and/or foreign exchange risk with respect to risks related to either such loans, the asset-backed securities or the contractual rights or other assets that a loan securitization may hold.[1901]

The first requirement that the written terms of the derivatives ''directly relate'' to either the loans or the asset-based securities themselves is intended to quantitatively and qualitatively limit the use of derivatives permitted under the loan securitization exclusion.[1902] The Agencies would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding principal balance of the asset-backed securities.[1903] Moreover, under the loan securitization exclusion, the type of derivatives must be related to the types of risks associated with the underlying assets and may not be derivatives designed to supplement income based on general economic scenarios, income management or unrelated risks.

The second requirement that derivatives reduce the interest rate and/or foreign exchange risks related to either such loans, contractual rights or other assets, or such asset-backed securities is intended to permit the use of derivatives to hedge interest rate and/or foreign exchange risks that result from a mismatch between the loans and the asset-backed securities.[1904]

The Agencies believe that the statutory rule of construction should be implemented in a manner that does not limit or restrict the sale and securitization of loans. The Agencies further believe that the sale and securitization of credit exposures other than ''loans'' as defined in the rule, such as through securities or derivatives, could be abused. The derivatives that may be held in a loan securitization for purposes of the exclusion may not be used for speculative purposes. Consistent with the proposal, the loan securitization exclusion does not permit a loan securitization relying on such exclusion to hold credit default swaps or other types of derivatives whether or not they are related either to the underlying loans or the asset-backed securities.[1905] Under the final rule, a synthetic securitization in which the asset-backed securities are supported by cash flow from derivatives, such as credit default swaps and total return swaps, would not be permitted to rely on the loan securitization exclusion because such derivatives are excluded from the final rule's definition of loan specifically, as a derivative. Similarly, a loan securitization that relies on the loan securitization exclusion would not be permitted to hold a credit default swap or total return swap that references a loan that is held by the loan securitization. Under the final rule as adopted, an excluded loan securitization would not be able to hold derivatives that would relate to risks to counterparties or issuers of the underlying assets referenced by these derivatives because the operation of derivatives, such as these, that expand potential exposures beyond the loans and other assets, would not in the Agencies' view be consistent with the limited exclusion contained in the rule of construction under section 13(g)(2) of the BHC Act, and could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act. The Agencies believe that the use of derivatives by an issuing entity for asset-backed securities that is excluded from the definition of covered fund under the loan securitization exclusion should be narrowly tailored to hedging activities that reduce the interest rate and/or foreign exchange risks directly related to the asset-backed securities or the loans supporting the asset-backed securities because the use of derivatives for purposes other than reducing interest rate risk and foreign exchange risks would introduce credit risk without necessarily relating to or involving a reduction of interest rate risk or foreign exchange risk.

On the other hand, while the Agencies are not expanding the types of permitted derivatives to be held in a loan securitization, the Agencies in the final rule are not restricting the use of all derivatives under the loan securitization exclusion as requested by certain commenters. The Agencies believe that a loan securitization that is excluded from the definition of covered fund should be allowed to engage in activities that reduce interest rate and foreign exchange risk because the hedging of such risks is consistent with the prudent risk management of interest rate and currency risk in a loan portfolio while at the same time avoiding the potential for additional risk arising from other types of derivatives.[1906] The Agencies do not believe that the exemption for hedging activity applicable to market making and underwriting under the final rule is the appropriate measure for permitted derivatives in a loan securitization that would be excluded from definition of covered fund[1907] because the hedging exemptions for market making and underwriting are not tailored to the hedging requirements of a securitization transaction.[1908] The Agencies also do not believe that they lack the statutory authority to permit a loan securitization

indicated that ''complex securitizations'' including those with ''synthetic features'' and ''embedded derivatives'' should not be allowed to rely on the exclusion for loan securitizations. *See* Sens. Merkley & Levin (Feb. 2012).

[1901] *See* final rule § ____.10(c)(8)(iv).

[1902] Under the final rule, the Agencies expect that a loan securitization relying on the loan securitization exclusion would not have a significant amount of interest rate and foreign exchange derivatives with respect to risks arising from contractual rights or other assets.

[1903] For example, a $100 million securitization cannot be hedged using an interest rate hedge with a notional amount of $200 million.

[1904] The derivatives permitted in a securitization that may rely on the loan securitization exclusion would permit a securitization to hedge the risk resulting from differences between the income received by the issuing entity and the amounts due under the terms of the asset-backed securities. For example, fixed rate loans could support floating rate asset-backed securities; loans with an interest rate determined by reference to the Prime Rate could support asset-backed securities with an interest rate determined by reference to LIBOR; or Euro-denominated loans could support U.S. Dollar-denominated asset-backed securities.

[1905] Loan securitizations excluded from the covered fund definition may only hold certain directly related derivatives as specified in § ____.11(c)(8)(iv) and as discussed in this Part.

[1906] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1907] *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity.

[1908] For example, a banking entity may hold an ownership interest in a covered fund in order to hedge employee compensation risks. Because securitizations do not have employees, such a hedging exemption would not be applicable to a securitization structure.

relying on the loan securitization exclusion to use derivatives, as suggested by one commenter,[1909] because the Agencies believe that the permitted derivatives relate directly to loans that are permitted and have limited the quality and quantity of derivatives that an excluded loan securitization is permitted to hold directly to the reduction of risks that result from the loans and the loan securitization.

While loan securitizations that include non-loan assets are not excluded from the definition of covered fund, banking entities are not prohibited from owning interests or sponsoring these covered funds under the final rule. Under the final rule, these securitizations would be covered funds, and banking entities engaged with these covered funds would be subject to the limitations on ownership interests and relationships with these covered funds imposed by section 13 of the BHC Act.

iv. SUBIs and Collateral Certificates

Commenters also argued that, under the proposed exemption for loan securitizations, securitizations that are backed by certain intermediate asset-backed securities would not satisfy the conditions for the exemption and therefore would be subject to the covered fund prohibitions.[1910] For example, commenters noted that, in a securitization of leases with respect to equipment where a titling trust is used to hold ownership of the equipment, a titling trust will typically own the equipment and the right to payment on the leases, and then will issue a security or other instrument, often referred to as a special unit of beneficial interest (SUBI), that represents an ownership interest in the titling trust to the securitization issuer.[1911] As another example, certain securitizations frequently use a master trust structure allowing the trust to issue more than one series of asset-backed security collectively backed by a common revolving pool of assets. In such a structure, a master trust may hold assets (such as loans) and issue a collateral certificate supported by those assets to an issuing trust that issues asset-backed securities to investors. The assets held by the master trust are typically a pool of revolving accounts that may be paid in full each month (*e.g.,* credit card receivables) or a revolving pool of short-term loans that are replaced with new loans as they mature (*e.g.,* floor plan loans).[1912] One commenter opposed the inclusion of securitizations backed by intermediate asset-backed securities, arguing that each step should be viewed separately to ensure compliance to prevent the inclusion of impermissible assets such as prohibited derivatives.[1913]

In response to comments, the Agencies are modifying the proposal to provide that a securitization backed by certain intermediate asset-backed securities will qualify for the loan securitization exclusion. The Agencies recognize that securitization structures that use these types of intermediate asset-backed securities are essentially loan securitization transactions, because the intermediate asset-backed securities in the asset pool are created solely for the purpose of facilitating a securitization [1914] and once created, are issued directly into a securitization vehicle rather than to any third party investor.

Under the final rule, a loan securitization that is excluded from the definition of covered fund may include SUBIs or collateral certificates, provided that four conditions are met.[1915] First, the special purpose vehicle issuing the SUBI or collateral certificate itself must meet the conditions of the loan securitization exclusion, as adopted in the final rule.[1916] Under this provision, for example, the special purpose vehicle, in addition to the issuing entity, may hold an interest rate or foreign exchange derivative or other assets only if the derivative or asset is permitted to be held in accordance with the requirements for derivatives in respect of the loan securitization exclusion. Second, the SUBI or collateral certificate must be used for the sole purpose of transferring economic risks and benefits of the loans (and other permissible assets) [1917] to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures. Third, the SUBI or collateral certificate must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization. Fourth, the special purpose vehicle issuing the SUBI or collateral certificate and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction. The Agencies believe that the fourth condition will ensure that the resecuritizations of asset-backed securities purchased in the secondary market, which the Agencies do not believe would constitute a loan securitization, will not be able to use these special provisions tailored only for transactions utilizing SUBIs and collateral certificates in order to fall within the loan securitization exclusion.

The Agencies believe that these conditions provide that only securitizations backed by SUBIs and collateral certificates involving loans—and not other types of securities or other types of assets—will be able to use the loan securitization exclusion. These conditions are intended to assure that for purposes of the loan securitization exclusion that only SUBI and collateral certificates that essentially represent the underlying loans are included consistent with the terms and the purpose of section 13 of the BHC Act, while also not adversely affecting securitization of ''loans'' as defined in the final rule.[1918] The Agencies believe that the limitation of the types of asset-backed securities permitted in an excluded loan securitization (only SUBIs and collateral certificates) and the restrictions placed on those SUBIs and collateral certificates that are permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

v. Impermissible Assets

As discussed above, commenters on the loan securitization proposals argued that various types of assets should be included within the definition of loan or otherwise permitted to be held by the loan securitization that would be entitled to rely on the proposed exemptions.

After considering comments, the Agencies have determined to retain the narrower scope of the permitted assets in a loan securitization that is eligible for the loan securitization exclusion.

[1909] *See* Occupy.

[1910] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Aug. 2012); PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1911] *See* SIFMA (Securitization) (Feb. 2012).

[1912] *See, e.g.,* ASF (Feb. 2012). UK RMBS master trusts also use a master trust structure. *See* AFME *et al.;* ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1913] *See* Occupy.

[1914] The use of SUBIs, for example, allows the sponsor to avoid administrative expenses in retitling the physical property underlying the leases.

[1915] *See* final rule § ____.10(c)(8)(v).

[1916] The provision will allow for the existing practice of a master trust to hold a collateral certificate issued by a legacy master trust.

[1917] This would include a collateral certificate issued by a legacy master trust that meets the requirements of the loan securitization exclusion.

[1918] *See, e.g.,* rule 190 under the Securities Act. *See also, e.g.,* ASF (Feb. 2012) (noting that certain rules under the Securities Act and staff interpretations have carved out SUBIs and collateral certificates from certain disclosure and other requirements).

The Agencies have revised the language regarding loan securitizations from the proposal to specify certain types of assets or holdings that a loan securitization would not be able to hold if it were eligible to rely on the exclusion from the definition of covered fund for loan securitizations.[1919] The Agencies recognize that securitization structures vary significantly and, accordingly, the loan securitization exclusion as adopted in the final rule accommodates a wider range of securitization practices. The Agencies believe that these limitations provide that only securitizations backed by loans—and not securities, derivatives or other types of assets—will be able to use the loan securitization exclusion consistent with the terms and the purpose of section 13 of the BHC Act.[1920] The Agencies believe that the limitation of the types of assets permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

Under the final rule, in order to be excluded from the definition of covered fund, a loan securitization may not hold (i) a security, including an asset-backed security, or an interest in an equity or debt security (unless specifically permitted, such as with respect to a SUBI or collateral certificate as described above), (ii) a derivative other than an interest rate or foreign exchange derivative that meets the requirements described above,[1921] or (iii) a commodity forward contract.[1922] The Agencies have determined that a loan securitization relying on the loan securitization exclusion may not include a commodity forward contract because a commodity forward contract is not a loan.[1923]

9. Asset-Backed Commercial Paper Conduits

Under the proposed rule, certain securitization vehicles, including ABCP conduits, would not have been covered by the loan securitization exclusion and, therefore, would have been deemed to be a covered fund.[1924] ABCP is a type of liability that is typically issued by a special purpose vehicle (commonly referred to as a ''conduit'') sponsored by a financial institution or other entity. The short term asset-backed securities issued by the conduit are supported by a managed pool of assets, which may change over the life of the entity. Depending on the type of ABCP conduit, the securitized assets ultimately supporting the short term asset-backed securities may consist of a wide range of assets including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans in addition to asset-backed securities supported by such assets. The term of ABCP typically is short, and the liabilities are ''rolled'' (*i.e.,* replaced or refinanced) at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.[1925] In this regard, in the proposing release, the Agencies requested comment on the proposed rule's definition of ''covered fund'' with respect to asset-backed securities and/or securitization vehicles[1926] and received numerous comments requesting a variety of exemptions for ABCP conduits.[1927]

A number of commenters requested that the final rule exclude ABCP conduits from the definition of covered fund[1928] or that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act[1929] to similar effect.[1930] One commenter argued that ABCP conduits do not have the characteristics of a private equity fund or hedge fund,[1931] even though they typically rely on the exemptions set forth in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Another commenter argued that the proposed rule's definition of covered fund would negatively impact asset-backed securitizations (including ABCP conduits), and suggested that the Agencies define covered funds, in part, as those that both (i) rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and (ii) have the traditional characteristics of private equity funds or hedge funds.[1932] Another commenter stated that the rule of construction set forth in section 13(g)(2) of the BHC Act[1933] is a clear indication that section 13 of the BHC Act was not intended to apply to securitization vehicles such as ABCP conduits.[1934] Another commenter stated that the lending that occurs through ABCP conduits is the type of activity that Congress and the Executive Branch have urged banks to expand in order to support economic growth and job creation,[1935] while another commenter stated that ABCP conduits provide low cost, reliable financing for registered investment companies, which poses little risk to the safety and soundness of banks because federal law requires registered investment companies to maintain prescribed asset coverage in connection with borrowings.[1936]

Two commenters contended that, while certain issuers of asset-backed securities may rely on section 3(c)(5) of the Investment Company Act or rule 3a–7 thereunder, and, therefore, not be brought under the proposed rule's definition of covered fund, ABCP conduits typically cannot rely on this section or rule either because to do so would be too restrictive (in the case of section 3(c)(5)) or because they cannot meet the rule's requirements.[1937]

One commenter, employing ABCP conduits as an example, stated that failing to exempt securitization vehicles from the covered fund prohibitions would preclude banking entities from engaging in activities that have long been recognized as permissible activities for banking entities and that are vital to the normal functioning of the securitization markets, and will have a significant and negative impact on the securitization markets and on the ability of banking entities and other companies to provide credit to their customers.[1938] This commenter further stated that ABCP conduits are an efficient and

[1919] *See* final rule § ____.10(c)(8)(ii).

[1920] The Agencies discuss earlier in this Part the permissible assets an excluded loan securitization may hold and the Agencies' belief that excluding loan securitizations as defined in the final rule is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction in section 13(g)(2). *See, e.g., supra* note 1866 and accompanying and following text.

[1921] *See* final rule § ____.10(c)(8)(iv); *See also* 7 U.S.C. 27(a)–(b).

[1922] *See* the discussion above in Part IV.B.1.c.8 of this **SUPPLEMENTARY INFORMATION.**

[1923] For a discussion of commodity forward contracts, *See* Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement;'' Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208 (Aug. 13, 2012) (Release Nos. 33–9338 and 34–67453, July 18, 2012).

[1924] *See* proposed rule § ____.13(d).

[1925] Structured investment vehicles (''SIVs'') and securities arbitrage ABCP programs both purchase securities (rather than receivables and loans). SIVs typically lack liquidity facilities covering all of these liabilities issued by the SIV, while securities arbitrage ABCP programs typically have such liquidity coverage, though the terms are more limited than those of the ABCP conduits eligible for the exclusion pursuant to the final rule.

[1926] *See* Joint Proposal, 76 FR 68,899.

[1927] *See, e.g.,* ASF (Feb. 2012); BoA; Capital Group; Eaton Vance; Fidelity; ICI (Feb. 2012); Japanese Bankers Ass'n.; PNC; RBC.

[1928] *See, e.g.,* ICI (Feb. 2012); PNC *et al.;* SIFMA (May 2012).

[1929] *See* 12 U.S.C. 1851(d)(1)(J).

[1930] *See* ICI (Feb. 2012).

[1931] *See* PNC.

[1932] *See* Barclays.

[1933] *See* 12 U.S.C. 1851(g)(2).

[1934] *See* ICI (Feb. 2012).

[1935] *See* Credit Suisse (Williams).

[1936] *See* Eaton Vance.

[1937] *See* RBC; ASF (Feb. 2012).

[1938] *See* Credit Suisse (Williams).

attractive way for banking entities to lend their own credit-worthiness to expand the pool of possible lenders willing to finance key economic activity while maintaining a low cost of funding for consumers, and because of the liquidity support provided by the sponsoring banking entity, the sponsoring banking entity to the ABCP conduit has full exposure to the assets acquired by or securing the amounts lent by the ABCP conduit and the banking entity subjects those assets and the obligors to the same analysis as it would engage in if the bank were lending directly against those assets.[1939] Another commenter stated that the provision of credit to companies to finance receivables through ABCP conduits is an area of traditional banking activity that should be distinguished from the type of high-risk, conflict-ridden financial activities that Congress sought to restrict under section 13 of the BHC Act.[1940]

To this end, commenters proposed several means to exclude ABCP conduits from the proposed rule's restrictions and requirements, including an expansion of the loan securitization exemption to treat two-step securitization transactions as a single loan securitization,[1941] a separate exclusion for ABCP conduits,[1942] an expansion of the definition of loan,[1943] or as part of a broad exclusion for all issuers of asset-backed securities.[1944] In order to allow ABCP conduits to qualify as loan securitizations, commenters suggested that the loan securitization exclusion should permit a limited amount of securities purchased in the secondary market.[1945] Commenters also proposed changes to the permissible assets such as allowing a loan securitization to hold liquidity and support commitments, asset-backed securities and certain financial assets in addition to loans that by their terms convert to cash within a finite period of time.[1946] Another commenter argued that the loan securitization exemption should allow banking entities to sponsor, control, and invest in ABCP conduits that facilitate the securitization of customer loans and receivables.[1947] In contrast, one commenter supported the restriction of the loan securitization exemption to the plain meaning of what constitutes a loan and advocated that the Agencies not include ABCP conduits under the exemption.[1948]

In addition to the effect the proposed rule's definition of covered fund would have on ABCP conduits, commenters also noted that section 13(f) of the BHC Act[1949] would prohibit certain transactions between a banking entity sponsor and a covered fund securitization.[1950] Two commenters requested a specific exemption from § ____.16 of the proposed rule for ABCP conduits based on the interpretation that the proposed rule subjects covered funds exempted under the loan securitization exemption or other exemptions to § ____.16.[1951] Commenters argued that without liquidity and credit support, ABCP conduits are not viable,[1952] cannot effectively operate,[1953] could not function,[1954] or would not be marketable.[1955] One commenter argued that prohibiting a banking entity from providing liquidity facilities to ABCP conduits is tantamount to requiring the banking entity to wind down the operation of such ABCP conduits.[1956]

In response to the comments received and in light of the rule of construction contained in section 13(g)(2) of the BHC Act, the Agencies have determined in the final rule to exclude from the definition of covered fund an ABCP conduit that is a ''qualifying asset-backed commercial paper conduit'' as defined in the final rule is excluded from the definition of covered fund.[1957]

Under the final rule, a qualifying asset-backed commercial paper conduit is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization[1958] and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.[1959] In addition, a qualifying asset-backed commercial paper conduit must issue only asset-backed securities, comprising of a residual and securities with a term of 397 days or less and in addition, a ''regulated liquidity provider,'' as defined in the final rule, must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term asset-backed

[1939] *Id.*

[1940] *See* ICI (Feb. 2012). This commenter emphasized the importance of the ABCP conduit market to money market funds, noting that as of November 2011, taxable money market funds held $126 billion of the $348.1 billion of securities issued by ABCP conduits outstanding, which represented approximately 5.4% of taxable money market funds' total assets. Another commenter noted that approximately $66.7 billion of automobile loans and leases, $52.1 billion of student loans, $22.3 billion of credit card charges, $49.4 billion of loans to commercial borrowers and $50.7 billion of trade receivables were financed by the U.S. ABCP conduit market as of October 31, 2011, and that the total outstanding amount of securities sold by ABCP conduits in the U.S. market was $344.5 billion as of January 18, 2012. *See* ASF (Feb. 2012).

[1941] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); PNC; SIFMA (Securitization) (Feb. 2012).

[1942] *See* ASF (Feb. 2012); Capital Group (alleging that ABCP does not pose the risks that the rule is meant to combat); GE (Feb. 2012). One commenter proposed an exemption for ABCP conduits that included a requirement of 100% liquidity support from a regulated, affiliated entity, and such liquidity support may be conditional or unconditional. *See* RBC.

[1943] *See* Credit Suisse (Williams) (alleging that ABCP conduits acquire ownership of loans indirectly through the purchase of variable funding notes, trust certificates, asset-backed securities, repurchase agreements and other instruments that may be considered securities, all of which economically are consistent with providing funding or extensions of credit to customers); ICI (Feb. 2012) (requesting that the definition of loan include the broad array of receivables that back ABCP).

[1944] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1945] *See* ASF (Feb. 2012) (requesting that ABCP conduits be permitted to own asset-backed securities purchased on the secondary market only if the aggregate principal amount of such securities does not exceed 5% of the aggregate principal or face amount of all assets held by the ABCP conduit in order to diversify their asset base and avoid the negative consequences of divestiture of such assets); RBC (requesting that loan securitizations be permitted to hold cash equivalents and assets, other than loans, which, by their terms, convert to cash within a finite period of time so long as such assets comprise no more than 10% of their total assets based on book value).

[1946] *See* ASF (Feb. 2012) (arguing that the loans, receivables, leases, or other assets purchased by the ABCP conduit might have fit the definition of loan in the proposed rules but for the proposal's express assertion that the definition of loan does not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans). *See* Joint Proposal, 76 FR 68,865; GE (Feb. 2012); RBC.

[1947] *See* PNC.

[1948] *See* Public Citizen.

[1949] *See* 12 U.S.C. 1851(f); *See also* § ____.16 of the proposed rule.

[1950] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Fidelity; IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1951] *See* ICI (Feb. 2012); Fidelity.

[1952] *See* JPMC.

[1953] *See* ASF (Mar. 2012).

[1954] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1955] *See* ASF (Feb. 2012); Fidelity.

[1956] *See* ASF (Mar. 2012).

[1957] *See* final rule § ____.10(c)(9)(i). The rule of construction contained in section 13(g)(2) of the BHC Act provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise permitted by law. As noted above and explained below, a qualifying asset-backed commercial paper conduit under the final rule is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.

[1958] *See* final rule § ____.10(c)(8).

[1959] *See* final rule § ____.10(c)(9)(i)(B).

securities issued by the qualifying asset-backed commercial paper conduit in the event that funds are required to redeem the maturing securities.[1960]

Under the final rule, a regulated liquidity provider is (i) a depository institution as defined in section 3 of the Federal Deposit Insurance Act;[1961] (ii) a bank holding company or a subsidiary thereof;[1962] (iii) a savings and loan holding company,[1963] provided all or substantially all of the holding company's activities are permissible for a financial holding company,[1964] or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in section 211.21 of the Federal Reserve Board's Regulation K[1965] has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof or (v) a sovereign nation.[1966] In order for a sovereign nation to qualify as a regulated liquidity provider, the liquidity provided must be unconditionally guaranteed by the sovereign, which would include its departments and ministries, including the central bank.

In this regard, under the final rule, the exclusion from the definition of covered fund in respect of ABCP conduits is only available to an issuer of short-term asset-backed securities supported by loans and certain asset-backed securities supported by loans that were issued or initially sold to the ABCP conduit, and the short term asset-backed securities issued by the ABCP conduit are supported by a liquidity facility that provides 100 percent liquidity coverage from a regulated liquidity provider. The exclusion, therefore, is not available to ABCP conduits that lack 100 percent liquidity coverage. The liquidity coverage may be provided in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement and 100 percent liquidity coverage means that, in the event the qualifying asset-backed commercial paper conduit is unable for any reason to repay maturing asset-backed securities issued by the issuing entity, the total amount for which the regulated liquidity provider may be obligated is equal to 100 percent of the amount of asset-backed securities outstanding plus accrued and unpaid interest. In addition, amounts due pursuant to the required liquidity coverage may not be subject to the credit performance of the asset-backed securities held by the qualifying asset-backed commercial paper conduit or reduced by the amount of credit support provided to the qualifying asset-backed commercial paper conduit. Under the final rule, liquidity coverage that only funds an amount determined by reference to the amount of performing loans, receivables, or asset-backed securities will not be permitted to satisfy the liquidity requirement for a qualifying asset-backed commercial paper conduit.

As discussed above, the final rule defines a qualifying asset-backed commercial paper conduit as having certain elements. First, a qualifying asset-backed commercial paper conduit must issue only a residual interest and short-term asset-backed securities. This requirement distinguishes ABCP conduits from covered funds that issue partnership interests and mitigates the potential that a qualifying ABCP conduit would be used for evasion of the covered fund prohibitions. The Agencies chose a maximum term of 397 days for these securities because this time frame corresponds to the maximum maturity of securities allowed to be purchased by money market funds under Rule 2a–7 of the Investment Company Act.

Second, the asset-backed securities issued by the ABCP conduit must be supported only by loans and certain asset-backed securities that meet the requirements of the loan securitization exclusion. By placing restrictions on the assets permitted to be held by an excluded loan securitization, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for qualifying ABCP conduits is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banks to continue to engage in securitizations of loans. Including all types of securities and other assets within the scope of permitted assets in a qualifying ABCP conduit, as with loan securitizations, would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

Third, the asset-backed securities supporting a qualifying asset-backed commercial paper conduit must be purchased as part of the initial issuance of such asset-backed securities. Asset-backed securities purchased by an ABCP conduit in the secondary market will not be permitted because such a purchase would not be part of an initial issuance and the banking entity that established and manages the ABCP conduit would not have participated in the negotiation of the terms of such asset-backed securities. Without a more direct connection between the banking entity and the ABCP conduit, the purchase of such asset-backed securities in the secondary market would resemble investments in securities.

Fourth, under the final rule, the ABCP conduit exclusion will not be available to ABCP conduits that lack 100 percent liquidity coverage. The Agencies believe that the 100 percent liquidity coverage requirement distinguishes the conduits eligible for the exemption, which sometimes hold and securitize a customer's loans through an intervening special-purpose vehicle instead of holding the loans directly, and are supported by a 100 percent liquidity guarantee, from other types of conduits with partial liquidity guarantees (such as structured investment vehicles) that have sometimes been operated by banking entities for the purpose of financing portfolios of securities acquired or retained as part of their activities in the securities markets.

The Agencies recognize that ABCP conduits that do not satisfy the elements of the ABCP conduit exclusion may be covered funds and therefore would be subject to section 13(f) of the BHC Act.[1967] As a result of section 13(f) of the BHC Act, which prohibits certain transactions between banking entities and a covered fund securitization that the banking entity sponsors or for which it provides investment management services, the banking entity would be prohibited from providing liquidity support for the ABCP conduit.

Similarly, while some commenters requested that the loan securitization exclusion permit the holding of a limited amount of securities purchased in the secondary market, the final rule does not provide for this in the context of ABCP conduits. The Agencies believe that the limitations on the types of securities that a qualifying asset-backed commercial paper conduit may invest in are needed to avoid the possibility that a banking entity could use a qualifying asset-backed commercial paper conduit to securitize non-loan assets or to engage in proprietary trading of such securities prohibited under the final rule. Thus this limitation reduces the potential for evasion of the covered fund provisions of section 13 of the BHC Act. In developing the exclusion from the definition of covered fund for qualifying asset-backed commercial paper conduits

[1960] *See* final rule § ____.10(c)(9)(ii) and (iii).

[1961] *See* 12 U.S.C. 1813.

[1962] *See* 12 U.S.C. 1841.

[1963] *See* 12 U.S.C. 1467a.

[1964] *See* 12 U.S. C. 1843(k).

[1965] *See* 12 CFR 211.21.

[1966] *See* final rule § ____.10(c)(9)(iii).

[1967] *See* 12 U.S.C. 1851(f); *See also* § ____.16 of the proposed rule.

in the final rule, the Agencies considered the factors set forth in sections 13(g)(2) and 13(h)(2) of the BHC Act. The final rule includes conditions designed to ensure that an ABCP conduit established and managed by a banking entity serves as a means of facilitating that banking entity's loan securitization activity rather than financing that banking entity's capital market investments. The final rule distinguishes between qualifying asset-backed commercial paper conduits and other ABCP conduits in order to adhere to the tenets of section 13 of the BHC Act while accommodating the market practices discussed by the commenters by facilitating reasonable access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. As discussed above, the Agencies understand that some existing ABCP conduits may need to be restructured to conform to the requirements of the ABCP conduit exclusion.

To the extent that the definition of covered fund, the loan securitization exclusion and the ABCP conduit exclusion do not eliminate the applicability of the final rule provisions to certain covered funds, there may be adverse effects on the provision of capital to customers,[1968] to securitization markets,[1969] and to the creation of new securitization products to meet investor demands that Congress may not have contemplated. [1970] However, financial institutions that are not banking entities and therefore are not subject to the restrictions on ownership can continue to engage in activities relating to securitization, including those securitizations that fall under the definition of covered fund. Furthermore, new securitizations may be structured so as to qualify for the loan securitization exclusion or other exclusions under the final rule. For these reasons, the impact on securitizations that are not excluded under the final rule may be mitigated.

The Agencies believe that the final rule excludes from the definition of covered fund typical structures used in the most common loan securitizations representing a significant majority of the current securitization market, such as residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases and equipment leases. Additionally, the Agencies believe that esoteric asset classes supported by loans may also be able to rely on the loan securitization exclusion, such as time share loans, container leases and servicer advances.

10. Covered Bonds

Several commenters called for covered bond structures to be excluded from the definition of covered fund.[1971] They indicated that the proposed rule may interfere with and restrict non-U.S. banks' ability to establish or issue covered bonds. As described by several commenters, covered bonds are full recourse debt instruments typically issued by a non-U.S. entity that are fully secured or ''covered'' by a pool of high-quality collateral (*e.g.,* residential or commercial mortgage loans or public sector loans).[1972] Certain of these covered bond structures utilize a special purpose vehicle (''SPV'') that holds a collateral pool. As such, under the proposed rule, an SPV could be a covered fund that relies on the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

According to one commenter, the majority of covered bonds are issued under specific legislative frameworks which define permitted characteristics for covered bond issuances, including the kinds and quality of collateral that may be included in cover pools, the specific legal framework for issuance of covered bonds, and the procedures for resolution in the event that the issuer becomes insolvent.[1973] Some commenters expressed concern about the possibility that certain covered bond structures could fall within the definition of covered fund, as proposed. In particular, commenters expressed concern about covered bond structures in the United Kingdom that also would be relevant in principle with respect to covered bond structures used in other European Union (''EU'') jurisdictions (*e.g.,* the Netherlands and Italy) and certain non-EU jurisdictions (*e.g.,* Canada, Australia, and New Zealand).[1974] Another commenter indicated that covered bonds issued by certain French entities that hold a revolving pool of loans may be impacted by the proposed rule.[1975]

Certain commenters argued that in order to achieve the intended economic effect of providing recourse to both the bank issuing covered bonds and to the collateral pool, the issuing bank may enter into a number of agreements with the SPV that holds the collateral. This includes transactions where the bank takes on credit exposure to the SPV (*e.g.,* through derivatives and securities lending, provision of loans, and/or investments in securities of the SPV).[1976] The issuing bank typically also provides asset and liability management services to the SPV and may also repurchase certain assets from the SPV.[1977] Commenters also contended that under certain legislative frameworks, the SPV issues the covered bonds and holds the collateral, and a sponsoring bank lends money to the SPV.[1978] According to commenters, the broad definition of covered fund in the proposed rule could capture an SPV that holds the collateral, so transactions between an SPV and the issuing bank or sponsor bank may be prohibited.[1979] These commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule, would have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1980]

According to certain commenters, SPVs whose sole function is as part of an offering of covered bonds should be excluded from the definition of covered fund in the final rule. These commenters provided that the proposed rule was not clear on whether these SPVs, which effectively function as collateral devices for the covered bond, would be excluded from the definition of covered fund.[1981] One commenter indicated that the key concern was primarily due to the wide definition of

[1968] *See, e.g.,* ASF (Feb. 2012).

[1969] *See* Credit Suisse (Williams) (employing ABCP conduits as an example); ASF (Feb. 2012) (describing the constriction of the market for asset-backed securities if banking entities are restricted from owning debt classes of new asset backed securities).

[1970] *See* RBC; ASF (Feb. 2012).

[1971] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012).

[1972] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); FSA (Apr. 2012); UKRCBC.

[1973] *See* UKRCBC. For example, a commenter indicated that in the European Union, Article 52(4) of the EU UCITS Directive sets out the defining characteristics of covered bonds, and this directive is implemented by specific legislative frameworks.

[1974] *See* UKRCBC; FSA (Apr. 2012). One commenter argued that there are two main models used for covered bond structures in Europe—the integrated model (where the collateral pool continues to be owned directly by the bank issuer and is segregated by special legislation) and the structured model (where the pool is transferred to a special purpose vehicle and is segregated by operation of legal principles). *See* UKRCBC.

[1975] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1976] *See* FSA (Apr. 2012).

[1977] *See* UKRCBC.

[1978] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1979] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012).

[1980] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012); AFME *et al.* For a discussion of possible economic effects, *See* FSA (Feb. 2012); UKRCBC; Allen & Overy (on behalf of Foreign Bank Group).

[1981] *See* ASF (Feb. 2012); AFME *et al.;* UKRCBC.

covered fund in the proposed rule.[1982] Other commenters indicated that the final rule should not apply to covered bond transactions because they are not traditionally recognized or regulated as asset-backed securities transactions, and they are not the type of transactions that the rule was intended to address.[1983]

As a result of comments received on covered bond vehicles, the final rule specifically excludes from the definition of covered fund certain entities that own or hold a dynamic or fixed pool of assets that covers the payment obligations of covered bonds. In order to qualify for the exclusion, the assets or holdings in the cover pool must satisfy the conditions in the loan securitization exclusion, except for the requirement that the securities they issue are asset-backed securities (the ''permitted cover pool'').[1984] The Agencies believe this approach is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act. The rule of construction in section 13(g)(2) of the BHC Act specifically refers to the ''sale and securitization of loans'' and the Agencies would not want a banking entity to use an excluded cover pool to engage in proprietary trading of such securities prohibited under the final rule. The Agencies believe this restriction reduces the potential for evasion of the final rule.

By placing restrictions on the assets permitted to be held by a cover pool, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for cover pools is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banking entities to continue to engage in lending activities and the financing those lending activities. Including all types of securities and other assets within the scope of permitted assets in a cover pools would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction. Additionally, because the exclusion for cover pools is only available to foreign banking organizations, allowing such cover pools to hold securities would provide unequal treatment of covered bonds as compared to a loan securitization sponsored by a U.S. banking entity.

Under the definition of covered bond in the final rule, the debt obligation may be issued directly by a foreign banking organization or by an entity that owns a permitted cover pool. In both cases, the payment obligations of the debt obligation must be fully and unconditionally guaranteed. If the debt obligation is issued by a foreign banking organization, such debt obligation will be a ''covered bond'' under the final rule if the payment obligations are fully and unconditionally guaranteed by an entity that owns a permitted cover pool.[1985] If the debt obligation is issued by an entity that owns a permitted cover pool, such debt obligation will be a ''covered bond'' under the final rule if (i) the payment obligations are fully and unconditionally guaranteed by a foreign banking organization and (ii) the issuer of the debt obligation is a wholly-owned subsidiary (as defined) by such foreign banking organization.[1986] Thus, under the final rule, a covered bond structure in which an entity holds the cover pool and issues securities that are fully and unconditionally guaranteed by a foreign banking organization may also be able to rely on the loan securitization exclusion if it meets all of the requirements of that exclusion.

The Agencies recognize that many covered bond programs may involve foreign covered bond programs (and their related cover pools) that are permitted by their respective laws to own residential mortgage-backed securities and other non-loan assets. As a result, the exclusion for covered bonds in the final rule may not be available to many of the existing cover pools that support outstanding covered bonds. The Agencies recognize that this approach may not exclude all foreign covered bond programs. Although certain commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule,[1987] the Agencies believe that the exclusion for qualifying covered bonds, including the limitations on the types of securities that a loan securitization can hold, is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act and appropriate for the reasons discussed directly above and under ''Definition of Loan.'' The Agencies also recognize that commenters argued that including covered bonds as covered funds could have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1988] The Agencies note that, although they do not know the composition of the cover pools, the Agencies believe that foreign banking organizations should be able to look at the composition of their cover pools to evaluate how to meet the requirements of the exclusion—and thus to avoid or mitigate the adverse effects commenters asserted would occur—as they determine appropriate.

11. Certain Permissible Public Welfare and Similar Funds

Section 13(d)(1)(E) of the BHC Act permits a banking entity to make and retain: (i) investments in one or more small business investment companies (''SBICs''), as defined in section 103(3) of the Small Business Investment Act of 1958 (SBA) (15 U.S.C. 662) [1989]; (ii) investments that are designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24); and (iii) investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[1990] The proposed rule permitted banking entities to invest in and act as sponsor [1991] to these entities, but did not explicitly exclude them from the definition of covered fund.[1992]

Commenters generally supported the proposed exemption for investments in and sponsorship of funds designed to promote the public welfare, SBICs, and other tax credit funds given the valuable funding and assistance these investments provide in facilitating community and economic priorities and

[1982] *See* UKRCBC.

[1983] *See, e.g.,* AFME *et al.*

[1984] *See* final rule § ____.10(c)(10).

[1985] *See* final rule § ____.10(c)(10)(ii)(A).

[1986] *See* final rule § ____.10(c)(10)(ii)(B). As discussed above in the section describing the wholly-owned subsidiary exclusion from the definition of covered fund, the Agencies are permitting 0.5 of a wholly-owned subsidiary to be owned by an unaffiliated party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

[1987] *See supra* note 1980 and accompanying text.

[1988] *Id.*

[1989] The Agencies note that section 13(d)(1)(E) of the BHC Act incorrectly provides that the term ''small business investment company'' is defined in section 102 of the SBA, while the definition is in fact contained in section 103(3) of the SBA as codified at 15 U.S.C. 662. The statute includes the correct citation to 15 U.S.C. 662. The Agencies are correcting this technical error in the final rule by updating the reference to section 102 to section 103(3).

[1990] *See* 12 U.S.C. 1851(d)(1)(E).

[1991] The proposal implemented a proposed determination by the Agencies under 13(d)(1)(J) ''that a banking entity may not only invest in such entities as provided under section 13(d)(1)(E) of the BHC Act, but also may sponsor an entity described in that paragraph and that such activity, since it generally would facilitate investment in small businesses and support the public welfare, would promote and protect the safety and soundness of banking entities and the financial stability of the United States.'' Joint Proposal, 76 FR 68,908 n.292.

[1992] *See* proposed rule § ____.13(a).

the role these investments play in the ability of banking entities, especially community and regional banks, to achieve their financial and Community Reinvestment Act (''CRA'') goals. However, commenters raised some issues with respect to the proposed exemption and sought clarification on its application to specific investments.[1993] Of primary concern to commenters was the impact of the prohibition in section 13(f) of the BHC Act on the ability of a banking entity sponsoring a tax credit fund or its affiliate to guarantee certain obligations of the fund in order to provide assurance to investors that the investment has been properly structured to enable the investor to receive the tax benefits on which the investment are sold.[1994] Some commenters noted that failure to address this issue in the final rule would damage a large segment of this market and therefore urged the Agencies to exempt these investments from the application of section 13(f) or, in the alternative, from the definition of covered fund.[1995]

In addition, commenters requested clarification that specific types of public welfare, SBIC, and other tax credit investments would be eligible for the exemption, including Low Income Housing Tax Credits, Renewable Energy Tax Credits, New Markets Tax Credits, and Rural Business Investment Companies.[1996] One commenter requested that applicants for an SBIC license that have received permission from the Small Business Administration to file a formal SBIC license application be viewed the same as an SBIC.[1997] Other commenters sought coverage of investments in non-SBIC funds that provide capital to small and middle-market companies,[1998] investments in any state administered tax credit program,[1999] and investments outside the United States that are of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24).[2000]

In light of the comments received, the final rule excludes from the definition of covered fund an issuer that is an SBIC (or that has received from the Small Business Administration notice to proceed to qualify for a license as an SBIC, which notice or license has not been revoked) or the business of which is to make investments that are: (i) designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or (ii) qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[2001]

By excluding SBICs and other public interest funds from the definition of covered fund—rather than provide a permitted activity exemption as proposed—the Agencies addressed commenters' concerns regarding the burdens imposed by section 13(f). The Agencies believe that excluding these investments from the definition of covered fund addresses the issues many commenters raised with respect to the application of section 13(f) of the BHC Act, and gives effect to the statutory exemption of these investments in a way that appropriately facilitates national community and economic development objectives. The Agencies believe that permitting a banking entity to sponsor and invest in these types of public interest entities will result in banking entities being able to provide valuable expertise and services to these entities and to provide funding and assistance to small businesses and low- and moderate-income communities. The Agencies believe that providing the exclusion will also allow banking entities to continue to provide capital to community-improving projects and in some instances promote capital formation.

12. Registered Investment Companies and Excluded Entities

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[2002] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[2003] A few commenters argued that the final rule should specifically provide that all SEC-registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[2004]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[2005]

Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are *excluded* from SEC

[1993] *See* Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); PNC; Raymond James; SIFMA *et al.* (Covered Funds) (Feb. 2012); SBIA.

[1994] *See* AHIC; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SBIA; Union Bank; U.S. Bancorp.

[1995] *See* ABA (Keating); Lone Star; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SVB; U.S. Bancorp.

[1996] *See* NCHSA; SBIA; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC).

[1997] *See* SBIA; *See also* SEC Rule 3c-2.

[1998] *See* ABA (Keating); PNC.

[1999] *See* USAA.

[2000] *See* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2001] *See* final rule § ____.10(c)(11). This provision would cover any issuer that engages in the business of making tax credit investments (*e.g.,* Low Income Housing Tax Credit, New Markets Tax Credit, Renewable Energy Tax Credit, Rural Business Investment Company) that are either designed to promote the public welfare of the type permitted under 12 U.S.C. 24(Eleventh) or are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as provided for under § ____.10(c)(11).

[2002] *See* proposed rule § ____.10(b)(1).

[2003] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

[2004] *See* Arnold & Porter; Goldman (Covered Funds); *See also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC (requesting clarification that registered investment companies are not banking entities); TCW.

[2005] *See* ICI (Feb. 2012); TCW.

regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which *are* regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[2006]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed above.

In order to prevent banking entities from purporting to use this exclusion for vehicles that the banking entity does not reasonably expect to become a registered investment company or business development company, the exclusion is available only with respect to a vehicle that the banking entity operates (i) pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or business development company within the time period provided by the final rule for seeding a covered fund; (ii) consistently with the leverage requirements under the Investment Company Act of 1940 that are applicable to registered investment companies and SEC-regulated business development companies.[2007] A banking entity that seeds a covered fund for any purpose other than to register it as an investment company or establish a business development company must comply with the requirements of section 13(d)(1)(G) of the BHC Act and § ____.11 of the final rule as described above. The Agencies will monitor this seeding activity for attempts to use this exclusion to evade the requirements governing the ownership of and relationships with covered funds under section 13 of the BHC Act and the final rule.[2008]

13. Other Excluded Entities

Section 13(h)(2) permits the Agencies to include similar funds within the definition of covered fund, but the proposal did not contain a process for excluding from the definition of covered fund other entities that do not engage in the investment activities contemplated by section 13. Many commenters argued that the breadth of entities that may be required to rely on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act could result in additional unidentified entities becoming subject to the definition of covered fund.[2009] In order to ensure that the final rule effectively addresses the full scope of entities that may inadvertently be included within the definition of covered fund, a number of commenters urged that the final rule include a mechanism to exclude other entities from the term ''covered fund'' by rule or order if the Agencies determine such an exclusion is appropriate.[2010]

As evidenced by the extensive comments discussed above identifying the many types of corporate structures and other vehicles (not just investment funds) that rely on sections 3(c)(1) and 3(c)(7) but do not engage in investment activities of the type contemplated by section 13, the scope of an overly broad definition of covered fund may impose significant burdens on banking entities that are in conflict with the purposes of section 13 of the BHC Act. In response to commenters' concerns and to address the potential that the final rule's definition of covered fund might encompass entities that do not engage in the investment activities contemplated by section 13, the final rule includes a provision that provides that the Agencies may *jointly* determine to exclude an issuer from the definition of covered fund if the exclusion is consistent with the purposes of section 13 of the BHC Act.[2011]

As noted above, the statute permits the Agencies to act by rule to modify the definition of covered fund. After issuing the proposed rule and receiving comment on it, the final rule provides that the Agencies may act jointly to provide an exclusion.[2012] The Agencies are working to establish a process within which to evaluate requests for exclusions and expect to provide additional guidance on this matter as the Agencies gain experience with the final rule.[2013] As a result, the definition of covered fund would remain unified and consistent. The final rule also provides that a determination by the Agencies to exclude an entity from the definition of covered fund will be promptly made public in order to ensure that both banking entities and the public may understand what entities are and are not included within the definition of covered fund.

d. Entities Not Specifically Excluded From the Definition of Covered Fund

In addition to the entities identified above which are excluded from the definition of covered fund under the final rule, commenters argued that a number of other entities such as financial market utilities, venture capital funds, credit funds, cash management vehicles or cash collateral pools may also be an investment company but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act and requested that these entities expressly be excluded from the final rule's definition of covered fund. The Agencies have considered carefully the comments received on each of these entities but, for the reasons explained below, have declined to provide a separate exclusion for them from the definition of covered fund at this time. As discussed below, some of these entities are not covered funds for various reasons or may, with relatively little cost, conform to the terms of an exclusion or exemption from the definition of covered fund. As noted above, to the extent that one of these entities qualifies for one or more of the

[2006] *See* final rule § ____.10(c)(12).

[2007] *See* final rule §§ ____.10(c)(12)(i); 10(c)(12)(iii); ____.20(e).

[2008] The Agencies also note that banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years must maintain records that include, among other things, documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity in determining that such fund is not a covered fund. *See* final rule § ____.20(e).

[2009] *See also* FSOC study.

[2010] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[2011] *See* final rule § ____.10(c)(14).

[2012] As discussed above, the Agencies also may determine jointly that an entity excluded from the definition of covered fund under § ____.10(c) is in fact a covered fund, and consequently banking entities' investments in and transactions with such fund would be subject to limitations and/or divestiture. The Agencies intend to utilize this authority to monitor for and address, as appropriate, instances of evasion. *See, e.g.,* 12 U.S.C. 1851(e)(2).

[2013] A joint determination specified under § ____.10(c)(14) may take a variety of forms.

other exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

A number of commenters requested that certain existing covered funds be either excluded from the definition of covered fund or grandfathered and not be subject to the limitations of section 13 of the BHC Act.[2014] The Agencies note, however, that section 13 specifically addresses a banking entity's preexisting investments in covered funds by providing a conformance period, which banking entities may use to bring their activities and investments into compliance with the requirements of section 13 and the final rule. To the extent that section 13 could be interpreted to permit the Agencies to take a different approach, despite addressing banking entities' preexisting covered fund investments directly, the Agencies believe it would be inconsistent with the purposes of section 13 to permit banking entities to continue to hold ownership interests in covered funds beyond the conformance period provided by the statute. Section 13's prohibition on banking entities' investments in and relationships with covered funds and the requirement that banking entities divest or conform these investments appear to reflect the statutory purpose that banking entities be limited in their ability to continue to be exposed to these investments outside of the statutorily-provided conformance period. The Agencies believe that permitting banking entities to hold ownership interests indefinitely beyond the conformance period provided by the statute appears inconsistent with this purpose.

1. Financial Market Utilities

Several commenters contended that financial market utilities (''FMUs'') could be covered funds because they might rely on section 3(c)(1) or 3(c)(7) for an exclusion from the definition of investment company under the Investment Company Act and may not qualify for an alternative exemption.[2015] These commenters argued that banking entities have long been investors in domestic and foreign FMUs, such as securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems. These commenters expressed concern that, unless FMUs are expressly excluded from the definition of covered fund, banking entities could be prohibited from entering into any new covered transactions with related FMUs and would be required to divest their investments in FMUs, thereby disrupting the operations of those FMUs and financial markets generally.

After carefully considering commenters' concerns, the Agencies believe that FMUs are not investment vehicles of the type section 13 of the BHC Act was designed to address, but rather entities that generally engage in other activities, including acting as central counterparties that reduce counterparty risk in clearing and settlement activities. Congress recognized, in the Payment, Clearing, and Settlement Supervision Act of 2010 (title VIII of the Dodd–Frank Act),[2016] that properly designed, operated, and supervised financial market utilities as defined in that Act mitigate systemic risk and promote financial stability.[2017]

However, the Agencies have not provided an exclusion from the covered fund definition for FMUs because these kinds of entities do not generally appear to rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act, and therefore do not appear to need an exclusion. For example, section 3(b)(1) of the Investment Company Act excludes from the definition of investment company—and thus from the definition of a covered fund—entities primarily engaged in a business other than that of an investment company.[2018] If an FMU is primarily engaged in a business other than those that would make it an investment company, for example, if the FMU is primarily engaged in transferring, clearing, or settling payments, securities, or other financial transactions among or between financial institutions,[2019] the FMU could rely on the exclusion to the definition of investment company provided by section 3(b)(1) and would not need to rely on section 3(c)(1) or 3(c)(7) and, as such, would not be a covered fund.

2. Cash Collateral Pools

Some commenters expressed concern that cash collateral pools, which are part of securities lending programs, could be included in the definition of covered fund.[2020] According to these commenters, banking entities, including bank custodians acting as lending agent for customer's securities lending activities, typically manage these pools as fiduciaries for their customers.[2021] These commenters argued that collateral pools are part of a banks' traditional custody and advisory services and have been an integral part of any lending agent's role (whether custodial or non-custodial) for years.[2022]

Cash collateral pools are typically formed when, as part of a securities lending program, a customer of a bank authorizes the bank to take securities from the customer's account and lend them in the open market. The agent bank then lends those securities and receives collateral in return from the borrower; a securities lending customer of a bank typically elects to have cash collateral provided by a borrower pooled by the agent bank with other cash collateral provided to other clients.[2023] These investment pools may exist in the form of trusts, partnerships, limited liability companies, or separate accounts maintained by more than one party and these structures may rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid being an investment company.[2024] While their ownership interest may be nominal in amount, the agent banks may hold a general partnership, limited liability company membership or trustee interest in the cash collateral pool.[2025] As part of these arrangements, custodian banks routinely offer borrower default indemnifications to the securities lender in a securities lending transactions.

Commenters raised concerns that these indemnification agreements could be considered a covered transaction prohibited by section 13(f) of the BHC Act.[2026] Since some cash collateral

[2014] *See, e.g.,* PNC; SVB; SIFMA (Securitization) (Feb. 2012); AFME *et al.*; BoA. *See also, e.g.,* Credit Suisse (Williams).

[2015] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2016] 12 USC 5461 *et seq.*

[2017] *See id.*

[2018] Section 3(b)(1) of the Investment Company Act excludes from the definition of investment company ''[a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.''

[2019] *See* 12 U.S.C. 1562(6); 12 CFR Part 234.

[2020] *See* RMA; State Street (Feb. 2012); *See also* BNY Mellon *et al.*

[2021] *See* RMA; State Street (Feb. 2012).

[2022] *See* RMA; BNY Mellon *et al.* (citing Comptroller's Handbook: Custody Services (Jan. 2002)).

[2023] *See* RMA.

[2024] *See* RMA.

[2025] *See* RMA.

[2026] *See* State Street; RMA. Commenters also argued that as part of offering pooled cash collateral management, agent banks have traditionally provided short-term extensions of credit and contractual income and settlement services to lending clients and cash collateral pools to facilitate trade settlement and related cash collateral investment activities. *See* RMA. One commenter further argued that if banks are required to ''outsource'' cash collateral pools and/or the related short-term credit services provided to the pools, ''participation in securities lending programs would only be cost effective for the largest lending clients''

pools are established outside of the United States, commenters requested that the final rule permit banking entities to have interests in and relationships with both U.S. and non-U.S. cash collateral pools.[2027] These commenters suggested that cash collateral pools be excluded from the definition of covered fund or, in the alternative, that the Agencies make clear that cash collateral pools managed by agent banks qualify for the exemption in § ____.11 of the proposed rule for organizing and offering a covered fund and that the prime brokerage exemption from the restrictions of section 13(f) would permit the indemnification and income or settlement services agent banks typically provide to the pools.[2028] These commenters also suggested that the Agencies use their authority under section 13(d)(1)(J) to provide an exemption for banking entities to continue to have interests in and provide services to these types of pools.[2029]

After carefully considering comments received, the final rule does not provide a specific exclusion from the definition of covered fund for cash collateral pools. The Agencies have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for cash collateral pools.

The Agencies note, however, that some cash collateral pools may not be covered funds because they rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2030] Banking entities may determine to register cash collateral pools with the SEC as investment companies or to operate them as separate accounts to exclude the pools from the covered fund definition or, if the pools remain covered funds, to organize and offer them in compliance with the requirements of § ____.11 of the final rule.

In response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not a covered transaction subject to 13(f) or a guarantee of the performance or obligations of a covered fund prohibited under § ____.11 of the final rule. Those restrictions apply to transactions with the covered fund or guarantees of the covered fund's performance. Borrower default indemnifications are provided to the bank's securities lending customer, not to the cash collateral pool.

3. Pass-through REITS

Some banking entities may issue real estate investment trust (''REIT'') preferred securities to the public directly from a subsidiary that qualifies for the exclusion in section 3(c)(5) or section 3(c)(6) of the Investment Company Act. These entities would not be considered a ''covered fund'' because they may rely on an exclusion from the definition of an investment company other than the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2031] However, in order to meet the demands of customers and avoid undesirable tax consequences, some banking entities structure their REIT offerings by using a passive, pass-through statutory trust between the banking entity and the REIT to issue REIT preferred securities to the public.[2032] Because the pass-through trust holds the preferred securities of the underlying REIT (which would itself not be a covered fund), as well as provides administrative and ministerial functions for the REIT (including passing through dividends from the underlying REIT), the pass-through trust may not itself rely on the exclusion contained in section 3(c)(5) or 3(c)(6) and, thus, typically relies on section 3(c)(1) or 3(c)(7).[2033]

Some commenters urged the Agencies to provide an exclusion for pass-through REITS from the definition of covered fund.[2034] These commenters argued that because the pass-through trust exists as a corporate convenience as part of issuing REIT preferred securities to the banking entity and its customers, it is not the type of entity that the covered fund prohibition in section 13 of the BHC Act was intended to address. These commenters also argued that pass-through REITs enable banking entities to offer preferable tax treatment to holders of the REIT preferred securities and that if pass-through REITs were included as covered funds, because of the limitations on covered transactions contained in section 13(f), the minority interests in the preferred securities issued by the REIT would no longer be able to be included in a banking entity's tier 1 capital, thereby negatively impacting the safety and soundness of the banking entity.[2035]

The Agencies are not providing a specific exclusion from the definition of covered fund for pass-through REITs because the Agencies are concerned that such an exclusion could enable banking entities to structure non-loan securitization transactions using a pass-through entity in a manner inconsistent with the final rule's treatment of similar vehicles that invest in securities. Furthermore, banking entities have alternative manners in which they may issue or hold REIT preferred securities, including through REITs directly, which do not raise the same concerns about evasion.[2036]

4. Municipal Securities Tender Option Bond Transactions

The Agencies received a number of comments addressing how the final rule should treat municipal securities tender option bond vehicles. A number of commenters argued that issuers of municipal securities tender option bonds would fall under the definition of covered fund in the proposed rule because these issuers typically rely on the exclusion contained in section

and, as a result, ''many small and intermediate securities lending clients would be denied the incremental revenue securities lending can provide''; ''securities lending programs could lose significant diversification in lending clients, lendable assets, borrowers and agent banks''; and, as a result of lost revenues, ''the actual costs of [] custodial or other services provided to clients that no longer participate in lending would increase.'' *Id.*

[2027] *See* RMA.

[2028] *See* RMA.

[2029] *See* RMA.

[2030] For instance, the Agencies understand that a banking entity may set up a cash collateral pool in reliance on the exclusion contained in section 3(c)(3) of the Investment Company Act, or may be able to structure these pools as SEC-registered money market funds operated in accordance with rule 2a–7 under the Investment Company Act.

[2031] *See* PNC.

[2032] *See* PNC.

[2033] *See* ABA (Keating); PNC.

[2034] *See* ABA (Keating); PNC.

[2035] *See* PNC; ABA (Keating). These commenters argued that most REIT preferred securities contain a conditional exchange provision that allows the primary regulator to direct that the preferred securities be automatically exchanged for preferred shares of the bank or parent BHC upon occurrence of a conditional exchange event. Because this arrangement involves the purchase of securities issued by an affiliate or the purchase of assets, it would be prohibited under section 13(f) of the BHC Act if the pass-through REIT were a covered fund.

[2036] The Agencies recognize that banking entities may have relied on pass-through REIT structures to issue preferred securities in the past and prohibiting such transactions may pose inefficiencies. Furthermore, it may not be possible to unwind or conform past issuances without significant effort by the banking entity and negotiation with the holders of the preferred securities. As noted above, in these circumstances, section 13 provides a conformance period which banking entities may take advantage of in order to bring their activities and investments into compliance with the requirements of section 13 and the final rule.

3(c)(1) or 3(c)(7) of the Investment Company Act.[2037] According to commenters, a typical tender option bond transaction consists of the deposit of a single issue of highly-rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: A floating rate, puttable security (the ''floaters''), and an inverse floating rate security (the ''residual'') with no tranching involved. According to commenters, the holders of the floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par. The put right is supported by a liquidity facility delivered by a highly-rated provider (in many cases, the banking entity sponsoring the trust) and allows the floaters to be treated as a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer-term investor (in many cases the banking entity sponsoring the trust, or an insurance company, mutual fund, or hedge fund). According to commenters, the residual investors take all of the market and structural risk related to the tender option bonds structure, with the investors in floaters taking only limited, well-defined insolvency and default risks associated with the underlying municipal bonds generally equivalent to the risks associated with investing in the municipal bonds directly. According to commenters, the structure of tender option bond transactions is governed by certain provisions of the Internal Revenue Code in order to preserve the tax-exempt treatment of the underlying municipal securities.

Many commenters requested a specific exclusion for municipal tender option bond vehicles from the definition of a covered fund.[2038] These commenters argued that, without an exclusion from the definition of covered fund, banking entities would be prohibited from owning or sponsoring tender option bonds and from providing credit enhancement, liquidity support, remarketing, and other services required in connection with a tender option bond program.[2039] Commenters argued that tender option bond vehicles should be excluded because section 13(d)(1)(A) of the BHC Act already allows banking entities to own and dispose of municipal securities directly,[2040] tender option bonds are economically similar to repurchase agreements, which are expressly excluded from the proprietary trading restrictions of the proposed rule, and, because they are safe and low risk are similar to the types of transactions that the proposed rule would have exempted.[2041] Commenters also argued that tender option bonds are different from other covered funds that rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act [2042] and play an important role in the municipal bond markets.[2043] Commenters requested that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act to exclude tender option bonds because they argued that tender option bonds promote the safety and soundness of banking entities and the financial stability of the United States by providing for a deeper, richer pool of potential investors, a larger and more liquid market for municipal securities that results in lower borrowing costs for municipalities and other issuers of municipal securities, and greater efficiency and risk diversification.[2044] Commenters also suggested a number of other ways to exclude tender option bonds, including defining ownership interest to exclude any interest in a tender option bond transaction; [2045] defining banking entity to exclude tender option bond issuers; [2046] expanding the loan securitization exclusion to include tender option bond issuers; [2047] and revising the definition of sponsor to exclude sponsors of tender option bond vehicles.[2048] One commenter urged the Commission to consider amending the exemption under rule 3a–7 under the Investment Company Act or providing formal guidance regarding the status of tender option bond programs.[2049] In addition, some commenters requested an exclusion for tender option bond transactions from the provisions of section 13(f) of the BHC Act.[2050]

After carefully considering the comments received, the final rule does not provide a specific exclusion from the definition of covered fund or from the prohibitions and requirements of the final rule for tender option bond vehicles.[2051] The Agencies have determined to provide specific exclusions for entities that they believe fall within the rule of construction contained in section 13(g)(2) of the BHC Act, which expressly relates to the sale and securitization of loans,[2052] do not function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations. The Agencies do not believe that these considerations support a separate exclusion for tender option bond vehicles, which have municipal securities as underlying assets and not loans.

The Agencies recognize commenters' concerns about the treatment of tender option bonds under the final rule, as discussed above. However, as there is no corresponding rule of construction in section 13 of the BHC Act for financial instruments other than loans, the Agencies do not believe that the resecuritization of municipal debt instruments should be treated differently than the resecuritization of other debt instruments.[2053] Notwithstanding the statutory treatment of municipal securities for purposes of the proprietary trading restrictions, the Agencies also do not believe that tender option bond vehicles fall within the rule

[2037] *See, e.g.,* Ashurst; SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Cadwalader (Municipal Securities); Vanguard; ICI (Feb. 2012); ASF (Feb. 2012); Fidelity; Wells Fargo (Covered Funds). Commenters also noted that tender option bond programs as currently structured may not meet the requirements of section 3(a)(5) of the Investment Company Act or rule 3a-7 thereunder, or any other exclusion or exemption under the Investment Company Act. *See* Ashurst; RBC; ASF (Feb. 2012).

[2038] *See, e.g.,* ASF (Feb. 2012); BDA (Feb. 2012); Eaton Vance; Fidelity; ICI (Feb. 2012); RBC; SIFMA (Municipal Securities) (Feb. 2012); SIFMA (May 2012); State Street (Feb. 2012); Vanguard.

[2039] *See* Ashurst; ASF (Feb. 2012).

[2040] *See* ASF (Feb. 2012); SIFMA (Municipal Securities) (Feb. 13, 2012); Citigroup (Jan. 2012). *See also* Cadwalader (Municipal Securities) (alleging that the legislative history of section 13 of the BHC Act suggests that the exemption relating to municipal securities should not be construed to apply only to the section of the rule pertaining to the proprietary trading prohibitions); BDA (Feb. 2012) (arguing that any fund or trust the assets of which are entirely invested in any of the obligations that are excluded from the proprietary trading prohibitions should also be excluded from the definition of covered fund).

[2041] *See, e.g.,* Ashurst; Cadwalader (Municipal Securities); Eaton Vance; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 13, 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds); Citigroup (Jan. 2012).

[2042] *See, e.g.,* ASF (Feb. 2012); State Street (Feb. 2012); Citigroup (Jan. 2012); Vanguard; Wells Fargo (Covered Funds); Cadwalader (Municipal Securities); Ashurst.

[2043] *See* Cadwalader (Municipal Securities); ICI (Feb. 2012); Ashurst; ASF (Feb. 2012).

[2044] *See* Cadwalader (Municipal Securities).

[2045] *See* RBC.

[2046] *See* ICI (Feb. 2012).

[2047] *See* ASF (Feb. 2012).

[2048] *See* RBC.

[2049] *See* Ashurst.

[2050] *See, e.g.,* RBC; ASF (Mar. 2012); ASF (Feb. 2012).

[2051] The Agencies received a variety of requests requesting specific treatment of tender option bond transactions. *See, e.g., supra* notes 2045–2050. As discussed above, the Agencies believe that, in light of the comments received, tender option bond vehicles do not fall within the rule of construction contained in section 13(g)(2) of the BHC Act and, as a result, the final rule does not provide such treatment.

[2052] *See* 12 U.S.C. 1851(g)(2).

[2053] For these same reasons, and based on the definitions of sponsor and banking entity in section 13, the Agencies have not modified those definitions in the final rule to exclude sponsors of tender options bonds and tender bond issuers, respectively, as some commenters requested. *See supra* notes 2046 and 2048 and accompanying text.

of construction contained in section 13(g)(2) of the BHC Act, because, in light of commenters' descriptions of these vehicles, tender option bond vehicles are more in the nature of other types of bond repackaging securitizations and other non-excluded securitization vehicles.[2054] The final rule, however, does not prevent a banking entity from owning or otherwise participating in a tender option bond vehicle; it requires that these activities be conducted in the same manner as with other covered funds.

In this regard, under the final rule, a banking entity would need to evaluate whether a tender option bond vehicle is a covered fund as defined in the final rule. If a tender option bond vehicle is a covered fund and an exclusion from that definition is not available, then banking entities sponsoring such a vehicle will be subject to the prohibitions in § ____.14 of the final rule and the provisions of section 13(f) of the BHC Act.[2055]

As tender option bond vehicles are considered issuers of asset-backed securities subject to the risk retention requirements of section 15G of the Exchange Act, banking entities may look to the provisions of the final rule governing the limits applicable to banking entities' interests in and relationships with those funds. Under the final rule, as in the statute, a banking entity that conducts the activities described in section 13(f) of the BHC Act is subject to the restrictions on transactions with a tender option bond vehicle, including guaranteeing or insuring the performance of the tender option bond vehicle, contained in section 13(f) of the BHC Act. As a result, a banking entity is not permitted to provide credit enhancement, liquidity support, and other similar services if it serves in a capacity covered by section 13(f) with the tender option bond program.[2056] An unaffiliated third party may provide such services if it does not have a relationship with the tender option bond vehicle that triggers application of section 13(f). The extent to which the final rule causes a disruption to the securitization of, and market for, municipal tender option bonds may also affect the economic burden and effects on the municipal bond market and its participants, including money market mutual funds [2057] and issuers of municipal securities. The Agencies recognize that a potential economic burden may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities customarily included in municipal tender option bond vehicles [2058] and therefore potential effects on the depth and liquidity of the market for certain types of municipal securities.[2059]

5. Venture Capital Funds

Some private equity funds that make investments in early-stage start-up companies or other companies with significant growth potential (''venture capital funds'') would be investment companies but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Venture capital funds would therefore qualify as a covered fund under the proposal. The proposal specifically requested comment on whether venture capital funds should be excluded from the definition of ''covered fund.''

Some commenters argued that venture capital funds should be treated differently than other covered funds and excluded from the definition. These commenters argued that, unlike conventional hedge funds and private equity funds, venture capital funds do not possess high leverage and do not engage in risky trading activities of the type section 13 of the BHC Act was designed to address.[2060] These commenters contended that investments and relationships by banking entities in venture capital funds would be consistent with safety and soundness; provide important funding and expertise and other services to start-up companies; and provide positive benefits to employment, GDP, growth, and innovation.[2061] These commenters argued that restricting banking entities' ability to invest in or sponsor venture capital funds would have a negative impact on companies and the U.S. economy generally.[2062] Some commenters asserted that bank investments in venture capital funds are important to the success of venture capital,[2063] with some citing a consulting firm's data indicating that approximately 7 percent of all venture capital is provided by banks.[2064] One commenter argued, therefore, that ''preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term,'' and the funding gap that would result if banks could not invest in venture capital funds would not be met by other market participants if bank investments in venture capital were restricted.[2065] Several commenters recommended that venture capital funds be excluded if they: (i) Do not fundamentally engage in proprietary trading; (ii) do not use leverage to increase investment returns; and (iii) typically invest in high-growth start-up companies as compared to more mature publicly traded companies.[2066]

Conversely, one commenter alleged that there was no credible way to exclude venture capital funds without providing a means to circumvent the requirements of section 13 and the final rule.[2067] Another commenter argued that venture capital funds do in fact engage in risky activities and that, instead of making investments in venture capital funds, banking entities may directly extend credit to start-up

[2054] Commenters also argued that to the extent tender option bond programs are not excluded from the definition of covered fund, the definition of ownership interest should exclude any interest in a tender option bond program (*See* RBC) or that where a third party owns the residual, the banking entity should not be treated as having an ownership interest, even when it owns a small interest for tax purposes or becomes the owner through liquidity or remarketing agreements (*See* Cadwalader (Municipal Securities)). The definition of ownership interest in the final rule focuses on the attributes of the interest, as discussed below, and not the particular type of covered fund involved. The Agencies are not providing separate definitions of or exclusions from the ownership interest definition based on the type of vehicle or financing involved. *See infra* note 2098 and preceding and following text. Banking entities will need to evaluate whether the interests they may acquire are ownership interests as defined under the final rule.

[2055] *See* 12 U.S.C. 1851(f).

[2056] As discussed above, while commenters requested treatment of municipal tender option bond vehicles that would cause section 13(f) of the BHC Act not to apply to them, the final rule does not exclude these vehicles from the definition of covered fund or the prohibitions relating to covered funds. As a result, section 13(f) of the BHC Act will apply to a banking entity that is sponsoring a tender option bond vehicle.

[2057] *See* ASF (Feb. 2012); Nuveen Asset Mgmt.

[2058] *See* Ashurst.

[2059] *See* Eaton Vance.

[2060] *See* SVB; NVCA; Rep. Eshoo; Sen. Boxer; Rep. Goodlatte; Rep. Schweikert; Rep. Speier; Rep. Honda; Rep. Lofgren; Rep. Peters *et. al.*

[2061] *See, e.g.,* NVCA; SVB; Scale.

[2062] *See, e.g.,* SVB; Scale; Sen. Boxer; SIFMA *et al.* (Covered Funds) (Feb. 2012) (citing a colloquy between Sen. Dodd and Sen. Boxer supporting an exemption for venture capital funds (156 Cong. Rec. H5226 (daily ed., June 30, 2010)).

[2063] *See* River Cities; Scale. *See also* Sofinnova; Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Mohr Davidow; ATV; BlueRun; Westly; Charles River; Flybridge; SVB.

[2064] *See, e.g.,* SVB.

[2065] *See* SVB.

[2066] *See, e.g.,* SVB (arguing that the definition of ''venture capital fund'' in section 203(l)–1 of the Investment Advisers Act and the SEC's Form PF reporting requirements for investment advisers to private funds would be instructive for defining an exclusion for venture capital funds for purposes of section 13 of the BHC Act).

[2067] *See* Occupy.

companies in a safe and sound manner.[2068]

The final rule does not provide an exclusion for venture capital funds. The Agencies believe that the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund. Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act and accorded distinct treatment for venture capital fund advisers by exempting them from registration requirements under the Investment Advisers Act.[2069] This indicates that Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so.[2070] No such distinction appears in section 13 of the BHC Act. Because Congress chose to distinguish between private equity and venture capital in one part of the Dodd-Frank Act, but chose not to do so for purposes of section 13, the Agencies believe it is appropriate to follow this Congressional determination.

In addition to the language of the statute, it appears to the Agencies that the activities and risk profiles for banking entities regarding sponsorship of, and investment in, venture capital funds and private equity funds are not readily distinguishable. Many key structural and operational characteristics of venture capital funds are substantially similar to those of hedge funds and private equity funds, thereby making it difficult to define venture capital funds in a manner that would not provide banking entities with an opportunity to evade the restrictions of section 13 of the BHC Act.

For instance, in addition to relying on the same exemptions under the Securities Act,[2071] venture capital funds, private equity funds and hedge funds all rely on the exclusion in section 3(c)(1) or 3(c)(7) from the definition of investment company under the Investment Company Act. Moreover, like private equity funds, venture capital funds pool funds from multiple investors and invest those funds in interests of portfolio companies for the purpose of profiting from the resale of those interests. Indeed, funds that are called ''venture capital funds'' may invest in the very same entities and to the same extent as do funds that call themselves private equity funds. Venture capital funds, like private equity funds, also typically charge incentive compensation to fund investors based on the price appreciation achieved on the investments held by the fund and provide a return of principal plus gains at specific times during the limited life of the fund. Not including venture capital funds in the definition of covered fund, therefore, could allow banking entities, either directly or indirectly, to engage in the type of activities section 13 was designed to address.

While the final rule does not provide a separate exclusion for venture capital funds from the definition of covered fund, the Agencies recognize that certain venture capital investments by banking entities provide capital and funding to nascent or early-stage companies and small businesses and also may provide these companies expertise and other services.[2072] Other provisions of the final rule or the statute may facilitate, or at least not impede, other forms of investing that may provide the same or similar benefits. For example, in addition to permitting a banking entity to organize and offer a covered fund in section 13(d)(1)(G), section 13 of the BHC Act does not prohibit a banking entity, to the extent otherwise permitted under applicable law, from making a venture capital-style investment in a company or business so long as that investment is not through or in a covered fund, such as through a direct investment made pursuant to merchant banking authority[2073] or through business development companies which are not covered funds and, like venture capital funds, often invest in small, early-stage companies.[2074]

Thus, to the extent that banking entities are required to reduce their investments in venture capital funds, certain of these investments may be redirected to the types of entities in which venture capital funds invest through alternative means. To the extent that banking entities may reduce their investments in venture capital funds that are covered funds, the potential funding gap for venture capital funds may also be offset, in whole or in part, by investments from firms that are not banking entities and thus not subject to section 13's restrictions.

6. Credit Funds

Several commenters requested that the final rule explicitly exclude from the definition of covered fund entities that are generally formed as partnerships with third-party capital and invest in loans or make loans or otherwise extend the type of credit that banks are authorized to undertake on their own balance sheet (''credit funds'').[2075] Two commenters contended that the language of section 13(g)(2) indicates that Congress did not intend section 13 of the BHC Act to limit a banking entity's ability to extend credit.[2076] They argued that lending is a fundamental banking activity, whether accomplished through direct loans or through a fund structure. These commenters argued that credit funds functioned like syndicated loans that enable borrowers to secure credit during periods of market distress and reduce the concentration of risk for both individual banking entities and the banking system as a whole.

Commenters suggested different approaches for excluding credit funds from the definition of covered fund. One commenter recommended excluding an entity that would otherwise be a covered fund if more than 50 percent of its assets consist of loans.[2077] Another

[2068] *See* Sens. Merkley & Levin (Feb. 2012).

[2069] *See* S. Rep. No. 111–176, at 71–3 (2010) (''S. Rep. No. 111–176''); H. Rep. No. 111–517, at 866 (2010) (''H. Rep. No. 111–517''). H. Rep. No. 111–517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference. *See* S. Rep. No. 111–176, at 74 (''The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title.''). *Compare* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 408 (2010) (as passed by the Senate) with The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) (''H.R. 4173'') and Dodd-Frank Act (2010).

[2070] *But See* Rep. Honda.

[2071] These funds all typically offer their shares on an unregistered basis in reliance on section 4(a)(2) of the Securities Act of 1933 or Regulation D thereunder.

[2072] As noted above, some commenters quantified the importance of banking entities to the provision of venture capital by providing information indicating that approximately 7 percent of all venture capital is provided by banks. *See, e.g.,* SVB (citing *The Venture Capital Industry: A Preqin Special Report,* published by Preqin, Ltd. (Oct. 2010)). The 7% estimate commenters identified includes information on investors based in North America, Europe, and Asia; thus, although potentially indicative of the extent of venture capital investing by banking entities in venture capital funds, the estimate does not specifically address the proportion of investment by banking entities in venture capital funds that are covered funds, as those terms are defined in the final rule.

[2073] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq.*

[2074] *See* 15 U.S.C. 80a–54. Companies that have elected to be treated as a business development company are subject to limits under the Investment Company Act, including: (i) Limits on how much debt the business development company may incur; (ii) prohibitions on certain affiliated transactions; (iii) regulation and examination by the SEC; and (iv) registration and filing requirements.

[2075] *See, e.g.,* Goldman (Covered Funds); ABA (Keating); Credit Suisse (Williams); Comm. on Capital Markets Regulation; Chamber (Feb. 2012).

[2076] *See* ABA (Keating); Goldman (Covered Funds).

[2077] *See* Credit Suisse (Williams).

commenter proposed defining a credit fund as an entity that met a number of criteria designed to ensure the entity only held loans or otherwise engaged in prudent lending activity.[2078] Another commenter requested that the Agencies use their authority under section 13(d)(1)(J) to permit a banking entity to sponsor, invest in, or enter into covered transactions with related credit funds that are covered funds.[2079]

The Agencies, however, are unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of section 13 and not raise concerns about banking entities being able to evade the requirements of section 13. Moreover, the Agencies also believe that the final rule largely addresses commenters' concerns in other ways because some credit funds may be able to rely on another exclusion from the definition of covered fund in the final rule such as the exclusion for joint ventures or the exclusion, discussed above, for loan securitizations. To the extent that a credit fund may rely on another exclusion from the definition of covered fund, it would not be a covered fund under section 13 of the BHC Act.

7. Employee Securities Companies

Several commenters argued that employee securities companies (''ESCs'') should be explicitly excluded from the definition of covered fund.[2080] One commenter alleged that, though many ESCs could qualify for the exemption in section 6(b) of the Investment Company Act, they often opt to rely on section 3(c)(1) or 3(c)(7) instead due to the fact that the section 6(b) exemption is available only upon application to the SEC.[2081] According to this commenter, the limitations contained in section 13 on employee investments and intercompany transactions with covered funds would severely limit the ability of a banking entity to design competitive employee compensation arrangements.[2082] This commenter also argued that an exclusion should be provided for any investment vehicle that satisfies the definition of an ESC under section 2(a)(13) of the Investment Company Act.

After considering carefully the comments received on the proposed rule, the final rule does not provide a specific exclusion for ESCs because the Agencies believe that these vehicles may avoid being a covered fund by either complying with the conditions of another exclusion from the definition of covered fund or seeking and receiving an exemption available under section 6(b) of the Investment Company Act. As such, the Agencies believe a banking entity has a reasonable alternative to design competitive employee compensation arrangements. The Agencies recognize that preparing an application under section 6(b) of the Investment Company Act or modifying an ESC's activities to meet the terms of another exclusion from the covered fund definition is not without costs, but have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the purpose of section 13, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for ESCs.

The Agencies also note that non-qualified plans are not exempt from the Investment Company Act under 3(c)(11) and thus would be covered funds if they are operating in reliance on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Some of these non-qualified plans may be formed as employees' securities companies, however, and could qualify for an exemption under section 6(b) of the Investment Company Act for employees' securities companies as discussed above.

e. Definition of ''Ownership Interest''

The proposed rule defined ''ownership interest'' in a covered fund to mean any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, as well as any derivative of such an interest.[2083] This definition focused on the attributes of the interest and whether it provided a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. The proposal thus would also have included a debt security or other interest in a covered fund as an ownership interest if it exhibited substantially the same characteristics as an equity or other ownership interest (*e.g.,* provides the holder with voting rights, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments).[2084] As described further below, the proposed rule excluded carried interest (termed ''restricted profit interest'' in the final rule) from the definition of ownership interest.

Many commenters argued that the proposed definition of ownership interest was too broad and urged excluding one or more types of interests from the definition. A number of commenters raised concerns regarding the difficulty of applying the ownership interest definition to securitization structures and questioned whether the definition of ownership interest might apply to a debt security issued by, or a debt interest in, a covered fund that has some characteristics similar to an equity or other ownership interest.[2085] One commenter argued that the ownership interest definition should not include debt instruments with equity features unless the Agencies determine with respect to a particular debt instrument, after appropriate notice and opportunity for hearing, that the equity features are so pervasive that the debt instrument is the functional equivalent of an equity interest or partnership interest and was structured to evade the prohibitions and

[2078] *See* Goldman (Covered Funds).

[2079] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also.* ABA (Keating); Chamber (Feb. 2012).

[2080] *See, e.g.,* ABA (Keating), Credit Suisse (Williams), Arnold & Porter (as it relates to commodity pools). Section 2(a)(13) of the Investment Company Act generally defines an ESC as ''any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned'' by employees and certain related persons (*e.g.,* employees' immediate family members).

[2081] Section 6(b) of the Investment Company Act provides, in part, that ''[u]pon application by any employees' security company, the Commission shall by order exempt such company from the provisions of this title and of the rules and regulations hereunder, if and to the extent that such exemption is consistent with the protection of investors.''

[2082] *See* Credit Suisse (Williams).

[2083] *See* proposed rule § ____.10(b)(3).

[2084] *See* Joint Proposal, 76 FR 68,897.

[2085] *See* AFME *et al.;* AFR *et al.* (Feb. 2012); ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); Credit Suisse (Williams); Deutsche Bank (Repackaging Transactions); Occupy; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); TCW. For example, securitization structures generally provide that either the most senior or the most junior tranche notes have controlling voting rights. One commenter argued that under the proposed ownership interest definition, a banking entity could be deemed to have an ownership interest in an entity it does not own or sponsor simply due to its obtaining voting rights. *See* ASF (Feb. 2012). As a further example, one commenter alleged that securitization structures generally are not viewed as providing economic exposure to the profits and losses of the issuer in the same manner as equity interests in hedge funds and private equity funds. This commenter argued that the ownership interest definition should include only those interests that permit the banking entity to share without limit in the profits and losses or that earn a return that is based on the performance of the underlying assets. *See* SIFMA (Securitization) (Feb. 2012).

restrictions in the proposal.[2086] Several commenters argued that the Agencies should explicitly exclude certain debt instruments with equity features from the ownership interest definition.[2087] Finally, certain commenters argued that, because the application of the ownership interest definition to securitization structures was problematic, alternative regulatory treatment was appropriate.[2088]

One commenter expressed concern over the proposal's inclusion of ''derivatives'' of ownership interests in the definition of ownership interest and recommended certain derivative interests of ownership interests in hedge funds and private equity funds not be included within the definition of ownership interest.[2089] This commenter also recommended that the Agencies expressly exclude from the definition of ownership interest lending arrangements with a covered fund that contain protective covenants linking the interest rate on the loan to the profits of the borrowing fund.[2090]

As discussed in detail below, the Agencies are adopting the definition of ''ownership interest'' largely as proposed but clarifying the scope of that definition, including with respect to the inclusion of interests that are linked to profits and losses of a covered fund and the exclusion for a restricted profit interest in a covered fund.[2091] The definition is centered on equity interests, partnership interests, membership interests, trust certificates, and similar interests, and would not generally cover typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate. However, as under the proposal, to the extent that a debt security or other interest in a covered fund exhibits specified characteristics that are similar to those of equity or other ownership interests (*e.g.,* provides the holder with the ability to participate in the election or removal of a party with investment discretion, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments), the instrument would be an ownership interest under the final rule.

In response to commenters and in order to provide clarity about the types of interests that would be considered within the scope of ownership interest, the Agencies have revised the definition of ''ownership interest'' to define the term more clearly. The Agencies are not explicitly excluding or including debt securities, instruments or interests with equity features as requested by some commenters, but are instead identifying certain specific characteristics that would cause a particular interest, regardless of the name or legal form of that interest, to be included within the definition of ownership interest. The Agencies believe that this elaboration on the characteristics of an ownership interest will enable parties, including securitization structures, to more easily analyze whether their interest is an ownership interest, regardless of the type of legal entity or the name of the particular interest.

As adopted, the final rule provides that an ownership interest would be any interest in or security issued by a covered fund that exhibits any of the following features or characteristics on a current, future, or contingent basis:[2092]

- Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund. For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or similar rights arising due to an acceleration event;
- has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund. This would apply regardless of whether the right is pro rata with other owners or holders of interests;[2093]
- has the right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full (commonly known as the ''residual'' in securitizations). For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or similar rights arising due to an acceleration event;
- has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the

[2086] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2087] *See* AFME *et al.;* ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); RBC; SIFMA (Securitization) (Feb. 2012). These commenters argued that the ownership interest definition should not include tender option bond programs and other debt asset-backed securities. Two of these commenters argued that debt asset-backed securities should not be viewed as ownership interests because: (i) They are not typically viewed as having economic exposure to profits and losses of an ABS Issuer; (ii) they have a limited life, periodic fixed or fluctuating cumulative payments, and are senior to equity of the issuer should the issuer fail; (iii) they do not have perpetual life with broad voting rights, appreciation in the market value of the issuer and non-cumulative dividends, and subordination to the claims of debt holders if the issuer fails; and (iv) their limited voting rights (such as the rights to replace a servicer or manager) and such rights are protective in nature and similar to voting rights that accompany securities traditionally classified by the Agencies as debt securities (including securities formally structured as equity). *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012). One of these commenters argued that the ownership interest definition should be limited to those interests that share in the profits or losses of the relevant entity on an unlimited basis or that otherwise earn a return that is specifically based upon the performance of the underlying assets because the senior tranche in an asset-based securities transaction often has substantial voting rights and banking entities should not be penalized for requiring or otherwise obtaining voting rights that protect their interests. This commenter also expressed the view that banking entities should not be restricted from owning debt classes of new asset-backed securities because ''doing so would substantially constrict the market for asset-backed securities.'' *See* ASF (Feb. 2012).

[2088] *See* AFR *et al.* (Feb. 2012); Credit Suisse (Williams); Occupy. One of these commenters argued that any general statement about what instruments would be considered an ''ownership interest'' for purposes of securitization structures would be problematic and easy to evade because transaction documents underlying securitization structures are not standardized. This commenter suggested as an alternative using a safe harbor for standardized, pre-specified securitization structures. *See* AFR *et al.* (Feb. 2012). Another of these commenters argued that ''it is difficult to characterize holders of ABS securities in most securitization structures as having 'ownership interests' in any common understanding of the term'' and the concept of ownership interest is a ''poor fit for the securitization market, underscoring the benefits of excluding securitization issuers from the definition of covered fund entirely.'' *See* Credit Suisse (Williams).

[2089] *See* Credit Suisse (Williams).

[2090] *See* Credit Suisse (Williams) (arguing that such arrangements are a fundamental part of a bank's lending activities).

[2091] *See* final rule § ____.10(d)(6). The concept of a restricted profit share was referred to as ''carried interest'' in the proposed rule, a term that is often used as a generic reference to performance-based allocations or compensation. The Agencies have instead used the term ''restricted profit interest'' in the final rule to avoid any confusion that could result from using a term that is also used in other contexts. The final rule focuses only on whether a profit interest is excluded from the definition of ownership interest under section 13, and the final rule does not address in any way the treatment of such profit interests under other laws, including under Federal income tax law.

[2092] Each of these factors are designed to clarify the interests identified in the proposed definition of ownership interest as noted above.

[2093] This characteristic exists for both multi-class and single-class covered funds. In the context of an entity that issues shares, this right could cover, for example, common shares, as well as preferred shares the dividend payments of which are determined by reference to the performance of the covered fund.

holders of other outstanding interests);[2094]

• provides that the amounts payable by the covered fund with respect to the interest could, under the terms of the interest, be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;[2095]

• receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund.[2096] This provision would not include an interest that is entitled to receive dividend amounts calculated at a fixed or at a floating rate based on an index or interbank rate such as LIBOR; or

• any synthetic right to have, receive or be allocated any of the rights above. This provision would not permit banking entities to obtain synthetic or derivative exposure to any of the characteristics identified above in order to avoid being considered to have an ownership interest in the covered fund.

This definition of ''ownership interest'' is intended to address commenters' concerns regarding the applicability of the ownership interest definition to different types of interests. The Agencies believe defining ''ownership interest'' in this way will allow existing as well as potential holders of interests in covered funds, including securitizations, to effectively determine whether they have an ownership interest. As an example, this definition would include preferred stock, as well as a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. As a contrasting example, the Agencies believe that a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant would not generally be an ownership interest. Banking entities will be expected to evaluate the specific terms of their interests to determine whether any of the specified characteristics exist. In this manner, the Agencies believe that the definition of ownership interest in the final rule is clearer than under the proposal and thus should be less burdensome for banking entities in their determination of whether certain rights would cause an interest to be an ownership interest for purposes of compliance with the rule.

As indicated above, many commenters on securitizations under the proposed rule made arguments regarding the difficulty of applying the proposal's definition of ownership interest to securitization structures, contending that the definition should not include debt instruments with equity features, or that the final rule should provide a safe harbor under which the use of a standardized, pre-specified securitization structure would not give rise to an ownership interest.[2097] The Agencies are not adopting a separate definition of ownership interest for securitization transactions, providing for differing treatment of financial instruments, or providing a safe harbor as requested by some commenters. The revised definition of ownership interest will apply regardless of the type of legal entity or the name or legal form of the particular interest. The determination of whether an interest is an ownership interest under the final rule will depend on the features and characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights. While some commenters argued that securities issued in asset-backed securities transactions and by tender option bond issuers should not be viewed as ownership interests due to the nature of the securities issued or the possible lack of exposure to profits and losses,[2098] the Agencies do not believe that the type of covered fund involved or the type of security issued is an appropriate basis for determining whether there is an ownership interest for purposes of the restrictions contained in section 13(a)(1)(B) of the BHC Act. The Agencies believe that making distinctions in the definition of ownership interest based on the type of entity or the type of security, in which many of the same rights exist as for other types of ownership interests, would not be consistent with the statutory restrictions on ownership. Similarly, while some commenters argued that including a safe harbor for standardized securitization structures would be more effective in identifying an ownership interest in securitizations, the Agencies believe that the type of interest and the rights associated with the interest are more appropriate to determine whether an interest is an ownership interest and is necessary to avoid potential evasion of the ownership restrictions contained in section 13 of the BHC Act.

The Agencies understand that the definition of ownership interest in the final rule may include interests in a covered fund that might not be considered an ownership interest or equity interest in other contexts. For instance, it may include loans with an interest rate determined by reference to the performance of a covered fund or senior debt interests issued in a securitization. While the definition of ownership interest may affect the ability of a banking entity to hold such interests, whether existing or in the future, the Agencies believe that the definition of ownership interest as adopted in the final rule is more effective in preventing possible evasion of section 13 by capturing interests that may be characterized as debt but confer benefits of ownership, including voting rights and/or the ability to participate in profits or losses of the covered fund.

The definition of ownership interest in the final rule, like the proposed rule, includes derivatives of the interests described above. Derivatives of ownership interests provide holders with economic exposure to the profits and losses of the covered fund or an ability to earn a return based on the performance of the fund's underlying holdings or investments in a manner substantially similar to an ownership interest. The Agencies believe the final rule's approach appropriately addresses the statutory purpose to limit a banking entity's economic exposure to covered funds, irrespective of the legal form, name, or issuer of that ownership interest.

As noted above, the proposed definition of ownership interest did not include carried interest (termed ''restricted profit interest'' in the final rule). The proposal recognized that many banking entities that serve as investment adviser or provide other services to a covered fund are routinely

[2094] The reference to ''all or a portion of excess spread'' is meant to include within the definition of ownership interest the right to receive any excess spread which remains after the excess spread is used to pay expenses, maintain credit enhancement such as overcollateralization or is otherwise reduced.

[2095] This characteristic does not refer to any reduction in the stated claim to principal or interest of a holder of an interest that occurs either as a result of a *bona fide* subsequent renegotiation of the terms of an interest or as a result of a bankruptcy, insolvency, or similar proceeding.

[2096] This provision is not intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities. However, the activities of banking entities are subject to the anti-evasion provisions.

[2097] *See supra* note 2085.

[2098] *See supra* note 2087.

compensated for services they provide to the fund through receipt of carried interest. As a result, the proposed rule provided that an ownership interest with respect to a covered fund did not include an interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the banking entity (or an affiliate, subsidiary or employee thereof) served as investment manager, investment adviser, or commodity trading advisor, so long as certain enumerated conditions were met.[2099]

The enumerated conditions contained in the proposal were designed to narrow the scope of the exclusion of carried interest from the definition of ''ownership interest'' so as to distinguish between an investor's economic risks and a service provider's performance-based compensation. This was designed to limit the ability of a banking entity to structure carried interest in a manner that would evade section 13's restriction on the amount of ownership interests a banking entity may have as an investment in a covered fund.

Commenters disagreed over whether the definition of ownership interest should exclude carried interest. For instance, some commenters did not support excluding carried interest from the definition of ownership interest, arguing that such an exclusion was too permissive and inconsistent with the statute because, for instance, carried interest derives its value in part by tracking gains on price movements of investments by the fund.[2100] One commenter argued that, despite the fact that carried interest is typically provided as compensation for services provided to a fund, carried interest is a form of investment and therefore should be included as an ownership interest.[2101] Another commenter argued that permitting banking entities to hold an unrestricted amount of carried interest could create an indirect and undesirable link between prohibited proprietary trading and covered fund activities.[2102] These commenters also argued that treating carried interest as compensation for providing services would be inconsistent with the manner in which carried interest is treated for tax purposes.[2103]

Other commenters, however, supported excluding carried interest from the definition of an ownership interest and argued the exclusion was consistent with the words and purpose of section 13.[2104] One commenter argued that carried interest is readily distinguished from an investment in a covered fund because carried interest normally does not expose a banking entity to a covered fund's losses (other than in limited instances such as when a ''clawback'' provision is triggered).[2105] Another commenter argued that permitting a banking entity to receive carried interest without being subject to the requirements of section 13 regarding ownership interests better aligns the interest of the investment manager with that of the fund and its investors.[2106] Another commenter supported expanding the definition of carried interest to include an interest received by a banking entity in return for qualifying services (*e.g.,* lending, placement, distribution, or equity financing) provided to the investment manager of the fund, but not directly provided to the fund itself.[2107]

The proposal established four criteria that must be met in order for carried interest to be excluded from the definition of ownership interest. First, the proposal required that carried interest have the sole purpose and effect of permitting the banking entity or an employee thereof to share in the covered fund's profits as performance compensation for services provided to the fund. While most commenters did not object to this criterion, one commenter argued that the wording of this approach would appear to prohibit an employee of the banking entity from retaining a carried interest after the employee has changed employment.[2108] This commenter argued that the determination of the carried interest's purpose should be made only at the time the interest is granted, thereby enabling an employee to retain the carried interest if and when the employee no longer provides investment management, investment advisory, or similar services to the fund or is no longer employed at the banking entity.

Second, the proposal required that carried interest, once allocated, be distributed to the banking entity promptly after it is earned or, if not so distributed, not share in the subsequent profits and losses of the covered fund. One commenter urged the Agencies to allow the ''reserve'' portion of carried interest that for tax purposes is allocated to the investment manager or investment adviser, but invested alongside the fund and not formally allocated or distributed by the fund, also to qualify for the exclusion as carried interest.[2109] This commenter also suggested that this criterion should not affect the common European structure in which allocated carried interest may share in the subsequent losses, but not the profits, of the fund.

Third, under the proposal a banking entity (including its affiliates or employees) was not permitted to provide funds to the covered fund in connection with receiving a carried interest. The proposal specifically requested comment on whether the exemption for carried interest, including this requirement, was consistent with the current tax treatment and requirements of carried interest arrangements.[2110] Commenters urged the Agencies to relax or amend this criterion so that banking entities, including their affiliates and employees, whether directly or indirectly through a fund vehicle, would be permitted to make minimal capital contributions to the fund (typically less than 1 percent) in connection with the receipt of carried interest to the extent that such contributions provide the basis for treating the interest as carried interest for tax purposes.[2111] However, these commenters supported the proposal's requirement that any amount contributed by a banking entity in connection with receiving a carried interest should be aggregated with the banking entity's ownership interests for purposes of the 3 percent investment limits.

Fourth, the proposal provided that carried interest may not be transferable by the banking entity (or the affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary of the banking entity. Commenters generally urged removing the proposal's limitations on transferability and argued, among other things, that this criterion could prevent a banking entity (or its affiliate or employee) from transferring the carried interest in connection with selling or otherwise transferring the provision of advisory or other services that gave rise to the carried interest.[2112] Similarly, one commenter argued that the final rule should not require carried interest to be

[2099] *See* proposed rule § ____.10(b)(3)(ii).

[2100] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012).

[2101] *See* Public Citizens; *See also* Occupy.

[2102] *See* AFR *et al.* (Feb. 2012).

[2103] *See* Occupy; Public Citizens; AFR *et al.* (Feb. 2012).

[2104] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Credit Suisse (Williams); SVB.

[2105] *See* Credit Suisse (Williams).

[2106] *See* TCW.

[2107] *See* Credit Suisse (Williams).

[2108] *See* TCW.

[2109] *See* Credit Suisse (Williams).

[2110] Joint Proposal, 76 FR 68,899.

[2111] *See* TCW; SIFMA (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2112] *See* ASF (Feb. 2012); *See also* Credit Suisse (Williams); SVB.

re-characterized as an ownership interest if it is transferred among employees, family members of employees or to estate planning vehicles upon an employee's death.[2113]

After considering carefully comments received on the proposal, the Agencies have determined to retain in the final rule the exclusion from the definition of ''ownership interest'' for a restricted profit interest (termed ''carried interest'' in the proposed rule[2114]) largely as provided in the proposed rule. The final rule, like the proposal, recognizes that banking entities that serve as investment adviser or provide other services to a covered fund are routinely compensated for such services through receipt of a restricted profit interest. The final rule, also like the proposal, generally excludes restricted profit interest from the definition of ownership interest subject to conditions designed to distinguish restricted profit interest, which serves as a form of compensation, from an investment in the fund prohibited (or limited) by section 13. As explained in detail below, the definition of restricted profit interest in the final rule has been modified from the proposal in several aspects to respond to commenters' concerns and to more effectively capture the types of compensation that is often granted in exchange for services provided to a fund. However, like the proposal, the final rule continues to contain a number of requirements designed to ensure that restricted profit interest functions as compensation for providing certain services to a covered fund and does not permit a banking entity to evade the investment limitations or other requirements of section 13.

Under the final rule, restricted profit interest is defined to include an interest held by an entity (or employee or former employee thereof) that serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as:

(i) The sole purpose and effect of the interest is to allow the entity (or an employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

(ii) all such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in subsequent investment gains of the covered fund;

(iii) any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the investment limitations of § ____.12; and

(iv) the interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.[2115]

The final rule, like the proposal, permits any entity (or the affiliate or employee thereof) to receive or hold restricted profit interest if the entity (or the affiliate or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider to the covered fund. For example, an entity that provides services to the covered fund in a capacity as sub-adviser or placement agent would be eligible to receive or hold restricted profit interest.

As requested by commenters, the first condition in the final rule, in contrast to the proposal, permits an employee or former employee to retain a restricted profit interest after a change in employment status so long as the restricted profit interest was originally received as compensation for qualifying services provided to the covered fund.

Also in response to issues raised by commenters, the second condition in the final rule has been modified to permit so-called ''clawback'' features whereby restricted profit interest that has been provided to an investment manager, investment adviser, commodity trading advisor, or similar service provider may be taken back if certain subsequent events occur, such as if the fund fails to achieve a specified preferred rate of return or if liabilities or subsequent losses are incurred by the fund. Under these circumstances, the Agencies believe it is appropriate to allow the allocated but undistributed profits to be clawed back from the service provider's performance compensation, and the final rule has been amended to allow this practice. The final rule makes clear, however, that the undistributed profits may only be held in the fund in connection with such a clawback arrangement. Undistributed profits that remain in the covered fund after they have been allocated without connection to such an arrangement would be deemed to be an investment in the fund and would be an ownership interest under the final rule. Importantly, the final rule also retains the limitation in the proposal that undistributed profit may not share in subsequent investment gains of the covered fund. This limitation (together with the limited circumstances under which the undistributed profit may be retained in the fund) appears necessary in order to distinguish restricted profit interest, which functions as performance compensation and is not intended to be a form of investment, from an ownership interest, which is designed to be an investment. The Agencies believe that this approach achieves an appropriate balance between accommodating receipt of restricted profit interest, including such amounts held in ''reserve,''[2116] and limiting the ability of a banking entity to evade the investment limitations of section 13. The Agencies expect to review restricted profit interests to ensure banking entities do not use the exclusion for restricted profit interest in a manner that functions as an evasion of section 13.

As noted above, the Agencies understand that entities that provide investment management, investment advisory, commodity trading advisory or other services to a covered fund may, in connection with receiving restricted profit interest, be required to hold a small amount of ownership interests in a fund to provide the basis for desired tax treatment of restricted profit interest. Accordingly, the third condition of the final rule allows an entity that provides qualifying services to a fund to contribute funds to, and have an ownership interest in, the fund in connection with receiving restricted profit interest. As under the proposal, the amount of the contribution must be counted toward the investment limits under section 13(d)(4) and § ____.12 of the final rule. This would include attribution to the banking entity of sums invested by employees in connection with obtaining a restricted profit interest. Thus, the final rule permits a

[2113] *See* TCW.

[2114] *See supra* note 2091 and accompanying text.

[2115] *See* final rule § ____.10(d)(6)(ii).

[2116] The Agencies believe that this addresses a commenter's concern regarding the ''reserve'' portion of carried interest discussed above; however such amounts may not share in subsequent investment gains of the covered fund for the reasons also discussed above.

banking entity that provides investment management, investment advisory, or commodity trading advisory services to have both an ownership interest in, and receive restricted profit interest from, the covered fund, so long as the aggregate of the sums invested in all ownership interests acquired or retained by the banking entity (including a general partnership interest), either in connection with receiving the restricted profit interest or as an investment, are within the investment limitations in section 13(d)(4) and § ____.12 of the final rule. The Agencies believe this more appropriately implements the requirements of section 13 of the BHC Act by permitting banking entities to continue to provide customer-driven investment management services through organizing and offering covered funds, while also abiding by the investment limitations of section 13.

In response to comments, the fourth condition of the final rule permits the transfer of a restricted profit interest in connection with a sale to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund. In response to comments, the final rule also permits the transfer of a restricted profit interest to immediate family members of the banking entity's employees or former employees that provide investment management, investment advisory, commodity trading advisory, or other services to the covered fund, or in connection with the death of such employee. Also in response to comments, the final rule permits the transfer of a restricted profit interest to an affiliate or employee that provides investment management, investment advisory, commodity trading advisory, or other services to the covered fund. However, the final rule, like the proposed rule, would treat a restricted profit interest as an ownership interest if the restricted profit interest is otherwise transferable. This remaining restriction recognizes that a freely transferable restricted profit interest has the same economic benefits as an ownership interest and is essential to differentiating a restricted profit interest from an ownership interest.

f. Definition of ''Resident of the United States''

Section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' The statute does not define this term.

Under the proposed rule, the term ''resident of the United States'' was used in the context of the exemptions for covered trading and covered fund activities. As proposed, the definition of resident of the United States was similar, but not identical, to the SEC's definition of U.S. person in Regulation S, which governs offerings of securities outside of the United States.[2117] The Agencies proposed this approach in order to promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S.

Some commenters supported the proposed definition of resident of the United States.[2118] One commenter suggested that the proposed rule defined resident of the United States too broadly and inappropriately precluded investments in U.S. funds by foreign banking entities.[2119]

Other commenters generally argued that the final rule should adopt the definition of ''U.S. person'' under the SEC's Regulation S without the modifications in the proposed rule.[2120] According to many commenters, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S.[2121] They argued that, to the extent that the definitions of ''resident of the United States'' under section 13 and ''U.S. person'' under Regulation S differ, this would create unnecessary uncertainty and increase compliance burdens associated with monitoring multiple definitions.[2122] Other commenters urged the Agencies not to depart from the treatment of international parties and organizations (*e.g.,* the International Monetary Fund and the World Bank) under the SEC's Regulation S.[2123]

Many commenters contended that, because the definition of resident of the United States in the proposal was generally broader than the definition of U.S. person under Regulation S, many additional types of persons, entities and investors would be deemed residents of the United States for purposes of the foreign activity exemptions. Commenters argued that this would limit the potential for foreign banking entities to effectively use those statutorily provided exemptions. A few commenters noted that using a definition in the foreign fund exemption that differs from the definition in Regulation S loses the advantage of using a term that is already understood by market participants and that avoids confusion and limits compliance costs.[2124]

Other commenters suggested that defining resident of the United States as proposed presented problems for investment funds managed by U.S. investment advisers, even those without U.S. investors.[2125] Some commenters argued that, under the proposed definition, a foreign fund managed by a U.S. investment adviser or sub-adviser that is not otherwise subject to section 13 might be deemed a resident of the United States, thereby disqualifying the fund from relying on the foreign funds exemption, a result inconsistent with the purpose of section 13 and the statutory exemption in section 13(d)(1)(I).[2126]

Commenters also argued that the proposed definition raised issues for compensation plans of international organizations that are subject to section 13 of the BHC Act. Several commenters argued that U.S. employees of a foreign banking entity should not be considered residents of the United States if they invest in a non-U.S. covered fund pursuant to a *bona fide* employee investment, retirement or compensation program.[2127] The Agencies have carefully considered the comments received on the definition of resident of the United States, and have determined to modify the final rule as discussed below. The term ''resident of the United States'' is not defined in the statute and is used by the statute to clarify when

[2117] *See* proposed rule § ____.2(t); 17 CFR 230.901–230.905.

[2118] *See, e.g.,* Occupy.

[2119] *See* Sens. Merkley & Levin (Feb. 2012) (citing 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[2120] *See, e.g.,* Union Asset; EFAMA; BVI; AFME *et al.*; IIB/EBF; Credit Suisse (Williams); Hong Kong Inv. Funds Ass'n.; PEGCC; UBS; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); AFG.

[2121] *See* PEGCC; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); ICI (Feb. 2012); Credit Suisse (Williams).

[2122] *See* IIB/EBF; Credit Suisse (Williams); ICI (Feb. 2012); ICI Global; PEGCC.

[2123] *See* IIB/EBF; ICI Global; Credit Suisse (Williams).

[2124] *See* Allen & Overy (on behalf of Foreign Bank Group); IIB/EBF; PEGCC; Union Asset.

[2125] *See, e.g.,* MFA; TCW.

[2126] *See* AFG; BVI. *See also* MFA; TCW. Similarly, these commenters argued that although treated as a non-U.S. person under Regulation S, a non-U.S. fund organized as a trust in accordance with local law with a limited number of U.S. investors would have been a resident of the United States. Under the proposal, this foreign fund could not invest in another foreign covered fund *See*king to rely on the exemption for covered fund activities or investments that occur solely outside of the United States.

[2127] *See* IIB/EBF; Credit Suisse (Williams); UBS; JPMC.

foreign activity or investment of a foreign banking entity qualifies for the foreign funds exemption in section 13(d)(1)(I). The purpose of this exemption is to enable foreign banking entities to continue to engage in foreign funds activities and investments that do not have a sufficient nexus to the United States so as to present risk to U.S. investors or the U.S. financial system.[2128] The purpose of Regulation S is to provide a safe harbor from the registration provisions under the Securities Act for offerings that take place outside of the United States.[2129]

The Agencies believe that, because the covered funds provisions of the final rule involve sponsoring covered funds and offering and selling securities issued by funds (as compared to counterparty transactional relationships), the securities law framework reflected in Regulation S would most effectively achieve the purpose of the foreign funds exemption. As noted by commenters and discussed above, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S, and differing definitions under section 13 and Regulation S could create uncertainty and increase compliance burdens associated with monitoring multiple definitions. The Agencies therefore have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in Regulation S.[2130]

In addition, as explained in detail below in Part IV.B.4.b.3. of this **SUPPLEMENTARY INFORMATION**, the final rule provides that an ownership interest is offered for sale or sold to a resident of the United States if it is sold in an offering that ''targets'' residents of the United States.[2131] As explained in more detail in that section, this approach is consistent with Regulation S.

g. Definition of ''Sponsor''

Section 13(h)(5) of the BHC Act defines ''sponsor'' to mean: (i) Serving as a general partner, managing member, or trustee of a covered fund; (ii) in any manner selecting or controlling (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) sharing with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2132] Sponsor is a key definition because it defines, in part, the scope of activities to which the prohibition in section 13(a)(1) applies.[2133]

Under the proposal, the term sponsor would have been defined largely as in the statute.[2134] Nearly all commenters who addressed the definition of sponsor argued that the definition was too broad and suggested various ways to narrow or limit the definition.[2135] Commenters generally expressed concerns that a sponsor to a covered fund became subject to the restrictions of section 13(f), limiting the relationships of the banking entity with the covered fund. Commenters argued this would prevent banking entities from providing many customary services to covered funds.[2136]

The proposal excluded from the definition of ''trustee'' as used in the term sponsor a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee's Retirement Income Security Act (''ERISA'') (29 U.S.C. 1103(a)(1)).[2137] On the other hand, the proposal provided that any banking entity that directs a directed trustee, or that possesses authority and discretion to manage and control the assets of a covered fund for which a directed trustee serves as trustee, would be considered a trustee of the covered fund.

Commenters generally supported the exception for directed trustees in the proposed rule but argued that the exception was too narrow because it only referred to directed trustees under section 403(a)(1) of the ERISA and did not include other similar custodial or administrative arrangements that may not meet those requirements or be subject to ERISA.[2138] These commenters argued that banking entities that serve as trustees or custodians of covered funds may provide a limited range of ministerial services or exercise limited fiduciary duties that, while not subject to ERISA or beyond those permitted for a directed trustee under ERISA, nevertheless do not involve the exercise of investment discretion or control over the operations of the covered fund in the same manner as a general partner or managing member. Some of these commenters advocated defining ''directed trustee'' more expansively to include any situation in which a banking entity serves solely in a directed, fiduciary, or administrative role where a third-party and not the banking entity exercises investment discretion.

In particular, some commenters also argued that a trustee should not be viewed as having investment discretion, and therefore should not be treated as a sponsor, if it possesses only the authority to terminate an investment adviser to a covered fund and to appoint another unaffiliated investment adviser in order to fulfill a demonstrable legal or contractual obligation of the trustee, or the formal but unexercised power to make investment decisions for a covered fund in circumstances where one or more unaffiliated investment advisers have been appointed to manage fund assets. Some commenters argued in favor of excluding trustees serving under non-U.S. trust arrangements pursuant to which they may have legal or contractual authority to, but in fact do not, exercise investment discretion (*i.e.,* the entity has the formal authority to appoint an investment adviser to a trust but does so only in extraordinary circumstances such as appointing a successor investment adviser).[2139]

A few commenters requested confirmation that a banking entity acting as a custodian should not be considered a sponsor of a covered fund.[2140] One commenter argued that traditional client trust accounts for which a bank serves as discretionary trustee should not, by implication, themselves become ''covered funds'' that are ''sponsored'' by the bank.[2141]

[2128] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2129] *Offers and Sales,* Securities Act Release No. 6863 (Apr. 24, 1990), 55 FR 18,306 (May 2, 1990).

[2130] *See* final rule § ____.10(d)(8).

[2131] *See infra* Part IV.B.4.b.3.

[2132] *See* 12 U.S.C. 1851(h)(5).

[2133] *See* 12 U.S.C. 1851(a)(1).

[2134] *See* proposed rule ____.10(b)(5).

[2135] A number of comments received regarding the definition of sponsor relate to securitization structures and are addressed below. There also were a few comments urging that insurance companies not be considered to sponsor their separate accounts. *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide. The Agencies believe these concerns should be addressed by the exclusion of separate accounts from the definition of covered fund, as discussed in Part IV.B.1.c.6. of this **SUPPLEMENTARY INFORMATION.**

[2136] *See, e.g.,* ASF (Feb. 2012); BNY Mellon *et al.;* Credit Suisse (Williams).

[2137] *See* proposed rule § ____.10(b)(6); *See also* 29 U.S.C. 1103(a)(1).

[2138] *See, e.g.,* Arnold & Porter; Ass'n. of Global Custodians; BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); *See also* Fin. Services Roundtable (June 14, 2011) (recommending the definition of directed trustee under the Board's Regulation R be used, which defines directed trustee to mean ''a trustee that does not exercise investment discretion with respect to the account'').

[2139] *See* BNY Mellon *et al.* (providing proposed rule text or suggesting in the alternative clarification regarding the phrase ''exercise investment discretion'' in the final rule preamble); Ass'n. of Global Custodians; ICI Global; State Street (Feb. 2012).

[2140] *See* Ass'n. of Global Custodians; SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); AFG; AFTI; BNY Mellon *et al.;* EFAMA; IMA; State Street (Feb. 2012).

[2141] *See* Arnold & Porter. To the extent that a client trust account would not be an investment company but for the exclusion contained in section

Continued

One commenter argued that any person performing similar functions to a directed trustee (such as a fund management company established under Irish law), regardless of its formal title or position, also should be excluded if the person does not exercise investment discretion.[2142] Some commenters argued more generally for an exclusion from the definition of trustee (and therefore from the definition of sponsor) for entities that act as service providers (such as custodians, trustees, or administrators) to non-U.S. regulated funds, arguing that European laws already impose significant obligations on entities serving in these roles.[2143]

Under both section 13 of the BHC Act and the proposal, the definition of sponsor also included the ability to select or control (or to have employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of a covered fund. Some commenters argued that an entity should not be treated as a sponsor of a covered fund when it selects a majority of the *initial* directors, trustees or management of a covered fund that are independent of the banking entity, so long as the banking entity may not remove or replace the directors, trustees, or management and directors are subsequently either chosen by others or self-perpetuating.[2144] One of these commenters argued similarly that a banking entity should not be deemed to sponsor a covered fund if it selects an independent general partner, managing member or trustee of a new fund, so long as the general partner, managing member or trustee may not be terminated and replaced by the banking entity.[2145] Commenters argued that initial selection of these parties was inherently part of, and necessary to allow, the formation of a covered fund and would not provide a banking entity with ongoing control over the fund to a degree that the banking entity should be considered to be a sponsor.

The statute and proposed rule also defined the term sponsor to include an entity that shares, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name, with a covered fund. One commenter argued in favor of a narrower interpretation of this statutory provision.[2146] This commenter argued that a covered fund should be permitted to share the name of the asset manager that advises the fund without the asset manager becoming a sponsor so long as the asset manager does not share the same name as an affiliated insured depository institution or the ultimate parent of an affiliated insured depository institution.[2147] Another commenter argued that the proposal would put U.S. banking entities at a competitive disadvantage relative to non-banking entities and foreign banks.[2148] These commenters argued that the costs of rebranding covered funds or an asset manager would far outweigh any potential benefit in terms of reducing the risk that a banking entity may be pressured to ''bail out'' a covered fund with a name similar to its investment manager.[2149] One commenter also requested clarification that the name sharing prohibition does not apply in the context of offering documents that carry the names of the manager, sponsor, distributor, as well as the name of the fund itself.[2150] This commenter also advocated that, because of the costs associated with changing a fund name, the Agencies give specific guidance regarding how similar a name may be so as not to be a ''variation of the same name'' for purposes of the definition of sponsor and the activities permitted under section 13(d)(1)(G) and § ____.11 of the rule.

The Agencies have carefully considered comments received in light of the terms of the statute. Section 13(h)(5) of the BHC Act specifically defines the term ''sponsor'' for purposes of section 13. The Agencies recognize that the broad definition of sponsor in the statute will result in some of the effects commenters identified, as discussed above.

The final rule generally retains the definition of ''sponsor'' in the statute and the proposed rule, although with certain modifications and clarifications to respond to comments received regarding the exclusion for ''directed trustees.'' As in the proposed rule, the definition of sponsor in the final rule covers an entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund as defined in § ____.10(b)(1)(ii) of the final rule, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2151]

While commenters urged the Agencies to provide an exemption from the definition of sponsor for a banking entity that selects the initial directors, trustees, or management of a fund,[2152] the final rule has not been modified in this manner because the initial selection of the directors, trustees or management of a fund is an action characteristic of a sponsor and is essential to the creation of a covered fund. The Agencies note, however, that the statute and the final rule allow banking entities to sponsor covered funds, including selecting the initial board of directors, trustees and management, so long as the banking entity observes certain requirements and conforms any initial investment in the covered fund to the limits in the statute and regulation during the relevant conformance period as discussed in Part IV.B.3.b. of this **SUPPLEMENTARY INFORMATION.**[2153] Moreover, a banking entity that does not continue to select or control a majority of the board of directors would not be considered to be a sponsor under this part of the definition once that role or control terminates. In the case of a covered fund that will have a self-perpetuating board

3(c)(1) or 3(c)(7) of the Investment Company Act, such as the exclusion for common trust funds under section 3(c)(3) of that Act, it would not be a covered fund regardless of whether a banking entity acts as trustee.

[2142] *See* BNY Mellon *et al.*

[2143] *See* EFAMA; F&C; IRSG; Union Asset.

[2144] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012) (recommending the Agencies adopt independence guidelines similar to the FDIC's guidelines for determining whether audit committee members of insured depository institutions are ''independent'' of management); Credit Suisse (Williams).

[2145] *See* Credit Suisse (Williams) (arguing that such an approach would be consistent with the existing BHC Act concept of control with respect to funds).

[2146] A number of comments were also received regarding the restriction on name sharing that is one of the requirements of section 13(d)(1)(G) and § ____.11 of the proposed rule. These comments are discussed in Part IV.B.2.a.5. of this **SUPPLEMENTARY INFORMATION.**

[2147] *See* Credit Suisse (Williams); *See also* ABA (Keating); BlackRock; Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW (proposing similarly to limit the name-sharing restriction to the insured depository institution in context of section 13(d)(1)(G)).

[2148] *See* Goldman (Covered Funds).

[2149] *See* Credit Suisse (Williams); *See also* Goldman (Covered Funds).

[2150] *See* Credit Suisse (Williams).

[2151] *See* final rule § ____.10(d)(9). Some commenters asserted that custodians and service providers should not treated as sponsors under the final rule. The Agencies note, however, that a banking entity is not a sponsor under the final rule unless it serves in one or more of the capacities specified in the definition; controls or makes up the fund's board of directors or management as described in the final rule; or shares the same name or a variation of the same name with the fund as described in the final rule. *See, e.g., supra* note 2151 and accompanying text. *See also infra* note 2155.

[2152] *See supra* note 2144 and accompanying text.

[2153] Similarly, a banking entity may share the same name or a variation of the same name with a covered fund so long as the banking entity does not organize and offer the covered fund in accordance with section 13(d)(1)(G) and § ____.11.

of directors or a board selected by the fund's shareholders, this would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity.

As explained below, the Agencies believe that, in context, the term trustee in the definition of the term sponsor refers to a trustee with investment discretion. Consistent with this view, commenters urged the Agencies to exclude from the definition of sponsor certain trustees and parties commenters asserted acted in a similar capacity, as discussed above.[2154] The final rule therefore has been modified to exclude from the definition of trustee: (i) a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or (ii) a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (i).[2155] Under the final rule, a trustee would be excluded if the trustee does not have any investment discretion, but is required to ensure that the underlying assets are appropriately segregated for the benefit of the trust. Similarly, a trustee would be excluded if the trustee has no investment discretion but is authorized to replace an investment adviser with an unaffiliated party when the investment adviser resigns. With respect to an issuing entity of asset-backed securities and as explained below, a directed trustee excluded from the definition of sponsor would include a person that conducts their actions solely in accordance with directions prepared by an unaffiliated party.

The Agencies believe that this exclusion is appropriate because the relevant prong of the definition of sponsor (*i.e.,* serving as general partner, managing member, or trustee) specifies entities that have the ongoing ability to exercise control over a fund; directed trustees excluded from definition of sponsor in the final rule do not appear to have this ability and thus do not appear to be the type of entity that this prong of the definition of sponsor was intended to capture. If a trustee were itself to assume the role of investment adviser, or have the ability to exercise investment discretion with respect to the covered fund, the trustee would not qualify for this exclusion. The final rule does not include within the definition of sponsor custodians or administrators of covered funds unless they otherwise meet the definitional qualifications set forth in section 13 and the final rule.

The definition of sponsor will continue to cover entities that share the same name or variation of the same name of a covered fund for corporate, marketing, promotional, or other purposes, consistent with the definition of sponsor in section 13(h)(5). The Agencies recognize that some commenters urged the Agencies to modify this aspect of the definition of sponsor, and that the name-sharing prohibition included in the definition of sponsor (and in the conditions for the organize and offer exemption) will require some banking entities to rebrand their covered funds, which may prove expensive and will limit the extent to which banking entities may continue to benefit from brand equity they have developed.[2156] The costs a banking entity would incur to rebrand its covered funds would depend on the cost to rebrand the banking entity's current funds, as well as the banking entity's ability to attract new investor capital to its current and future covered funds. The total burden per banking entity, therefore, would depend on the brand equity as well as the number of covered funds that share a similar name.[2157] One commenter argued that, as a result, banking entities subject to section 13 may be at a competitive disadvantage to other firms that are not subject to these or similar restrictions.[2158] The Agencies believe that the final rule addresses some commenters' concerns to an extent by adopting a more tailored definition of covered, including a focused definition of foreign funds that will be covered funds and an exclusion for foreign public funds.[2159] In addition, to the extent that a banking entity would otherwise come under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that bears the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity this assistance could pose.

B. Definition of Sponsor With Respect to Securitizations

Commenters on the definition of sponsor in the context of securitization vehicles generally argued that the proposed definition of sponsor was too broad and requested clarification that various roles that banking entities might serve within a securitization structure would be excluded from the definition of sponsor, including servicers;[2160] backup servicers and master servicers;[2161] collateral agents and administrators;[2162] custodians;[2163] indenture trustees;[2164] underwriters, distributors, placement agents;[2165] arrangers, structuring agents;[2166] originators, depositors, securitizers;[2167] ''sponsors'' under the SEC's Regulation AB;[2168] administrative agents;[2169] and securities administrators and remarketing agents.[2170] Commenters argued that these parties should not be included in the definition of sponsor because such parties have clearly defined and extremely limited authority and discretion,[2171] do not have the right to control the decision-making and operational functions of the issuer,[2172]

[2154] *See, e.g., supra* notes 2138–2139 and accompanying text. *See also supra* note 2151.

[2155] *See* final rule § ____.10(d)(10). With respect to the concept of a ''directed trustee'' under foreign law, commenters generally requested changes only if non-U.S. mutual fund equivalents were not excluded from the definition of covered fund. As discussed above, the final rule explicitly excludes foreign public funds from the definition of covered fund, which should address these commenters concerns. *See* final rule § ____.10(c)(1).

[2156] *See supra* notes 2146–2150 and accompanying text.

[2157] *See infra* note 2159.

[2158] *See supra* note 2148 and accompanying text.

[2159] For example, one commenter argued that it would need to rebrand approximately 500 established funds under the rule proposal if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2160] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commenters argued that servicers will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012). Another commenter stated that servicers do not have the authority to select assets or make investment decisions on behalf of investors. *See* PNC.

[2161] *See* ASF (Feb. 2012).

[2162] *Id.*

[2163] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012).

[2164] *Id.*

[2165] *See* Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commentators argued that placement agents and underwriters will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012).

[2166] *See* Cleary Gottlieb (''party that structures the asset-backed securities''); SIFMA (Securitization) (Feb. 2012).

[2167] *See* Credit Suisse (Williams); Wells Fargo (Covered Funds).

[2168] *See* SIFMA (Securitization) (Feb. 2012) (arguing that Regulation AB sponsors will not have the right to control the decision-making and operational functions of the issuer after they deposit the assets).

[2169] *See* Credit Suisse (Williams).

[2170] *See* ASF (Feb. 2012); Wells Fargo (Covered Funds).

[2171] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2172] *See* SIFMA (Securitization) (Feb. 2012).

and would not have ''control'' under BHC Act control precedent.[2173] Conversely, one commentator supported defining sponsor under the proposed rule to include the Regulation AB sponsor, the servicer and the investment manager.[2174] Commenters also made arguments regarding the potential detrimental effects to securitization and credit markets if banking entities are prohibited from acting as sponsors of securitizations.[2175]

Commenters disagreed as to whether or not a sponsor under the final rule should include a party with any investment discretion, some investment discretion or complete investment discretion. Some commenters argued that certain parties should not be considered a sponsor because they were not an investment advisor or did not have investment discretion.[2176] Other commenters argued that an entity should not be considered a sponsor even though it has limited investment discretion,[2177] while others argued that investment advisers and parties with investment discretion should not be included in the definition of sponsor.[2178]

After considering comments received and the language and purpose of section 13, the Agencies have determined not to adopt a separate definition of sponsor for issuers of covered funds that are issuers of an asset-backed security. As described above and consistent with the statute, the definition of sponsor only includes parties that: (i) Serve as a general partner, managing member, or trustee (other than a directed trustee) of a covered fund; (ii) have the right to select or control a majority of the directors, trustees, or management of a covered fund; or (iii) share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. If the parties that commenters described do not serve in those capacities for a covered fund, do not have those rights with respect to a covered fund or do not share a name with a covered fund, such parties would not be a sponsor for purposes of the final rule, and, therefore, they would not be subject to the restrictions applicable to the sponsor of a covered fund, including the restrictions contained in section 13(f).[2179]

Additionally, the Agencies believe that the exclusion of loan securitizations from the definition of covered fund under the final rule addresses many of the commenters' concerns about the sponsor definition because this exclusion limits the types of securitizations that are covered funds and subject to the final rule. Similarly, the exclusion of certain ABCP conduits from the definition of covered fund will mean that the restrictions under section 13(f) will not apply to qualifying asset-backed commercial paper conduits.

As with any other covered fund under the final rule, the term sponsor would include a trustee that has the right to exercise any investment discretion for the securitization. For issuers of asset-backed securities, this would generally not include a trustee that executes decision-making, including investment of funds prior to the occurrence of an event of default, solely according to the provisions of a written contract or at the written direction of an unaffiliated party. In addition, under the rule as adopted a trustee with investment discretion may avoid characterization as a sponsor if it irrevocably delegates all of its investment discretion to another unaffiliated party with respect to the covered fund. The Agencies believe that these considerations regarding when a trustee is a sponsor responds to commenters' concerns regarding the roles of trustees in securitizations.[2180]

2. Section ____.11: Activities Permitted in Connection With Organizing and Offering a Covered Fund

Section 13(d)(1)(G) of the BHC Act permits a banking entity to make investments in and sponsor covered funds within certain limits in connection with organizing and offering the covered fund.[2181] Section ____.11 of the final rule implements this statutory exemption, and includes several changes from the proposed rule in response to concerns raised by commenters as described in detail below.[2182]

a. Scope of Exemption

Section ____.11 of the proposed rule described the conditions that must be met in order to qualify for the exemption provided by section 13(d)(1)(G) for covered fund activities conducted in connection with organizing and offering a covered fund.[2183] These conditions generally mirrored section 13(d)(1)(G) of the statute, and included: (i) The banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;[2184] (ii) the covered fund must

[2173] *See* Credit Suisse (Williams).

[2174] *See* Occupy.

[2175] *See* ASF (Feb. 2012); Credit Suisse (Williams).

[2176] *See* ASF (Feb. 2012) (arguing that service providers, including trustees, custodians, collateral agents, servicers, master servicers, backup servicers, securities administrators, remarketing agents and collateral administrators, should not be considered the sponsor or investment manager of a fund under section 13 of the BHC Act because they have roles that are principally ministerial in nature and do not generally involve investment discretion or management and control activities); PNC (arguing that a banking entity should not be deemed a sponsor simply by serving as underwriter, distributor, placement agent, originator, depositor, investment adviser, servicer, administrative agent, securitizer or similar role because these parties do not have the authority to select assets or make investment decisions on behalf of investors).

[2177] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One commenter argued that the limited discretion that a servicer, trustee or custodian may have to either invest funds within certain parameters, liquidate assets following a default on the asset or the securitization default, or mitigate losses subject to a servicing standard, should not be considered a sponsor because these entities do not exercise the level of management and control exercised by the general partner or managing member of a hedge fund or private equity fund. Another commenter argued that to the extent that any of these parties exercises discretion, such discretion (A) involves decisions made after another party defaults (*e.g.,* post-event of default collateral sale), (B) prescribed by the transaction documents (*e.g.,* choosing among a limited number of eligible investments) and (C) governed by standards of care (*e.g.,* the servicing standards). *See* ASF (Feb. 2012). Another commenter requested clarification that the exclusion of trustees that do not exercise investment discretion would also cover trustees that (A) direct investment of amounts in accordance with the applicable transaction documents, (B) act as servicer pending the appointment of a successor or (C) liquidate collateral. *See* SIFMA (Securitization) (Feb. 2012). One commenter argued that the definition of sponsor should not include an investment manager unless the investment manager (A) serves in one of the capacities designated in the definition of sponsor and can be replaced at the discretion of one or more entities serving in such capacity or with or without cause by the security holders or (B) has the ''discretion to acquire or dispose of assets in the securitization for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.'' *Id.*

[2178] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); TCW (arguing that the investment manager is typically unaffiliated with the general partner or equivalent of such fund, does not control the board of directors, is not responsible for the operations or books and records of the fund and generally does not perform any other significant function for the fund, such as acting as transfer agent).

[2179] As discussed above, commenters argued that that various roles that banking entities might serve within a securitization structure should be excluded from the definition of sponsor. *See supra* notes 2160–2170 and accompanying text.

[2180] The Agencies also note that, while the entities commenters identified may not fall into the definition of sponsor, the ability of a banking entity to acquire and retain an interest in a securitization that is a covered fund will depend on whether it conducts its activity in a manner permitted under one of the exemptions contained in section 13(d)(1) of the BHC Act, such as the exemption for organizing and offering a covered fund.

[2181] 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) (arguing that section 13 permits a banking entity to engage in a certain level of traditional asset management business).

[2182] *See* final rule § ____.11; proposed rule § ____.11.

[2183] *See* proposed rule §§ ____.11(a)–(h).

[2184] While section 13(d)(1)(G) of the BHC Act does not explicitly mention ''commodity trading

be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except in accordance with the limitations on amounts and value of those interests as permitted under subpart C of the proposed rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under § ____.16 of the proposed rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and may not use the word ''bank'' in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; (viii) the banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in § ____.11(h) of the proposed rule; and (ix) the banking entity must comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[2185]

Commenters raised concern that the proposed rule could be read to extend the prohibition on covered fund activities beyond the scope intended by the statute.[2186] Because the proposed exemption was applicable to banking entities engaged in ''organizing and offering'' a covered fund, commenters were concerned that the proposed rule might be interpreted to prohibit a banking entity from engaging in activities that are part of organizing and offering a covered fund but that are not prohibited under the covered fund prohibition. In this regard, commenters contended that the activity of ''organizing and offering'' a covered fund would include serving as investment adviser, distributor, broker, and other activities not prohibited by section 13 of the BHC Act and not involving the acquisition or retention of an ownership interest in or sponsorship of a covered fund as those terms are defined in section 13.[2187]

The Agencies have modified the final rule to address this concern, which reflects a reading of the proposal not intended by the Agencies. Section 13(d)(1)(G) of the BHC Act by its terms provides an exemption from section 13(a) of the BHC Act, which prohibits a banking entity from acquiring or retaining an equity, partnership or other ownership interest in or sponsoring a covered fund. To the extent that an activity is not prohibited by section 13(a), no exemption to that statutory prohibition is needed to conduct that activity. However, it is common for prohibited and non-prohibited activities to be conducted together in connection with offering and organizing a covered fund. For example, an entity that provides investment advisory services to a covered fund (an activity not itself prohibited by section 13(a)(1)(B) of the BHC Act) often acquires an ownership interest in a covered fund and/or appoints a majority of management of the covered fund (which is included in the definition of sponsor under the statute), both of which are covered by the statutory prohibition in section 13(a)(1)(B). In that case, the banking entity may engage in the prohibited activity as part of organizing and offering a covered fund only if the prohibited activity is conducted in accordance with the requirements in the exemption in section 13(d)(1)(G) or some other exemption.

The final rule reflects this view in that it permits a banking entity to invest in or sponsor a covered fund in connection with organizing and offering the fund, which may involve activities that are not prohibited by section 13. Under the final rule, a banking entity that serves as an investment adviser to a covered fund (including a sub-adviser), for example, may permissibly invest in the covered fund to the extent the banking entity complies with the requirements of section 13(d)(1)(G) of the Act. An entity that serves only as investment adviser, without making any investment or conducting any activity covered by the prohibition in section 13(a), would not be covered by the prohibition in section 13(a) and thus would not need to rely on section 13(d)(1)(G) and § ____.11 of the final rule to conduct that investment advisory activity.

As described in more detail below, a number of commenters expressed concern about applying the requirements of section 13(d)(1)(G) and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of section 13 of the BHC Act and implementing regulations.[2188] The Agencies believe that many of the concerns raised with respect to applying section 13(d)(1)(G) and the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State.[2189] Furthermore, foreign public funds are excluded from the definition of covered fund in the final rule.[2190] Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of section 13(d)(1)(G) and § ____.11 of the final rule, such as the name-sharing restriction or limitations on director and employee investments.

1. Fiduciary Services

In order to qualify for the exemption for activities related to organizing and offering a covered fund, section 13(d)(1)(G) generally requires that a banking entity provide *bona fide* trust, fiduciary, investment advisory, or

advisory services,'' the Agencies proposed to treat commodity trading advisory services in the same way as investment advisory services because the proposed rule would have included commodity pools within the definition of ''covered fund.'' One commenter argued that a covered banking entity should not be permitted to qualify for the exemption in section 13(d)(1)(G) based on providing commodity trading advisory services. *See* Occupy. The Agencies believe that commodity trading advisors provide services to commodity pools that are similar to the services an investment adviser provides to a hedge fund or private equity fund. Because certain commodity pools are included within the definition of covered fund, banking entities may organize and offer these commodity pools as a means of providing these services to customers.

[2185] *See* proposed rule §§ ____.11(a)–(h).

[2186] *See, e.g.,* Arnold & Porter.

[2187] *See* Arnold & Porter; F&C.

[2188] *See, e.g.,* EFAMA; ICI Global; JPMC.

[2189] *See* final rule § ____.10(b)(1)(iii).

[2190] *See* final rule § ____.10(c)(1).

commodity trading advisory services, that the covered fund be organized and offered in connection with *providing these* services, and that the banking entity providing those services offer the covered fund only to persons that are customers of those services of the banking entity.[2191] These requirements were largely mirrored in the proposed rule. Requiring a customer relationship in connection with organizing and offering a covered fund helps to ensure that a banking entity is engaging in the covered fund activity for others and not on the banking entity's own behalf.[2192]

As noted in the proposal, section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the Agencies explained in the proposal that the customer relationship may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer. This application of the customer requirement is consistent with the manner in which these services are provided by banking entities. The proposed rule also required that a banking entity relying on the authority contained in § ____.11 adopt a credible plan or similar documentation outlining how the banking entity intended to provide advisory or similar services to its customers through organizing and offering such fund.

Several commenters indicated support for this customer requirement and, in particular, the Agencies' view that the customer relationship need not be a preexisting one.[2193] A few commenters contended that the statute required that a banking entity have a pre-existing customer relationship, and may not solicit investors outside of its existing asset management customers.[2194] One of these commenters argued that this would place banking entities at a competitive disadvantage compared to investment advisers that are not banking entities (and thus not subject to the requirements of section 13 and the final rule), but argued that this is a necessary result of section 13.[2195]

The final rule adopts the language largely as proposed, and the Agencies continue to believe that the customer relationship required under section 13(d)(1)(G) and the final rule may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer.[2196] The final rule requires that a covered fund be organized and offered pursuant to a written plan or similar documentation outlining how the banking entity (or an affiliate thereof) intends to provide advisory or similar services to its customers through organizing and offering the fund. As part of this requirement, the plan must be credible and indicate that the banking entity has conducted reasonable analysis to show that the fund is organized and offered for the purpose of providing *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to customers of the banking entity (or an affiliate thereof) and not to evade the restrictions of section 13 of the BHC Act.

The language of the final rule also adopts the statutory requirements (and modifications related to commodity pools as discussed above) that the banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and that the covered fund be organized and offered only in connection with the provision of those services. Banking entities provide a wide range of customer-oriented services which may qualify as *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.[2197] Historically, banking entities have used covered funds as a method of providing these services to customers in a manner that is both cost efficient for the customer and allows customers to benefit from access to advice and services that might not otherwise be available to them. These benefits apply to long-established customers as well as individuals or entities that have no pre-existing relationship with the banking entity but choose to obtain the benefit of trust, fiduciary, investment advisory, or commodity trading advisory services through participation in the covered fund. Covered funds also allow customers to gauge the historical record of the banking entity in providing these services by reviewing the funds' past performance.

The statute does not require that a covered fund be offered only to pre-existing customers of the banking entity, and the Agencies believe that imposing such a requirement would not improve the quality of the trust, fiduciary, investment advisory, or commodity trading advisory service, enhance the safety and soundness of the banking entity, or reduce the risks to the customers or the banking entity. In each case, the banking entity provides trust, fiduciary or advisory services to a covered fund for the benefit of the banking entity's customers, and the statute recognizes that organizing and offering a covered fund is a legitimate method for providing that service. In addition, the banking entity must abide by all the statutory and prudential requirements imposed by section 13 and the entity's supervisors on the provision of those services. The Agencies do not believe that a pre-existing customer relationship requirement would be meaningful because it could easily be satisfied by a prospective customer seeking to invest in a covered fund by first establishing an account with a banking entity or purchasing another product (*e.g.,* a brokerage account or shares of a mutual fund).

2. Compliance With Investment Limitations

Section 13(d)(1)(G)(iii) of the BHC Act limits the ability of a banking entity that organizes and offers a covered fund to acquire or retain an ownership interest in that covered fund as an investment.[2198] Both the proposed rule and the final rule implement this provision by requiring that a banking entity limit its investments in a covered fund that the banking entity organizes and offers as provided in § ____.12.[2199] Comments received on investment limitations in the proposed rule, and modifications made to the final rule implementing these limitations, are described in Part IV.B.3. below.

3. Compliance With Section 13(f) of the BHC Act

Section ____.11(d) of the proposed rule required that the banking entity comply with the limitations on

[2191] *See* 12 U.S.C. 1851(d)(1)(G)(i); proposed rule § ____.11(a).

[2192] *See* 156 Cong. Rec. at S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2193] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC.

[2194] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[2195] *See* Sens. Merkley & Levin.

[2196] *See* final rule § ____.11(a)(1)–(2). *See* Part IV.B.2.b. below for a discussion of these requirements in the context of a banking entity that organizes and offers a covered fund that is an issuing entity of asset-backed securities.

[2197] *See, e.g.,* 12 U.S.C. 1843(c)(4), (c)(8), (K), 12 CFR 225.28(b)(5) and (6), 12 CFR 225.86, 12 CFR 225.125 (with respect to a bank holding company); 12 U.S.C. 24 (Seventh), 92a, 12 CFR Part 9 (with respect to a national bank); 12 U.S.C. Part 362 (with respect to a state non-member bank).

[2198] *See* 12 U.S.C. 1851(d)(1)(G)(iii).

[2199] *See* proposed rule and final rule § ____.12.

relationships with covered funds imposed by section 13(f) of the BHC Act.[2200] The final rule adopts this requirement and provides that the banking entity (and its affiliates) must comply with the requirements of § ____.14. Section 13(f) of the BHC Act prohibits certain transactions or relationships that would be covered by section 23A of the Federal Reserve Act, and provides that any permitted transaction is subject to section 23B of the Federal Reserve Act, in each instance as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2201] These limitations apply in several contexts, and are contained in § ____.14 of the final rule, discussed in detail below in Part IV.B.5.

4. No Guarantees or Insurance of Fund Performance

Section ____.11(e) of the proposed rule prohibited a banking entity that organizes and offers a covered fund from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which such covered fund invests.[2202] This prong implemented section 13(d)(1)(G)(iv) of the BHC Act and was intended to prevent a banking entity from engaging in bailouts of a covered fund in which the banking entity has an interest.[2203]

There were only a few comments received on this aspect of the proposal. One commenter supported the restriction on guarantees as effective and consistent with the statute.[2204]

One commenter argued that the final rule should not prohibit borrower default indemnification services (*i.e.,* the guarantee of collateral sufficiency upon a securities borrower's default) provided to lending clients by agent banks in connection with securities lending transactions involving a covered fund.[2205] This commenter argued that borrower default indemnification services guarantee only the deficit between the mark to market value of cash collateral received and the amount of any borrower default, and are therefore different from and more limited than the type of general investment performance or obligation guarantee that section 13 was designed to prevent.

The Agencies believe that the statute does not permit either full or partial guarantees of the obligations of a covered fund that the banking entity organizes and offers. Accordingly, the final rule, like the proposed rule, continues to mirror the statutory restriction on direct or indirect guarantees of the obligations or performance of a covered fund by a banking entity in connection with reliance on the exemption provided in section 13(d)(1)(G) of the BHC Act. However, in response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not prohibited. This type of indemnification is not a guarantee of the performance or obligations of a covered fund because it represents a guarantee to the customer or borrower of the obligation of the counterparty to perform and not a guarantee of the performance or underlying obligations of the covered fund. The requirement of the final rule that a banking entity and its affiliates not guarantee the obligations or performance of a covered fund that it organizes and offers therefore does not prohibit a banking entity from providing borrower default indemnifications to customers.

5. Limitation on Name Sharing With a Covered Fund

Section ____.11(f) of the proposed rule prohibited the covered fund from sharing the same name or a variation of the same name with the banking entity that relies on the exemption in section 13(d)(1)(G) of the BHC Act.[2206] The proposed rule also prohibited the covered fund from using the word ''bank'' in its name.[2207]

The name-sharing restriction was one of the most commented upon aspects of § ____.11. A number of commenters on this section expressed the view that the name-sharing restriction in section 13(d)(1)(G)(vi) of the BHC Act and the proposed rule was too strict. In particular, a number of commenters argued that the name-sharing restriction should allow an asset manager to share its name with a sponsored covered fund so long as the covered fund does not share the name of the insured depository institution or its affiliated holding company or use the word ''bank.''[2208]

Commenters argued that the name-sharing restriction as proposed would impose significant business and branding burdens on the industry without providing incremental benefit to the public.[2209] These commenters argued that it would be unduly burdensome and costly for funds currently affiliated with banking entities or managers that are themselves banking entities to change the name of their affiliated funds and that many of these funds have developed a reputation in the marketplace based on the current name of the fund and/or fund manager. Some of these commenters argued that the name-sharing restriction would place asset managers and funds affiliated with banking entities at a competitive disadvantage to other asset managers and funds.[2210]

A few commenters argued that the rationale for the name-sharing restriction (*i.e.,* to discourage bailing out funds) was already addressed under other restrictions of section 13(d)(1)(G) and the proposed rule that prohibit a banking entity from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or of any covered fund in which such covered fund invested and that require disclosure that investments in the covered fund are not insured by the Federal Deposit Insurance Corporation.[2211] These commenters questioned the necessity for the name-sharing restriction when a prohibition on bailing out funds is already in place and where there is disclosure that investors bear the risk of loss in the fund. Some of these commenters contended it was unlikely that investors in a covered fund with an SEC-registered investment adviser that has a name unrelated to the name of an insured depository institution would be

[2200] 12 U.S.C. 1851(d)(1)(G)(iv); proposed rule § ____.11(d).

[2201] *See* Part IV.B.5. below. The comments received on section 13(f) and § ____.16 of the proposed rule are described below.

[2202] 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § ____.11(e).

[2203] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2204] *See* Occupy.

[2205] *See* RMA.

[2206] 12 U.S.C. 1851(d)(1)(G)(vi); proposed rule § ____.11(f).

[2207] Similar restrictions on a fund sharing the same name, or variation of the same name, with an insured depository institution or company that controls an insured depository institution or having the word ''bank'' in its name, have been used previously in order to prevent customer confusion regarding the relationship between such companies and a fund. *See, e.g., Bank of Ireland,* 82 Fed. Res. Bull. 1129 (1996).

[2208] *See* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; EFAMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Katten (on behalf of Int'l Clients); Union Asset.

[2209] *See, e.g.,* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; *See also* SVB; Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012); UBS.

[2210] *See* Ass'n of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2211] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); T. Rowe Price; TCW.

misled to believe that the fund would be backed in any way by a related insured depository institution or the Federal Deposit Insurance Corporation.[2212] One of these commenters argued that the name-sharing restriction should not apply to organizations where insured depository institutions represent a *de minimis* component of the organization's operations.[2213]

Other commenters recommended that the name-sharing restriction not be applied to covered funds that rely on the exemption for covered fund activities and investments that occur solely outside of the United States.[2214] A few commenters expressed concern that the name-sharing restriction could be incompatible with regulatory requirements in certain foreign jurisdictions that a covered fund's name must indicate the fund's connection with the fund sponsor.[2215] One commenter argued that it is common practice in Germany to disclose the designation of the sponsoring investment manager in the fund name in order to provide transparency to investors, while a few commenters contended that European jurisdictions, including the U.K., require an authorized fund to have a name representative of the authorized investment manager to avoid misleading fund investors.[2216] Commenters also argued that the name-sharing restriction was inconsistent with the laws of Ireland and Hong Kong.[2217] Certain commenters argued that the impact of the name-sharing restriction would be particularly unfair to non-U.S. retail funds like European UCITS if such funds are not allowed to use the name of the bank while U.S. mutual funds would not be subject to the same restriction.[2218]

By contrast, some commenters supported the name-sharing restriction. For example, one commenter indicated that the use of the word ''bank'' or a shared name in the fund's name was already strongly discouraged by prior guidance.[2219] Another commenter supported the name-sharing restriction but argued it did not go far enough because it did not apply to funds that a banking entity was permissibly allowed to sponsor and invest in under other provisions of section 13.[2220] According to this commenter, covered funds permitted under other exemptions should not be allowed to share the same name with the banking entity.[2221]

After carefully considering comments and the express terms of the statute, the final rule includes the name-sharing restriction as proposed.[2222] The name-sharing restriction is imposed by the statute and prohibits a banking entity from sharing the same name or variation of the same name with a covered fund. The statute also defines the scope of the prohibition by defining the term ''banking entity'' to generally include any affiliate or subsidiary of an insured depository institution or any company that controls an insured depository institution.[2223]

However, the Agencies believe that many of the concerns raised by commenters with respect to this provision should be addressed through the revised definition of covered fund in the final rule, and modifications to the exemption for covered fund activities and investments that occur solely outside of the United States.[2224] For example, as discussed in greater detail above in Part IV.B.1.c.1., foreign public funds sold outside the United States are excluded from the definition of covered fund.[2225] In addition, pursuant to the definition of covered fund in the final rule, a foreign fund only becomes a covered fund with respect to a U.S. banking entity (including a foreign affiliate of that U.S. banking entity) that acts as sponsor to, or has an ownership interest in, the fund. Moreover, numerous funds operate successfully with names that differ from the name of the fund sponsor or adviser.

The Agencies recognize, however, that the statutory name-sharing restriction may affect some entities that will be covered funds and that cannot rely on another permitted activity exemption under section 13(d)(1) and the final rule. The name-sharing restriction may result in certain costs and other economic burdens for banking entities that advise these funds, as discussed in greater detail in Part IV.B.1.g. above.[2226] However, as the Agencies also note above, to the extent that the restriction results in a banking entity not otherwise coming under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that shares the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity that this assistance might pose. The Agencies also expect that the conformance period, both for compliance with section 13 of the BHC Act generally and for funds that are illiquid funds, should be sufficient to allow covered funds to take the steps necessary to comply with the name-sharing restriction in the statute and final rule.

6. Limitation on Ownership by Directors and Employees

Section ____.11(g) of the proposed rule implemented section 13(d)(1)(G)(vii) of the BHC Act. That statutory provision prohibits any director or employee of the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[2227] This allows an individual employed by a banking entity, who also acts as fund manager or adviser (for example), to acquire or retain an ownership interest in a covered fund that aligns the manager or adviser's incentives with those of the banking entity's customers.[2228]

One commenter argued that only employees or directors who provide investment advisory services should be allowed to make an investment in the fund and that the rule should not allow employees or directors who provide other, unspecified services to invest in a fund.[2229] This commenter argued that the proposed rule would allow non-adviser banking entity employees who have no need to maintain ''skin in the game'' to earn profit on the fund's performance. According to another commenter, fiduciary clients of banking organizations often are less interested in whether the fund manager or other service providers have money in the fund than whether the client's own account manager, and those individuals

[2212] *See* TCW; Union Asset.

[2213] *See* T. Rowe Price.

[2214] *See, e.g.,* UBS.

[2215] *See* Credit Suisse (Williams); EFAMA; JPMC; Katten (on behalf of Int'l Clients); Union Asset; IAA; ICI Global; UBS; SIFMA *et al.* (Covered Funds) (Feb. 2012) (*citing* Directive 2004/39/EC of the European Parliament and Council).

[2216] *See* BVI; EFAMA; JPMC; UBS; Union Asset; ICI Global; IAA.

[2217] *See* UBS; Union Asset; ICI Global.

[2218] *See, e.g.,* AFG; ICI Global; JPMC.

[2219] *See* Arnold & Porter (citing SEC Division of Investment Management, Letter to Registrants (May 13, 1993); Memorandum to SEC Chairman Breeden from Division of Investment Management (May 6, 1993); FDIC, Board, OCC, OTS, Interagency Statement on Retail Sales of Non-Deposit Investment Products (Feb. 14, 1994)).

[2220] *See* Occupy the SEC at 165.

[2221] *See id.*

[2222] *See* final rule § ____.11(f).

[2223] *See* 12 U.S.C. 1851(d)(1)(G)(vi) & (h)(1).

[2224] For example, one commenter alleged that it would need to rebrand approximately 500 established funds if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2225] *See* final rule §§ ____.10(b)(1)(ii) & (c)(1).

[2226] *See* Part IV.B.1.g.

[2227] *See* 12 U.S.C. 1851(d)(1)(G)(vii); proposed rule § ____.11(g).

[2228] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2229] *See* Occupy.

above him/her who are responsible for investment decisions, have allocated his or her own assets in the same way and into the same general asset classes and funds as the client's fiduciary account is being allocated.[2230]

The more prevalent view among commenters was that the proposed rule should be revised and expanded to permit investments in a sponsored fund by a broader group of banking entity directors, officers, and employees, directly or indirectly through employee benefit programs or trust and fiduciary accounts, regardless of whether the individual provides services to the covered fund.[2231] Some commenters argued that narrowly limiting permissible director and employee investments could put asset managers affiliated with an insured depository institution at a competitive disadvantage relative to managers that are not affiliated with an insured depository institution,[2232] as well as make it more difficult for banking entities to offer their U.S. and non-U.S. employees similar choices in retirement plans.[2233]

Two commenters urged that the supervisors of a fund's portfolio managers or investment advisers should be permitted to invest.[2234] These commenters also argued that individuals who provide support services to the fund, including administrative, oversight and risk management, legal compliance, regulatory, product structuring, deal sourcing and origination, deal evaluation and diligence, investor relations, sales and marketing, tax, accounting, valuation and other operational support services, should be permitted to invest in the fund. These commenters also requested confirmation that any director, including an individual serving on the board or investment committee of a fund or its manager, should be permitted to invest.[2235] Another commenter argued that employees and directors should be permitted to make their own individual investment decisions independently without regard to whether they provide services to the covered fund.[2236] One commenter contended that a grandfathering approach is necessary to address situations where a pre-existing covered fund already has investments from directors and employees who do not directly provide services to the fund because the fund may be unable to force those individuals out of the fund.[2237]

A number of commenters argued that, if defined too narrowly, this restriction may conflict with the laws of other jurisdictions that require advisers and/or their directors and employees to invest in the funds they manage.[2238] For example, several commenters argued that this requirement will directly conflict with the European Alternative Investment Fund Managers Directive.[2239] Two commenters contended that certain jurisdictions, including the Netherlands, require directors and other personnel of fund managers to hold fund units or shares of funds managed by the fund manager as part of their pensions.[2240]

The final rule retains the requirement limiting the ownership of a covered fund by directors and employees of a banking entity (or an affiliate thereof) relying on the exemption in section 13(d)(1)(G) of the BHC Act.[2241] This limitation is imposed by statute on banking entities that rely on this exemption. If a director or employee does not provide services to the fund, they may not invest in that fund. As in the statute, the final rule allows employees who provide services to the fund other than investment advisory services to invest in the fund. Under the final rule, directors or employees who provide investment advice or investment management services to the fund may invest in that fund. Similarly, directors or employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services, may also invest in the fund. In response to comments, the final rule has been modified to make clear that a former director or employee may retain an interest in a covered fund if the director or employee acquired the interest while serving as a director or employee of the banking entity and providing investment advisory or other services to the covered fund.

The Agencies believe that many of the concerns raised by commenters regarding the effects of this limitation on foreign funds are addressed through the scope of foreign funds that will be covered funds, and revisions to the exemption provided for covered fund activities and investments that occur solely outside of the United States. Moreover, the final rule excludes foreign public funds and broad-based foreign pension funds from the definition of covered fund and they are thus not subject to the restrictions of section 13 or the final rule.[2242]

Section 13 clearly contemplates investments by certain employees and directors of the banking entity.[2243] However, the Agencies continue to believe that certain director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in section 13(d)(4) of the BHC Act and the final rule. In order to address this concern, the final rule attributes an ownership interest in a covered fund acquired or retained by a director or employee to a banking entity for purposes of the investment limits in section 13(d)(4) under certain circumstances. This attribution is discussed in detail below in Part IV.B.3.f.

7. Disclosure Requirements

Section ____.11(h) of the proposed rule required that, in connection with organizing and offering a covered fund, the banking entity clearly and conspicuously disclose, in writing, to prospective and actual investors in the covered fund that any losses in the covered fund will be borne solely by investors in the covered fund and not by the banking entity and its affiliates or subsidiaries; and that the banking entity's and its affiliates' or subsidiaries' losses in the covered fund will be limited to losses attributable to the ownership interests in the covered fund held by the banking entity and its affiliates or subsidiaries in their capacity as investors in the covered fund. In addition, the proposed rule required that a banking entity disclose, in writing: (i) That each investor should read the fund offering documents before investing in the covered fund; (ii) that the ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or

[2230] *See* Arnold & Porter.

[2231] *See* Arnold & Porter; BOK, Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011); PEGCC; T. Rowe Price.

[2232] *See* Credit Suisse (Williams).

[2233] *See* T. Rowe Price.

[2234] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2235] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2236] *See* BOK (citing proposed rule at § ____.17); Arnold & Porter.

[2237] *See* SVB.

[2238] *See* EFAMA; BVI; IAA; ICI Global; JPMC; Union Asset.

[2239] *See* Annex II para. 1(m). *Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers.*

[2240] *See* EFAMA; Union Asset.

[2241] *See* final rule § ____.11(g).

[2242] *See* final rule §§ ____.10(c)(1) and ____.10(c)(5).

[2243] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case); and (iii) the role of the banking entity and its affiliates, subsidiaries, and employees in sponsoring or providing any services to the covered fund. The proposed rule also required banking entities to comply with any additional rules of the appropriate Agency designed to ensure that losses in any covered fund are borne solely by the investors in the covered fund and not by the banking entity.[2244] In proposing the rule, the Agencies indicated that a banking entity may satisfy these disclosure requirements by making the required disclosures in the covered fund's offering documents.[2245]

A few commenters supported the disclosure requirement as effective and consistent with the statute.[2246] One commenter stated that the disclosures required in section 13(d)(1)(G)(viii) of the Act and the proposed rule are consistent with disclosures in the banking agencies' February 1994 ''Interagency Statement on Retail Sales of Non-deposit Investment Products'' and other FINRA and SEC guidance.[2247] One commenter suggested that the rule include a requirement that the disclosures be issued in plain English.[2248]

Another commenter argued that the Agencies should revise the disclosure requirements under the proposal so that offering materials of non-U.S. funds provided to non-U.S. investors outside the United States need not include the specified disclosures nor refer to the FDIC or other specific U.S. agencies.[2249] This commenter argued that a non-U.S. person investing in a non-U.S. fund offered or sponsored by a non-U.S. banking entity has no expectation that the fund or its interests would be insured by the FDIC. The Agencies believe this concern is addressed through the revised definition of covered fund, which generally provides that a foreign fund offered outside of the United States will only be a covered fund with respect to a U.S. banking entity (including a foreign affiliate of the U.S. banking entity) that acts as sponsor to, or invests in, the fund.[2250]

The final rule adopts the proposed disclosure requirements substantially as proposed. As explained above, these disclosures are largely required by the statute.[2251] The proposed requirement to disclose that ownership interests in a covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case) is not expressly required by the statute. However, section 13(d)(1)(G)(iii) permits the Agencies to impose additional rules designed to ensure that losses in a covered fund are borne solely by investors in the fund and not by a banking entity. The Agencies believe that requiring a banking entity to make this disclosure as part of organizing and offering a covered fund furthers this purpose by removing the potential for misperception that a covered fund sponsored by a banking entity (which by definition must be affiliated with a depository institution insured by the FDIC) is guaranteed by that insured institution or the FDIC. Moreover, as noted above, this disclosure is already commonly provided by banking entities.

b. Organizing and Offering an Issuing Entity of Asset-Backed Securities

To the extent that an issuing entity of asset-backed securities is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o–11) which requires a banking entity to retain and maintain a certain minimum interest in certain asset-backed securities.[2252] In order to give effect to this separate requirement under the Dodd-Frank Act, § ____.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under the provisions of that Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2253] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2254] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2255]

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides an exemption that permits a banking entity to organize and offer a covered fund that is an issuing entity of asset-backed securities.[2256] The Agencies have determined to provide this exemption in order to address the unique circumstances and ownership structures presented by securitizations.[2257] Under the final rule, a banking entity may permissibly organize and offer a covered fund that is an issuing entity of asset-backed securities so long as the banking entity (and its affiliates) comply with all of the requirements of § ____.11(a)(3) through (a)(8).[2258] As discussed above, the requirements of § ____.11(a)(3) through ____.11(a)(8) are that: (i) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § ____.12 of the final rule;[2259] (ii) the

[2244] 12 U.S.C. 1851(d)(1)(G)(viii); proposed rule § ____.11(h).

[2245] To the extent that any additional rules are issued to ensure that losses in a covered fund are borne solely by the investors in the covered fund and not by the banking entity, a banking entity would be required to comply with those as well in order to satisfy the requirements of section 13(d)(1)(G)(viii) of the BHC Act.

[2246] *See, e.g.,* Occupy.

[2247] *See* Arnold& Porter.

[2248] *See* Occupy.

[2249] *See* Katten (on behalf of Int'l Clients).

[2250] *See* final rule § ____.10(b)(1)(iii).

[2251] *See* 12 U.S.C. 1851(d)(1)(G)(viii).

[2252] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24,090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. *See* Credit Risk Retention, 78 FR 57,928 (Sept. 20, 2013).

[2253] *See* proposed rule § ____.14(a)(2)(iii).

[2254] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2255] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2256] *See* final rule § ____.11(b).

[2257] As used in this Supplementary Information, the term ''securitization'' means a transaction or series of transactions that result in the issuance of asset-backed securities.

[2258] *See* final rule § ____.11(b) (providing the requirements for a banking entity that is organizing and offering a covered fund that is an issuing entity of asset-backed securities by reference to the requirements of § ____.11(a), as discussed above).

[2259] As explained in detail below in Part IV.B.3. addressing the limitations on investments in covered funds by a banking entity, the final rule permits a banking entity to acquire and retain ownership interests in a covered fund in order to comply with section 15G of the Exchange Act (15 U.S.C.78o–11) in an amount that does not exceed the amount required to comply with the banking entity's chosen method of compliance under section

banking entity and its affiliates comply with the requirements of § ____.14 of the final rule; (iii) the banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (iv) the covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or variation of the same name with the banking entity (or an affiliate thereof) and does not use the word ''bank'' in its name; (v) no director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund except under the limited circumstances noted in the final rule; and (vi) the banking entity complies with the disclosure requirements regarding covered funds in the final rule.

The Agencies believe that the requirements of the exemption for organizing and offering a covered fund that is an issuing entity of asset-backed securities, which are in most aspects consistent with the exemption for organizing and offering a covered fund in section 13(d)(1)(G), provide limitations on a banking entity's securitization activities involving covered funds that are consistent with the limitations imposed with respect to organizing and offering a covered fund that is not an issuing entity of asset-backed securities. For instance, a banking entity may not share the same name as a covered fund that is an issuing entity of asset-backed securities and is prohibited from guaranteeing or otherwise ''bailing out'' a covered fund that is an issuing entity of asset-backed securities, including being required to comply with section 13(f) of the BHC Act regarding covered transactions with the covered fund. Furthermore, like a banking entity's investment in any covered fund, the final rule limits the ability of a banking entity to invest in a covered fund that is an issuing entity of asset-backed securities unless it meets the requirements of § ____.12.

Unlike many other covered funds, the Agencies understand that banking entities might not act in a fiduciary capacity when they organize and offer a covered fund that is a securitization vehicle. For instance, as part of organizing and offering a securitization vehicle, one or more parties may typically organize and initiate the securitization by selling or transferring assets, either directly or indirectly, to an issuing entity of asset-backed securities. An entity that provides these services typically does so as a service to provide investors and the entity's customers with the ability to invest in the assets in a manner and to a degree that they may otherwise be unable to do. In order to identify certain activities that would be included as organizing and offering a securitization, the final rule provides that organizing and offering an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, for the issuer, or acquiring or retaining an ownership interest in the issuer in compliance with the implementing regulations issued under section 15G of that Act.

The final rule reflects, as discussed above, that one or more parties that organize and offer an issuing entity of asset-backed securities may not provide any of the services identified in § ____.11(a)(1). In this case the banking entity is not required to comply with § ____.11(a)(1) or (a)(2). Section ____.11(b) of the final rule is designed to address situations where, as discussed above, a banking entity does not act in a fiduciary capacity when it organizes and offers a covered fund that is a securitization vehicle. With respect to any securitization vehicle that retains a collateral manager for investment advice regarding the assets of the securitization vehicle, such a collateral manager would be required to comply with all of the provisions of § ____.11(a) to acquire and retain an ownership interest in such securitization vehicle.

The final rule therefore both identifies certain activities that would be included as organizing and offering a securitization and modifies the requirements of § ____.11 to reflect differences between securitizations and other types of covered funds, as discussed above. The Agencies believe, therefore, that the final rule appropriately addresses the type of activity that is usually associated with organizing and offering a securitization and also comports with the manner in which Congress chose to define the type of parties engaged in activities that merit special attention related to issuing entities of asset-backed securities in another part of the Dodd-Frank Act.

The Agencies have determined to provide this exemption by using their authority in section 13(d)(1)(J) of the BHC Act and believe that this exemption promotes and protects the safety and soundness of banking entities and the financial stability of the United States. Many companies and other entities utilize securitization transactions to efficiently manage, allocate and distribute risks throughout the markets in a manner consistent with meeting the demands of their investors. Companies also utilize securitizations in order to help provide liquidity to certain asset classes or portions of the market that, absent this liquidity, may experience decreased liquidity and increased costs of funding. For instance, if banking entities were not permitted to organize and offer a securitization, the Agencies believe this would result in increased costs of funding or credit for many businesses of all sizes that are engaged in activities that section 13 of the BHC Act was not designed to address. Additionally, this exemption enables banking entities to acquire and retain ownership interests in a covered fund to comply with section 15G of the Exchange Act, which requires certain parties to a securitization transaction to retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. The Agencies therefore have determined that this exemption will promote and protect the safety and soundness of banking entities and the financial stability of the United States by facilitating the benefits securitizations can provide as discussed above, and also by enabling banking entities to comply with section 15G of the Exchange Act.

The Agencies believe it would not be consistent with the safety and soundness of banking entities or the financial stability of the United States to prevent banking entities from acquiring or retaining ownership interests in securitizations as part of the permitted activity of organizing and offering securitizations or from meeting any applicable requirements related to securitizations, including those imposed under section 15G of the Exchange Act. The Agencies note that the exemption for organizing and offering a securitization does not relieve banking entities of any requirements that they may be subject to with respect to their investments in or relationships with a securitization, such as any applicable requirements regarding conflicts of interest relating to certain securitizations under section 27B of the Securities Act of 1933.

c. Underwriting and Market Making for a Covered Fund

Section 13(d)(1)(B) permits a banking entity to purchase and sell securities and other instruments described in 13(h)(4) in connection with certain underwriting or market making-related activities.[2260] The proposal did not

15G and the implementing regulations issued thereunder.

[2260] *See* 12 U.S.C. 1851(d)(1)(B).

discuss how this exemption applied in the context of underwriting or market making of ownership interests in covered funds.

Commenters argued that the scope of the permitted activities under sections 13(d)(1)(B), (D) and (F), which respectively set out permitted activities of underwriting and market making-related activities, activities on behalf of customers, and activities by a regulated insurance company, apply to all of the activities prohibited under section 13(a), whether those activities would involve proprietary trading or ownership of or acting as a sponsor to covered funds.[2261] Commenters argued that the statutory exemption for underwriting and market making-related activities is applicable to both proprietary trading and covered fund activities, and recommended that the final rule allow banking entities to hold ownership interests and other securities of covered funds for the purpose of underwriting and engaging in market making-related activities.[2262] Commenters noted that many structured finance vehicles rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and argued that, without a market making exemption for securities of covered funds, banking entities would be unable to engage in customer-driven underwriting and market making activity with respect to securities issued by entities such as collateralized loan obligation issuers and non-U.S. exchange-traded funds.[2263]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to provide a covered fund specific provision for underwriting and market making-related activities of ownership interests in covered funds. These underwriting and market making activities are within the scope of permitted activities under the final rule so long as:

- The banking entity conducts the activities in accordance with the requirements of § ____.4(a) or § ____.4(b), respectively;
- With respect to any banking entity (or an affiliate thereof) that: Acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on § ____.11(a); acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § ____.11(b); or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § ____ .12(a)(2)(ii) and § ____.12(d); and
- With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § ____.11, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities under § ____ .11(c), are included in the calculation of all ownership interests under § ____.12(a)(2)(iii) and § ____.12(d).[2264]

The Agencies believe that providing a separate provision relating to permitted underwriting and market making-related activities for ownership interests in covered funds is supported by section 13(d)(1)(B) of the BHC Act.[2265] The exemption for underwriting and market making-related activities under section 13(d)(1)(B), by its terms, is a statutorily permitted activity and exemption from the prohibitions in section 13(a), whether on proprietary trading or on covered fund activities. Applying the statutory exemption in this manner accommodates the capital raising activities of covered funds and other issuers in accordance with the underwriting and market making provisions under the statute.

The final rule provides that a banking entity must include any ownership interests that it acquires or retains in connection with underwriting and market making-related activities for a particular covered fund for purposes of the per-fund limitation under § ____ .12(a)(2)(ii) if the banking entity: (i) Acts as a sponsor, investment adviser or commodity trading advisor to the covered fund; (ii) otherwise acquires and retains an ownership interest in the covered fund as permitted under § ____ .11(a); (iii) acquires and retains an ownership interest in the covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in the covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § ____ .11(b); or (iv) directly or indirectly guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests. This is designed to prevent any unintended expansion of ownership of covered funds by banking entities that are subject to the per fund limitations under § ____.12.

These banking entities will have a limited ability to engage in underwriting or market making-related activities for a covered fund for which the banking entity's investments are subject to the per-fund limitations in § ____.12 as discussed above. Such a banking entity will have more flexibility to underwrite and make a market in the ownership interests of such a covered fund in connection with organizing and offering the covered fund during the fund's seeding period, since during the seeding period a banking entity may own in excess of three percent of the covered fund, subject to the other requirements in § ____.12.

The final rule also provides that all banking entities that engage in underwriting and market-making related activities in covered funds are required to include the aggregate value of all ownership interests of the banking entity in all covered funds acquired and retained under § ____.11, including in connection with underwriting and market making-related activities under § ____.11(c), in the calculation of the aggregate covered fund ownership interest limitations under § ____ .12(a)(2)(iii) (and make the associated deduction from tier one capital for purposes of calculating compliance with applicable regulatory capital requirements).[2266]

Some commenters asked that the Agencies permit banking entities to engage in market making and underwriting in non-sponsored covered fund interests.[2267] The final rule permits

[2261] *See* Cleary Gottlieb *et al.*; JPMC; Credit Suisse (Williams).

[2262] *See* BoA; Cleary Gottlieb; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Deutsche Bank (Fund-Linked Products); SIFMA (Securitization) (Feb. 2012). Other commenters argued that application of Section 13(f) of the BHC Act would prohibit the underwriting and market making by a banking entity of the securities of a covered fund that such banking entity sponsors, organizes and offers or provides investment management advice or services because Section 13(f) of the BHC Act prohibits the purchase of securities by a banking entity from such a covered fund. *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); FSA (Feb. 2012).

[2263] *See* JPMC; Cleary Gottlieb.

[2264] *See* final rule § __.11(c).

[2265] A discussion of the implementation of section 13(d)(1)(D) and (F) with regard to the final rule's limitations on covered fund investments and activities is provided in the section that relates to permitted covered fund interests and activities by a regulated insurance company and § ____.13(c) of the final rule.

[2266] *See* final rule § ____.11(c)(3).

[2267] *See* Cleary Gottlieb; Credit Suisse (Williams).

a banking entity that does not hold an ownership interest in the covered fund in reliance on §§ ____.11(a) or ____.11(b) of the final rule, is not a sponsor of the covered fund, is not an investment adviser or commodity trading advisor to the covered fund, and does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests to rely on the market-making and underwriting exemption in § ____ .11(c) provided that the banking entity meets all of the requirements of that exemption. These conditions include the aggregate funds limitation and the capital deduction contained in § ____.12 after including all ownership interest held by the banking entity and its affiliates under § ____.11, including ownership interests acquired or retained under the exemption for underwriting and market making-related activities in § ____.11(c). In accordance with section 13(d)(1) of the BHC Act, the Agencies have determined that these restrictions on reliance on the market-making and underwriting exemption provided by section 13(d)(1)(B) are appropriate to address the purposes of section 13 of the BHC Act, which is aimed at assuring that banking entities do not bail-out a covered fund and maintain sufficient capital against the risks of ownership of covered funds. The Agencies note, however, that the guarantee restriction is not intended to prevent a banking entity from entering into arrangements with a covered fund that are not entered into for the purpose of guaranteeing the obligations or performance of the covered fund. For example, this restriction is not intended to prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity. The determination of whether an arrangement would fall within this guarantee restriction would depend on the facts and circumstances.

The Agencies emphasize that any banking entity that engages in underwriting or market making-related activities in covered funds must comply with all of the conditions applicable to such activity as set forth in section §§ ____.4(a) and ____.4(b).[2268] Thus, holdings of a single covered fund would be subject to limitations on risk as well as length of holding period, among other applicable limitations and requirements. These requirements are designed specifically to address a banking entity's underwriting and market making-related activities and to prohibit holding exposures in excess of reasonably expected near term demand of clients, customers and counterparties.

3. Section ____.12: Permitted Investment in a Covered Fund

a. Proposed Rule

Section ____.12 of the proposed rule implemented section 13(d)(4) of the BHC Act and described the limited circumstances under which a banking entity may acquire or retain an ownership interest in a covered fund that the banking entity (which includes its subsidiaries and affiliates) organizes and offers.[2269] Section 13(d)(4)(A) of the BHC Act permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers for the purpose of: (i) establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or (ii) making a *de minimis* investment in the fund, subject to several limitations. Section 13(d)(4)(B) of the BHC Act requires that investments by a banking entity in a covered fund must, not later than one year after the date of establishment of the fund, be reduced to an amount that is not more than three percent of the total outstanding ownership interests of the fund. Consistent with the statute, § .____12 of the proposal provided that, after expiration of the seeding period, a banking entity's investment in a single covered fund may not represent more than three percent of the total outstanding ownership interests in the covered fund (the ''per-fund limitation'').[2270] In addition, as provided in the statute, the proposal provided that the total amount invested by a banking entity in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (the ''aggregate funds limitation'').[2271]

b. Duration of Seeding Period for New Covered Funds

Commenters argued that it is essential to serving their customers efficiently that a banking entity be permitted to acquire and retain an ownership interest in a covered fund that it organizes and offers as a *de minimis* investment or for the purpose of establishing the fund. A number of commenters contended that a banking entity typically invests a limited amount of its own capital in a fund (''seed capital'') as part of organizing the fund to produce investment performance as a record of the fund's investment strategy (''track record'').[2272] Once a track record for the fund is established, the banking entity markets the fund to unaffiliated investors.

Commenters argued that the one-year seeding period provided in the proposed rule would be too short to establish a track record for many types of covered funds. Commenters argued that the duration of the track record investors typically demand before investing in a new fund depends on a number of factors (*e.g.,* the type of fund, investment strategy, and potential investors). According to commenters, an inability to demonstrate a track record over multiple years may reduce the allocation of capital by investors who are unable to gain an understanding of the investment strategy, risk profile, and potential performance of the fund.[2273]

Commenters provided alternative suggestions regarding how to define the start of the seeding period for purposes of applying the statutory exception for investments during the seeding period. For example, two commenters recommended that the Agencies treat a private equity fund as being established on the date on which the fund begins its asset-acquisition phase and is closed to new investors, and a hedge fund as established on the date on which the fund has reached its target amount of funding and begins investing according to the fund's stated investment objectives.[2274] Another commenter suggested that the permitted seeding period begin on the date on which third-party investors are first admitted to the fund.[2275]

Several commenters expressed concern that the per-fund limitation could be subject to evasion unless the Agencies require that the seeding period begin at the time funds are first invested

[2268] *See* final rule § ____.11(c)(1).

[2269] 12 U.S.C. 1851(d)(4); proposed rule § ____.12.

[2270] *See* proposed rule §§ ____.12(a)(1)(i);____.12(a)(2)(i)(A) and (B); ____.12(b).

[2271] *See id.* at §§ ____.12(a)(1)(ii); ____.12(a)(2)(ii); ____.12(c).

[2272] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); T. Rowe Price; Credit Suisse (Williams); Allen & Overy (on behalf of Canadian Banks);TCW.

[2273] *See et al.* (Covered Funds) (Feb. 2012); *See also* Ass'n of Institutional Investors (Feb. 2012); Bank of Montreal *et al.* (Jan. 2012); Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Japanese Bankers Ass'n; SSgA (Feb. 2012); T. Rowe Price; Union Asset. One commenter argued that this limitation would constrain portfolio composition of a covered fund due to an inability of a fund to raise sufficient capital to make larger investments. *See* Credit Suisse (Williams).

[2274] *See* AFG; Union Asset.

[2275] *See* SIFMA (Mar. 2012); *See also* Credit Suisse (Williams).

by the banking entity in the fund.[2276] Some of these commenters suggested the Agencies impose a dollar cap of $10 million on the seed capital that a banking entity may provide to a newly organized covered fund in addition to the statutory limits based on the amount of the fund's shares and the amount of the banking entity's tier 1 capital.[2277] These commenters argued that an explicit quantitative limit better accounted for the size of some banking entities, which otherwise made the potential amount of capital placed in covered funds quite large.[2278]

The Agencies have considered carefully the comments on the proposal and have made several modifications to the final rule to more clearly explain how the limitations apply during the seeding period. The final rule continues to provide that a banking entity may invest in a covered fund that it organizes and offers either in connection with establishing the fund, or as a *de minimis* investment.[2279] Importantly, the statute does not permit a banking entity to invest in a covered fund unless the banking entity organizes or offers the covered fund or qualifies for another exemption. As explained more fully in the discussion of § ____.11 above, a wide variety of activities are encompassed in organizing and offering a covered fund. Under the statute, which generally prohibits investments in covered funds, a banking entity may invest in a covered fund under the exemptions provided in section 13(d)(1) of the BHC Act, including section 13(d)(1)(G) and the provisions of section 13(d)(4), only if the banking entity engages in one or more of these permitted activities with regard to that covered fund and complies with all applicable limitations under the final rule regarding investments in a covered fund.

As noted above, the statute allows a banking entity to acquire and hold all of the ownership interests in a covered fund for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors.[2280] However, the statute also imposes a limit on the duration of an investment made in connection with seeding a covered fund. At the end of that period, the investment must conform to the limits on *de minimis* investments set by the statute. In keeping with the terms of the statute, the final rule, like the proposal, allows banking entities a seeding period of one-year for all covered funds. The statute also allows the Board to extend that period, upon an application by a banking entity, for two additional years if the Board finds an extension to be consistent with safety and soundness and in the public interest.[2281] As explained below, the final rule, like the proposal, incorporates this process and sets forth the factors the Board will consider when determining whether to allow an extended seeding period. The Board and the Agencies will monitor these extension requests to ensure that banking entities do not seek extensions for the purpose of evading the restrictions on covered funds or to engage in prohibited proprietary trading.

As noted above, the proposal did not specify ''date of establishment,'' and commenters suggested a variety of dates that could serve as the date of establishment for purposes of determining the duration of the seeding period and the per-fund limitations on ownership interests in a covered fund.[2282] After considering comments received on the proposal, the Agencies have modified the final rule to include a definition of ''date of establishment'' for a covered fund. In general, the date of establishment is the date on which an investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund. The Agencies perceive the act of making investments to execute an investment or trading strategy as demonstrating that the fund has begun its existence and is no longer simply a plan or proposal. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuing entity of asset-backed securities, the date of establishment under the final rule is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. This is the date that the entity is formed and the securities are generally sold around this time. The Agencies believe this is the appropriate time for the date of establishment for securitizations because this is the date that the securitization risks are transferred to the owners of the securitization vehicle. Once the assets have been transferred, the securitization has been established and securities of the issuer may typically be priced in support of organizing and offering the issuer. Setting a later time, such as when the fund becomes fully subscribed or the assets have been fully assembled, could permit a banking entity to engage in prohibited proprietary trading under the guise of waiting for investors that may never materialize.[2283]

The statute also requires a banking entity to actively seek unaffiliated investors to reduce or dilute the entity's ownership interest to the amount permitted under the statute. This requirement is included in the final rule, and underscores the nature of covered fund activities under section 13(d)(1)(G) as a method to provide investment advisory, trust and fiduciary services to customers rather than allow the banking entity to engage in prohibited proprietary trading. To effectuate the requirements of the statute, under the final rule, banking entities that organize and offer a covered fund must develop and document a plan for offering shares in the covered fund to other investors and conforming the banking entity's investments to the *de minimis* limits to help monitor and ensure compliance with this requirement.

While certain commenters requested that the final rule include a quantitative dollar limit on the amount of funds a banking entity may use to organize and offer a covered fund, the Agencies have declined to add this limitation in the final rule. This type of limit is not required by statute. Moreover, the Agencies believe that imposing a strict dollar limit may not adequately permit banking entities to employ trading or investment strategies that will attract unaffiliated investors, thereby precluding banking entities from meeting the demands of customers contrary to the purpose of section 13.

c. Limitations on Investments in a Single Covered Fund (''Per-Fund Limitation'')

Section 13(d)(4)(B) imposes limits on the amount of ownership interest a banking entity may have in any single covered fund at the end of the one year period (subject to limited extension) after the date of establishment of the fund (the ''seeding period''). In recognition of the fact that a covered

[2276] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2277] *See* Occupy; Sens. Merkley & Levin (Feb. 2012); *See also* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2278] *See, e.g.,* Public Citizen.

[2279] *See* final rule § ____.12(a)(1).

[2280] 12 U.S.C. 1851(d)(4).

[2281] *See id.* at 1851(d)(4)(C).

[2282] *See* SIFMA *et al.* (Mar. 2012); Credit Suisse (Williams); EFAMA: Hong Kong Inv. Funds Ass'n; AFG; Union Asset.

[2283] Importantly, the statute recognizes that a banking entity may need more than the automatic one-year *See*ding period to build a track record and/or market its interests to unaffiliated investors; therefore, a banking entity may apply for an extension of the *See*ding period as provided in __ __.12(e) of the final rule as discussed below in Part IV.B.3.h.

fund may have multiple classes or types of ownership interests with different characteristics or values, the proposal required that a banking entity apply the limits to both the total value of and total amount of the banking entity's ownership interest in a covered fund.

The proposed rule required a banking entity to calculate the per-fund limitation using two methods. First, a banking entity was required to calculate the value of its investments and capital contributions made with respect to any ownership interest in a single covered fund as a percentage of the value of all investments and capital contributions made by all persons in that covered fund. Second, a banking entity was required to determine the total number of ownership interests held by the banking entity in a single covered fund as a percentage of the total number of ownership interests held by all persons in that covered fund.[2284] Both calculations were required to be done without regard to committed funds not yet called for investment. The proposed rule also required the banking entity to calculate the value and amount of its ownership interest in each covered fund in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests.[2285] These calculations were designed to ensure that the banking entity's investment in a covered fund could not result in more than three percent of the losses of the covered fund being allocated to the banking entity's investment.[2286]

Commenters did not generally object to calculating the per-fund limitation based on both number and value of ownership interests. Several commenters urged the Agencies to allow a banking entity to value its investment in a covered fund based on the acquisition cost of the investment, instead of fair market value, notwithstanding the manner in which the covered fund accounts for or values investments for its shareholders generally.[2287] One commenter suggested that the Agencies allow a banking entity to choose between acquisition cost and fair value so long as the chosen valuation method is applied consistently to both the numerator and denominator when calculating the per-fund limitation.[2288]

To the extent that an issuer of an asset-backed security is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o–11) which requires certain parties to a securitization transaction, including banking entities, to retain and maintain a certain minimum interest in certain issuers or asset-backed securities.[2289] In order to give effect to this separate requirement under the Dodd-Frank Act, § ____.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under that provisions of the Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2290] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2291] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2292] Some commenters argued that the exemption should be broadened to permit a banking entity to hold in excess of the minimum amount required under section 15G of the Exchange Act instead of allowing only the minimum amount required by that section.[2293] One commenter requested that the final rule permit a banking entity to hold an amount of risk in a securitization that is commensurate with what investors demand rather than the minimum required by section 15G.[2294] Some commenters argued that banking entities may be subject to similar generally applicable requirements to hold risk in securitizations under foreign law, such as Article 122a of the Capital Requirements Directive issued by the European Union, and that the final rule should permit banking entities to comply with these foreign legal requirements.[2295]

Conversely, a few commenters objected to the proposed rule's exemption for risk-retention as unclear and argued that if the exemption was retained, the Agencies should provide that any amounts held by a banking entity in a securitization that exceed the minimum required to satisfy section 15G of the Exchange Act should count towards the aggregate funds limitation of the banking entity.[2296] One commenter argued that the final rule should impose higher capital charges for interests held in these securitizations due to concerns that securitizations involve heightened risks due to the complexity of their ownership structure.[2297]

The Agencies have carefully considered the comments received and are adopting the calculation requirements for the per-fund limitation as proposed with several modifications, including modifications designed to address the unique characteristics and ownership structure of securitizations. The final rule, like the proposal, requires that a banking entity calculate its per-fund investment limit in covered funds that are not issuing entities of asset-backed securities based on both the value of its investments and capital contributions in and to each covered fund and the total number of ownership interests it has in each covered fund. A banking entity's investment (including investments by its affiliates) may not exceed either three percent of the value of the covered fund or three percent of the number of ownership interests in the covered fund at the end of the seeding period. The Agencies continue to believe that requiring the per-fund limitation to be calculated based on these two measures best effectuates the terms and purpose of the per-fund

[2284] *See* proposed rule § ____.12(b)(2).

[2285] *See* proposed rule § ____.12(b)(4).

[2286] *See* Joint Proposal, 76 FR 68,904.

[2287] *See* ABA (Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2288] *See* ABA (Keating) (alleging that this is similar to the SEC's approach to the definition of venture capital fund for the purposes of being exempt from investment advisor registration).

[2289] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24,090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. *See Credit Risk Retention,* 78 FR 57,928 (Sept. 20, 2013).

[2290] *See* proposed rule § ____.14(a)(2)(iii).

[2291] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2292] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2293] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2294] *See* BoA.

[2295] *See* AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); SIFMA (Securitization) (Feb. 2012);BoA.

[2296] *See* Occupy.

[2297] *See* Sens. Merkley & Levin (Feb. 2012).

limitation in the statute. Together, these measures ensure that a banking entity's exposure to and ownership of each covered fund is limited. Each measure alone could provide a distorted view of the banking entity's ownership interest and could be more easily manipulated, for example by issuing ownership interests with high value or special governance provisions. As discussed in more detail below, the final rule contains a separate method for calculating the value of investments in issuing entities of asset-backed securities due to the fact that these entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

The per-fund limitation on ownership interests must be measured against the total ownership interests of the covered fund, as defined in § ____.10 of the final rule and as discussed above in Part IV.B.1.e. In determining the amount of ownership interests held by the banking entity and its affiliates, the banking entity must include an ownership interest permitted under §§ ____.4 and ____.11 of the final rule.[2298] Additionally, any banking entity that acts as underwriter or market-maker for ownership interests of a covered fund must do so in compliance with the limitations of §§ ____.4(a) and ____.4(b) of the final rule, including the limits on the amount, types, and risk of the underwriting position or market-maker inventory as well as in compliance with the per-fund limitation, as applicable, and the aggregate funds limitations and capital deduction in the final rule. The Agencies expect to monitor these activities to ensure that a banking entity does not engage in underwriting or market making-related activity in a manner that is inconsistent with the limitations of the statute and the final rule.[2299]

The final rule requires that the value of the ownership interests and contributions made by a banking entity in each covered fund (that is not an issuing entity of an asset-backed security) be the fair market value of the interest or contribution. The Agencies have determined to use fair market value as the measurement of value for the per-fund value limitation in order to ensure comparability with the investments made in the covered fund by others and limit the potential that the valuation measure can be manipulated (for example by altering the percentage of gains and losses that are associated with a particular ownership interest). A banking entity should determine fair market value for purposes of the final rule, including the calculation of both the per-fund and aggregate funds limitations, in a manner that is consistent with its determination of the fair market value of its assets for financial statement purposes and that fair market value would be determined in a manner consistent with the valuations reported by the relevant covered fund unless the banking entity determines otherwise for purposes of its financial statements and documents the reason for any disparity. If fair market value cannot be determined, then the value shall be the historical cost basis of all investments and capital contributions made by the banking entity to the covered fund. The final rule also requires that, once a valuation method is chosen, the banking entity calculate the value of its investments and the investments of all others in the covered fund for purposes of the per-fund limitation in the same manner and according to the same standards.[2300] This approach is intended to ensure that, for purposes of calculating the per-fund limitation, a banking entity does not calculate its investment in a covered fund in a manner more favorable to the banking entity than the method used by the covered fund for valuing the investments made by others. Under the final rule and as explained in more detail below, any ownership interest acquired or retained by an employee or director of the banking entity is attributed to the banking entity for purposes of the per-fund limitation if the banking entity financed the purchase of the ownership interest. Additionally, any amount contributed or paid by a banking entity or its employee to obtain an ownership interest in connection with obtaining the restricted profit interest must be included in calculating compliance with the per-fund and aggregate funds limitations (*See* Part IV.B.1.e. above).[2301]

In determining the per-fund limitation for purposes of § ____.12 of the final rule, the banking entity should use the same methodology for valuing its investments and capital contributions as the banking entity uses to prepare its financial statements and regulatory reports.[2302] In particular, the fair market value of a banking entity's investments and any capital contributions made to a covered fund should be the same for purposes of § ____.12 of the final rule as reported on the banking entity's financial statements and regulatory reports. Similarly, if fair market value of all investments in and capital contributions cannot be determined for purposes of § ____.12 of the final rule, then the banking entity should use the same methodology to calculate the historical cost basis of the investments and any capital contributions as the banking entity uses to prepare its financial statements and regulatory reports. The Agencies will review carefully the methodology that a banking entity uses to calculate the value of its investments in and capital contributions made to covered funds as part of the process to monitor compliance with the final rule.

The Agencies expect that for the majority of covered funds, the party that organizes and offers the fund or otherwise exercises control over the fund will provide a standard methodology for valuing interests in the fund. However, the Agencies understand that for some covered funds, including issuing entities of asset backed securities, there may be multiple parties that organize and offer the fund that each utilize a different methodology or standard for calculating the value of ownership interests of the fund. Going forward, the Agencies expect that in these circumstances the parties that organize and offer the covered fund will work together or select a responsible party to determine a single standard by

[2298] As discussed above in Part IV.B.2.c., the per-fund limitation does not apply to ownership interests held by a banking entity that acts as market maker or underwriter in accordance with § ____.11(c) of the final rule, so long as the banking entity does not also organize and offer, or act as sponsor, investment adviser or commodity trading advisor to, the fund, or, with respect to ownership interests in issuing entities of asset-backed securities, is not a securitizer who continues to own ownership interests or is not an entity that holds ownership interests in compliance with Section 15G of the Exchange Act and the implementing regulations adopted thereunder; however, the banking entity that is acting as market maker or underwriter that is not subject to the per-fund limitation must still comply with the other requirements set forth in §§ ____.4(a) and ____.4(b), respectively, and any other applicable requirements set out in § ____.11(c).

[2299] The Agencies note that if a banking entity acts as investment adviser or commodity trading advisor to a covered fund and shares the same name or variation of the same name with the fund, then that banking entity would be a sponsor and therefore subject to the limitations of section 13(f).

[2300] In the context of securitizations, the final rule similarly provides that the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all other investors in the covered fund in the same manner and according to the same standards.

[2301] *See* Part IV.B.1.e.

[2302] For example, a depository institution or bank holding company should use the same methodology as used in the Report of Condition and Income (Call Report) for depository institutions and the Consolidated Financial Statements for Holding Companies (FR Y–9C) for bank holding companies, respectively.

which all ownership interests in the covered fund will be valued.

One commenter suggested the Agencies count both invested funds and committed funds not yet called for investment towards the per-fund limitation.[2303] This commenter argued that a banking entity has already contractually allocated committed-yet-uncalled funds to the covered fund and that depositors face a risk of loss for such funds if the covered fund fails.

The final rule, like the proposal, does not count committed-yet-uncalled funds towards the per-fund limitation; instead, it counts funds once they are invested. This approach reflects the fact that these funds may never be called while at the same time ensuring that the banking entity must comply with the per-fund limitation once the funds are called. The Agencies note that a banking entity is prohibited from guaranteeing or bailing out a covered fund that the banking entity or one of its affiliates organizes and offers by the terms of the statute and the final rule and, accordingly, would not be permitted to provide committed funds to a covered fund in a manner inconsistent with the limitations in the statute and final rule.

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides that, for purposes of applying the per-fund limitation to an investment in a covered fund that is an issuing entity of an asset-backed security, the ownership interest held by the banking entity and its affiliates generally may not exceed three percent of the fair market value of the ownership interests of the fund as measured in accordance with § ____.12(b)(3), unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder. A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of section 13 of the BHC Act and this rule, the amount held by the banking entity may not exceed the amount required under the chosen option. Under the final rule, if a banking entity's investment in a covered fund is held pursuant to the requirements of section 15G of the Exchange Act, the banking entity must calculate the amount and value of its ownership interest for purposes of the per-fund limitation as of the date and according to the same valuation methodology applicable pursuant to the requirements of that section and the implementing regulations issued thereunder.

While the amount retained in compliance with section 15G of the Exchange Act and the implementing regulations issued thereunder may permit a banking entity to own more than three percent of the ownership interests in a securitization that is a covered fund, this approach is appropriate to reconcile the competing policies of section 13 of the BHC Act and section 15G of the Exchange Act which requires that a securitizer of certain securitizations retain a minimum of five percent of the risk of the securitization. Congress enacted these two apparently conflicting provisions in the same Act, and the Agencies believe the more specific section regarding risk retention in securitizations was intended to prevail over the more general restriction on ownership of covered funds (which applies to a broader range of entities). The Agencies believe that the risk limitation goals of section 13 of the BHC Act are met by satisfying the minimum requirement of an applicable option under section 15G of the Exchange Act as the maximum initial investment limit, and applying the other limitations discussed in this section governing aggregate investment in covered funds and capital deductions.

As under the proposal, if a banking entity does not have a minimum risk retention requirement, that banking entity would remain subject to the limitations of section 13(d)(4) of the BHC Act and § ____.12 on the amount of ownership interests it may hold in an issuing entity of asset-backed securities. A banking entity may not combine the amounts under these provisions to acquire or retain ownership interests in a securitization that exceed the aggregate permissible amounts.

Some commenters requested that the Agencies coordinate implementation of any exemption for risk-retention requirements under section 13 of the BHC Act with the issuance of rules implementing section 15G of the Exchange Act. The Agencies note that rules implementing section 15G have been proposed but not yet finalized, but the Agencies will review the interaction between the rules promulgated under section 13 of the BHC Act and section 15G of the Exchange Act once the rules under section 15G are finalized. Regardless of any action that may be taken regarding rules implementing section 15G, the final rule permits banking entities to own ownership interests in and sponsor covered funds as discussed above.

Some commenters also requested that the final rule provide an exemption to permit banking entities to comply with any risk retention requirement imposed under foreign law that is similar to section 15G of the Exchange Act. The Agencies are not revising the rule to permit banking entities to own ownership interests required to be retained pursuant to risk retention-type requirements under foreign law. The Agencies are providing the exemption for the required ownership arising from the risk retention provisions under section 15G of the Exchange Act in order to reconcile the requirements under the Dodd-Frank Act applicable to ownership of securitization interests; however, the Agencies do not believe at this time that such reconciliation is appropriate with respect to foreign law risk retention-type requirements and those requirements should not prevail over the purpose of section 13 of the BHC Act to reduce banking entities' exposure to risks from investments in covered funds.

The Agencies also note that the definition of covered fund has been modified to exclude certain foreign public funds and also any foreign fund that is not owned or sponsored by a U.S. banking entity. Moreover, the final rule permits foreign banking entities to engage in covered fund activities and investments that occur solely outside of the United States without regard to the investment limitations of section 13(d)(4) of the BHC Act and § ____.12 of the final rule, which may include retaining risk in a securitization to the extent required under foreign law. In these manners, the final rule permits foreign banking entities to comply with requirements under foreign law that govern their securitization activities or investments abroad. However, as noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities and, as such, U.S. banking entities' investments in foreign securitizations that are covered funds would remain subject to the investment limitations of section 13(d)(4) and § ____.12 of the final rule.

The proposed rule provided that a banking entity must comply with both measures of the per-fund limitation at all times. The preamble to the proposal explained that the Agencies expected a banking entity to calculate its per-fund limitation no less frequently than the

[2303] *See* Occupy.

frequency with which the fund performs such calculation or issues or redeems interests, and in no case less frequently than quarterly.[2304]

Several commenters requested that the Agencies modify the frequency of this calculation and monitoring requirement to a standard quarterly basis.[2305] These commenters argued that, although some covered funds may provide daily liquidation and redemption rights to investors, monitoring the per-fund limitation on a continuous basis would be costly and burdensome and would not provide a significant offsetting benefit.

The Agencies continue to believe that for covered funds other than issuing entities of asset-backed securities the per-fund limitations apply to investments in covered funds at all times following the end of the seeding period. However, to relieve burden and costs, while also setting a minimum recordkeeping standard, the final rule has been modified to require that a banking entity calculate the amount and value of its ownership interests in covered funds other than issuing entities of asset-backed securities quarterly.[2306] The Agencies believe that this change will assist in reducing unnecessary costs and burdens in connection with calculating the per-fund limitation, particularly for smaller banking entities, and will also facilitate consistency with the calculation for the aggregate funds limitation (which is also determined on a quarterly basis). Nevertheless, should a banking entity become aware that it has exceeded the per-fund limitation for a given fund at any time, the Agencies expect the banking entity to take steps to ensure that the banking entity complies promptly with the per-fund limitation.[2307]

The Agencies have also modified the timing and methodology of the per-fund limitation as it applies to securitizations to address the unique circumstances and ownership structure presented by securitizations, which typically wind down over time. Unlike many other covered funds, securitizations do not generally experience increases in the amount of investors or value of ownership interests during the life of the securitization; rather, they generally experience only a contraction of the investor base and reduction in the total outstanding value of ownership interests on an aggregate basis, and may do so at different rates under the terms of the transaction agreements, meaning that the percentage of ownership represented by a particular ownership interest may increase as the fund amortizes but without the banking entity adding any funds. The manner in which securitizations are organized and offered, as well as the amortization of securitizations, differs from many other covered funds; section 15G of the Exchange Act also requires that certain parties to securitization transactions, which may include banking entities, retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. Therefore, for purposes of calculating a banking entity's per-fund limitation with respect to a securitization, the calculation of the per-fund limitation shall be based on whether section 15G applies and the implementing regulations are effective. In the case of an ownership interest in an issuing entity of an asset-backed security that is subject to section 15G of the Exchange Act and for which effective implementing regulations have been issued, the calculation of the per-fund limitation shall be made as of the date and pursuant to the methodology applicable pursuant to the requirements of section 15G of the Exchange Act and the implementing regulations issued. For securitizations executed after the effective date of the final rule and prior to the adoption and implementation of the rules promulgated under section 15G of the Exchange Act and for securitizations for which a fair valuation calculation is not required by the implementing rules promulgated under section 15G of the Exchange Act, the per fund limitation is calculated as of the date on which the assets are initially transferred into the issuing entity of the asset-backed securities or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund.[2308] This calculation for issuers of asset backed securities is only required to be performed once on the date noted above, and thereafter only upon the date on which the price of additional securities of the covered fund to be sold to third parties is determined.

As noted above, the per-fund limitations for ownership interests in issuing entities of asset-backed securities are calculated based only on the value of the ownership interest in relation to the value of all ownership interests in the issuing entity of the asset-backed security and are not calculated on a class by class, or tranche by tranche basis. For purposes of the valuation, the aggregate value of all the assets that are transferred to the issuing entity of the asset-backed securities, and any assets otherwise held by the issuing entity, are determined based on the valuation methodology used for determining the value of the assets for financial statement purposes. This valuation will be the value of the ownership interests in the issuing entity for purposes of the calculation. A banking entity will need to determine its percentage ownership in the issuing entity based on the its contributions to the entity in relation to the contributions of all parties and after taking into account the value of any residual interest in the issuing entity. In addition, for purposes of the final rule, the asset valuation is as of the date of establishment (the date of the asset transfer to the issuing entity of the asset-backed securities).

d. Limitation on Aggregate Permitted Investments in all Covered Funds (''Aggregate Funds Limitation'')

In addition to the per-fund limitation, section 13(d)(4) of the BHC Act provides that the aggregate of a banking entity's investments in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (referred to above as the ''aggregate funds limitation'').[2309] To implement this limitation, the proposed rule required a banking entity to determine the aggregate value of the banking entity's investments in covered funds by calculating the sum of the value of each investment in a covered fund, as determined in accordance with applicable accounting standards. This amount was then measured as a percentage of the tier 1 capital of the banking entity for purposes of determining compliance with the aggregate funds limitation. For purposes of applying the limit, a banking entity that is subject to regulatory capital requirements was required under the proposed rule to measure tier 1 capital

[2304] *See* proposed rule § ____.12(b); Joint Proposal, 76 FR 68,904.

[2305] *See, e.g.,* ABA (Keating); Credit Suisse (Williams); JPMC.

[2306] *See* final rule § __.12(b)(2)(i) and (ii). For covered funds that are an issuing entity of asset-backed securities, recalculation of the banking entity's permitted ownership for purposes of the per-fund limitation is not required unless the covered fund sells additional securities.

[2307] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(I).

[2308] In addition, although some commenters requested that banking entities be able to hold more than the minimum required by section 15G, the Agencies are not revising the per fund limitation in that manner. One of the purposes of section 13 of the BHC Act is to reduce banking entities' exposure to risks from investments in covered funds, and the Agencies believe at this time that permitting banking entities to retain risk exposure to the covered fund in excess of the minimum required to be retained would contradict the purposes of section 13 of the BHC Act.

[2309] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(II).

in accordance with those regulatory capital requirements; a banking entity that is not a subsidiary of a reporting banking entity and that is not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency was required by the proposed rule to calculate its tier 1 capital based on the total amount of shareholders' equity of the top-tier entity as of the last day of the most recent calendar quarter, as determined under applicable accounting standards.

Commenters expressed a variety of views regarding the aggregate funds limitation. One commenter argued that basing the aggregate funds limitation on the size of tier 1 capital of a banking entity provides an advantage to the largest institutions with large absolute capital bases and disadvantages smaller banks that are well capitalized but have a smaller absolute capital base.[2310] This commenter urged the Agencies to permit all banking entities to invest in covered funds in an amount that is, in the aggregate, the greater of $1 billion (subject to prudential investment limitations and safety and soundness concerns), or three percent of tier 1 capital.[2311]

In contrast, other commenters urged the Agencies to decrease the statutory limit in order to prevent the largest banking entities from investing amounts that, while within the statutory limit, could be very large in absolute terms.[2312] One commenter argued that a loss of three percent of tier 1 capital would be a material loss reflected in a change in stock price.[2313] Another commenter suggested the Agencies consider whether the investment supports a large flow of management fees linked to market volatility or has significant embedded leverage.[2314]

Some commenters argued that the final rule should calculate the value of covered fund investments based on acquisition cost instead of fair market value.[2315] These commenters argued that using fair value to calculate the aggregate funds limitation penalizes banking entities for organizing and investing in successful funds and, conversely, would allow banking entities to increase investments in unsuccessful funds (the value of which would decline relative to the capital of the banking entity).

In contrast, another commenter argued that valuation of a covered fund investment should include any mark-to-market increase in a banking entity's aggregate investments in order to keep pace with increases in the capital of the banking entity.[2316]

Some commenters discussing the frequency of the calculation of the aggregate funds limitation supported determining the aggregate funds limitation on the last day of each calendar quarter as required in the proposal.[2317] Other commenters argued that the statute requires compliance at all times rather than periodic calculations of compliance.[2318]

After consideration of the comments in light of the statutory provisions, the Agencies have adopted the requirements for calculating the aggregate funds limitation as proposed with several modifications as explained below. Under the final rule, the aggregate value is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in each covered fund (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ____.10(d)(6)(ii)), as measured on a historical cost basis. This aggregate value is measured against the total applicable tier 1 capital for the banking entity as explained below.

For purposes of determining the aggregate funds limitation, the final rule requires that the value of investments made by a banking entity be calculated on a historical cost basis. This approach limits the aggregate amount of funds a banking entity may provide to covered funds as a percentage of the banking entity's capital as required by statute. At the same time, this approach does not permit a banking entity to increase its exposure to covered funds in the event any investment in a particular covered fund declines in value as a result of the fund's investment activities. Permitting a banking entity to increase its aggregate investments as covered funds lose value would permit the banking entity both to increase its exposure to covered funds at the same time the covered funds it already owns are losing value and to effectively bail-out investors by providing additional capital to troubled covered funds. Neither of these actions is consistent with the purposes of section 13 of the BHC Act. Moreover and as explained below, because the final rule requires that the banking entity deduct from the entity's capital the greater of historical cost (plus earnings) or fair market value of its investments in covered funds, the deduction accounts for any profits resulting from investments in covered funds.

Historical cost basis means, with respect to a banking entity's ownership interest in a covered fund, the sum of all amounts paid or contributed by the banking entity to a covered fund in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest)), less any amounts received as a redemption, sale or distribution of such ownership interest or restricted profit interest. Under the final rule, any reduction of the historical cost would not generally include gains or losses, fees, income, expenses or similar items. However, as noted above, the final rule also requires that a banking entity deduct any earnings from its tier 1 capital even if it values its ownership interests in a covered fund pursuant to historical cost.

The concern expressed by commenters that the aggregate funds limitation should account for increases in the fair market value of covered funds is addressed in other ways under the final rule. In particular, the final rule requires that for purposes of calculating compliance with regulatory capital requirements the banking entity deduct from the entity's capital the greater of fair market value (or historical cost plus earnings) of its investment in each covered fund; thus, profits resulting from investments in covered funds will not inflate the capital of the banking entity for regulatory compliance purposes. Moreover, as explained above, the per-fund limitation is generally based on fair market value, which maintains the relative level of a banking entity's investment in each covered fund.

As noted above, the aggregate funds limitation applies to all investments by a banking entity in a covered fund that the banking entity or an affiliate thereof holds under §§ ____.4 and ____.11 of the final rule. The limitation would also apply to investments by a banking entity made or held during the seeding period as part of organizing and offering a covered fund, including ownership interests held in order to satisfy the requirements of section 15G of the Exchange Act, as well as ownership interests held by a banking entity in the capacity of acting as underwriter or market-maker.

As under the proposal, this calculation must be made as of the last day of each calendar quarter, consistent with when tier 1 capital is reported by banking entities to the Agencies.

[2310] *See* ABA (Abernathy).

[2311] *See, e.g.,* ABA (Abernathy).

[2312] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2313] *See* Public Citizen.

[2314] *See* AFR *et al.* (Feb. 2012).

[2315] *See* ABA(Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2316] *See* Occupy.

[2317] *See* ABA (Keating).

[2318] *See* AFR *et al.* (Feb. 2012); Occupy.

Because compliance with the aggregate funds limitations is calculated based on tier 1 capital, the Agencies believe it is more appropriate to require the calculation to be performed on the same schedule as tier 1 capital is reported. While the aggregate funds limitation must be calculated on a quarterly basis, the Agencies expect banking entities to monitor investments in covered funds regularly and remain in compliance with the limitations on covered fund investments throughout the quarter. The Agencies intend, through their respective supervisory processes, to monitor covered fund investment activity to ensure that a banking entity is not attempting to evade the requirements of section 13.

The Agencies recognize that banks with large absolute capital bases will be able to place a greater amount of capital in covered funds compared to banks with small absolute capital bases. However, the amount of risk exposure to a covered fund, despite their different investment strategies, will be relatively similar across banking entities, which is consistent with the language and risk-limiting purpose of section 13.

e. Capital Treatment of an Investment in a Covered Fund

Section 13(d)(4)(B)(iii) of the BHC Act provides that, for purposes of determining compliance with applicable capital standards under section 13(d)(3) of that Act, the aggregate amount of outstanding investments by a banking entity under section 13(d)(4), including retained earnings, must be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate with the leverage of the covered fund.[2319] Section 13(d)(3) authorizes the Agencies, by rule, to impose additional capital requirements and quantitative limitations, including diversification requirements on any of the activities permitted under section 13 of the BHC Act if the Agencies determine that such additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.[2320]

The proposed rule implemented the capital deduction provided for under section 13(d)(4)(B)(iii) of the BHC Act by requiring a banking entity to deduct the aggregate fair value of its investments in covered funds, including any attributed profits, from tier 1 capital. As in the statute, the proposed rule applied the capital deduction to ownership interests in covered funds held as an investment by a banking entity pursuant to the provisions of section 13(d)(4) of the BHC Act, and not to ownership interests acquired under other permitted authorities, such as a risk-mitigating hedge under section 13 of the BHC Act. The proposed rule required the deduction to be calculated consistent with the method for calculating other deductions under the applicable risk-based capital rules. The proposed rule did not otherwise adopt additional capital requirements and quantitative limitations under section 13(d)(3) of the BHC Act.

Some commenters supported the proposed dollar-for-dollar deduction from tier 1 capital of a banking entity's aggregate investments in covered funds and asserted it is consistent with the statute.[2321] One of these commenters urged the Agencies to rely on their authority under section 13(d)(3) of the BHC Act to apply the capital deduction to other permitted ownership interests in covered funds to protect the safety and soundness of the banking entity.[2322] In contrast, other commenters urged the Agencies to eliminate the capital deduction for investments in covered funds and questioned the Agencies' statutory authority to impose the capital deduction.[2323] These commenters argued that the statute does not authorize or require the Agencies to require banking entities to deduct their investments in covered funds for purposes of calculating capital pursuant to the applicable capital rules. According to these commenters, section 13 only requires deductions for purposes of determining compliance with applicable capital standards under section 13 and argued the Agencies did not make the necessary safety and soundness findings under section 13(d)(3) to impose additional capital requirements on any activities permitted under section 13(d)(1).[2324] One commenter urged the Agencies to make any capital adjustment as part of the banking agencies' broader efforts to implement the Basel III capital framework.[2325] Another commenter urged the Agencies to apply the capital deduction only for purposes of determining a banking entity's compliance with the aggregate funds limitation and not for other regulatory capital purposes.[2326] This commenter also argued that a capital deduction is normally not required for assets reflected on a bank's consolidated balance sheet, and that the Agencies should not require a deduction for a covered fund investment that is not consolidated with the banking entity for financial reporting purposes under GAAP.[2327] Some commenters urged the Agencies to apply the capital deduction only to a banking entity's investment in a covered fund that the banking entity organizes and offers and not to ownership interests otherwise permitted to be held under section 13 of the BHC Act.[2328]

Several commenters addressed the manner for valuing an investment subject to the deduction. One commenter urged the Agencies to permit a banking entity to calculate the deduction based on the acquisition cost, instead of the fair market value, of the banking entity's ownership interest in the covered fund.[2329] This commenter emphasized that valuing the investment at fair market value would penalize a banking entity if the covered fund performs well by reducing the amount of capital available for additional covered fund investments but reduce the capital charge against troubled investments. One commenter argued that the Agencies did not perform an appropriate cost-benefit analysis of the deduction in the proposed rules.[2330]

Other commenters sought clarification on how the capital deduction would apply to a foreign banking organization. Several commenters argued that the capital deduction should not apply to a foreign banking entity that calculates its tier 1 capital under the standards of its home country.[2331] These commenters argued that imposing a capital deduction requirement on foreign banks would not be consistent with past practices on the application of U.S. risk-based capital requirements to foreign banking organizations.

The Agencies have carefully considered the comments in light of the statutory provisions requiring a capital deduction. The statute requires that the aggregate amount of outstanding investments by a banking entity, including retained earnings, be deducted from the assets and tangible equity of the banking entity.[2332] This requirement is independent of the minimum regulatory capital

[2319] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[2320] *Id.* at 1851(d)(3).

[2321] *See* Occupy.

[2322] *See* Occupy.

[2323] *See* ABA (Keating); BNY Mellon *et al.;* PNC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2324] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2325] *Id.*

[2326] *See* ABA (Keating).

[2327] *See* ABA (Keating); *See also* letter from PNC.

[2328] *See* Arnold & Porter; SVB.

[2329] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2330] *Id.*

[2331] *See* IIB/EBF.

[2332] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

requirements in the final capital rule published by the Federal Banking agencies in 2013 (''regulatory capital rule'').[2333]

The Federal Banking agencies recognize that the regulatory capital rule imposes risk weights and deductions that do not correspond to the deduction for covered fund investments imposed by section 13 of the BHC Act. The Federal Banking agencies intend to review the interaction between the requirements of this rule and the requirements of the regulatory capital rule and expect to propose steps to reconcile the two rules.

At the same time, the Agencies believe that the dollar-for-dollar deduction of the fair market value of a banking entity's investment in a covered fund is appropriate to protect the safety and soundness of the banking entity, as provided in section 13(d) of the BHC Act. This approach ensures that a banking entity can withstand the failure of a covered fund without causing the banking entity to breach the minimum regulatory capital requirements. Consistent with the language and purpose of section 13 of the BHC Act, this deduction will help provide that a banking entity has sufficient capital to absorb losses that may occur from covered fund investments without endangering the safety and soundness of the banking entity or the financial stability of the United States.

Accordingly, under the final rule, a banking entity must, for purposes of determining compliance with applicable regulatory capital requirements, deduct the greater of (i) the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ____.10(b)(6)(ii)), on a historical cost basis, including earnings or (ii) the fair market value of the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ____.10(b)(6)(ii)), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.[2334] This deduction must be made whenever the banking entity calculates its tier 1 capital, either quarterly or at such other time at which the appropriate Federal banking agency may request such a calculation. Requiring a banking entity to deduct the greater of historical cost or fair market value of all covered fund investments made by a banking entity from the entity's tier 1 capital should result in an appropriate deduction that is consistent with the manner in which the banking entity accounts for its covered fund investments. For instance, if a banking entity accounts for its investments in covered funds using fair market value, then any changes in the fair market value of the banking entity's investment in a covered fund should similarly be reflected in the banking entity's tier 1 capital. Thus, this deduction should not unduly penalize banking entities for making successful investments or allow more investments in troubled covered funds.

The final rule does not require a foreign banking entity that makes a covered fund investment in the United States, either directly or through a branch or agency, to deduct the aggregate value of the investment from the foreign bank's tier 1 capital calculated under applicable home country standards. However, any U.S. subsidiary of a foreign banking entity that is required to calculate tier 1 capital under U.S. risk based capital regulations must deduct the aggregate value of investment held through that subsidiary from its tier 1 capital.

While some commenters requested that additional capital charges be imposed on banking entity's interests in securitizations, the Agencies have declined to do so at this time. Under the final rule, the banking entity must deduct the value of its investment in a securitization that is a covered fund from its tier 1 capital for purposes of determining compliance with the applicable regulatory capital requirements. This requirement already requires the banking entity to adjust its capital for the possibility of losses on the full amount of its investment. The Agencies do not believe that it is appropriate to impose additional capital charges on these securitizations because it would act as a disincentive to retain risk in securitizations for which the banking entity acts as issuer or sponsor, a result that would contradict the purpose of section 15G of the Exchange Act. Additionally and as noted in the proposal, permitting a banking entity to retain the minimum level of economic interest and risk in a securitization will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

The Agencies have also declined to impose additional quantitative limitations or diversification requirements on covered fund investments at this time. The Agencies believe that the per-fund and aggregate funds limitations, as well as the capital deduction required by the rule, acting together with the other limitations on covered fund activities, establish an appropriate framework for ensuring that the covered fund investments and activities of banking entities are conducted in a manner that is safe and sound and consistent with financial stability. The Agencies will continue to monitor these activities and investments to determine whether other limitations are appropriate over time.

f. Attribution of Ownership Interests to a Banking Entity

The proposed rule attributed an ownership interest to a banking entity based on whether or not the banking entity held the interest through a controlled entity. The proposed rule required that any ownership interest held by any entity that is controlled, directly or indirectly, by a banking entity be included in the amount and value of the banking entity's permitted investments in a single covered fund. The proposed rule required that the *pro rata* share of any ownership interest held by any covered fund that is not controlled by the banking entity, but in which the banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares, be included in the amount and value of the banking entity's permitted investments in a single covered fund.

Many commenters expressed concerns regarding the proposed attribution requirements.[2335] These commenters argued that the proposed *pro rata* attribution requirements are not required or permitted by the statute, have unintended and inconsistent consequences for covered fund investments, impose heavy compliance costs on banking entities, and would impede the ability of funds sponsored by banking entities to invest in third-party funds for the benefit of clients.

[2333] *See* 78 FR 62,018, 62,072 (Oct. 11, 2013) (Board/OCC/FDIC Basel III Final Rule); 78 FR 55,340, 55,391 (Sept. 10, 2013) (FDIC Basel III interim final rule).

[2334] *See* 12 CFR part 208, subpart D and appendixes A, B, E, and F; 12 CFR part 217 (to be codified), and 12 CFR part 225, appendixes A, D, E, and G; *See also* 12 CFR 240.15c3–1 (net capital requirements for brokers or dealers).

[2335] *See* ABA (Keating); Arnold & Porter; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012).

Some commenters argued that the costs and complexity of determining whether a banking entity ''controls'' another banking entity under the BHC Act and the Board's precedent are high and urged the Agencies to adopt a simpler test.[2336] For example, some commenters urged that shares of a company be attributed to a banking entity only when the banking entity maintains ownership of 25 percent or more of voting shares of the company.[2337]

Several commenters maintained that applying the attribution requirements to fund-of-funds structures and parallel or master-feeder structures would be unworkable.[2338] Commenters contended that the proposed attribution rules could result in a banking entity calculating the per-fund limitation in a way that exceeds the banking entity's actual loss exposure if the attribution rule for controlled investments is interpreted to require that 100 percent of all investments made by controlled entities be attributed to the banking entity.[2339]

In addition, several commenters argued that the *pro rata* attribution of investments held through non-controlled structures is not consistent with the Board's rules and practices for purposes of the activity and investment limits in other sections of the BHC Act. Commenters also maintained that this *pro rata* attribution for non-controlled entities would be impracticable because a banking entity has only a limited ability to monitor, direct, or restrain investments of a covered fund that it does not control.[2340]

Conversely, one commenter supported the *pro rata* attribution requirement in the proposal. This commenter argued that this requirement reduced opportunities for evasion through subsidiaries, affiliates or related entities.[2341]

The final rule has been modified in light of the comments. Under the final rule, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations only if the investment is made by the banking entity or another entity controlled by the banking entity. Accordingly, the final rule does not generally require that a banking entity include the *pro rata* share of any ownership interest held by any entity that is not controlled by the banking entity, and thus reduces the potential compliance costs of the final rule. The Agencies believe that this concept of attribution is more consistent with how the Board has historically applied the concept of ''control'' under the BHC Act for purposes of determining whether a company subject to that Act is engaged in an activity or whether to attribute an investment to that company. Furthermore, because a banking entity does not control a non-affiliate and typically has less access to information about the holdings of a non-affiliate, this change is unlikely to present opportunity for circumvention of the per-fund and aggregate funds limitations. The Agencies will monitor these limitations for practices that appear to be attempts to circumvent them.[2342]

Whether a banking entity controls another entity under the BHC Act may vary depending on the type of entity in question. As noted above in Part IV.B.1.b.3., the Board's regulations and orders have long recognized that the concept of control is different for funds than for operating companies.[2343] In contrast to the proposal, the final rule incorporates these different concepts of control in part by providing that, for purposes of section 13 of the BHC Act and the final rule, a registered investment company, SEC-regulated business development company, and a foreign public fund as described in § ____.10(c)(1) of the final rule will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.[2344]

In response to commenter concerns regarding the workability of the proposed rule, the final rule has been modified to address how ownership interests would be attributed to a banking entity when those interests are held in a fund-of-funds or multi-tiered fund structures. For instance, banking entities may use a variety of structures to satisfy operational needs or meet the investment needs of customers of their trust, fiduciary, investment advisory or commodity trading advisory services.

First, except as explained for purposes of calculating a banking entity's permitted investment in multi-tier fund structures, the final rule does not generally attribute to a banking entity ownership interests held by a covered fund so long as the banking entity's investment in the covered fund meets the per-fund limitation in the final rule.[2345] Absent unusual circumstances or structures, a banking entity would not control a covered fund in which the banking entity has an ownership interest that conforms to the per-fund and aggregate funds limitations contained in the final rule. Thus, the interests held by that covered fund would not be attributed to the banking entity for the reasons discussed above.

The final rule also explains how the investment limitations apply to investments of a banking entity in multi-tier fund structures. The Agencies believe that master-feeder fund structures typically constitute a single investment program in which the master fund holds and manages investments and the feeder funds typically make no investments other than in the master fund and exist as a convenience for customers of the trust, fiduciary, investment advisory, or commodity trading advisory services of the banking entity. Similarly, trust, fiduciary, or advisory customers of a banking entity may desire to obtain diversified exposure to a variety of funds or investments through investing in a fund-of-funds structure that the banking entity organizes and offers.

In order to meet the demands of these customers, the final rule provides that if the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the

[2336] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Arnold & Porter.

[2337] *See* ABA (Keating); Arnold & Porter.

[2338] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012). These commenters argued that banking entities traditionally utilize a fund-of-funds structure to offer customers the opportunity to invest indirectly in a portfolio of other funds (including some funds sponsored and managed by one or more third parties) and that these structures provide customers with certain risk-mitigating benefits and allow customers to gain exposure to a diverse portfolio without having to satisfy the minimum investment requirements of each fund directly. They also argued that parallel and feeder entities are established for a variety of client-driven reasons, including to accommodate tax needs of clients and that these entities should be viewed as a single investment program in which the master fund holds and manages investments in portfolio assets and the feeder fund typically makes no investments other than in the master fund.

[2339] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Arnold & Porter; SSgA (Feb. 2012).

[2340] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2341] *See* Occupy.

[2342] The Agencies note that other provisions of the BHC Act and Savings and Loan Holding Company Act would prohibit a banking entity that is a bank holding company or savings and loan holding company from acquiring 5 percent or more of a covered fund that is itself a bank holding company or a savings and loan holding company, respectively, without regulatory approval. *See* 12 U.S.C. 1842(a); 12 U.S.C. 1467a(e).

[2343] *See, e.g.,* First Union Letter.

[2344] *Id. See* final rule § ____.12(b)(1)(ii).

[2345] *See* final rule § ____.12(b)(1)(iii).

per-fund limitation the banking entity's permitted investment shall be measured only at the master fund. However, in order to appropriately capture the banking entity's amount of investment in the master fund, a banking entity must include in this calculation any investment held by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund.[2346]

Similarly, regarding fund-of-funds structures, the final rule provides that if a banking entity organizes and offers a covered fund pursuant to § ____.11 for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity organizes and offers, then the banking entity's permitted investment in that other covered fund shall include any investment held by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the other fund that is held through the fund of funds. The banking entity's investment in the fund of funds must also meet the investment limitations contained in § ____.12. In these manners, the final rule permit a banking entity to meet the demands of customers of their trust, fiduciary, or advisory services while also limiting the ability of a banking entity to be exposed to more than the amount of risk of a covered fund contemplated by section 13.

As described above in the discussion of organizing and offering a covered fund, other provisions of section 13 contemplate investments by employees and directors of the banking entity that provide qualifying services to a covered fund.[2347] The Agencies recognized in the proposal that employee and director investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire in a covered fund.[2348] In order to address this concern, the proposal attributed an ownership interest in a covered fund acquired or retained by a director or employee to the person's employing banking entity if the banking entity either extends credit for the purposes of allowing the director or employee to acquire the ownership interest, guaranteed the director or employee's purchase, or guarantees the director or employee against loss on the investment.

One commenter supported the way the proposal addressed evasion concerns by attributing an ownership interest in a covered fund acquired or retained by a director or employee to a banking entity.[2349] A different commenter urged the Agencies to attribute any employee investments in a covered fund to the banking entity itself, regardless of the source of funds.[2350] Another commenter argued that the statute prohibits a banking entity from guaranteeing an investment by an employee or director.[2351]

After considering the comments and the language of the statute, the Agencies have determined to retain the requirement that all director or employee investments in a covered fund be attributed to the banking entity for purposes of the per-fund limitation and the aggregate funds limitation whenever the banking entity provides the employee or director funding for the purpose of acquiring the ownership interest. Specifically, under the final rule, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.[2352] It is also important to note that the statute prohibits a banking entity from guaranteeing the obligations or performance of a covered fund in which it acts as investment adviser, investment manager or sponsor, or organizes and offers.[2353]

As discussed above in the definition of ownership interest, the final rule also attributes to the banking entity any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity. This approach ensures that all funding provided by the banking entity—whether directly or through its employees or directors—and all exposures of the banking entity—whether directly or through a guarantee provided to or on behalf of an employee or director—is counted against the limits on exposure contained in the statute and final rule. At the same time, this approach recognizes that employees and directors may use their own resources, not protected by the banking entity, to invest in a covered fund. Employees of investment advisers in particular often invest their own resources in covered funds they advise, both by choice and as a method to align their personal financial interests with those of other investors in the covered fund. So long as these investments are truly with personal resources, and are not funded by the banking entity, these personal investments would not expose the banking entity to loss and would not be attributed by the final rule to the banking entity. This approach is also consistent with the terms of the statute, which expressly contemplates investments by directors or employees of a banking entity in their individual capacity.[2354]

The Agencies intend to monitor investments by directors and employees of a banking entity to ensure that employee ownership interests are not used to circumvent the per-fund and aggregate funds limitations in section 13. Among the factors the Agencies will consider, in addition to financing and guarantee arrangements, are whether the benefits of the acquisition and retention, such as dividends, inure to the benefit of the director or employee and not the banking entity; the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity; and the employee or director, rather than the banking entity, determines whether the employee or director should make the investment.

The proposed rule contained a provision intended to curb potential evasion of the per-fund limitation and aggregate limitation through parallel investments by banking entities that were not otherwise subject to section 13 of the BHC Act. Specifically, the proposed rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation.

Several commenters objected to this requirement and argued that it was not consistent with the statute. These commenters argued that section 13 of

[2346] *See* final rule § ____.12(b)(34).

[2347] *See* 12 U.S.C. 1851(d)(1)(G)(vii); final rule § ____.11(g).

[2348] *See* Joint Proposal, 76 FR 68,902.

[2349] *See* Ass'n. of Institutional Investors (Feb. 2012).

[2350] *See* Occupy.

[2351] *See* Arnold & Porter.

[2352] *See* final rule § ____.12(b)(1)(iv).

[2353] *See* 12 U.S.C. 1851(f)(1).

[2354] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

the BHC Act restricts a banking entity's investments in covered funds, and not direct investments by a banking entity in individual companies under other authorities, such as the merchant banking investment authority in section 4(k)(4)(H) of the BHC Act.[2355] Some commenters argued that prohibiting or limiting direct investments could cause a conflict between a banking entity's fiduciary duty to its clients to manage their covered fund investments and the banking entity's duty to its shareholders to pursue legitimate merchant banking investments.[2356] Some commenters urged the Agencies not to attribute any parallel co-investment alongside a covered fund to a banking entity unless there is a pattern of evasion, and some requested that there be prior notice and an opportunity for a hearing to determine whether such a pattern has occurred.[2357] Another commenter recommended the Agencies provide a safe harbor for situations where a bank trustee is acting on behalf of customers.[2358]

In contrast, other commenters contended that the risks of direct investments, such as those made under merchant banking authority, are similar to those of many investments in covered funds. These commenters urged the Agencies to restrict direct investments in the underlying holdings or assets of a covered fund in the same manner as direct investments in covered funds.[2359]

After carefully considering the comments and the language of the statute, the Agencies have determined not to adopt the proposed prohibition on parallel investments in the final rule. As illustrated by commenters, banking entities rely on a number of investment authorities and structures to meet the needs of their clients and make investments under a variety of authorities that are not coordinated with investments made by covered funds owned or advised by the banking entity. The Agencies believe that many investments made by banking entities are made for the purpose of serving the legitimate needs of customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate funds limitations in section 13.

Nevertheless, the Agencies continue to believe that the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors. For instance, the Agencies understand that it is relatively common for the sponsor of a covered fund in connection with a privately negotiated investment to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment. Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a ''co-investment fund''), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund. Finally, the Agencies note that if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund.

g. Calculation of Tier 1 Capital

The proposal explained that tier 1 capital is a banking law concept that, in the United States, is calculated and reported by certain depository institutions and bank holding companies in order to determine their compliance with regulatory capital standards. Accordingly, the proposed rule clarified that for purposes of the aggregate funds limitation in § ____.12, a banking entity that is a bank, a bank holding company, a company that controls an insured depository institution that reports tier 1 capital, or uninsured trust company that reports tier 1 capital (each a ''reporting banking entity'') needed to use the reporting banking entity's tier 1 capital as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.

The proposal also recognizes that not all entities subject to section 13 of the BHC Act calculate and report tier 1 capital. In order to provide a measure of equality related to the aggregate funds limitation contained in section 13(d)(4)(B)(ii)(II) of the BHC Act and § ____.12(c) of the proposed rule, the proposed rule clarified how the aggregate funds limitation should be calculated for entities that are not required to calculate and report tier 1 capital in order to determine compliance with regulatory capital standards. Under the proposed rule, with respect to any banking entity that is not affiliated with a reporting banking entity and not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency, the banking entity's tier 1 capital for purposes of the aggregate funds limitation was the total amount of shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.[2360] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank), the aggregate funds limitation was the amount of tier 1 capital reported by such depository institution.[2361] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is not a depository institution (*e.g.,* a nonbank subsidiary of a bank holding company), the aggregate funds limitation was the amount of tier 1 capital reported by the top-tier affiliate of such banking entity that holds and reports tier 1 capital under the proposal.[2362]

Commenters did not generally object to the proposed approach for determining the applicable tier 1 capital for banking entities. One commenter advocated calculating the aggregate funds limitation based on the tier 1 capital of the banking entity making the covered fund investment instead of the tier 1 capital of the consolidated banking entity.[2363] In addition, the commenter urged the Agencies to require banking entities to divest any portions of the investment that exceeds 3 percent of that entity's tier 1 capital.

The final rule provides that any banking entity that is required to

[2355] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq. See* ABA (Keating); BoA; BOK; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2356] *See* ABA (Keating).

[2357] *See* BOK; SVB; ABA (Keating); BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2358] *See* BOK.

[2359] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2360] *See* proposed rule § ____.12(c)(2)(ii)(B)(2).

[2361] *See* proposed rule § ____.12(c)(2)(ii)(A).

[2362] *See* proposed rule § ____.12(c)(1)(B(2)(ii)(B)(1).

[2363] *See* Occupy.

calculate and report tier 1 capital (a ''reporting banking entity'') must calculate the aggregate funds limitation using the tier 1 capital amount reported by the entity as of the last day of the most recent calendar quarter as reported to the relevant Federal banking agency. A non-depository institution subsidiary of a reporting banking entity may rely on the consolidated tier 1 capital of the reporting banking entity for purposes of calculating compliance with the aggregate funds limitation. In the case of a depository institution that is itself a reporting banking entity and that is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in covered funds held by the depository institution (including the investments by its subsidiaries) may not exceed three percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution. The final rule also provides that any banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank) may compute compliance with the aggregate funds limitations using the amount of tier 1 capital reported by such depository institution.

Several commenters argued that foreign banking organizations should be permitted to use the consolidated tier 1 capital at the top-tier foreign banking organization level, as calculated under applicable home country capital standards, to calculate compliance with the aggregate funds limitation.[2364] One commenter noted that the tier 1 capital of a banking entity may fluctuate based on specific conditions relevant only to the banking entity, and urged the Agencies to consider an alternative measure of capital, although this commenter did not suggest any alternative.[2365]

After considering the comments received and that purpose and language of section 13 of the BHC Act, the Agencies have determined that for foreign banking organizations, the aggregate funds limitation would be based on the consolidated tier 1 capital of the foreign banking organization, as calculated under applicable home country standards. However, a U.S. bank holding company or U.S. savings and loan holding company that is controlled by a foreign banking entity must separately meet the per-fund and aggregate funds limitations for each and all (respectively) covered fund investments made by the U.S. holding company, based on the tier 1 capital of the U.S. bank holding company or U.S. savings and loan holding company. The Federal banking agencies may revisit this approach in light of the manner in which the Board implements the enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies, including the proposed U.S. intermediate holding company requirements under that rule.[2366]

h. Extension of Time to Divest Ownership Interest in a Single Fund

The proposed rule provided that the Board may, upon application by a banking entity, extend the period of time that a banking entity may have to conform an investment to the 3 percent per-fund limitation. As in the statute, the proposed rule permitted the Board to grant up to an additional two years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. The proposal required a banking entity to submit an application for extension to the Board, and set forth the factors that the Board would consider in reviewing an application for extension, including a requirement that the Board consult with the primary federal supervisory agency for the banking entity prior to acting on an application.

Some commenters argued that the final rule should be modified to extend automatically the one-year statutory period for complying with the per-fund limitation by an additional two years without application or approval on a case-by-case basis and to apply the extended conformance period to the aggregate funds limitations.[2367] Some of these commenters suggested that Congress explicitly recognized the need for a banking entity to have a sufficient seeding period following establishment of a fund, and that funds often require more than one year to attract enough unaffiliated investors to enable the sponsoring banking entity to reduce its ownership interests in the fund to the level required by section 13(d)(4).

Other commenters argued that the amount of a banking entity's own capital involved in seeding a fund is typically ''small'' and suggested that, in order to prevent banking entities from engaging in prohibited proprietary trading through a fund, the Board should condition the ability of a banking entity to qualify for an extension of the one-year statutory period on several requirements, including a requirement that the banking entity not have provided more than $10 million in seed capital as part of establishing the covered fund.[2368]

The Agencies have carefully considered comments received on the proposal and have determined instead to adopt the process and standards governing requests for extensions of time to divest an ownership interest in a single covered fund largely as proposed. The Agencies believe that this approach is consistent with the process and standards set out under the statute.

As under the proposal, the final rule requires any banking entity that seeks an extension of the conformance period provided for the per-funds limitation to submit a written request to the Board. Any such request must be submitted to the Board at least 90 days prior to the expiration of the applicable time period and provide the reasons why the banking entity believes the extension should be granted. In addition, the request must explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods to the limits imposed by the final rule. To allow the Board to assess the factors provided in the statute, the final rule provides that any extension request by a banking entity must address: (i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (ii) the contractual terms governing the banking entity's interest in the covered fund; (iii) the total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States; (iv) the cost to the banking entity of divesting or disposing of the investment within the applicable period; (v) whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty; (vi) the banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership

[2364] *See* Credit Suisse (Williams); IIB/EBF.

[2365] *See* Japanese Bankers Ass'n.

[2366] *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 FR 76,628, 76,637 (Dec. 28, 2012).

[2367] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); TCW; Credit Suisse (Williams).

[2368] *See, e.g.,* Occupy; Sens. Merkley & Levin (Feb. 2012).

interests in the covered fund, including activities related to the marketing of interests in such covered fund; (vii) market conditions; and (viii) any other factor that the Board believes appropriate. In contrast to the proposal, the final rule does not require information on whether the extension would pose a threat to safety and soundness of the covered banking entity or to financial stability of the United States. The categories of information in final rule have been modified in order to eliminate redundancies.

The final rule continues to permit the Board to impose conditions on granting any extension granted if the Board determines conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or otherwise unsound practices, or to otherwise further the purposes of section 13 of the BHC Act and the final rule. In cases where the banking entity is primarily supervised by another Agency, the Board will consult with such Agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period. While some commenters requested that the Board modify the final rule to permit a banking entity to have covered fund investments in excess of the aggregate funds limitation,[2369] the final rule does not contain such a provision. As noted in the release for the proposed rule, the statutory grant of authority to provide extensions of time to comply with the investment limits refers specifically and only to the period for conforming a seeding investment to the per-fund limitation.[2370]

As noted in the proposed rule, the Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through misuse of requests for extension of the seeding period for covered funds. Therefore, the Board and the Agencies will monitor requests for extensions of the seeding period for activity in covered funds that is inconsistent with the requirements of section 13 of the BHC Act.

4. Section ____.13: Other Permitted Covered Fund Activities

a. Permitted Risk-Mitigating Hedging Activities

Section 13(d)(1)(C) of the BHC Act provides an exemption for certain risk-mitigating hedging activities.[2371] In the context of covered fund activities, the proposed rule implemented this authority narrowly and permitted a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge only in two situations: (i) When acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund; and (ii) with respect to a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.[2372] The proposed rule imposed specific requirements on a banking entity seeking to rely on this exemption.[2373]

The Agencies received a range of comments on the proposed risk-mitigating hedging exemption for ownership interests in covered funds. Some commenters objected to the limited applicability of the statutory risk-mitigating hedging exemption in the covered funds context and urged the Agencies to allow ownership interests in covered funds to be used in any appropriate risk-mitigating hedging.[2374] In contrast, other commenters urged the Agencies to delete one or both of the risk-mitigating hedging exemptions as the commenters argued they were inconsistent with the statute or otherwise inappropriate.[2375] Commenters also argued that a separate risk-mitigating hedging exemption for covered funds is unnecessary because the statute provides a single risk-mitigating hedging exemption.[2376]

Some commenters argued that the proposed rule would impede banking entities from offering covered-fund linked products to customers, including hedging these products, and would, in particular, impair the ability of banking entities to hedge the risks of fund-linked derivatives with fund-linked swaps or shares of covered funds referenced in fund-linked products.[2377] These commenters argued this limitation would increase risks at banking entities and was inconsistent with the purpose of the risk-mitigating hedging exemption. Commenters also proposed modifying the proposal to permit risk-mitigating hedging activities that facilitate a customer's exposure to profits and/or losses of the covered fund, to permit portfolio or dynamic hedging strategies involving covered fund interests, and to eliminate the proposed condition that a customer would not itself be a banking entity.[2378] Some commenters also urged the Agencies to grandfather existing risk-mitigating hedging activities with respect to any covered-fund linked products that comply with the hedging requirements for proprietary trading under § ____.5 of the proposed rule.[2379]

In contrast, other commenters objected to the exemption for hedging covered fund-linked products sold to customers. These commenters asserted that this activity would authorize investment in covered funds in a manner that would not be subject to the three percent per-fund limitation;[2380] or would be inconsistent with the statutory requirement that a banking entity actively seek additional investors for a fund.[2381]

Some commenters urged the Agencies to expand the hedging exemption to allow banking entities to invest in covered funds in order to hedge obligations relating to deferred compensation plans for employees who do not directly provide services to the covered fund for which the hedge relates.[2382] Another commenter argued that banking entities should be permitted to hedge compensation investment accounts for executive officers who are not involved in the management of the investment accounts.[2383] In contrast, other commenters objected to the hedging exemption for compensation arrangements, arguing that it may increase risk to banking entities,[2384] is

[2369] *See* ABA (Keating).

[2370] *See* 12 U.S.C. 1851(d)(4)(C).

[2371] *See* 12 U.S.C. 1851(d)(1)(C).

[2372] *See* proposed rule § ____.13(b)(1)(i)(A) and (B).

[2373] These requirements were substantially similar to the requirements for the risk-mitigating hedging exemption for trading activities contained in proposed § ____.5. In addition, proposed § ____ .13(b) also required that: (i) The hedge represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund arising out of the transaction to accommodate a specific customer request or directly connected to the banking entity's compensation arrangement with an employee; and (ii) the banking entity document, at the time the transaction is executed, the hedging rationale for all hedging transactions involving an ownership interest in a covered fund.

[2374] *See* BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2375] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2376] *See* BoA.

[2377] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2378] *See, e.g.,* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Deutsche Bank (Fund-Linked Products).

[2379] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA.

[2380] *See* Sens. Merkley & Levin (Feb. 2012).

[2381] *See* AFR *et al.* (Feb. 2012).

[2382] *See* Arnold & Porter.

[2383] *See* BOK.

[2384] *See* Occupy.

unnecessary,[2385] or may provide banking entities with an opportunity to evade the limitations on the amount of ownership interests they may have as an investment in a covered fund.[2386]

After review of the comments, the Agencies believe at this time that permitting only limited risk-mitigating hedging activities involving ownership interests in covered funds is consistent with the safe and sound conduct of banking entities, and that increased use of ownership interests in covered funds could result in exposure to higher risks.[2387]

In particular, the Agencies have determined that transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity. These transactions expose the banking entity to the risk that the customer will fail to perform, thereby effectively exposing the banking entity to the risks of the covered fund. Furthermore, a customer's failure to perform may be concurrent with a decline in value of the covered fund, which could expose the banking entity to additional losses. Accordingly, the Agencies believe that these transactions pose a significant potential to expose banking entities to the same or similar economic risks that section 13 of the BHC Act sought to eliminate, and have not adopted the proposed exemption for using ownership interests in covered funds to hedge these types of transactions in the final rule.

As argued by some commenters, modifying the proposal to eliminate the exemption for permitting banking entities to acquire covered fund interests in connection with customer facilitation may impact banking entities ability to hedge the risks of fund-linked derivatives through the use of fund-linked swaps or shares of covered funds referenced by fund-linked products.[2388] Some commenters on the proposal argued that innovation of financial products may potentially be reduced if the final rule does not permit this type of activity related to fund-linked products.[2389] The Agencies recognize that U.S. banking entities may no longer be able to participate in offering certain customer facilitation products relating to covered funds, but believe it is consistent with the purposes of section 13 to restrict these activities.

The final rule maintains the proposed exemption for hedging employee compensation arrangements with several changes. To ensure that exempt hedging activities are designed to reduce one or more specific risks, as required by section 13(d)(1)(C) of the BHC Act, the proposed rule required that permitted hedging activity be designed to reduce the specific risks to the banking entity in connection with and related to its obligations or liabilities. The final rule permits a banking entity to acquire or retain an ownership interest in a covered fund provided that the ownership interest is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund. Under the final rule, a banking entity may not use as a hedge ownership interests of a covered fund for which the employee does not provide services. The requirement under the final rule that the hedging activity be designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity is consistent with the requirement in § ____.5 of the final rule, as discussed above in Part IV.A.4. The final rule permits a banking entity to hedge its exposures to price and other risks based on fund performance that arise from restricted profit interest and other performance based compensation arrangements with its investment managers.

Section 13(a)(2) of the final rule describes the criteria a banking entity must meet in order to rely on the risk-mitigating hedging exemption for covered funds. These requirements, which are based on the requirements for the risk-mitigating hedging exemption for trading activities under § ____.5 of the final rule and which are discussed in detail above in Part IV.A.4, have been modified from the proposal to reflect the more limited scope of this section.[2390] In particular, the final rule permits a banking entity to engage in risk-mitigating hedging activities involving ownership interests in a covered fund only if the banking entity has established and implements, maintains and enforces an internal compliance program that is reasonably designed to ensure the covered banking entity's compliance with the requirements of the hedging exemption, including reasonably designed written policies and procedures and internal controls and ongoing monitoring and authorization procedures, and has acquired or retained the ownership interest in accordance with these written policies, procedures and internal controls. Furthermore, the acquisition or retention of an ownership interest must demonstrably reduce or otherwise significantly mitigate, at the inception of the hedge, one or more specific, identifiable risks arising in connection with the compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund. The acquisition or retention also may not, at the inception of the hedge, result in any significant new or additional risk that is not itself hedged contemporaneously in accordance with the hedging exemption, and the hedge must be subject to continuing review, monitoring and management by the banking entity.

The final rule also permits a banking entity to engage in risk-mitigating hedging activities in connection with a compensation arrangement, subject to the conditions noted above, only if the compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate thereof has acquired an ownership interest and the losses on such ownership interest are offset by corresponding decreases in the amounts payable in connection with the related employee compensation arrangement.[2391]

b. Permitted Covered Fund Activities and Investments Outside of the United States

Section 13(d)(1)(I) of the BHC Act[2392] permits foreign banking entities to acquire or retain an ownership interest in, or act as sponsor to, covered funds, so long as those activities and investments occur solely outside the United States and certain other conditions are met (the ''foreign fund

[2385] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2386] *See* Occupy.

[2387] *See* 12 U.S.C. 1851(d)(2).

[2388] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2389] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2390] *See* final rule § ____.13(a)(2).

[2391] *See* final rule § ____.13(a)(2)(iii).

[2392] Section 13(d)(1)(I) of the BHC Act permits a banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund notwithstanding the restrictions on investments in, and relationships with, a covered fund, if: (i) Such activity or investment is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (ii) the activity occurs solely outside of the United States; (iii) no ownership interest in such fund is offered for sale or sold to a resident of the United States; and (iv) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(I).

exemption'').[2393] As described in the proposal, the purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities and investments, while preserving national treatment and competitive equality among U.S. and foreign banking entities within the United States.[2394] The statute does not explicitly define what is meant by ''solely outside of the United States.''

The proposed rule allowed foreign banking entities that met certain qualifications to engage in covered fund activities, including owning, organizing and offering, and sponsoring funds outside the United States. The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and when an activity or investment would occur ''solely outside of the United States.'' The proposed rule allowed a qualifying foreign banking entity to acquire or retain an ownership interest in, or act as sponsor to, a covered fund under the exemption only if no subsidiary, affiliate or employee of the banking entity that's incorporated or physically located in the United States engaged in offering or selling the covered fund. The proposed rule also implemented the statutory requirement that prohibited an ownership interest in the covered fund from being offered for sale or sold to a resident of the United States.

Commenters generally expressed support for an exemption to allow foreign banking entities to conduct foreign covered fund activities and make investments outside the United States.[2395] A number of commenters also expressed concerns that the proposed foreign fund exemption was too narrow and would not be effective in permitting foreign banking entities to engage in covered fund activities and investments outside of the United States. For instance, many commenters argued that several of the proposal's restrictions on the exemption were not required by statute and were inconsistent with congressional intent to limit the extraterritorial impact of section 13 of the BHC Act.[2396] These commenters argued that the foreign funds exemption should focus on whether a prohibited activity, such as sponsoring or investing in a covered fund, involves principal risk taken or held by the foreign banking entity that poses risk to U.S. banking entities or the financial stability of the United States.[2397] Commenters also argued that a broader exemption would better recognize the regulation and supervision of the home country supervisor of the foreign banking entity and of its covered fund activities.[2398]

Some commenters contended that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[2399] Commenters also alleged that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities conducting activity pursuant to this exemption.[2400] These commenters argued that foreign banking entities relying on the foreign fund exemption should not be subject to the compliance program requirements contained in Appendix C with respect to their non-U.S. operations.[2401]

Several commenters argued that the restrictions of section 13(f), which limits transactions between a banking entity and certain covered funds, would not apply to activities and investments made in reliance on the foreign fund exemption.[2402] Some commenters argued that the Agencies should grandfather all existing foreign covered funds and argued that failure to provide relief for existing relationships could cause substantial disruption to foreign covered funds and significantly harm investors in existing funds without producing a clear offsetting benefit.[2403]

In response to comments received on the proposal, the final rule contains a number of modifications to more effectively implement the foreign fund exemption in light of the language and purpose of the statute. Importantly, as explained in the section defining covered funds, the Agencies also believe that the more circumscribed definition of covered fund, including the exclusion for foreign public funds, should alleviate many of the concerns raised and potential burdens identified by commenters with respect to the funds activities of foreign banking entities.[2404]

1. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(I) provides that, in order to be eligible for the foreign funds exemption, the banking entity must not be directly or indirectly controlled by a banking

[2393] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the final rule's implementation of section 13(d)(1)(I) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[2394] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley). (''Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs *Seek* to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.'').

[2395] *See, e.g.,* IIB/EBF; SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Occupy.

[2396] *See* Ass'n. of German Banks; BVI; Allen & Overy (on behalf of Canadian Banks); EFAMA; F&C; HSBC; IIB/EBF; ICSA; PEGCC; Société Générale; Union Asset; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Williams); Cadwalader (on behalf of Thai Banks).

[2397] *See* IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Katten (on behalf of Int'l Clients).

[2398] *See* Credit Suisse (Williams); PEGCC; *See also* Commissioner Barnier.

[2399] *See e.g.,* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Ass'n. of German Banks; Société Générale; Chamber (Feb. 2012).

[2400] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA. As discussed below in Part IV.C.1, other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[2401] *See* AFG; Ass'n. of German Banks; BVI; Comm. on Capital Markets Regulation; IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; Union Asset. As discussed in greater detail below in Part IV.C.1, activities and investments of a foreign bank that are conducted under the foreign funds exemption are generally not subject to the specific requirements of § ____.20 and Appendices A and B. The U.S. operations of foreign banking entities are expected to have policies and procedures in place to ensure that they conduct activities under this part in full compliance with this part.

[2402] *See* Australian Bankers Ass'n.; AFMA; Allen & Overy (on behalf of Foreign Bank Group); British Bankers' Ass'n.; F&C; French Banking Fed'n.; IIB/EBF; Japanese Bankers Ass'n; Katten (on behalf of Int'l Clients); Union Asset. *See also infra* Part IV.B.5.

[2403] *See* BVI; Credit Suisse (Williams); EFAMA; IIB/EBF; PEGCC; Union Asset. *See supra* Part II for a discussion regarding the conformance period.

[2404] For instance, many commenters raised concerns regarding the treatment of foreign public funds such as UCITS. As discussed in greater detail above in Part IV.B.1, the definition of covered fund under the final rule has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute (*e.g.,* certain foreign funds that are established by U.S. banking entities). Foreign public funds are also excluded from the definition of covered fund under the final rule. The modifications in the final rule in part address commenters' request that foreign funds be grandfathered. To the extent that an entity qualifies for one or more of the exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Moreover, any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

entity that is organized under the laws of the United States or of one or more States. Consistent with this statutory language, the proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

The Agencies did not receive substantive comment on this aspect of the proposal related to the foreign fund exemption, though some commenters offered suggestions to clarify various parts of the wording of the scope of the definition of banking entities that may qualify for the exemption. The final rule makes only minor, technical changes to more fully carry out the purposes of the statute.

Consistent with the statutory language and purpose of section 13(d)(1)(I) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under [2405] or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. As noted above, section 13(d)(1)(I) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[2406] Because of this express statutory requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its sponsorship or investment activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act. The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule also provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[2407]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[2408] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[2409] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[2410] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[2411] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the foreign fund exemption.[2412]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of the foreign fund exemption [2413] if the entity, on a fully-consolidated basis [2414], meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[2415] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and § 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign

[2405] The final rule clarifies the eligibility requirements for banking entities Seeking to rely on the foreign fund exemption. Section 13(d)(1)(I) of the BHC Act and § ____.13(c)(1)(i) of the proposal require that a banking entity Seeking to rely on the foreign fund exemption not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states. For clarification purposes, in addition to the eligibility requirement in Section 13(d)(1)(I) of the BHC Act and the proposal, the final rule also expressly requires that the banking entity not itself be organized under the laws of the United States.

[2406] *See* 12 U.S.C. 1851(d)(1)(I).

[2407] Section ____.13(b)(2) only addresses when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(I) of the BHC Act, are unable to rely on the foreign funds exemption.

[2408] *See* 12 U.S.C. 1843(c)(9).

[2409] *See* 12 CFR 211.20 *et seq.*

[2410] Some commenters argued that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign fund exemption. For example, subpart B of the Board's Regulation K includes various approval requirements and interstate office location restrictions. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. The final rule does not retain the proposal's requirement that the activity be conducted in compliance with all of subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the foreign fund exemption in section 13(d)(1)(I) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[2411] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule only referenced the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[2412] This modification to the definition of foreign banking organization from the proposed definition is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

[2413] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[2414] For clarification purposes, the final rule has been modified from the proposal to provide that the requirements for this provision must be met on a fully-consolidated basis.

[2415] *See* final rule § ____.13(b)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § ____.13(b)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

entity to demonstrate that more than half of its banking business is outside the United States.[2416] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the restrictions on covered fund activities and investments, a result that the Agencies do not believe was intended.

2. Activities or Investments Solely Outside of the United States

As noted above, the proposed rule adopted a transaction-based approach to implementing the foreign fund exemption and focused on the extent to which the foreign fund transactions occur within, or are carried out by personnel, subsidiaries or affiliates within, the United States. In particular, § ____.13(c)(3) of the proposed rule provided that a transaction or activity be considered to have occurred solely outside of the United States only if: (i) the transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; (ii) no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

Commenters suggested that, like the foreign trading exemption, the foreign fund exemption should focus on the location of activities that a banking entity engages in as principal.[2417] These commenters argued that the location of sales activities of a fund should not determine whether a banking entity has sponsored or acquired an ownership interest in a covered fund solely outside of the United States. Commenters also argued that foreign banking entities typically locate marketing and sales personnel for foreign funds in the United States in order to serve customers, including those that are not residents of the United States, and that the proposal would needlessly force all covered fund sales activities to shift outside of the United States. These commenters alleged that the restrictions under the proposal would cause foreign banking entities to relocate their personnel from the United States to overseas, diminishing U.S. jobs with no concomitant benefit.[2418]

Many commenters requested removal of the proposal's prohibition on a U.S. subsidiary, affiliate, or employee of the foreign banking entity offering or selling fund interests in order to qualify for the foreign fund exemption.[2419] Commenters argued that this limitation was not included in the statute and that the limited involvement of persons located in the U.S. in the distribution of ownership interests in a foreign covered fund should not, by itself, disqualify the banking entity from relying on the foreign fund exemption so long as the fund is offered only outside the United States.[2420] These commenters argued that organizing and offering a fund is not a prohibited activity so long as it is not accompanied by ownership or sponsorship of the covered fund. One commenter urged that the final rule permit U.S. personnel of a foreign banking entity to engage in non-selling activities related to a covered fund, including acting as investment advisor, establishing fund vehicles, conducting back-office functions such as day-to-day management and deal sourcing tax structuring, obtaining licenses, interfacing with regulators, and other related activities that do not involve U.S. sales activity.[2421]

Instead of the proposal's transaction-based approach to implementing the foreign fund exemption, many commenters suggested the final rule adopt a risk-based approach.[2422] These commenters argued that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign activity of foreign banking entities in line with the purpose of the statute.[2423] Commenters also contended that foreign activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[2424]

In response to commenters' concerns and in order to more effectively implement both the statutory prohibition as well as the foreign fund exemption, the final rule has been modified to better reflect the purpose of the statute by ensuring that the principal risks of covered fund investments and sponsorship by foreign banking entities permitted under the foreign funds exemption occur and remain solely outside of the United States. One of the principal purposes of section 13 is to limit the risks that covered fund investments and activities pose to the safety and soundness of U.S. banking entities and the U.S. financial system. Another purpose of the foreign fund exemption was to limit the extraterritorial application of section 13 as it applies to foreign banking entities subject to section 13.

To accomplish these purposes in light of the structure and purpose of the statute and in response to commenters, the final rule adopts a risk-based approach rather than a transaction approach to the foreign fund exemption. In order to ensure these risks remain solely outside of the United States, the final rule also includes several conditions on the availability of the foreign fund exemption. Specifically, the final rule provides that an activity or investment occurs solely outside the United States for purposes of the foreign fund exemption only if:

- The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and it not controlled directly or indirectly by, a banking entity that is located in the United States or established under the laws of the United States or of any State;
- The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;
- The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or

[2416] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § ____.13(b)(2)(ii)(B).

[2417] *See* Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2418] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Société Générale; Union Asset.

[2419] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients); TCW; Union Asset.

[2420] *See* IIB/EBF; Société Générale; TCW; Union Asset; Credit Suisse (Williams); *See also* Katten (on behalf of Int'l Clients) (recommending that, similar to the SEC's Regulation S, the final rule provide that involvement of persons located in the United States in the distribution of a non-U.S. covered fund's securities to potential purchasers outside of the United States not affect the analysis of whether a non-U.S. banking entity's investment or sponsorship occurs outside the United States).

[2421] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2422] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); George Osborne.

[2423] *See* IIB/EBF.

[2424] *See* IIB/EBF.

affiliate that is located in the United States or organized under the laws of the United States or of any State; and

• No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.[2425]

These requirements are designed to ensure that any foreign banking entity engaging in activity under the foreign fund exemption does so in a manner that ensures the risk and sponsorship of the activity or investment occurs and resides solely outside of the United States.

The final rule has been modified from the proposal to specifically recognize that, for purposes of the foreign fund exemption, a U.S. branch, agency, or subsidiary of a foreign bank, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[2426] A subsidiary (wherever located) of a U.S. branch, agency, or subsidiary of a foreign bank is also considered itself to be located in the United States. This provision helps give effect to the statutory language limiting the foreign fund exemption to activities of foreign banking entities that occur ''solely outside of the United States'' by clarifying that the U.S. operations of foreign banking entities may not sponsor or acquire or retain an ownership interest in a covered fund as principal based on this exemption.

Because so-called ''back office'' activities do not involve sponsoring or acquiring or retaining an ownership interest in a covered fund, the final rule does not impose restrictions on U.S. personnel of a foreign banking entity engaging in these activities in connection with one or more covered funds. This allows providing administrative services or similar functions to the covered fund as an incident to the activity conducted under the foreign fund exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund).

The foreign fund exemption in the final rule also permits the U.S. personnel and operations of a foreign banking entity to act as investment adviser to a covered fund in certain circumstances. For instance, the U.S. personnel of a foreign banking entity may provide investment advice and recommend investment selections to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States. As explained above, the final rule also explicitly provides that acquiring or retaining an ownership interest does not include acquiring or retaining an ownership interest in a covered fund by a banking entity acting solely as agent, broker, or custodian, subject to certain conditions, or acting on behalf of customers as a trustee, or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of the customer and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest.[2427] The final rule would thus allow a foreign bank to engage in any of these capacities in the U.S. without the need to rely on the foreign fund exemption.

3. Offered for Sale or Sold to a Resident of the United States

The proposed rule provided that no ownership interest in the covered fund be offered for sale or sold to a resident of the United States, a requirement of the statute.[2428] Numerous commenters focused on the definition of ''resident of the United States'' in the proposed rule and the manner in which the restriction on offers and sales to such persons would interrelate with Regulation S under the Securities Act of 1933. Commenters asserted that, since market participants have long conducted offerings of foreign funds in reliance on Regulation S [2429] in order to comply with U.S. securities law obligations, these same securities law principles should be applied to determine whether a person is a resident of the United States for purposes of section 13 and the final rule to determine whether an offer or sale is made to residents of the United States.[2430]

Certain commenters argued that because of the way the restriction in the statute and proposed rule was written, it was unclear whether the restriction on offering for sale to a resident of the United States applied to the foreign banking entity or to any third party that establishes a fund.[2431] Commenters argued the prohibition against offers or sales of ownership interests to residents of the United States should apply only to offers and sales of covered funds organized and offered by the foreign banking entity but not to covered funds established by unaffiliated third parties.[2432] These commenters reasoned that a foreign banking entity should be permitted to make a passive investment in a covered fund sponsored and controlled by an unaffiliated third party that has U.S. investors as long as the foreign banking entity does not itself offer or sell ownership interest in the covered fund to residents of the United States.[2433] Commenters contended that this interpretation would be consistent with section 13's purpose to prevent foreign banks from using the foreign fund exemption to market and sell covered funds to U.S. investors, while simultaneously limiting the extraterritorial impact of section 13.[2434] Commenters argued that the proposal's foreign fund exemption would negatively impact U.S. asset managers unaffiliated with any banking entity because they would either be forced to exclude foreign banking entities from investing in their funds or would need to ensure that no residents of the United States hold ownership interests in funds offered to these entities.[2435] Commenters also contended that foreign banking entities, including sovereign wealth funds that own or control foreign banking organizations, invest tens of billions of dollars in U.S. covered funds and that if these types of investments were not permitted under the foreign fund exemption an important source of foreign investment in the U.S. could be eliminated.[2436]

Commenters argued that an investment by a foreign banking entity in a third-party unaffiliated fund does not pose any risk to a U.S. banking entity or to the U.S. financial system. Moreover, commenters argued that a foreign banking entity that has invested in a fund sponsored and advised by a

[2425] *See* final rule § ____.13(b)(4).

[2426] *See* final rule § ____.13(b)(5).

[2427] *See* final rule § ____.10(a)(2).

[2428] *See* proposed rule § ____.13(c)(1)(iii).

[2429] *See* 17 CFR 230.901–905.

[2430] *See* IIB/EBF; EFAMA; ICI Global.

[2431] *See* Cadwalader (on behalf of Thai Banks); Grosvenor; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2432] *See* Ass'n. of German Banks; BAROC; Cadwalader (on behalf of Thai Banks); Comm. on Capital Markets Regulation; Credit Suisse (Williams); IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); PEGCC.

[2433] *See* Grosvenor; IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); Sens. Merkley & Levin (Feb.2012); Norinchukin; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2434] *See* BAROC; Credit Suisse (Williams); Grosvenor; IIB/EBF.

[2435] *See* Comm. on Capital Markets Regulation; Credit Suisse (Williams); PEGCC.

[2436] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Grosvenor; PEGCC.

third party has no control over whether—and may have no knowledge—that the third party has determined to offer or sell the fund to U.S. residents.[2437]

As noted above, one of the purposes of section 13 is to limit the risk to banking entities and the financial system of the United States. Another purpose of the statute appears to be to permit foreign banking entities to engage in foreign activities without being subject to the restrictions of section 13 while also ensuring that these foreign entities do not receive a competitive advantage over U.S. banking entities with respect to offering and selling their covered fund services in the United States.[2438] As such, the final rule does not prohibit a foreign banking entity from making an investment in or sponsoring a foreign fund. However, a foreign banking entity would not be permitted under the foreign fund exemption to invest in, or engage in the sponsorship of, a U.S. or foreign covered fund that offers ownership interests to residents in the United States unless it does so pursuant to and subject to the limitations of the permitted activity exemption for organizing and offering a covered fund, for example, which has the same effect for U.S. banking entities. The final rule ensures that the risk of the sponsoring and investing in non-U.S. covered funds by foreign banking entities remains outside of the United States and that the foreign fund exemption does not advantage foreign banking entities relative to U.S. banking entities with respect to providing their covered fund services in the United States by prohibiting the offer or sale of ownership interests in related covered funds to residents of the United States.

Commenters also argued that foreign investors in a foreign covered fund should not be treated as residents of the United States for purposes of the final rule if, after purchasing their interest in the covered fund, they relocate to the U.S.,[2439] or travel to the U.S. on a temporary basis.[2440] Commenters also argued that non-U.S. investors in a fund offered by a foreign banking entity should not be prohibited from transferring their interests to residents of the United States in the secondary market.[2441] One commenter alleged that, notwithstanding the reasonable efforts of foreign banking entities to prevent residents of the United States from investing in their foreign covered funds, investors may find ways to circumvent and invest in covered funds without knowledge or assistance from the foreign banking entity.[2442]

Certain commenters argued that there was a substantial risk that foreign funds offered by foreign banking entities would not be able to rely on the exemption due to the presence of a limited number of investors who are residents of the United States.[2443] A few commenters suggested that the final rule should require that, for both related and unrelated covered funds, a banking entity need only have a reasonable belief that an ownership interest in a covered fund is not offered or sold to residents of the United States in order to qualify for the foreign fund exemption. Commenters argued that only active targeting or marketing towards a resident of the United States by the foreign banking entity should be prohibited by the final rule, and that the incidental presence of a limited number of investors that are residents of the United States in a foreign covered fund offered by a foreign banking entity should not prohibit the foreign banking entity from relying on the foreign fund exemption.[2444] One commenter argued that, for certain complex fund structures (*e.g.,* a structure with a master fund and multiple feeder funds that investors invest in or a parallel fund structure both managed by the same fund manager), eligibility for the foreign fund exemption should not be precluded for a fund with no ownership interests offered for sale or sold to U.S. residents even if a related covered fund is offered to residents of the United States.[2445]

After considering comments received on the proposal, the final rule retains the statutory requirement that no ownership interest in the covered fund be offered for sale to a resident of the United States.[2446] The final rule provides that an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold or has been sold pursuant to an offering that targets residents of the United States.[2447]

Absent circumstances otherwise indicating a nexus with residents of the United States, the sponsor of a foreign fund would not be viewed as targeting U.S. residents for purposes of the foreign fund exemption if it conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States.[2448] If ownership interests that are issued in a foreign offering are listed on a foreign exchange, secondary market transactions could be undertaken by the banking entity outside the United States in accordance with Regulation S under the foreign fund exemption.[2449] Foreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a discretionary account or similar account for a person who is not a resident of the United States).[2450] In order to comply with the rule as adopted, sponsors of covered funds established outside of the United States must examine the facts and circumstances of their particular offerings and confirm that the offering does not target residents of the United States.

With respect to the treatment of multi-tiered fund structures under the foreign fund exemption, the Agencies expect that activities related to certain complex fund structures should be integrated in

[2437] *See* AFG; BAROC; Cadwalader (on behalf of Thai Banks); Japanese Bankers Ass'n.

[2438] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2439] *See* IIB/EBF; Katten (on behalf of Int'l Clients); Union Asset.

[2440] *See* IFIC; *See also* Allen & Overy (on behalf of Canadian Banks).

[2441] *See* Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2442] *See* Credit Suisse (Williams).

[2443] *See* BVI; EFAMA; Union Asset.

[2444] *See* AFG; Union Asset; *See also* BVI; Allen & Overy (on behalf of Canadian Banks); Katten (on behalf of Int'l Clients).

[2445] *See* Japanese Bankers Ass'n.

[2446] *See* final rule § ____.13(b)(1)(iii).

[2447] *See* final rule § ____.13(b)(3).

[2448] *See Statement of the Commission Regarding Use of Internet Web sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore,* Securities Act Release No. 7516 (Mar. 23, 1998). Reliance on these principles only applies with respect to whether an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of section 13 of the BHC Act. In addition, reliance would not be appropriate if a foreign fund engages in a private placement of ownership interests in the United States in reliance on Section 4(a)(2) of the Securities Act of 1933 or Regulation D (17 CFR 230.501–506).

[2449] An offer or sale is made in an ''offshore transaction'' under Regulation S if, among other conditions, the transaction is executed in, on or through the facilities of a ''designated offshore securities market'' as described in Regulation S, which includes a number of foreign stock exchanges and markets and any others the SEC designates. *See* Securities Act rule 902(h).

[2450] *See* Securities Act rule 902(k)(2).

order to determine whether an ownership interest in a covered fund is offered for sale to a resident of the United States. For example, a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity.

4. Definition of ''Resident of the United States''

As discussed in greater detail above in Part IV.B.1, section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' As noted above in Part IV.B.1.f describing the definition of ''resident of the United States,'' the statute does not define this term.

After carefully considering comments received, the Agencies have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in the SEC's Regulation S.[2451] The Agencies note, however, that it would not be permissible under the foreign fund exemption for a foreign banking entity to facilitate or participate in the formation of a non-U.S. investment vehicle for a person or entity that is itself a U.S. person for the specific purpose of investing in a foreign fund. The Agencies believe that this type of activity would constitute an evasion of the requirements of section 13 of the BHC Act.

c. Permitted Covered Fund Interests and Activities by a Regulated Insurance Company

As discussed above, section 13(d)(1)(F) of the BHC Act permits a banking entity that is a regulated insurance company acting for its general account, or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions.[2452] Section 13(d)(1)(D) of the Act permits a banking entity to purchase or sell a financial instrument on behalf of customers.[2453] The proposal implemented these exemptions with respect to the proprietary trading activities of insurance companies by permitting a banking entity that is an insurance company to purchase or sell a financial instrument for the general account of the insurance company or for a separate account, in each case subject to certain restrictions.[2454] The proposal did not apply these exemptions to covered fund activities or investments.

A number of commenters argued that section 13 was designed to accommodate the business of insurance by exempting both the proprietary trading and covered fund activities of insurance companies.[2455] These commenters argued that providing an exemption for covered fund activities and investments through both the general account and separate accounts of an insurance company was integral to the business of insurance and that, absent an exemption from the covered fund provisions, insurance companies would lack an effective means to diversify their holdings and obtain adequate rates of return in order to maintain affordable premiums for customers.[2456]

Some commenters argued that section 13 of the BHC Act specifically provides exemptions from both the covered fund prohibition of section 13(a)(1), and the prohibition on proprietary trading.[2457] Commenters contended that the exemptions in section 13(d)(1)(F) (referencing activity in general accounts of insurance companies) and 13(d)(1)(D) (referencing activities on behalf of customers) cross-reference the *instruments* described in section 13(h)(4) and not *activity* described in section 13(h)(4). On this basis, commenters argued the statute exempts both proprietary trading in these instruments described in section 13(h)(4) and investments in those instruments (including when those instruments are ownership interests in covered funds).[2458]

Alternatively, commenters argued that the Agencies should use their authority in section 13(d)(1)(J) of the BHC Act to provide an exemption for the covered fund activities and investments of insurance companies.[2459] These commenters argued that exempting covered funds activities and investments of insurance companies would promote and protect the safety and soundness of the banking entity and financial stability of the United States and provide certain benefits to the U.S. financial system by allowing insurance companies to access important asset classes (for better investment diversity and returns), provide more diverse product offerings to customers, better manage their investment risks through diversification and more closely matching the maturity of their assets and liabilities, contribute liquidity to capital markets, and support economic growth through the provision of capital to entrepreneurs and businesses.[2460] Commenters also argued that an exemption for insurance companies from the covered fund prohibitions was necessary to permit insurance companies that are banking entities to effectively compete with insurance companies not affiliated with an insured depository institution.[2461] Commenters alleged that insurance companies are already subject to extensive regulation under state insurance laws that specifically include provisions designed to diversify risk among investment categories, limit exposure to particular types of asset classes including covered fund investments, and protect the safety and soundness of the insurance company.[2462]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to permit

[2451] *See* final rule § ____.10(d)(8).

[2452] *See* 12 U.S.C. 1851(d)(1)(F).

[2453] *See* 12 U.S.C. 1851(d)(1)(D).

[2454] *See* proposed rule §§ ____.6(b)(2)(iii); ____.6(c).

[2455] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers); ACLI (Jan. 2012); Country Fin. *et al.;* Nationwide; NAMIC; Fin. Services Roundtable (Feb. 3, 2012) (citing FSOC study at 71); HSBC Life; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; *See also* Rep. McCarthy *et al.;* Sen. Nelson; Sen. Hagan; Sens. Brown & Harkin.

[2456] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); USAA (citing FSOC study at 71); HSBC Life; ACLI; NAMIC; Nationwide.

[2457] *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide; *See also* Rep. McCarthy *et al.;* Sens. Brown & Harkin.

[2458] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); USAA; HSBC Life; Country Fin. *et al.;* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide (discussing the exemption for the general account of an insurance company); ACLI; Nationwide (discussing the exemption for separate accounts).

[2459] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers).

[2460] *See* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); USAA; HSBC Life; ACLI (Jan. 2012); NAMIC; Nationwide.

[2461] *See, e.g.,* Nationwide.

[2462] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); USAA; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; NAMIC; Nationwide; Rep. McCarthy *et al. See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that activities of insurance companies ''are heavily regulated by State insurance regulators, and in most cases do not pose the same level of risk as other proprietary trading'').

an insurance company or its affiliate[2463] to acquire or retain an ownership interest in, or act as sponsor to, a covered fund for either the general account of the insurance company or one or more separate accounts established by the insurance company.[2464]

These activities are only permitted under the final rule so long as: (1) the insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company; (2) the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which the insurance company is domiciled; and (3) the appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in § ____.13(c)(2) of the final rule is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[2465]

The Agencies believe that exempting insurance activities and investments from the covered fund restrictions is supported by the language of sections 13(d)(1)(D) and (F) of the BHC Act,[2466] and more fully carries out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2467] Section 13(d)(1)(F) of the statute specifically exempts general accounts of insurance companies, and, as explained above in Part IV.A.7, separate accounts are managed and maintained on behalf of customers, an activity exempt under section 13(d)(1)(D) of the statute. By their terms, these are statutory exemptions from the prohibitions in section 13(a), which includes both the prohibition on proprietary trading and the prohibition on covered fund investments and sponsorship. Moreover, the statutory language of sections 13(d)(1)(D) and 13(d)(1)(F), both cross-reference the *instruments* described in section 13(h)(4) and not *activity* described in section 13(h)(4). These instruments are ''any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract or any other security or financial instrument that [the Agencies determine by rule.]'' This reference covers an ownership interest in a covered fund. The Agencies believe these exemptions as modified more fully carry out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2468] Insurance companies are already subject to a robust regulatory regime including limitations on their investment activities.

5. Section ____.14: Limitations on Relationships With a Covered Fund

Section 13(f) of the BHC Act generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section 13(d)(1)(G) of the BHC Act) from entering into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act (''FR Act'').[2469] The statute also provides an exemption for prime brokerage transactions between a banking entity and a covered fund in which a covered fund managed, sponsored, or advised by that banking entity has taken an ownership interest. Section 13(f) subjects any transaction permitted under section 13(f) of the BHC Act (including a permitted prime brokerage transaction) between the banking entity and covered fund to section 23B of the FR Act.[2470] In general, section 23B of the FR Act requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party. Section ____.16 of the proposed rule implemented these provisions.[2471]

a. Scope of Application

Section 13(f) of the BHC Act and the related provisions of the proposal were among the most commented upon aspects of the covered funds section. The majority of commenters argued that the broad definition of ''covered fund'' under the proposal made the proposed implementation of section 13(f) unworkable and disruptive to existing market practices because it would prohibit corporate funding transactions with ordinary corporate entities that do not engage in hedge fund or private equity activities.[2472] Commenters also argued that activities that the proposal appeared to permit as a permitted activity exemption (*e.g.,* investments in public welfare funds) would be prohibited by the restrictions in 13(f)[2473] and that the Agencies should construe section 13(d)(1)(J) of the BHC Act as allowing them to permit banking entities to enter into covered transactions with a covered fund, if those activities would promote and protect the safety and soundness of banking entities and the financial stability of the United States.[2474] However, many of the comments discussed above and some of the economic burdens noted by these commenters have been addressed by revisions discussed above in Part IV.B.1 to the definition of covered fund.[2475] A number of these and related comments are also addressed by portions of the

[2463] Some commenters urged the Agencies to provide that an affiliate or subsidiary of an insurance company could purchase covered funds for the insurance company's general account or a separate account. *See e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012). The Agencies note that the final rule provides (as does the statute) an exemption that permits an insurance company or its affiliate to acquire and retain an ownership interest in a covered fund solely for the insurance's company general account (or one or more of its separate account); such an affiliate or subsidiary also may be a wholly-owned subsidiary, as defined in the final rule.

[2464] The final rule defines the terms ''general account'' and ''separate account'' largely as proposed, and includes the new defined term ''insurance company,'' defined as a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act. *Cf.* section 2(a)(17) of the Investment Company Act (defining the term insurance company).

[2465] *See* final rule § ____.13(c).

[2466] *See* 12 U.S.C. 1851(d)(1)(D), (F).

[2467] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2468] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2469] 12 U.S.C. 371c. The Agencies note that this does not alter the applicability of section 23A of the FR Act and the Board's Regulation W to covered transactions between insured depository institutions and their affiliates.

[2470] 12 U.S.C. 371c–1.

[2471] *See* proposed rule § ____.16.

[2472] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); BoA; Barclays; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI Global; ISDA (Feb. 2012); RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2473] *See* SunTrust; AHIC; SBIA.

[2474] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2475] *See* final rule § ____.10(b). *See supra* Part IV.B.1.

final rule that provide that the prohibitions of section 13 do not apply to interests acquired, for example, as agent, broker, custodian, in satisfaction of a debt previously contracted, through a pension fund, or as trustee or fiduciary (all within the limits defined in the final rule).

Several commenters argued that applying the restrictions in section 13(f) to foreign activities of foreign banking entities would be inconsistent with the presumption against extraterritorial application of U.S. law and principles of international comity, including deference to home-country regulation.[2476] For example, one commenter expressed concern that rules being developed around custody obligations in the European Union may require a prime broker or custodian to indirectly guarantee assets of a fund, which would directly conflict with the prohibition on guarantees in section 13(f) of the BHC Act.[2477] As explained above, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds.[2478] These changes substantially address the issues raised by commenters regarding the applicability of section 13(f) of the BHC Act to foreign funds.

Commenters also raised a number of other issues. For instance, some commenters argued that applying section 13(f) to securitization entities would in some instances run counter to the rule of construction contained in section 13(g)(2) regarding the sale and securitization of loans.[2479] These commenters recommended that the final rule, at a minimum, grandfather pre-existing relationships between banking entities and existing securitization vehicles to reduce the potential effects of the final rule on agreements and positions entered into before the enactment of the statute.[2480]

One commenter argued that a banking entity that delegates its responsibility for acting as sponsor, investment manager, or investment adviser to an unaffiliated entity should no longer be subject to the restrictions of section 13(f).[2481] By its terms, section 13(f) of the BHC Act applies to a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that relies on section 13(d)(1)(G) of the BHC Act in connection with organizing and offering a covered fund). The Agencies believe that a banking entity that delegates its responsibility to act as sponsor, investment manager, or investment adviser to an unaffiliated party would still be subject to the limitations of section 13(f) if the banking entity retains the ability to select, remove, direct, or otherwise exert control over the sponsor, investment manager, or investment adviser designee. In addition, the unaffiliated party designated as sponsor, investment manager, or investment adviser would be subject to the restrictions of section 13(f) if the third party is a banking entity.

b. Transactions That Would Be a ''Covered Transaction''

Section 13(f) of the BHC Act prohibits covered transactions as defined in section 23A of the FR Act between a banking entity that serves as investment manager, investment advisor or sponsor to a covered fund or that relies on the exemption in section 13(d)(1)(G) and a covered fund.[2482] A number of commenters contended that the definition of ''covered transaction'' in section 13(f) of the BHC Act should incorporate the exemptions available under section 23A and the Board's Regulation W.[2483] These commenters alleged that the statute's general reference to section 23A suggests that the term ''covered transaction'' should be construed in light of section 23A as a whole, including the exemptions in subsection (d) of that Act and as implemented in the Board's Regulation W.[2484] These commenters also argued that the Board's authority to interpret and issue rules pursuant to section 23A of the FR Act and section 5(b) of the BHC Act, the general rule-making authority contained in section 13(b) of the BHC Act, and the exemptive authority in section 13(d)(1)(J) all provide a basis for providing such exemptions.[2485]

In particular, commenters argued that intraday extensions of credit;[2486] transactions fully secured by cash or U.S. government securities;[2487] purchases of liquid assets and marketable securities from covered funds;[2488] and riskless principal transactions with covered funds all should be exempt from the restrictions in section 13(f) of the BHC Act.[2489] These commenters argued that providing an exemption for intraday extensions of credit in particular was necessary to allow a banking entity to continue to provide affiliated covered funds with standard custody, clearing, and settlement services that include intra-day or overnight overdrafts necessary to facilitate securities settlement, contractual settlement, pre-determined income, or similar custody-related transactions. Some commenters argued that transactions fully secured by

[2476] *See* IIB/EBF; Katten (on behalf of Int'l Clients); EBF; EFAMA; French Banking Fed'n.; Japanese Bankers Ass'n.

[2477] *See* AIMA.

[2478] *See* final rule § ____.10(b)(1)(ii) & (c)(1). *See supra* Part IV.B.1.

[2479] Section ____.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. As discussed in greater detail above in Part IV.B.2.b, a banking entity that continues to hold interests in a securitization in reliance on this exemption must comply with certain requirements, including the requirements of § ____.14. Accordingly, § ____.14 of the final rule has also been modified from the proposal to prohibit a banking entity that continues to hold an ownership interest in accordance with § ____11(b), and its affiliates, from entering into a covered transaction with a covered fund, subject to certain exceptions.

[2480] *See* AFME *et al.*: ASF (Feb. 2012); Ashurst; BoA; Barclays; Cadwalader (Municipal Securities); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Deutsche Bank (Fund-Linked Products); Fidelity; GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI (Feb. 2012); IIB/EBF; ISDA (Feb. 2012); JPMC; PNC *et al.*; PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Chamber (Feb. 2012). These comments are addressed above in Part II regarding availability of the conformance period provisions of section 13 of the BHC Act.

[2481] *See* Katten (on behalf of Int'l Clients).

[2482] The term ''covered transaction'' is defined in section 23A of the FR Act to mean, with respect to an affiliate of a member bank: (i) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase; (ii) a purchase of or an investment in securities issued by the affiliate; (iii) a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation; (iv) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company; (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; (vi) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate; or (vii) a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7), *as amended* by section 608 of the Dodd-Frank Act.

[2483] *See* 12 U.S.C. 371c(d); 12 CFR 223.42; ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.*; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Allen & Overy (on behalf of Foreign Bank Group).

[2484] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.*; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2485] *See* BNY Mellon *et al.*; SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Credit Suisse (Williams).

[2486] *See* ABA (Keating); AFG; Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.*; Credit Suisse (Williams); EFAMA; French Treasury *et al.*; JPMC; IMA; RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); SSgA (Feb. 2012); Vanguard.

[2487] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2488] *See* Credit Suisse (Williams).

[2489] *See, e.g.,* Credit Suisse (Williams).

cash or U.S. government securities do not expose banking entities to inappropriate risks, are permitted in unlimited amounts under section 23A, and should not be entirely prohibited under the rule.[2490] A few commenters argued that the proposal would prohibit securities lending transactions and argued that borrower default indemnifications by a banking entity in agency securities lending arrangements should not be prohibited under section 13(f).[2491] Some commenters argued that a banking entity should be allowed to accept the shares of a sponsored covered fund as collateral for a loan to any person or entity, in particular where the loan is not for the purpose of purchasing interests in the covered fund.[2492]

One commenter argued that no exceptions should be granted to the definition of covered transaction, and financing of covered funds would relate to greater fund risk.[2493] In addition, that commenter contended that the Agencies should prohibit a sale of securities by a banking entity to a covered fund even though these transactions are not within the definition of covered transaction for purposes of section 23A of the FR Act.[2494]

The final rule continues to apply the same definition of covered transaction as the proposal. Section 13(f) refers to a covered transaction, *as defined* in section 23A of the FR Act. Section 13(f) of the BHC Act does not incorporate or reference the exemptions contained in section 23A of the FR Act or the Board's Regulation W. Indeed, the exemptions for these transactions are not included in the definition of covered transactions in section 23A; the exemptions are instead in a different subsection of section 23A and provide an exemption from only some (but not all) of the provisions of section 23A governing covered transactions.[2495] Therefore, the final rule does not incorporate the exemptions in section 23A.

Similarly, the final rule incorporates the statutory restriction as written, which provides that a banking entity that serves in certain specified roles may not enter into a transaction *with a covered fund* that would be a covered transaction as defined in section 23A of the FR Act as if the banking entity were a member bank and the covered fund were an affiliate thereof. There are certain occasions when the restrictions of section 23A apply to transactions that involve a third party other than an affiliate of a member bank. For example, section 23A would apply to an extension of credit by a member bank to a customer where the extension of credit is secured by shares of an affiliate. The Agencies believe that these transactions between a banking entity and a third party that is not a covered fund are not covered by the terms of section 13(f), which (as discussed above) make specific reference to transactions by the banking entity *with* the covered fund. A contrary reading would prohibit securities margin lending, which Congress has specifically addressed (and permitted) in other statutes. There is no indication in the legislative history that Congress intended section 13(f) to prohibit margin lending that occurs in accordance with other specific statutes. Thus, section 13(f) does not prohibit a banking entity from extending credit to a customer secured by shares of a covered fund (as well as, perhaps, other securities) held in a margin account. However, the Agencies expect banking entities not to structure transactions with third parties in an attempt to evade the restrictions on transactions with covered funds, and the Agencies will use their supervisory authority to monitor and restrict transactions that appear to be evasions of section 13(f).

c. Certain Transactions and Relationships Permitted

While section 13(f)(1) of the BHC Act generally prohibits a banking entity from entering into a transaction with a related covered fund that would be a covered transaction as defined under section 23A of the FR Act, other specific portions of the statute permit a banking entity to engage in certain transactions or relationships with such funds.

1. Permitted Investments and Ownerships Interests

The proposed rule permitted a banking entity to acquire or retain an ownership interest in a covered fund in accordance with the requirements of section 13.[2496] This was consistent with the text of section 13(f), which by its terms is triggered by the presence of certain ownership interests. This view also resolved an apparent conflict between the text of section 13(f) and the reference in section 13(f) prohibiting covered transactions under section 23A of the FR Act, which includes acquiring or retaining an interest in securities issued by an affiliate.

Several commenters supported this aspect of the proposal.[2497] There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section. Moreover, a contrary reading would make these more specific sections that permit covered transactions between a banking entity and a covered fund mere surplusage. Therefore, the final rule adopts this provision as proposed.[2498]

2. Prime Brokerage Transactions

Section 13(f) provides an exception from the prohibition on covered transactions with a covered fund for any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored, or advised by a banking entity has taken an ownership interest (a ''second-tier fund''). However, the statute does not define prime brokerage transaction. The proposed rule defined prime brokerage transaction to include providing one or more products or services, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.[2499]

A few commenters argued that the proposed definition of prime brokerage transaction was overly broad and should not permit securities lending or borrowing services. These commenters argued that securities lending and borrowing (and certain other services) could increase leverage by covered funds and the risk that a banking entity would bailout these funds.[2500]

Other commenters argued that the proposed definition of prime brokerage transaction was confusing because it included transactions (such as data or portfolio management support) that were not ''covered transactions'' under section 23A of the FR Act and thus not prohibited as an initial matter by section 13(f). These commenters argued that including otherwise permissible transactions within the definition of prime brokerage transaction created uncertainty about the permissibility of other transactions or services that are not expressly covered transactions

[2490] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2491] *See* State Street (Feb. 2012); RMA.

[2492] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); *See also* Katten (on behalf of Int'l Clients).

[2493] *See* Occupy.

[2494] *See* 12 U.S.C. 371c(b)(7); *See also* 12 U.S.C. 371c–1(a)(2)(B) (including the sale of securities or other assets to an affiliate as a transaction subject to section 23B).

[2495] *See* 12 U.S.C. 371c(d).

[2496] *See* proposed rule § ____.16(a)(2)(i).

[2497] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2498] The final rule modifies the proposal to clarify that a banking entity may acquire and retain an ownership interest in a covered fund by express reference to the permitted activities described in §§ ____.11, ____.12 and ____.13.

[2499] *See* proposed rule § ____.10(b)(4).

[2500] *See, e.g.,* Occupy; Public Citizen.

under section 23A of the FR Act and thus not prohibited under section 13(f). One commenter proposed defining prime brokerage transaction as any ''covered transaction'' entered into by a banking entity with a covered fund ''for purposes of custody, clearance, securities borrowing or lending services, trade execution and settlement, financing and related hedging, intermediation, or a similar purpose.'' [2501]

A few commenters supported expanding the definition of prime brokerage transaction to include any service or transaction ''related to'' a specific list of permissible transactions. For instance, one commenter argued that acting as agent in providing contractual income and settlement services and intraday and overnight overdraft protection should expressly be included within the definition of prime brokerage transaction.[2502] This commenter also urged that borrower default indemnification should be included as a prime brokerage transaction to the extent it would be a covered transaction that is prohibited by section 13(f).[2503] Another commenter recommended that the definition of prime brokerage transaction expressly include transactions in commodities, futures and foreign exchange, as well as securities, and transactions effected through OTC derivatives, including, without limitation, contracts for differences, various swaps and security-based swaps, foreign exchange swaps and forwards and ''FX prime brokerage.'' [2504]

Based on review of the comments, the definition of prime brokerage transaction has been modified in several ways. For purposes of the final rule, prime brokerage transaction is defined to mean any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the FR Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support. The definition of prime brokerage transaction under the final rule generally recognizes the same relationships that were considered when defining prime brokerage transaction under the proposal,[2505] without certain of the modifications suggested by some commenters that are discussed above. The Agencies carefully considered comments received on the definition of prime brokerage transaction. As noted above, certain commenters requested that various types of transactions be included in or omitted from the definition. The Agencies believe it appropriate to include within the definition of prime brokerage transaction those transactions that the Agencies believe generally constitute the typical type of prime brokerage transactions provided in the market. Including this list of relationships provides clarity and certainty for transactions that are commonly considered to be prime brokerage transactions.

The final rule incorporates within the definition of prime brokerage transaction a reference to covered transactions under section 23A(b)(7) of the FR Act. This change aligns the final rules with section 13(f) of the BHC Act and is designed to eliminate confusion and provide certainty regarding both the breath of the prohibition on covered transactions in section 13(f) and the scope of the exception for prime brokerage transactions. Thus, a transaction or relationship that is not a covered transaction under section 13(f) of the BHC Act is not prohibited in the first instance (unless prohibited elsewhere in section 13). Within the category of transactions prohibited by section 13(f), transactions within the definition of prime brokerage transaction are permitted.

Some commenters argued that the Agencies should provide an exemption for prime brokerage transactions with a broader array of funds than the proposal permitted. For instance, some commenters argued that the Agencies should permit a banking entity to enter into a prime brokerage transaction with any covered fund or fund structure that the banking entity organizes and offers or for which it directly serves as investment manager, investment adviser, or sponsor, and should not limit the exception for prime brokerage transactions to only a second-tier covered fund.[2506] Conversely, a few commenters argued that the prime brokerage exemption should only permit a banking entity to provide these services to a third-party fund in order to ensure that the provision of prime brokerage services does not give rise to the same risks that section 13 was designed more generally to limit.[2507]

The Agencies note that the statute by its terms does not restrict prime brokerage transactions generally. As noted above, section 13(f)(3)(A) of the BHC Act provides that a banking entity may enter into any prime brokerage transaction with a second-tier fund. The statute by its terms permits a banking entity with a relationship to a covered fund described in section 13(f) to engage in prime brokerage transactions (that are covered transactions) only with second-tier funds and does not extend to covered funds more generally. Neither the statute nor the final rule limit covered transactions between a banking entity and a covered fund for which the banking entity does not serve as investment manager, investment adviser, or sponsor (as defined in section 13 of the BHC Act) or have an interest in reliance on section 13(d)(1)(G) of the BHC Act. Under the statute, the exemption for prime brokerage transactions is available only so long as certain enumerated conditions are satisfied.[2508] The conditions are that (i) the chief executive officer (or equivalent officer) of the banking entity certifies in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests, and (ii) the Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity. The proposed rule incorporated each of these provisions. The final rule provides that this certification be made to the appropriate Federal supervisor for the banking entity.

A few commenters argued that the proposal did not adequately address how the CEO attestation requirement in section 13(f) would apply to foreign banking organizations. They argued that a senior officer with authority for the U.S. operations of the foreign bank should be permitted to make the required attestation.[2509]

The statute allows the attestation for purposes of the prime brokerage exception in section 13(f) of the BHC Act to be from the chief executive officer or ''equivalent officer.'' [2510] In the case of the U.S. operations of foreign banking entities, the senior officer of the foreign banking entity's U.S. operations or the chief executive officer of the U.S.

[2501] *See* SIFMA *et al.* (Mar. 2012).

[2502] *See* RMA.

[2503] *See* RMA.

[2504] *See* Katten (on behalf of Int'l Clients).

[2505] *See* final rule § ____.10(d)(5).

[2506] *See* RMA; Katten (on behalf of Int'l Clients); EFAMA; *See also* Hong Kong Inv. Funds Ass'n.; IMA; Union Asset.

[2507] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2508] *See* 12 U.S.C. 1851(f)(3).

[2509] *See* proposed rule § ____.16(a)(2)(ii); IIB/EBF; Credit Suisse (Williams).

[2510] *See* 12 U.S.C. 1851(f)(3)(A)(ii).

banking entity may provide the required attestation.

d. Restrictions on Transactions With Any Permitted Covered Fund

Sections 13(f)(2) and 13(f)(3)(B) of the BHC Act apply section 23B of the FR Act[2511] to certain transactions and investments between a banking entity and a covered fund as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2512] Section 23B provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.[2513]

Mirroring the statute, the proposal applied this requirement to transactions between a banking entity that serves as investment manager, investment adviser, or sponsor to a covered fund and that fund and any other fund controlled by that fund. It also applied this condition to a permissible prime brokerage transaction in which a banking entity may engage under the proposal.

Commenters generally did not raise any issues regarding the proposal's implementation of section 13(f)(2) and 13(f)(3)(B). The final rule generally implements these requirements in the same manner as the proposal.[2514]

6. Section ____.15: Other Limitations on Permitted Covered Fund Activities

Like § ____.8, § ____.17 of the proposed rule implemented section 13(d)(2) of the BHC Act, which places certain limitations on the permitted covered fund activities and investments in which a banking entity may engage. Consistent with the statute and § ____.8 of the proposed rule, § ____.17 provided that no transaction, class of transactions, or activity was permissible under §§ ____.11 through ____.14 and § ____.16 of the proposed rule if the transaction, class of transactions, or activity would: (i) involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Section ____.17 of the proposed rule defined ''material conflict of interest,'' ''high-risk assets,'' and ''high-risk trading strategies'' for these purposes in a fashion identical to the definitions of the same terms for purposes of § ____.8 of the proposed rule related to proprietary trading. In the final rule, other than the permitted activities to which §§ ____.7 and ____.15 apply, §§ ____.7 and ____.15 are also identical. Comments received on the definitions in these sections, as well as the treatment of these concepts under the final rule, are described in detail in Part IV.A.9 above.

The Agencies also note that some concerns identified by commenters regarding the rule's extraterritorial application are addressed by modifications in the final rule to the definition of a covered fund under § ____.10. As noted above, commenters requested that the Agencies clarify that the limitations in §§ ____.8 or ____.17 of the proposed rule apply only to a foreign banking entity's U.S. activities and affiliates.[2515] As discussed in greater detail above in Part IV.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in § ____.10(b)(1), a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States. Foreign public funds, as defined in § ____.10(c)(1) of the final rule, are also excluded from the definition of a covered fund. By excluding foreign public funds from the definition of covered fund and by narrowing the scope of the definition of a covered fund with respect to foreign funds, the Agencies have addressed some commenters' concerns regarding the burdens imposed by proposed rule § ____.17.

C. Subpart D and Appendices A and B—Compliance Program, Reporting, and Violations

Subpart D of the proposed rule implemented section 13(e)(1) of the BHC Act and required certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on activities and investments set forth in section 13 and the proposed rule.

As explained in detail below, in response to comments on the compliance program requirements and Appendix C (Minimum Standards for Programmatic Compliance) and to conform to modifications to other sections of the proposed rule, the Agencies are adopting a variety of modifications to Subpart D of the proposed rule, which requires certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the final rule. As described above, this compliance program requirement forms a key part of the multi-faceted approach to implementing section 13 of the BHC Act, and is intended to ensure that banking entities establish, maintain and enforce compliance procedures and controls to prevent violation or evasion of the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments.

The proposal adopted a tiered approach to implementing the compliance program mandate, requiring a banking entity engaged in proprietary trading activities or covered fund activities and investments to establish a compliance program that contained specific elements and, if the banking entity's activities were significant, meet a number of more detailed minimum standards. If a banking entity did not engage in proprietary trading activities and covered fund activities and investments, it was required to ensure that its existing compliance policies and procedures included measures that were designed to prevent the banking entity from becoming engaged in such activities and making such investments and to develop and provide for the required program under § __.20(a) of the proposed rule prior to engaging in such activities or making such investments, but was not otherwise required to meet

[2511] 12 U.S.C. 371c–1.

[2512] *See* proposed rule § ____.16(b).

[2513] 12 U.S.C. 371c–1(a); 12 CFR 223.51.

[2514] *See* final rule § ____.14(b). As discussed above, § ____.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. A banking entity that continues to own interests in a securitization in reliance on this exemption must comply, among other things, with the requirements of § ____.14. Accordingly, § ____.14(b) of the final rule has been modified to require that a banking entity that continues to hold an ownership interest in accordance with § ____.11(b) is subject to section 23B of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate.

[2515] *See* EBF; Ass'n. of German Banks.

the requirements of subpart D of the proposed rule.

1. Section __.20: Compliance Program Mandate

a. Program Requirement

A number of commenters argued that the compliance program requirements of the proposal were overly specific, too prescriptive and complex to be workable, and not justified by the costs and benefits of having a compliance program.[2516] For instance, one commenter expressed concern that the complexity of the proposed compliance regime would undermine compliance efforts because the requirements were overlapping, imprecise, and did not provide sufficient clarity to traders or banking entities as to what types or levels of activities would be viewed as permissible trading.[2517] Some commenters argued that the compliance program would be challenging to enforce or administer with any consistency across different banking entities and jurisdictions.[2518] A few commenters objected to any attempt to identify every possible instance of prohibited proprietary trading in otherwise permitted activity.[2519] By contrast, some commenters supported the proposed compliance program as effective and consistent with the statute but also suggested a number of ways that the proposal's compliance program could be improved.[2520]

A few commenters argued that the proposed compliance program should be replaced with a more principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the structure and activities of their organizations.[2521] A few commenters argued that building on compliance regimes that already exist at banking entities, including risk limits, risk management systems, board-level governance protocols, and the level at which compliance is monitored, would reduce the costs and complexity of the proposal while also enabling a robust compliance mechanism for section 13.[2522]

Another commenter suggested that the focus of the compliance program be on the key goal of reducing risk at banking entities by requiring each banking entity to establish a risk architecture that prescribes a customer-focused business model for market making-related activities including a comprehensive set of risk limits that focuses on servicing customers and ensuring safety and soundness.[2523] This commenter suggested the proposal's compliance requirements be replaced by a simpler compliance framework that could be harmonized with the broader systemic capital and risk management framework under the Basel accord. This commenter argued such a framework would increase transparency as well as reduce overall complexity and costs of regulation, and that information relevant to the compliance infrastructure, including customer orientation policies and procedures, target customer and product lists, trade histories, and risk limit calibration methodology and analyses, should all be made available to examiners.[2524] Another commenter urged that the compliance program could be generally improved by having a greater focus on the compensation incentives within the compliance program of banking entities.[2525]

A number of other commenters requested certain types of banking entities be specifically excluded from having to implement the requirements of the compliance program. For example, some commenters urged that the details required in proposed Appendix C apply only to those banking entities and business lines within a banking group that have ''significant'' covered funds or trading activities and not apply to an affiliate of a banking entity that does not engage in the types of activities section 13 is designed to address (*e.g.,* an industrial affiliate that manufactures machinery).[2526] One commenter argued that the final rule should not impose a compliance program requirement on a banking entity that owns 50 percent or less of another banking entity in order to ensure the compliance program did not discourage joint ventures or other arrangements where a banking entity does not have actual control over an affiliate.[2527] As discussed in Part IV.B.4.c. above,[2528] other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities because insurance companies are already subject to comprehensive regulation of the kinds and amounts of investments they can make under State or foreign insurance laws and regulations.[2529] However, another commenter suggested that insurance company affiliates of banking entities expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[2530]

A few commenters argued that requiring securitization vehicles to establish even the minimal requirements set forth in § __.20(d) would impose unnecessary costs and burdens on these entities.[2531] By contrast, another commenter argued that, because of the perceived risks of these entities, securitization vehicles related to a banking entity should be required to comply fully with the proposed rule regardless of how such compliance procedures are funded by the banking entity.[2532]

Several commenters urged that foreign activities of foreign banking entities, which are already subject to

[2516] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading); *See also* Barclays; BlackRock; Chamber (Dec. 2011); Comm. on Capital Markets Regulation; Credit Suisse (Williams); FIA; Goldman (Covered Funds); Investure; NYSE Euronext; RBC; STANY; Wedbush; *See also* Northern Trust; Chamber (Feb. 2012).

[2517] *See* Citigroup (Feb. 2012).

[2518] *See* ABA (Abernathy); IIB/EBF; ICFR. While the Agencies recognize these issues, the Agencies believe the final rule's modifications to the proposal—for example, providing for simplified programs for smaller, less active banking entities and increasing the asset threshold that triggers enhanced compliance requirements—helps balance enforceability and consistency concerns with implementing a program that helps to ensure compliance consistent with section 13(e)(1) of the BHC Act. *See* 12 U.S.C. 1851(e)(1).

[2519] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; STANY; *See also* Barclays.

[2520] *See* AFR (Nov. 2012); Occupy; Sens. Merkley & Levin (Feb. 2012)

[2521] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *See also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); *See also* NYSE Euronext; Stephen Roach.

[2522] *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* ABA (Abernathy); Paul Volcker.

[2523] *See* Citigroup (Feb. 2012); *See also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2524] *See* Citigroup (Feb. 2012).

[2525] *See* Occupy.

[2526] *See, e.g.,* Credit Suisse (Williams); GE (Feb. 2012); *See also* NAIB *et al.;* Chamber (Feb. 2012).

[2527] *See* GE (Feb. 2012). Under the BHC Act, an entity would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution. Pursuant to the BHC Act, a company controls another company if, for instance, the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company. *See* 12 U.S.C. 1841(a)(2). The compliance program requirement applies to all banking entities in order to ensure their compliance with the final rule.

[2528] *See* Part IV.B.4.c.

[2529] *See, e.g.,* ACLI (Jan. 2012); Country Fin. *et al.;* NAMIC.

[2530] *See* Sens. Merkley & Levin (Feb. 2012). As noted above, the compliance program requirement applies to all banking entities, including insurance companies that are considered banking entities, in order to ensure their compliance with the final rule.

[2531] *See* ASF (Feb. 2012); AFME *et al.;* SIFMA (Securitization) (Feb. 2012); Commercial Real Estate Fin. Council.

[2532] *See* Occupy.

their own prudential regulation under applicable home country regulation, be excluded from the compliance program and argued that to do otherwise would be an extraterritorial expansion of U.S. law.[2533] These commenters contended that the compliance program requirements for foreign banking entities should, in any event, be narrowly circumscribed.[2534] One commenter proposed that the foreign activity of foreign banking entities be excluded from compliance, reporting and other obligations where the risk of the activity is outside of the United States because those risks do not pose a threat to U.S. taxpayers.[2535] Another commenter argued that only U.S. affiliates of foreign banking entities engaged in proprietary trading and covered fund activities as principal in the United States should be required to institute the compliance and reporting systems required in the proposal, and that all foreign affiliates only be required to have policies and procedures designed to prevent the banking entity from engaging in relevant trading and covered fund activities in the United States.[2536] This commenter also expressed concern that the reporting and recordkeeping requirements could be interpreted to apply to an entire trading unit, even trading activities with no U.S. nexus, if any portion of a trading unit's activities, even a single trade, would be required to rely on the market-making, hedging, underwriting or U.S. government security exemptions.[2537]

Commenters also offered thoughts on the timeframe within which banking entities must establish a compliance program. One commenter urged that reporting begin immediately,[2538] while another commenter contended that the effective date provided banking entities with sufficient time to implement the proposal's compliance program.[2539] Other commenters, however, argued that banking entities should have additional time to establish compliance programs.[2540] Some commenters argued banking entities should have one-year from the date of publication of the final rule to implement their compliance programs,[2541] while others urged that banking entities have a two-year period to build compliance systems.[2542] One commenter suggested the Board amend its conformance rule to provide U.S. banking entities with an additional year for implementing the compliance requirements with respect to their foreign operations.[2543]

After considering comments on the proposal, the final rule retains the compliance program requirement with a variety of modifications. In particular, the modifications are designed to make the compliance program requirements clearer and more tailored to the size, complexity and type of activity conducted by each banking entity.[2544] The Agencies also believe that the revisions build on the limits, procedures and elements of risk management programs that many banking entities have already developed to monitor and control the risk of existing trading and investment activities.[2545]

The final rule builds on the proposed rule's tiered approach by adjusting asset thresholds and by adding a new provision allowing a banking entity with modest covered activities to customize its compliance program. Specifically, the final rule allows banking entities with total assets below $10 billion to fold compliance measures into their existing compliance program in a manner that addresses the types and amounts of activities the entity conducts.[2546] The proposal did not contain such a provision. Similar to the proposal, the final rule requires that a banking entity that conducts no activity subject to section 13 of the BHC Act is not required to develop any compliance program until it begins conducting activities subject to section 13.[2547] The final rule further modifies the proposal by requiring that a banking entity with total assets greater than $10 billion but less than $50 billion is generally required to establish a compliance program suited to its activities which includes the six elements described in the final rule.[2548] Additionally, the final rule requires that the largest and most active banking entities, with total assets above $50 billion, or that are subject to the quantitative measurements requirement due to the size of their trading assets and liabilities, adopt an enhanced compliance program that addresses the six elements described in the rule plus a number of more detailed requirements described in Appendix B.[2549]

In response to commenters' concerns regarding compliance program burdens in connection with covered fund activities and investments, the final rule is further modified with respect to thresholds for covered fund activities and investments. As noted above, this and the other modifications are designed to make the compliance program requirement clearer and more tailored to the size, complexity and type of activity conducted by each banking entity. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invests in the aggregate

[2533] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *See also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2534] *See, e.g.,* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Williams); HSBC.

[2535] *See* Australian Bankers Ass'n. (Feb. 2012); *See also* RBC.

[2536] *See* IIB/EBF.

[2537] *See* IIB/EBF.

[2538] *See* Occupy.

[2539] *See* Alfred Brock.

[2540] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop.Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *See also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012).

[2541] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Credit Suisse (Seidel); *See also* BDA (Mar. 2012).

[2542] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* GE; Credit Suisse (Williams); Goldman (Prop. Trading); Morgan Stanley; RBC; SVB.

[2543] *See* Morgan Stanley.

[2544] The Agencies believe these modifications, such as increasing the threshold that triggers enhanced compliance standards and allowing smaller banking entities to customize their compliance programs, help address concerns that the proposed requirement was too complex and unworkable. *See, e.g.,* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading).

[2545] Some commenters argued that the requirement should build on banking entities' existing compliance regimes. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop.Trading) (Feb. 2012); *See also* ABA (Abernathy); Paul Volcker.

[2546] *See* final rule § __.20(f)(2).

[2547] *See* final rule § __.20(f)(1). In response to a few commenters, the final rule, unlike § __.20(d) of the proposed rule, no longer requires a banking entity include measures that are designed to prevent such entity from becoming engaged in covered trading activities or covered fund investments and activities.

[2548] Under the proposal, each banking entity was required to have a compliance program that addressed the elements described in the rule, unless the banking entity did not engage in prohibited activities or investments, in which case it need only have existing policies and procedures requiring the banking entity to develop a compliance program before engaging in such activities. Further, a banking entity that has trading assets and liabilities equal to or greater than $1 billion, or equal to 10% or more of total assets, would have been subject to additional standards under the proposed rule. *See* proposed rule §§ __.20(a), (c), (d).

[2549] Because the Agencies have determined not to retain proposed Appendix B in the final rule, proposed Appendix C is now Appendix B under the final rule.

more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total asset thresholds discussed above, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies have also modified the compliance program reporting obligations of foreign banking entities with respect to their covered trading and covered fund activities that are conducted pursuant to the exemptions contained in §§ __.6(e) and __.13(b).[2550]

The final rule also responds to commenters' concerns regarding the timeframe within which a banking entity must establish and implement the compliance program required for that entity under § ____.20. Under the final rule, each banking entity must establish the compliance program required for that entity under § ____.20 as soon as practicable and in no case later than the end of the conformance period.[2551] The Agencies expect that during this period a banking entity will develop and implement the compliance program requirements of the final rule as part of its good-faith efforts to fully conform its activities and investments to the requirements of section 13 and the final rule. As explained below in the discussion of the enhanced minimum standards for compliance programs under Appendix B, the final rule also requires larger and more active banking entities to report certain data regarding their trading activities. These requirements have been phased-in to provide banking entities an opportunity to develop the necessary systems to capture and report the relevant data.[2552] In addition, as explained below, the Agencies will consider, after a period to gain experience with the data, revisiting these data collections to determine their usefulness in monitoring the risk and types of activities conducted by banking entities.

b. Compliance Program Elements

Section ____.20 of the final rule specifies six elements that each compliance program required under that section must at a minimum contain. With some minor modifications, these are the same six elements that were included in the proposed rule. The changes reflect modifications made in requirements and limits in the other provisions of the rule and, in particular, acknowledge the importance of trading and hedging limits, appropriate setting, monitoring and management review of trading and hedging limits, strategies, and activities and investments, incentive compensation and other matters.

The six elements specified in § ____.20(b) are:

- Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities and covered fund activities and investments conducted by the banking entity to ensure that all activities and investments that are subject to section 13 of the BHC Act and the rule comply with section 13 of the BHC Act and the rule;[2553]
- A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and the rule and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and the rule;[2554]
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the rule or by management as requiring attention;[2555]
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;[2556]
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program;[2557] and
- Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and the rule, which a banking entity must promptly provide to the relevant supervisory Agency upon request and retain for a period of no less than 5 years.

Under the final rule, these six elements must be part of the compliance program of each banking entity with total consolidated assets greater than $10 billion that engages in activities covered by section 13 of the BHC Act.

As discussed above, the Agencies have moved particular elements with respect to the required compliance program for the exemptions contained in § ____.4(a), § ____.4(b), and § ____.5 into the specific requirements of these exemptions. The Agencies believe this structure more effectively conveys that satisfying the requirements of these exemptions involves specific compliance measures or, with respect to underwriting and market making, a customer-focused business model, as requested by some commenters.[2558]

In addition to the generally required compliance program elements specified in § ____.20(b), a banking entity relying on any of these exemptions should employ the specific compliance tools specified within the relevant section of

[2550] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *See also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2551] As discussed in Part II., the Board is extending the conformance period by one year. Extension of the conformance period will, among other things, provide banking entities with additional time to establish the required compliance program. The Agencies believe the extension of the conformance period, as well as the phased-in approach to implementing the enhanced compliance program in Appendix B, address certain commenters' requests for additional time to establish a compliance program. *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop.Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *See also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012); Morgan Stanley.

[2552] Commenters provided a wide range of feedback regarding the timeframe for establishing a compliance program, from requesting that reporting begin immediately to requesting two years from the date of publication of the final rule. *See, e.g.,* Occupy; Alfred Brock; Wells Fargo (Prop. Trading); PNC *et al.;* SIFMA *et al.* (Prop.Trading) (Feb. 2012). The Agencies believe that the final rule's approach appropriately balances the desire for effective regulation with requests for additional time to establish a compliance program.

[2553] This requirement is substantially the same as the proposed written policies and procedures requirement. *See* proposed rule § ____20(b)(1).

[2554] This requirement is substantially the same as the proposed internal controls requirement. *See* proposed rule § ____.20(b)(2).

[2555] The final rule modifies the proposed management framework requirement by adding that the management framework element must include appropriate management review of trading limits, strategies, hedging activities, incentive compensation, and other matters. *See* final rule § ____.20(b)(3). *See also* proposed rule § ____20(b)(3). One commenter suggested that the compliance program requirement have a greater focus on compensation incentives. *See* Citigroup (Feb. 2012).

[2556] The final rule modifies the proposed independent testing requirement by specifying that such testing must be done ''periodically.'' *See* final rule § ____.20(b)(4). *See also* proposed rule § ____.20(b)(4). The meaning of ''independent testing'' is discussed in more detail below in Part IV.C.2.e. The reference to ''audit'' does not mean that the independent testing must be performed by a designated auditor, whether internal or external.

[2557] The final rule retains the proposed training requirement. *See* final rule § ____.20(b)(5). *See also* proposed rule § ____.20(b)(5).

[2558] One of these commenters suggested the Agencies adopt a simpler compliance framework that could be harmonized with the Basel accord. *See* Citigroup (Feb. 2012). The Agencies believe the final framework described above helps address concerns about streamlining the compliance program requirement while meeting the statutory requirement to issue regulations ''in order to insure compliance'' with section 13. 12 U.S.C. 1851(e)(1).

this rule to facilitate compliance with the applicable exemption and should appropriately tailor the required compliance program elements to the individual trading activities and strategies of each trading desk on an ongoing basis. By specifying particular compliance program-related requirements in the exemptions, the Agencies have sought to provide additional guidance and clarity as to how a compliance program should be structured,[2559] while at the same time providing the banking entity with sufficient discretion to consider the type, size, scope and complexity of its activities and business structure in designing a compliance program to meet the requirements set forth in § ____.20(b).[2560]

For a banking entity with more than $10 billion in total consolidated assets, the compliance program requires additional documentation with respect to funds. For example, the banking entity is required to maintain records that include documentation of exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliate) in determining that such fund is not a covered fund.[2561] The banking entity is also required to maintain, with respect to each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions provided by §§ ____.10(c)(1), ____.10(c)(5), ____.10(c)(8), ____.10(c)(9), or ____.10(c)(10) of subpart C, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions.[2562] If the banking entity operates a seeding vehicle described in §§ ____.10(c)(12)(i) or ____.10(c)(12)(iii) of subpart C that will become a registered investment company or SEC-regulated business development company, the compliance program must also include a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § ____.12(a)(2)(i)(B) of subpart C.[2563] Furthermore, for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interest in foreign public funds as described in § ____.10(c)(1) of subpart C owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, such banking entity must include in its compliance program documentation the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized. Such calculation must be done at the end of each calendar quarter and must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters.[2564]

c. Simplified Programs for Less Active Banking Entities

The proposed rule provided that the six elements of the compliance program required by § ____.20 would apply to all banking entities engaged in covered trading activities or covered fund activities and investments and that the minimum detailed standards of Appendix C would apply to only those banking entities above specified thresholds. The application of detailed minimum standards was intended to reflect the heightened compliance risks of significant covered trading and significant covered fund activities and investments.

The proposed rule provided that a banking entity with no covered activities or investments could satisfy the requirements of § ____.20 if its existing compliance policies and procedures were amended to include measures that were designed to prevent the banking entity from becoming engaged in such activities or making such investments and required the banking entity to develop and provide for the required compliance program prior to engaging in covered activities or making covered investments.

Several commenters expressed concern over the requirement in § ____.20(d) of the proposed rule that a banking entity that did not engage in any covered trading activities or covered fund activities or investments must ensure that its existing compliance policies and procedures include measures designed to prevent the banking entity from becoming engaged in such activities and making such investments.[2565] In particular, some commenters expressed concern that the proposal would have a burdensome impact on community banks and force community banks to hire specialists to amend their policies and procedures to ensure compliance with section 13 and the final regulations. These commenters argued that a banking entity should not be required to amend its compliance policies and procedures and set up a monitoring program if the banking entity does not engage in prohibited activities.[2566]

A few commenters argued that the Agencies should more carefully

[2559] One commenter stated that the proposed rule did not provide sufficient clarity as to what types or levels of activities would be permissible. *See* Citigroup (Feb. 2012).

[2560] Some commenters requested a more principles-based framework that allows banking entities to customize compliance programs to the structure and activities of their organizations. *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *See also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); NYSE Euronext; Stephen Roach.

[2561] *See* final rule § ____.20(e)(1). As discussed under § ____.10 regarding entities excluded from the definition of covered fund, the Agencies recognize that the final rule's definition of covered fund does not include certain pooled investment vehicles. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule. The Agencies are adopting this additional documentation requirement to facilitate such monitoring activities.

[2562] *See* final rule § ____.20(e)(2). The Agencies are adopting this additional documentation requirement for the same reasons discussed above with respect to § ____.20(e)(1).

[2563] *See* final rule § ____.20(e)(3). The rationale for this additional documentation requirement is provided under the discussion regarding registered investment companies and business development companies in § ____.10.

[2564] *See* final rule § ____.20(e)(4). The rationale for this additional documentation requirement is provided under the discussion regarding foreign public funds in § ____.10. For purposes of this requirement, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. *See* final rule § ____.20(e)(5).

[2565] *See, e.g.,* ICBA; ABA (Keating); Conf. of State Bank Supervisors; NAIB; Ryan Kamphuis; Wisconsin Bankers Ass'n.

[2566] *See, e.g.,* ICBA; ABA (Keating).

consider the burden of the compliance program on smaller institutions that engage in a modest level of permissible trading or covered fund activity.[2567] One commenter recommended that smaller banks be given the benefit of the doubt regarding compliance.[2568] For instance, one commenter recommended that banking entities with consolidated assets of $10 billion or less be permitted to engage in a limited amount of interest rate swaps and certain other traditional banking activities without being required to establish a compliance program.[2569]

The Agencies have considered carefully the comments received and, as noted above, have modified the rule in order to limit the implementation, operational or other burdens or expenses associated with the compliance requirements for a banking entity that engages in no covered activities or investments. The final rule permits banking entities that have no covered activities or investments (other than covered transactions in obligations of or guaranteed by the United States or an agency of the United States and municipal securities) to satisfy the compliance program requirements by establishing the required compliance program prior to becoming engaged in such activities or making such investments. This eliminates the burden on banking entities that do not engage in covered activities or investments.

Similarly, § ____.20(f)(2) of the final rule provides that a banking entity with total consolidated assets of $10 billion or less as measured on December 31 of the previous two years that does engage in covered activities and investments may satisfy the requirements of § ____.20 by including in its existing compliance policies and procedures references to the requirements of section 13 and subpart D as appropriate given the activities, size, scope and complexity of the banking entity. [2570] This could include appropriate references to the limits on trading activities permitted in reliance upon any of the exemptions contained in § _____.4(a), § _____.4(b) or § _____.5.

d. Threshold for Application of Enhanced Minimum Standards

Under the proposed rule, banking entities with significant covered trading activities or covered fund activities and investments were required to establish an enhanced compliance program in accordance with Appendix C, which contained detailed compliance program requirements. The proposed rule required a banking entity to implement the enhanced compliance program under Appendix C if the banking entity engaged in covered activities and investments and either: (i) Has, on a consolidated basis, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion or equals 10 percent or more of its total assets; or (ii) has, on a consolidated basis, aggregate investments in covered funds the average value of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion, or sponsors and advises one or more covered funds the total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

In general, commenters argued that the activities and investments subject to section 13 are conducted by only a small number of the nation's largest financial firms and that the compliance program requirements should be tailored to target these firms.[2571] Some commenters urged the Agencies to raise substantially the proposed $1 billion threshold for trading assets and liabilities in § ____.20(c)(2) of the proposal to $10 billion or higher due to the high costs of implementing the enhanced compliance program. A few commenters argued that even if the threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements included in Appendix C.[2572] Some of these commenters recommended the threshold for trading assets for compliance should be increased to no less than $10 billion to mitigate the costs and impact on regional banking organizations that do not engage proprietary trading subject to the prohibition of section 13. These commenters argued that the compliance requirements of § ____.20(a)-(b) are sufficient to ensure that regional banking organizations have appropriate compliance programs.[2573] One commenter suggested the threshold for the enhanced compliance requirement be increased to $50 billion in combined trading assets and liabilities.[2574] One commenter also argued that banking entities required to establish enhanced compliance programs should no longer be required to do so if they fall below the threshold.[2575]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which compliance program requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold triggering the enhanced compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering Appendix C.[2576] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2577] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2578] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be

[2567] *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB.

[2568] *See* Sens. Merkley & Levin (Feb. 2012).

[2569] *See* ICBA.

[2570] Some commenters asked the Agencies to consider the burden of the compliance program requirement on smaller institutions and recommended that small banks be given the benefit of the doubt regarding compliance. *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB. The Agencies decline to follow the approach suggested by another commenter to allow banking entities with assets of $10 billion or less be permitted to engage in certain limited activities without having to establish a compliance program. *See* ICBA. The Agencies believe that requiring a banking entity engaged in covered trading or covered fund activity to establish a compliance program is a fundamental part of the multi-faceted approach to implementing section 13 of the BHC Act, which requires the Agencies to implement rules ''to insure compliance with this section.'' 12 U.S.C. 1851(e)(1). Further, the Agencies believe that the final rule's modification of the proposal to allow banking entities with total assets under $10 billion to customize their compliance programs helps ease the burden of this requirement on smaller institutions.

[2571] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); PNC *et al.*

[2572] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2573] *See* PNC *et al.;* M&T Bank; *See also* ABA (Abernathy).

[2574] *See* State Street (Feb. 2012).

[2575] *See* ABA (Keating).

[2576] *See* PNC *et al.*

[2577] *See* PNC *et al.*

[2578] *See* Northern Trust.

included in the $1 billion standard for becoming subject to any reporting and recordkeeping requirements under the final rule.[2579]

A few commenters argued that the $1 billion threshold for establishing an enhanced compliance program should not include the amount of investments in, or assets of, funds that are SBICs or similar funds that contain, SBICs or other investments specified under section 13(d)(1)(E) of the BHC Act, such as investments in and funds that qualify for low-income housing tax credits, or New Markets Tax Credits or that qualify for Federal historic tax credits or similar state programs.[2580] These commenters argued that each of these types of funds is expressly permitted by the statute and that including these investments and funds in the dollar thresholds that trigger the programmatic compliance requirements of Appendix C would provide a disincentive to banking entities investing in or sponsoring these funds, a result inconsistent with permitting these types of investments. Similarly, one commenter urged that investments by a banking entity in, and assets held by, loan securitizations not be included in these thresholds because these activities and investments are expressly excluded from coverage under the rule of construction contained in section 13(g)(2) of the BHC Act regarding the securitization of loans.[2581] Another commenter urged that this threshold not include investments in, or assets of, any securitization vehicle that would be considered a covered fund because many smaller and regional banking entities that were not intended to be subject to Appendix C likely would exceed the $1 billion threshold if these assets are included.[2582] A few commenters also argued that, during the conformance period, investments in, and relationships with, a covered fund that a banking entity is required to terminate or otherwise divest in order to comply with section 13 should not be included for purposes of calculating the compliance thresholds.[2583]

After considering comments received on the proposal and in order to implement a compliance program requirement that is consistent with the purpose and language of the statute and rule while at the same time appropriately calibrating the associated resource burden on banking entities, the final rule applies the enhanced minimum standards contained in Appendix B to only those banking entities with the most significant covered trading activities or those that meet a specified threshold of total consolidated assets. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invest in the aggregate more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total consolidated asset thresholds, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies believe that commenters' concerns about whether certain types of covered fund investments or activities (e.g., amounts or relationships held during the conformance period) are included for purposes of calculating the enhanced compliance thresholds are addressed because under the final rule, the enhanced compliance thresholds are based on total consolidated assets and not the amount of covered fund investments and activities. Similar to the proposed rule, which provided that a banking entity could be subject to the enhanced compliance program if the Agency deemed it appropriate, the final rule's enhanced compliance program also could apply if the Agency notifies the banking entity in writing that it must satisfy the requirements.[2584]

Section ____.20 provides that three categories of banking entities will be subject to the enhanced minimum standards contained in Appendix B. The first category is any banking entity that engages in proprietary trading and is required to report metrics regarding its trading activities to its primary Federal supervisory agency under the final rule.[2585] This category includes a banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities that equal or exceed $50 billion based on the average gross sum of trading assets and liabilities (on a worldwide consolidated basis and after excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters. A foreign banking entity with U.S. operations is required to adopt an enhanced compliance program if its total trading assets and liabilities across all its U.S. operations equal or exceed $50 billion (after excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. or any agency of the U.S.). While these banking entities will be required to begin to report and record quantitative measurements by June 30, 2014, they will not be required to implement an enhanced compliance program by this date. Instead, as discussed above, a banking entity must establish a compliance program as soon as practicable and in no event later than the end of the conformance period. As explained more fully in Part IV.C.3., this category expands over time to include any banking entity with trading assets and liabilities that equal or exceed $10 billion (as measured in the manner described above). For banking entities below the $50 billion threshold that become subject to the quantitative measurements requirement through the phased-in approach, they will not become subject to the enhanced compliance program until the date they are required to comply with the quantitative measurements requirement. However, these banking entities will be required to have a compliance program that meets the requirements of § ____.20(b) by the end of the conformance period. Thus, banking entities with between $25 billion and $50 billion trading assets and liabilities (as described in § ____.20(d)) will be required to implement an enhanced compliance program under Appendix B by April 30, 2016. Similarly, banking entities with between $10 billion and $25 billion trading assets and liabilities will be subject to the requirements of Appendix B by December 31, 2016.

After considering comments, the Agencies have increased the trading asset and liability thresholds triggering the enhanced compliance program requirements. The Agencies believe that banking entities with a significant amount of trading assets should have the most detailed programs for ensuring compliance with the trading and other requirements of section 13 of the BHC Act and the final rule. Specifically, consistent with the thresholds for reporting and recording quantitative measurements, the threshold will initially be $50 billion trading assets and liabilities and, over time, will be reduced to $10 billion.[2586] As noted by

[2579] *See* Occupy.

[2580] *See* ABA (Keating); PNC *et al.*

[2581] *See* PNC *et al.*

[2582] *See* ASF (Feb. 2012).

[2583] *See* PNC *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2584] *See* proposed rule § ____.20(c)(2)(iii); final rule § ____.20(c)(3).

[2585] Issues related to the threshold for reporting quantitative measurements are discussed in detail in Part IV.C.3., below.

[2586] Some commenters requested raising this dollar threshold to at least $10 billion. *See* PNC *et al.;* PNC; ABA (Keating). One commenter suggested

commenters, these thresholds will continue to capture a significant percentage of the total trading assets and liabilities in the banking system, but will reduce the burdens to smaller, less complex banking entities.[2587] With respect to this first category, the Agencies determined, in response to comments,[2588] that the threshold for proprietary trading should not include trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States. This approach reduces the burdens associated with the enhanced minimum compliance program on banking entities whose trading operations consist primarily of trading U.S. government or agency obligations, which are generally exempt from the proprietary trading prohibition under § ____.6(a)(1)(i). While some commenters argued that additional assets or liabilities, such as securitizations or investments in SBICs, should be excluded from the calculation,[2589] the Agencies believe that trading in other assets involves more complex trading activity and warrants being included in the threshold calculation for applying the enhanced compliance program requirement.

To balance the increased trading asset and liability threshold with the goal of requiring appropriate specificity and rigor for large and complex banking organizations' compliance programs, the Agencies have determined to also require an enhanced compliance program for any banking entity that has reported total consolidated assets, as of the previous calendar year-end, of $50 billion or more. Banking entities with total assets of $50 billion or more are among the most complex banking entities and have been found by Congress to pose sufficient risk to the financial stability of the United States to warrant being generally subject to enhanced prudential standards under section 165 of the Dodd-Frank Act. With respect to foreign banking entities, this threshold is calculated by reference solely to the aggregate assets of the foreign banking entity's U.S. operations, including its U.S. branches and agencies. This approach is consistent with the statute's focus on the risks posed by covered trading activities and investments within the United States and also responds to commenters' concerns regarding the level of burden placed on foreign banking entities with respect to their foreign operations.[2590]

The third category includes any banking entity that is notified by its primary Federal supervisory Agency in writing that it must satisfy the requirements and other standards contained in Appendix B. By retaining the flexibility to impose enhanced compliance requirements on a given banking entity upon specific notice to the firm, the Agencies have the ability to apply additional standards to any banking entity with a mix, level, complexity or risk of activities that, in the judgment of the relevant supervisory Agency, indicates that the firm should appropriately have in place an enhanced compliance program.

Some commenters argued that the final rule should not require a banking entity to establish the type of detailed compliance regime dictated by Appendix C for both trading and covered fund activities and investments simply because the banking entity engages in one but not the other activity.[2591]

To comply with the applicable compliance program requirements under § ____.20 and Appendix B of the final rule, banking entities should appropriately take into account the type, size, scope and complexity of their activities and business structure in determining the terms, scope and detail of the compliance program to be instituted.[2592] For example, if all of a banking entity's activities subject to the rule involve covered fund activities or investments, it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the proprietary trading provision of the rule. Similarly, if a banking entity engages only in activities that are subject to the proprietary trading provisions of the rule and does not engage in any covered fund activities or investments, it would not be expected that the banking entity would implement the same detailed compliance program under the covered funds section as would be required for its proprietary trading activities. In each of these situations, the banking entity would be expected to put in place sufficient controls to ensure that an appropriate compliance program is established before the banking entity commences a new covered activity. The Agencies believe that this treatment is consistent with the statutory language regarding internal controls and recordkeeping to ensure compliance with section 13 and also reduces unnecessary costs and burdens associated with requiring banking entities to implement compliance requirements that are not appropriate to the size, scope and risk of their relevant activities.

2. Appendix B: Enhanced Minimum Standards for Compliance Programs

The proposed rule contained an appendix (Appendix C) which specified a variety of minimum standards applicable to the compliance program of a banking entity with significant covered trading activities or covered fund activities and investments. The Agencies proposed to include these minimum standards as part of the regulation itself, rather than as accompanying guidance, reflecting the compliance program's importance within the general implementation framework for the rule.

As explained above, the Agencies continue to believe that the inclusion of specified minimum standards for the compliance program within the regulation itself rather than as accompanying guidance serves to reinforce the importance of the compliance program in the implementation framework for section 13 of the BHC Act. As explained above, the Agencies believe that large banking entities and banking entities engaged in significant trading activities should establish, maintain and enforce an enhanced compliance program. The requirements for an enhanced compliance program have been consolidated in Appendix B of the final rule.

the threshold be increased to $50 billion. *See* State Street (Feb. 2012).

[2587] *See* PNC *et al.;* M&T Bank; *See also* ABA (Abernathy); ABA (Keating). The Agencies recognize that, at the $10 billion threshold, a significant percentage of the trading assets and liabilities in the banking industry will remain subject to the enhanced compliance program requirement. *See* PNC.

[2588] *See* PNC *et al.*

[2589] *See, e.g.,* ABA (Keating) (suggesting the threshold should not include the amount of investments in or assets of SBICs, or those that qualify for low-income housing tax credits (LIHTC) New Markets Tax Credits (NMTC), or Federal historic tax credits (HTC)); PNC *et al.* (loans); Northern Trust.

[2590] Several commenters requested that foreign activities of foreign banking entities be excluded from the compliance program requirement. *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de Mexico; Norinchukin. One commenter stated the only U.S. affiliates of foreign banking entities should be required to institute the proposed reporting and compliance requirements. *See* IIB/EBF.

[2591] *See, e.g.,* SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[2592] This is generally consistent with the proposed rule's compliance program requirement. *See* proposed rule § ____.20(a) (requiring that the banking entity's compliance program be appropriate for the size, scope and complexity of activities and business structure of the banking entity).

Similar to the proposed rule, section I of Appendix B provides that the enhanced compliance program must:

- Be reasonably designed to identify, document, monitor and report the covered trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and the rule;
- Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and the rule;
- Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;
- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program; and
- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

The proposed rule included several definitions within the appendix. In the final rule, all definitions have been moved to other sections of the rule or into Appendix A (governing metrics). Any banking entity subject to the enhanced minimum standards contained in Appendix B may incorporate existing policies, procedures and internal controls into the compliance program required by Appendix B to the extent that such existing policies, procedures and internal controls assist in satisfying the requirements of Appendix B.

Section II of Appendix B contains two parts: one that sets forth the enhanced minimum compliance program standards applicable to covered trading activities of a banking entity and one that sets forth the corresponding enhanced minimum compliance program standards with respect to covered fund activities and investments. As noted above, if all of a banking entity's activities subject to the final rule involve only covered trading activities (or only covered fund activities and investments), it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the covered funds (or proprietary trading) provisions of the rule. As discussed below, the Agencies have determined not to include the provisions regarding enterprise-wide compliance programs.

a. Proprietary Trading Activities

Like the proposed compliance appendix, section II.A of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities.[2593] This portion of Appendix B requires a banking entity to devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its covered trading activities, and to promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program and changes in legal, regulatory or other requirements.

Similar to the proposed rule, section II.A of Appendix B requires a banking entity subject to the Appendix to: (i) Have written policies and procedures governing each trading desk that include a description of certain information specific to each trading desk that will delineate its processes, mission and strategy, risks, limits, types of clients, customers and counterparties and its compensation arrangements; (ii) include a comprehensive description of the risk management program for the trading activity of the banking entity, as well as a description of the governance, approval, reporting, escalation, review and other processes that the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and subpart B; (iii) implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and subpart B and with the banking entity's policies and procedures, and establish and enforce risk limits appropriate for the activity of each trading desk; and (iv) for any hedging activities that are conducted in reliance on the exemption contained in § ____.5, establish, maintain and enforce policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that describe the positions, techniques and strategies that each trading desk may use, the manner in which the banking entity will determine that the risks generated by each trading desk have been properly and effectively hedged, the level of the organization at which hedging activity and management will occur, the management in which such hedging strategies will be monitored and the personnel responsible for such monitoring, the risk management processes used to control unhedged or residual risks, and a description of the process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § ____.5.

To the extent that any of the standards contained in Appendix B may be appropriately met by policies and procedures, internal controls and other requirements that are common to more than one trading desk, a banking entity may satisfy the requirements for the enhanced minimum standards of the compliance program by implementing such common requirements with respect to any such desks as to which they are appropriately applicable.[2594] To the extent the required elements of the compliance program apply differently to different trading desks that conduct trading in the same financial instruments, a banking entity must document the differences and adopt policies and procedures and implement internal controls specific to each of the different trading desks. Overall, the policies and procedures should provide the Agencies with a clear, comprehensive picture of a banking entity's covered trading activities that can be effectively reviewed.

Appendix B also requires that the banking entity perform robust analysis and quantitative measurement of its covered trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading

[2593] *See* Joint Proposal, 76 FR 68,963.

[2594] This is consistent with proposed Appendix C, except that the term ''trading unit'' from the proposal has been replaced with the term ''trading desk.'' *See* Joint Proposal, 76 FR 68,965.

activity; and prevent the occurrence of prohibited proprietary trading. In particular, the banking entity must incorporate into its compliance program any quantitative measure reported by the banking entity pursuant to Appendix A where applicable, and include at a minimum: (i) Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of the quantitative measures employed; (ii) ongoing timely monitoring and review of calculated quantitative measurements; (iii) the establishment of thresholds and trading measures for each trading desk and heightened review of any trading activity that is inconsistent with those thresholds; and (iv) review, investigation and escalation with respect to matters that suggest a reasonable likelihood that a trading desk has violated any part of section 13 of the BHC Act or the rule.[2595]

Where a banking entity is subject to the reporting requirements of Appendix A, any additional quantitative measurements developed and implemented by the banking entity under the compliance program requirement are not required to be routinely submitted to the relevant Agency as provided in Appendix A, but are subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request. Where a banking entity is not subject to the requirements of Appendix A, that banking entity would likewise not be required by this rule to routinely submit these additional quantitative measurements to the relevant Agency, but would be subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request.

In addition to the other requirements that are specific to proprietary trading, the banking entity's compliance program must identify the activities of each trading desk that will be conducted in reliance on the exemptions contained in §§ ____.4 through ____.6, including an explanation of (i) how and where in the organization such activity occurs, and (ii) which exemption is being relied on and how the activity meets the specific requirements of such exemption. For trading activities that rely on an exemption contained in §§ ____.4 through § ____.6, the banking entity's compliance program should include an explanation of how, and its policies, procedures and internal controls that demonstrate that, such trading activities satisfy such exemption and any other requirements of section 13 of the BHC Act and the final rule that are applicable to such activities. A foreign banking entity that engages in proprietary trading in reliance on the exemption contained in § ____.6(e) will be expected to provide information regarding the compliance program implemented to ensure compliance with the requirements of that section, including compliance by the U.S. operations of the foreign banking firm, but will only be expected to provide trading information regarding activity conducted within the United States (absent an indication of activity conducted or designed to evade the requirements of section 13 of the BHC Act of the final rule).[2596]

In addition, the compliance program must describe the process for ensuring that liquidity management activities are conducted in conformance with the limits and policies contained in § ____.3(d)(3). This includes processes for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any proprietary trading activity that may indicate potential violations of section 13 of the BHC Act and subpart B and to prevent violations of section 13 of the BHC Act and subpart B. The standards set forth in subpart D direct the banking entity to include requirements in its compliance program for documenting remediation efforts, assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the implementation of the compliance program.

b. Covered Fund Activities or Investments

Section II.B of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

The enhanced compliance program requirements for covered funds and investments focus on: (i) Ensuring that the compliance program provides a process for identifying all covered funds that the banking entity sponsors, organizes or offers, and covered funds in which the banking entity invests; (ii) ensuring that the compliance program provides a method for identifying all funds and pools that the banking entity sponsors or has an interest in and the type of exemption from the Investment Company Act or Commodity Exchange Act (whether or not the fund relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act or section 4.7 of the regulations under the Commodity Exchange Act), and the amount of ownership interest the banking entity has in those funds or pools; (iii) identifying, documenting, and mapping where any covered fund activities are permitted to be conducted within the banking entity; and (iv) including an explanation of compliance; (v) describing sponsorship activities related to covered funds; and (vi) establishing, maintaining and enforcing internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and subpart C, and (vii) monitoring of the banking entity's investments in and transactions with any covered funds.

In addition, the banking entity's compliance program must document the banking entity's plan for seeking unaffiliated investors to ensure that any investment by the banking entity in a covered fund conforms to the limits contained in the final rule or that the covered fund is registered in compliance with the securities laws within the conformance period provided in the final rule. Similarly, the compliance program must ensure that the banking entity complies with any limits on transactions or relationships with the covered fund contained in the final rule, including in situations in which the banking entity is designated as a sponsor, investment manager, investment adviser or commodity trading adviser by another banking entity.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity that may indicate potential violations of section 13 of the BHC Act and subpart C. The standards set forth in subpart D require the banking entity to include requirements in its compliance program for documenting remediation efforts,

[2595] *See* Joint Proposal, 76 FR 68,965.

[2596] *See* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Seidel); HSBC.

assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the design or implementation of the compliance program.

c. Enterprise-Wide Programs

Appendix C in the proposed rule contained a provision that permitted a banking entity to establish a compliance program on an enterprise-wide basis. Some commenters argued that a less specific and more flexible compliance regime would be essential to make the enterprise-wide compliance structures contemplated in Appendix C effective because requiring individualized policies and procedures for each business line would diminish the benefits of enterprise-wide compliance and prevent consistency of these policies and procedures within the banking entity.[2597] One of these commenters recommended the Agencies provide greater options for developing a compliance program and not limit a banking entity to a choice between a single enterprise-wide program or a separate program for each subsidiary engaged in activities covered by the proposed rule.[2598]

In contrast, one commenter argued that any enterprise-wide compliance program would only be effective if combined with additional programs at the trading unit or subsidiary level to train all employees at a banking entity.[2599] This commenter argued that each trading unit is different and suggested that it would be more efficient to mandate enterprise-wide default internal controls, but provide each individual trading unit the flexibility to tailor these requirements to its own specific business.[2600] This commenter also urged that Appendix C's elements III (internal controls), IV (responsibility and accountability) and VII (recordkeeping) should not be imposed solely at the enterprise-wide level.[2601]

After considering carefully the comments on the proposal, the Agencies have removed the reference to an enterprise-wide compliance program from the final rule; however, the Agencies acknowledge that a banking entity may establish a compliance program on an enterprise-wide basis, as long as the program satisfies the requirements of § ____.20 and, where applicable, Appendix B. A banking entity may employ common policies and procedures that are established at the enterprise-wide level or at a business-unit level to the extent that such policies and procedures are appropriately applicable to more than one trading desk or activity, as long as the required elements of Appendix B and all of the other applicable compliance-related provisions of the rule are incorporated in the compliance program and effectively administered across trading desks and banking entities within the consolidated enterprise or designated business. If a banking entity establishes an enterprise-wide program, like a non-enterprise wide program, that program will be subject to supervisory review and examination by any Agency vested with rule writing authority under section 13 of the BHC Act with respect to the compliance program and the activities or investments of each banking entity for which the Agency has such authority.[2602] The banking organization would be expected to provide each appropriate Agency with access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rule writing authority.

For similar reasons, the Agencies have determined not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13.[2603] At this time the Agencies do not believe such an approach would be consistent with the statute, which requires each Agency to adopt a rule for the types of banking entities under its jurisdiction,[2604] or effective given the different authorities and expertise of each Agency. The Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.[2605]

d. Responsibility and Accountability

Section III of Appendix B includes the enhanced minimum standards for responsibility and accountability. Section III contains many of the provisions contained in the proposed rule relating to responsibility and accountability, with certain modifications.[2606] Section III requires a banking entity to establish, maintain and enforce both a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and the rule. The standards in Section III focus on four key constituencies—the board of directors, the CEO, senior management, and business line managers. Certain of the standards contained in the proposed rule relating to business management are separately covered by specific requirements contained in sections II.A and II.B of Appendix B. Section III makes it clear that the board of directors, or similar corporate body, and the CEO and senior management are responsible for creating an appropriate ''tone at the top'' by setting an appropriate culture of compliance and establishing clear policies regarding the management of the firm's trading activities and its fund activities and investments. Senior management must be made responsible for communicating and reinforcing the culture of compliance established by it and the board of directors, for the actual implementation and enforcement of the approved compliance program, and for taking corrective action where appropriate.

In response to a question in the preamble to the proposed rule regarding whether the chief executive officer or similar officer of a banking entity should be required to provide a certification regarding the compliance program requirements, a few commenters urged that the final rule should not require that the board of directors or CEO of a banking entity review or certify the effectiveness of the compliance program.[2607] These commenters argued that existing processes developed by large, complex banking entities for board of director reporting and governance processes ensure that compliance programs work appropriately, and argued that these protocols would establish appropriate management and board of directors' oversight of the section 13 compliance

[2597] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2598] *See* Wells Fargo (Prop. Trading).

[2599] *See* Occupy.

[2600] *See* Occupy.

[2601] *See* Occupy.

[2602] *See* 12 U.S.C. 1851(b)(2)(B)(i).

[2603] *See* Barclays; Goldman (Prop. Trading); BoA; SIFMA Funds *et al.* (Prop. Trading) (Feb. 2012); Comm. on Capital Markets Regulation.

[2604] *See* 12 U.S.C. 1851(b)(2)(B).

[2605] Accordingly, the SEC's and CFTC's final rules, unlike the applicable proposals, do not incorporate by reference the rules and interpretations of the Federal banking agencies with respect to covered fund activities or investments. *See* SEC proposed rule 255.10(a)(2), Joint Proposal, 76 FR 68,942–68,943, and CFTC proposed rule, 77 FR 8421–8423.

[2606] *See* Joint Proposal, 76 FR 68,966.

[2607] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

program.[2608] By contrast, several commenters advocated requiring CEO attestation regarding compliance with section 13.[2609] One commenter suggested that the rule require an annual assessment by management of the effectiveness of internal controls and policies and require a public accounting firm to attest to the accuracy of those annual assessments.[2610]

After considering comments received on the proposal, the Agencies have determined to include a requirement in the final rule that a banking entity's CEO annually attest in writing to the appropriate Agency for the banking entity that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix B and § __.20 of the rule in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this rule. Although some commenters stated that existing protocols of certain banking entities would establish appropriate oversight of the rule's compliance program,[2611] the Agencies believe this requirement will better help to ensure that a strong governance framework is implemented with respect to compliance with section 13 of the BHC Act, and that it more directly underscores the importance of CEO engagement in the governance and management framework supporting compliance with the rule. In the case of the U.S. operations of a foreign banking entity, including a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations of the foreign banking entity who is located in the United States.

e. Independent Testing

Section IV of the Appendix B includes the enhanced minimum standards for independent testing, which are substantially similar to the proposed independent testing standards.[2612] A banking entity subject to Appendix B must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the trading desk or other organizational unit being tested, outside auditors, consultants, or other qualified independent parties. If a banking entity uses internal personnel to conduct the independent testing, the Agencies would expect that the banking entity ensure that the personnel responsible for the testing are separate from the unit and functions being tested (*e.g.,* the personnel do not report to a person who is directly responsible for the unit or involved in the functions being tested) and have knowledge of the requirements of section 13 and its implementing rules. Although an external audit is not required to meet the independent testing requirement, the Agencies would expect that, when external auditors are engaged to review compliance by a banking entity with laws and regulations, the banking entity would give appropriate consideration to the need to review the compliance program required under this rule.

While one commenter suggested the final rule prescribe the precise manner in which a banking entity must conduct its compliance testing,[2613] the Agencies believe such a requirement is unnecessary because the standards in the final rule will ensure that independent testing of the effectiveness of a banking entity's compliance program is objective and robust. The independent testing must examine both the banking entity's compliance program and its actual compliance with the rule. This testing must include not only testing of the overall adequacy and effectiveness of the compliance program and compliance efforts, but also the effectiveness of each element of the compliance program and the banking entity's compliance with each provision of the rule. This requirement is intended to ensure that a banking entity continually reviews and assesses, in an objective manner, the strength of its compliance efforts and promptly identifies and remedies any weaknesses or matters requiring attention within the compliance framework.

f. Training

Like the proposed compliance appendix, Section V of Appendix B includes the enhanced minimum standards for training.[2614] It requires that a banking entity provide adequate training to its trading personnel and managers, as well as other appropriate personnel, in order to effectively implement and enforce the compliance program. In particular, personnel engaged in covered trading activities and investments should be educated with respect to applicable prohibitions and restrictions, exemptions, and compliance program elements to an extent sufficient to permit them to make informed, day-to-day decisions that support the banking entity's compliance with section 13 of the BHC Act and the rule. In particular, any personnel with discretionary authority to trade, in any amount, should be appropriately trained regarding the differentiation of prohibited proprietary trading and permitted trading activities and given detailed guidance regarding what types of trading activities are prohibited. Similarly, personnel providing investment management or advisory services, or acting as general partner, managing member, or trustee of a covered fund, should be appropriately trained regarding what covered fund activities and investments are permitted and prohibited.

g. Recordkeeping

Section VI of Appendix B contains the enhanced minimum standards for recordkeeping which are consistent with the proposed recordkeeping standards.[2615] Generally, a banking entity must create records sufficient to demonstrate compliance and support the operation and effectiveness of its compliance program (*i.e.,* records demonstrating the banking entity's compliance with the requirements of section 13 of the BHC Act and the rule, any scrutiny or investigation by compliance personnel or risk managers, and any remedies taken in the event of a violation or non-compliance), and retain these records for no less than five years in a form that allows the banking entity to promptly produce these records to any relevant Agency upon request. Records created and retained under the compliance program must include trading records of the trading units, including trades and positions of each such unit. Records created and

[2608] *See* SIFMA *et al.* (Prop.Trading); *See also* Wells Fargo (Prop. Trading).

[2609] *See* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Ralph Saul (Oct. 2011); John Reed; *See also* BEC *et al.* (Oct. 2011); Matthew Richardson.

[2610] *See* Merkley & Levin (Feb. 2012).

[2611] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); *See also* Wells Fargo (Prop. Trading).

[2612] *See* Joint Proposal, 76 FR 68,967.

[2613] One commenter suggested that any compliance testing under the final rule be monitored by the Agencies and initially tested by internal audit personnel of the banking entity who are subject to a specific licensing and registration process for section 13 of the BHC Act and supplemented by an annual independent external review. *See* Occupy; *See also* proposed rule § __.20(b)(4). The Agencies believe it would be unnecessarily burdensome to require particular licensing and registration processes for internal auditors that are specific to section 13 of the BHC Act.

[2614] *See* Joint Proposal, 76 FR 68,967.

[2615] *See* Joint Proposal, 76 FR 68,967.

retained under the enhanced compliance program must also include documentation of any exemption in the final rule relied on by the banking entity to invest in or sponsor a covered fund.

While one commenter requested that the period for retaining records be extended from 5 years to 6 years, the final rule does not make this change.[2616] The Agencies believe that 5 years is an appropriate minimum period for requiring retention of records to demonstrate compliance with the final rule. The final rule allows the Agencies to require a banking entity to retain records for a longer period if appropriate.

3. Section ____.20(d) and Appendix A: Reporting and Recordkeeping Requirements Applicable to Trading Activities

Section ____.7 of the proposed rule, which the Agencies proposed to implement in part section 13(e)(1) of the BHC Act,[2617] required certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, § ____.7 required banking entities to comply with the recordkeeping requirements in § __.20 of the proposed rule, related to the banking entity's compliance program,[2618] as well as any other reporting or recordkeeping requirements that the relevant Agency may impose to evaluate the banking entity's compliance with the proposed rule.[2619]

Proposed Appendix A required a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The measurements varied depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contained a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of a banking entity's market-making operations, would constitute prohibited proprietary trading.[2620] Under the proposal, a banking entity was required to comply with proposed Appendix A's reporting and recordkeeping requirements only if it had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) was, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.[2621] The Agencies did not propose to extend the reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appeared that the more limited benefits of applying these requirements to such banking entities, whose trading activities are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements.

a. Approach to Reporting and Recordkeeping Requirements Under the Proposal

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

However, as noted in the proposal, the Agencies recognize that no single quantitative measurement or combination of measurements can accurately identify prohibited proprietary trading without further analysis of the context, facts, and circumstances of the trading activity. In addition, certain quantitative measurements may be useful for assessing one type of trading activity, but not helpful in assessing another type of trading activity. As a result, the Agencies proposed to use a variety of quantitative measurements to help identify transactions or activities that warrant more in-depth analysis or review.

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

[2616] One commenter specifically urged that records for any type of compliance program be required to be kept on all hedges, rather than only those placed at a different level or trading unit as under the proposal, and that the retention period for all compliance records be changed from 5 years to 6 years in line with the statute of limitations on civil suits for fraud, contracts and collection of debt in accounts in New York State. *See* Occupy.

[2617] Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. *See* 12 U.S.C. 1851(e)(1). Section ____.20 and Appendix C of the proposed rule also implemented section 13(e)(1) of the BHC Act.

[2618] *See* Part III.D. of this **SUPPLEMENTARY INFORMATION.**

[2619] *See* proposed rule § ____.7.

[2620] *See supra* Part IV.A.3.c.8 (explaining why Appendix B was removed from the final rule).

[2621] *See* proposed rule § __.7(a).

proprietary trading from permitted market making-related activities.[2622]

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

In addition to the proposed quantitative measurements, the proposal explained that a banking entity may itself develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and the proposed rule and to establish, maintain, and enforce an effective compliance program, as required by § ____.20 of the proposed rule and Appendix C. The Agencies noted that the proposed quantitative measurements in Appendix A were intended to assist banking entities and Agencies in monitoring compliance with the proprietary trading restrictions and would not necessarily provide all the data necessary for the banking entity to establish an effective compliance program. The Agencies also recognized that appropriate and effective quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading unit, including types of instruments traded, trading activities and strategies, and history and experience (*e.g.,* whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities needed to ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within risk tolerances established by the banking entity, and to monitor for compliance with the proprietary trading restrictions in the proposed rule.

To the extent that data regarding measurements, as set forth in the proposed rule, are collected, the Agencies proposed to utilize the conformance period provided in section 13 of the BHC Act to carefully review that data, further study the design and utility of these measurements, and if necessary, propose changes to the reporting requirements as the Agencies believe are needed to ensure that these measurements are as effective as possible.[2623] This heuristic, gradual approach to implementing reporting requirements for quantitative measurements was intended to ensure that the requirements are formulated in a manner that maximizes their utility for identifying trading activity that warrants additional scrutiny in assessing compliance with the prohibition on proprietary trading, while limiting the risk that the use of quantitative measurements could inadvertently curtail permissible market making-related activities that provide an important service to market participants and the capital markets at large.

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

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

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $5 billion would be required the banking entity to furnish quantitative measurements for all trading units of the banking entity engaged in trading activity subject to §§ ____.4, ____.5, or ____.6(a) of the proposed rule (*i.e.,* permitted underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations). The scope of data to be furnished depended on the activity in which the trading unit was engaged. First, for the trading units of such a banking entity that are engaged in market making-related activity pursuant to § __.4(b) of the proposed rule, proposed Appendix A required that a banking entity furnish seventeen quantitative measurements.[2624] Second, all trading units of such a banking entity engaged in trading activity subject to §§ ____.4(a), ____.5, or ____.6(a) of the proposed rule were required to report five quantitative measurements designed to measure the general risk and profitability of the trading unit.[2625] The Agencies expected that each of these general types of measurements would be useful in assessing the extent to which any permitted trading activity involves exposure to high-risk assets or high-risk trading strategies. These requirements would apply to all type of trading units engaged in underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations. These additional measurements applicable only to trading units engaged in market making-related activities were designed to help evaluate the extent to which the quantitative profile of a trading unit's

[2622] Joint Proposal, 76 FR 68,883.

[2623] *See* 12 U.S.C. 1851(c)(2); Joint Proposal, 76 FR 68,883.

[2624] *See* proposed rule Appendix A.III.A. These seventeen quantitative measurements are discussed further below.

[2625] *See* proposed rule Appendix A.III.A. These five quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) VaR and Stress VaR; (iv) Risk Factor Sensitivities; and (v) Risk and Position Limits. Each of these and other quantitative measurements discussed in proposed Appendix A are discussed in detail below.

activities is consistent with permissible market making-related activities.

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $1 billion but is less than $5 billion would be required to provide quantitative measurements to be furnished for trading units that engaged in market making-related activity subject to § ____.4(b) of the proposed rule. Trading units of such banking entities that engaged in market making-related activities needed to report eight quantitative measurements designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.[2626] The proposal applied a smaller number of measurements to a smaller universe of trading units for this class of banking entities because they are likely to pose lesser compliance risk and fewer supervisory and examination challenges. The Agencies noted in the proposal that a less burdensome reporting regime, coupled with other elements of the proposal (*e.g.,* the compliance program requirement), was likely to be equally as effective in ensuring compliance with section 13 of the BHC Act and the proposed rule for banking entities with smaller trading operations.

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

b. General Comments on the Proposed Metrics

A number of commenters were supportive of metrics. A few commenters argued that the metrics could reveal prohibited proprietary trading activity and be an appropriate and valuable tool in analyzing positions.[2627] One commenter argued that metrics are the single most valuable tool available to the Agencies for distinguishing between prohibited and permitted activities and recommended the compliance program be structured around metrics.[2628] Another commenter stated that the identification of metrics is one of the strengths of the proposed rule and offered great promise for successful implementation of the rule.[2629] One commenter expressed support for the metrics and argued that there would be substantial evasion of the rule without reporting of these measurements.[2630] Some commenters proposed a presumption of compliance so long as trading activity is conducted in a manner consistent with tailored quantitative metrics and related specific thresholds as coordinated and agreed with the relevant Agency.[2631] A few of commenters suggested that metrics not be used as a bright-line trigger and recommended flexibility in the application of metrics for assessing market-making activities.[2632] Two commenters supported metrics as part of a bright lines approach.[2633]

A number of commenters felt that some metrics might be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity.[2634] These commenters advocated an approach where banking entities and examiners would determine over time the usefulness and relevance of particular metrics.[2635] One commenter expressed support for the 5 metrics required for trading in U.S. government obligations.[2636] A number of commenters recommended that metrics be tailored to different asset classes and markets, to avoid the drawbacks of a one-size-fits-all approach.[2637] One commenter argued that application of metrics to market-making activities at different firms may produce very different results, all of which might reflect legitimate market-making.[2638] Commenters also indicated that not all metrics are meaningful and calculable for all trading units and some would be unnecessarily burdensome.[2639]

Other commenters did not support the use of metrics. These commenters argued that metrics reporting was one aspect of the complexity of the proposal that increased the cost and difficulty of distinguishing market-making from prohibited proprietary trading.[2640] One commenter argued that banking entities may avoid legitimate market making activities that would produce ''worse'' metrics results.[2641]

Several commenters expressed concern that the costs exceeded the benefits of the required quantitative metrics in the proposal. In particular, commenters argued that the 17 metrics in the proposal calculated at each trading unit was excessive, would generate an unmanageable amount of data, would yield numerous false positives, and would require the construction and programming of highly sophisticated systems that are not currently employed.[2642] A few commenters suggested that a more limited set of metrics would reduce compliance complexity.[2643] Some commenters noted that many of these metrics have not been historically reported by banking entities and some of the metrics would require substantial resources and investment infrastructure to produce some of the metrics without a clear functional purpose.[2644] According to other commenters, however, banking entities currently use

[2626] *See* proposed rule Appendix A.III.A. These eight quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) Portfolio Profit and Loss; (iv) Fee Income and Expense; (v) Spread Profit and Loss; (vi) VaR; (vii) Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and (viii) Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

[2627] *See, e.g.,* Paul Volcker; SIFMA *et al.* (Prop.Trading) (Feb. 2012); Invesco; Comm. on Capital Markets Regulation.

[2628] *See* Goldman (Prop. Trading).

[2629] *See* Sens. Merkley & Levin (Feb. 2012).

[2630] *See* Occupy.

[2631] *See* Barclays; *See* also BoA; Invesco; ISDA (Feb. 2012); JPMC; Morgan Stanley; SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[2632] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Oliver Wyman (Feb. 2012); UBS; Western Asset Mgmt.; Goldman (Prop. Trading); Northern Trust.

[2633] *See* John Reed; Public Citizen.

[2634] *See* Morgan Stanley; SIFMA *et al.* (Prop.Trading) (Feb. 2012); Stephen Roach.

[2635] *See* Wells Fargo (Prop. Trading); Morgan Stanley; SIFMA *et al.* (Prop.Trading) (Feb. 2012); Stephen Roach.

[2636] *See* UBS.

[2637] *See* Goldman (Prop. Trading); Northern Trust; *See also* UBS.

[2638] *See* Comm. on Capital Markets Regulation.

[2639] *See* Morgan Stanley; *See also* ISDA (Feb. 2012).

[2640] *See* ABA (Keating); Barclays; Citigroup (Feb. 2012); ISDA (Feb. 2012); UBS; Oliver Wyman (Feb. 2012); Prof. Duffie; Wellington.

[2641] *See* Oliver Wyman (Feb. 2012).

[2642] *See* BoA (expressing concern about the need for new systems to distinguish bid-ask spreads from price appreciation); UBS; Wellington.

[2643] *See* BoA; Barclays; Citigroup (Feb. 2012).

[2644] *See* Credit Suisse (Seidel); Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale (arguing that many calculation questions need to be resolved before banking entities can create necessary systems to measure metrics).

all or nearly all of the proposed metrics.[2645] One commenter urged that it would be good to make metrics consistent with the banking entities' internal reporting and control systems.[2646] Some commenters argued it was critical for the Agencies to get the metrics right,[2647] while others indicated it was unclear how the Agencies could analyze such information to draw useful conclusions.[2648]

Some commenters expressed concern that metrics were vulnerable to manipulation and arbitrage.[2649] These commenters generally felt that the quantitative measurements were only appropriate for certain liquid and transparent trading activities but not meaningful for illiquid markets, including opaque securities and derivatives.[2650] These commenters also argued that the vast majority of proprietary trading would not be differentiable through analysis of the data.[2651] Other commenters expressed concern that the use of metrics not replace regulatory review of actual specific trading positions held by banking entities.[2652] One commenter argued that in relying on metrics to be elaborated upon and discussed in the examination process, the proposed rule did not meet the fundamental fair notice goal of regulation.[2653]

A few commenters also recommended creation of a central data repository or data sharing protocol that would promote consistency and accountability in oversight and regulation and suggested the Office of Financial Research (''OFR'') be given access to this data so that it can provide centralized analysis and monitoring to identify any trends that give rise to systemic risk.[2654] These commenters generally supported compliance benefits that would result from increased public disclosure of banking entities' trading and funds activities, including all of their trading positions, their valuation models, and their compliance metrics.[2655]

Some commenters expressed support for the reporting thresholds contained in Appendix A.[2656] One commenter suggested that all banking entities that engage in any trading (regardless of threshold) report certain metrics.[2657] Other commenters supported metrics reporting, but recommended the threshold for trading assets and liabilities be increased from $1 billion to $10 billion to mitigate any cost and burden impact on smaller banking entities.[2658] These commenters pointed out that even if the minimum dollar threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements including Appendix A.[2659] One commenter suggested the threshold be raised to $50 billion in combined trading assets and liabilities.[2660]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which reporting requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold for compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering metrics reporting.[2661] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2662] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2663] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be included in the $1 billion standard for becoming subject to any reporting and record-keeping requirements under the final rule.[2664]

A number of commenters argued that monthly reporting was too frequent because of the complexity of the process that surrounds generation of regulatory reports and suggested that the frequency of reporting should be quarterly.[2665] One commenter supported the reporting frequency as extremely effective and said it should not be reduced in any way.[2666]

A number of comments were received on the implementation timeframe for metrics reporting. Several commenters urged allowing banking entities the use of the full conformance period for creating the systems and processes to capture and report the quantitative metrics.[2667] Some commenters suggested that metrics should not be required to be reported until one year after adoption of final regulations.[2668] A different commenter suggested that the Agencies provide a one-year period during which they determine which metrics will be employed for different asset classes and an additional one-year period during which such metrics could be reviewed so metrics would be a required component of a banking entity's compliance program no sooner than 2 years after issuance of the final rule.[2669] Another commenter suggested that banking entities and regulators use the first year of the conformance period to consult with one another and determine the usefulness and relevance of individual metrics for different activities, asset classes, and markets and the second year of the conformance period to test the metrics systems to validate the accuracy and relevance of metrics that are agreed upon the first year.[2670] One commenter suggested a subset of metrics be rolled out gradually

[2645] *See* Occupy; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen. For example, one commenter cited a study finding that 14 out of 17 of the proposed metrics are either in wide use today or are possible to implement fairly easily using data already collected for internal risk management and profit and loss purposes. *See* AFR *et al.* (Feb. 2012) (citing John Lester and Dylan Walsh, ''The Volcker Rule Ban On Prop Trading: A Step Closer to Reality, Point of View,'' Oliver Wyman Company (Oct. 2011)).

[2646] *See* Paul Volcker.

[2647] *See, e.g.,* UBS.

[2648] *See* BoA; UBS; Wellington.

[2649] *See* AFR (Nov. 2012); *See also* Occupy; Public Citizen.

[2650] *See* Occupy; AFR (Nov. 2012); Wells Fargo (Prop. Trading).

[2651] *See* Occupy.

[2652] *See* Sens. Merkley & Levin (Feb. 2012).

[2653] *See* ISDA (Feb. 2012) (citing *Mason* v. *Florida Bar,* 208 F.3d 952, 958–59 (11th Cir. 2000)).

[2654] *See* Sens. Merkley & Levin (Feb. 2012); *See also* Occupy; Public Citizen.

[2655] *See* Sens. Merkley & Levin (Feb. 2012); *See also* Public Citizen; John Reed.

[2656] *See* ICBA; Occupy.

[2657] *See* Occupy (suggesting all banking entities that engage in trading be required to provide VaR Exceedance, Risk Factor Sensitivities and Risk and Position Limits).

[2658] *See* PNC *et al.;* M&T Bank; *See also* ABA (Abernathy).

[2659] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2660] *See* State Street (Feb. 2012).

[2661] *See* PNC *et al.*

[2662] *See* PNC *et al.*

[2663] *See* Northern Trust.

[2664] *See* Occupy at 60.

[2665] *See* JPMC; *See also* Stephen Roach.

[2666] *See* Occupy.

[2667] *See* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop.Trading) (Feb. 2012); UBS; Stephen Roach.

[2668] *See* Credit Suisse (Seidel); JPMC; Wells Fargo (Prop. Trading).

[2669] *See* BoA.

[2670] *See* Morgan Stanley; *See also* SIFMA *et al.* (Prop.Trading) (Feb. 2012).

across trading units before implementing the full suite of metrics that are ultimately adopted or metrics could be rolled out one trading unit at a time.[2671] Another commenter said the Agencies should identify key metrics that are clearly workable across all ranges of trading activity and most likely to provide useful data and require those metrics be implemented first and require other metrics to be phased in over time in consultation with the banking entity's primary federal regulator.[2672] One commenter supported the heuristic approach of the proposal and suggested the Agencies should draw on resources and comment from the public and the industry in continuing the process of developing and building out metrics.[2673]

Another commenter requested that the final rule specify how trading assets and liabilities should be reported for savings and loan holding companies.[2674] This commenter requested clarification that positions held for hedging or liquidity management purposes should not count as trading assets or liabilities for the $5 billion threshold in Appendix A. Another commenter expressed concern that derivatives valuation may value derivatives substantially lower than their notional exposure and thereby make high reporting thresholds not meaningful or reflective of inherent risk.[2675]

Many commenters expressed concern that the smallest trading unit level was too low a level for collecting metrics data and suggested the final rule provide a higher reporting level.[2676] These commenters stated that calculating at too low of a level would be more likely to generate false positives[2677] and would be burdensome, particularly for firms with large trading operations.[2678] In addition, some commenters indicated that it would be problematic if the definition of ''trading unit'' is applied at a legal entity level and cannot be applied across multiple legal entities within the same affiliate group.[2679] By contrast, two commenters supported the collection of metrics at the trading desk level and appropriate levels above the trading desk.[2680] One of these commenters expressed concern that the rule allowed for an inappropriately large trading desk unit that could combine significantly unrelated trading desks, which would impede detection of proprietary trading and supported measurements at multiple levels of organization to combat evasion concerns.

In response to questions in the proposal about whether the Agencies should establish numerical thresholds for some or all of the proposed quantitative measurements, a number of commenters expressed opposition to establishing numerical thresholds for purposes of the rule,[2681] while others stated that thresholds should be established over time.[2682] In opposition of thresholds, one commenter expressed concern that numerical thresholds could be easily abused and evaded and may need to be constantly revised and updated as financial markets evolve.[2683] In addition, another commenter stated that numerical thresholds should not be imposed because metric levels will differ by asset class and type of activity.[2684] A few commenters suggested that numerical thresholds, based on the specific asset class or market, would be useful to provide clarity or consistency about the types of activity that are permitted under the rule.[2685] Two commenters expressed support for banking entities establishing numerical thresholds, in consultation with the relevant regulator, for different trading units based on differences between markets and asset classes.[2686]

c. Approach of the Final Rule

As explained below, the Agencies have reduced the number of metrics that banking entities must report under Appendix A from the 17 metrics in the proposal to 7 metrics in the final rule. The final rule also increases the level of activity that is required to trigger mandatory reporting of metrics data and phases in the reporting requirement over time.

Under the final rule, a banking entity engaged in significant trading activity as defined by § ____.20 must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

In response to comments, the final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in approach based on the size of trading assets and liabilities.[2687] Banking entities that meet the relevant thresholds must collect and report metrics for all trading desks engaged in covered trading activity beginning on the dates established in § ____.20 of the final rule. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States). Banking entities with less than $50 billion and greater than or equal to $25 billion in trading assets and liabilities and banking entities with less than $25 billion and greater than or equal to $10

[2671] *See* Goldman (Prop. Trading).

[2672] *See* Wells Fargo (Prop. Trading).

[2673] *See* AFR *et al.* (Feb. 2012).

[2674] *See* GE (Feb. 2012).

[2675] *See* Occupy.

[2676] *See, e.g.,* BoA; Goldman (Prop.Trading); JPMC; SIFMA *et al.* (Prop.Trading) (Feb. 2012); Morgan Stanley; RBC.

[2677] *See* JPMC; Goldman (Prop.Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012); BoA. *See also* Sen. Gillibrand.

[2678] *See* Goldman (Prop.Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012); BoA.

[2679] *See* Goldman (Prop.Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[2680] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2681] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012); Occupy; Alfred Brock.

[2682] *See* Wellington; Barclays; Goldman (Prop. Trading); CalPERS; John Reed.

[2683] *See* Occupy.

[2684] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[2685] *See* Wellington; CalPERS; John Reed.

[2686] *See* Goldman (Prop. Trading); Barclays.

[2687] As noted above, a number of commenters suggested setting a higher threshold than the proposed $1 billion and $5 billion trading asset and liability thresholds because even thresholds of $10 billion to $50 billion would capture a significant percentage of the total trading assets and liabilities in the banking system. *See* ABA (Keating); M&T Bank; PNC *et al.*; State Street (Feb. 2012). The Agencies believe that the phase-in approach to the metrics requirement established in the final rule should generally address commenters' concerns about the implementation timeframe by providing time for analysis, development of systems (if needed), and implementation of the quantitative measurements requirement. *See, e.g.,* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop.Trading) (Feb. 2012); UBS; Stephen Roach; Credit Suisse (Seidel); Wells Fargo (Prop. Trading). The Agencies are establishing a phase-in approach, rather than requiring all banking entities above the $10 billion threshold to report metrics within the same timeframe, to strike a balance between the benefits of receiving data to help monitor compliance with the rule against the need for time to assess the effectiveness and usefulness of the quantitative measurements in practice and for some firms to develop additional systems for purposes of this requirement.

billion in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively. The Agencies believe that these delayed dates for reporting metrics should allow firms adequate time to develop systems to calculate and report the quantitative metrics. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in § ____.20 unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion or greater in trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis.[2688] All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by § ____.20, unless another time is requested by the primary supervisory Agency for the entity except for a preliminary period when reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[2689]

The Agencies believe that together the reduced number of metrics, the higher thresholds for reporting metrics, delayed reporting dates, and modified reporting frequency reduce the costs and burden from the proposal while allowing collection of data to permit better monitoring of compliance with section 13 of the BHC Act. The Agencies also believe that the delayed dates for reporting quantitative metrics will provide banking entities with the time to develop systems to calculate and report these metrics. The Agencies are not applying these reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appears that the more limited benefits of applying these requirements to banking entities with lower levels of trading activities, which represent entities that are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements of Appendix A.

The final rule defines ''trading desk'' to replace the concept of ''trading unit'' in the proposal.[2690] Under the final rule, trading desk means the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies believe that applying quantitative measurements to a level that aggregates a variety of distinct trading activities may obscure or ''smooth'' differences between distinct lines of business, asset categories and risk management processes in a way that renders the measurement relatively uninformative because it does not adequately reflect the specific characteristics of the trading activities being conducted.

While the Agencies recognize that applying quantitative measurements at the trading desk level may result in some ''noise'' in the data and false positives, the Agencies believe it is necessary to apply the quantitative measurements at the trading desk level to enhance consistency with other provisions of the final rule. For example, because the requirements of the market-making exemption apply at the trading desk level of organization, the Agencies believe quantitative measurements used to monitor a banking entity's market making-related activities should also calculated, reported, and recorded at the trading desk level. In response to commenters' concerns that trading desk level measurements are more likely to generate false positives, the Agencies emphasize that quantitative measurements will not be used as a dispositive tool for determining compliance and, rather, will be used to monitor patterns and identify activity that may warrant further review.

Like the proposal, the final rule does not include specific numerical thresholds. Commenters did not suggest specific thresholds for particular metrics or provide data and analysis that would support particular thresholds.[2691] Given the range of financial instruments and trading activity covered by the final rule, as well as potential differences among banking entities' organizational structures, trading strategies, and level of presence in a particular market, the Agencies are concerned that numerical thresholds for specific metrics would not account for these differences and could inappropriately constrain legitimate activity.[2692] Further, mandated thresholds for the metrics would not recognize the impact changing market conditions may have on a given trading desk's quantitative measurements. Consistent with two commenters' suggested approach, banking entities will be required to establish their own numerical thresholds for quantitative measurements under the enhanced compliance program requirement in Appendix B.[2693]

d. Proposed Quantitative Measurements and Comments on Specific Metrics

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

- *Risk-management measurements*—VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;
- *Source-of-revenue measurements*—Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;
- *Revenues-relative-to-risk measurements*—Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;
- *Customer-facing activity measurements*—Inventory Turnover, Inventory Aging, and Customer-facing Trade Ratio; and
- *Payment of fees, commissions, and spreads measurements*—Pay-to-Receive Spread Ratio.

[2688] Consistent with certain commenters' requests, the final rule generally requires less frequent reporting than was proposed. However, the Agencies continue to believe that monthly reporting is appropriate for the largest banking entities above the $50 billion threshold. More frequent reporting for these firms is appropriate to allow for more effective supervision of their large-scale trading operations. *See* JPMC; Stephen Roach.

[2689] *See* final rule § ____.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements after the end of the relevant period than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

[2690] *See* final rule § ____.3(e)(13); *See also supra* Parts IV.A.2.c.1.c.ii. and IV.A.3.c.1.c.i.

[2691] *See* Wellington; CalPERS; John Reed.

[2692] *See* SIFMA *et al.* (Prop.Trading) (Feb. 2012).

[2693] *See* Goldman (Prop. Trading); Barclays. *See also* final rule Appendix B.

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

Under the proposal, the first set of quantitative measurements related to risk management, and included VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits. Commenters generally supported the use of risk-management metrics as the most important measure of compliance, indicating that these metrics could potentially provide useful supervisory information.[2694]

In general, commenters supported the use of the VaR metric.[2695] One of these commenters argued that VaR was not particularly indicative of proprietary trading, but could be helpful to reveal a trading unit's overall size and risk profile.[2696] Another commenter indicated that significant, abrupt or inconsistent changes to VaR may need to be absorbed by market makers who absorb large demand and supply shocks into their inventories.[2697] This commenter contended that the six largest bank holding companies had proprietary trading losses that frequently exceeded their VaR estimates and the design and supervision of such risk measures should be revisited.

One commenter argued that the definition of VaR was not made clear in the proposal and was missing some important information regarding methodology as VaR methodologies tend to vary among banking entities.[2698] This commenter recommended the development of a standard methodology by the OFR including a central repository for historical calculation data for each asset for the purpose of ensuring standard calculation across the industry. This commenter also expressed concern that VaR calculations are heavily reliant on the quality of input data and stated that many markets are unable to provide sufficient information such that VaR calculations are meaningful, including markets for illiquid products for which accurate historical price and market information is sparse and could severely under represent true potential losses under VaR calculations.[2699]

A few commenters expressed concern about the applicability of VaR when applied to ALM activities.[2700] These commenters argued that risk management metrics such as VaR would not help to distinguish ALM and valid risk mitigating hedging activities from prohibited proprietary trading. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not marked to market but the corresponding hedge may be.

One commenter argued that the use of stress VaR would be important to guard against excessive risk taking.[2701] A few commenters suggested that additional guidance be provided for Stress VaR including linking it to the broader stress testing regime and based on extreme conditions that are not based on historic precedent.[2702] These commenters also argued that a one-day holding period assumption is inadequate, especially for less liquid asset classes, and recommended that stress be measured over a longer period. One commenter argued that Stress VaR should be removed from the list of required metrics as it is not in regular use for day-to-day risk management and provides little relevant information about the intent or proportionality between risk assumed and client demands.[2703]

A number of commenters requested that VaR Exceedance be removed from the list of metrics. These commenters argued that the primary function of VaR Exceedance is to analyze the quality of a VaR model and that VaR backtesting is already reported to regulators as part of the supervisory process. These commenters argued that VaR Exceedance does not reveal trading intent or actual risk taken.[2704] One commenter argued that VaR Exceedance may be useful to the Agencies as an indicator of the quality of the VaR measure relative to the profit and loss of the trading unit but that a more rigorous back-testing process would serve as a better analytical tool than VaR Exceedance to evaluate the quality of the VaR model result and should be included as an additional metric.[2705] One commenter suggested that risk-based metrics should measure risk as a function of capital.[2706] Another commenter warned that risk metrics could be significantly higher during times of market stress and volatility than during normal times.[2707]

A few commenters expressed support for risk factor sensitivities as useful, supervisory information.[2708] One of these commenters suggested that risk factor sensitivities could orient regulators to a trading unit's overall size and risk profile,[2709] while another commenter stated that risk factor sensitivities would be the most useful tool for identifying the accumulation of market risk in different areas of a banking entity.[2710] One commenter suggested that several risk factor sensitivity snapshots be taken throughout the day with an average

[2694] *See, e.g.,* AFR *et al.* (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *See also* BNY Mellon *et al.* (suggesting the use of VaR measures for foreign exchange trading activity).

[2695] *See, e.g.,* Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; Public Citizen.

[2696] *See* Goldman (Prop. Trading).

[2697] *See* Prof. Duffie.

[2698] *See* Occupy.

[2699] *See* Occupy.

[2700] *See* JPMC; State Street (Feb. 2012); *See also* BoA; CH/ABASA. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not mark-to-market but the corresponding hedge may be. *See* State Street (Feb. 2012).

[2701] *See* Public Citizen.

[2702] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2703] *See* JPMC.

[2704] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2705] *See* Occupy.

[2706] *See* Citigroup (Feb. 2012).

[2707] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2708] *See* Citigroup (Feb. 2012); Prof. Duffie; Occupy.

[2709] *See* Goldman (Prop. Trading).

[2710] *See* Occupy.

value reported at the end of day.[2711] This commenter also recommended that trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios), should trigger additional disclosures in risk factor sensitivity reporting.[2712]

Commenters also supported risk and position limits as providing useful, supervisory information. Several commenters indicated that these limits could be helpful to orient regulators to a trading unit's overall size and risk profile.[2713] Another commenter expressed the view risk and position limits are the most comprehensive measures of risk taking and incorporate VaR, Stress VaR, and Risk Factor Sensitivities.[2714] A different commenter argued it was unclear how position limits are in fact a quantitative metric and not a description of a banking entity's internal risk policies.[2715]

After carefully considering the comments received, the final rule retains the risk-management metrics other than VaR Exceedance. The collection of information regarding Risk and Position Limits, VaR, Stress VaR, and Risk Factor Sensitivities is consistent with the aim of providing a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible activities. Moreover, a number of commenters indicated that the risk management measures would be effective at achieving these goals.[2716] The risk management measure that was not retained in the final rule, VaR Exceedance, was considered, in light of the comments, as not offering significant additional information on the overall risk profile and activities of the trading desk relative to the burden associated with computing, auditing and reporting it on an ongoing basis.[2717]

The risk-management measurements included in the final rule are widely used by banking entities to measure and manage trading risks and activities.[2718] VaR, Stress VaR, and Risk Factor Sensitivities provide internal, model-based assessments of overall risk, stated in terms of large but plausible losses that may occur or changes in revenue that would be expected to result from movements in underlying risk factors. The provided description and calculation guidance for each of these measures is consistent with both current market practice and regulatory capital requirements for banks. The final rule does not provide a prescriptive definition of each of these measurements as these measures must be flexible enough to be tailored to the specific trading activities of each trading desk. Supervisory guidance and comparisons of these measures across similarly situated trading desks at a given entity as well as across entities will be used to ensure that the provided measurements conform to the description and calculation guidance provided in Appendix A. Risk and Position Limits and Usage provide an explicit assessment of management's expectation of how much risk is required to perform permitted market-making, underwriting and hedging activities. The final rule requires that the usage of each risk and position limit be reported so that the risk taking by each trading desk can be monitored and assessed on an ongoing basis.[2719]

With the exception of Stress VaR, each of these measurements are routinely used to manage and control risk taking activities, and are also used by some banking entities for purposes of calculating regulatory capital and allocating capital internally.[2720] In the context of permitted market making-related activities, these risk management measures are useful in assessing whether the actual risk taken is consistent with the level of principal risk that a banking entity must retain in order to service the near-term demands of customers. Significant, abrupt or inconsistent changes to key risk management measures, such as VaR, that are inconsistent with prior experience, the experience of similarly situated trading desks and management's stated expectations for such measures may indicate impermissible proprietary trading, and may warrant further review. In addition, indicators of unanticipated or unusual levels of risk taken, such as breaches of internal Risk and Position Limits, may suggest behavior that is inconsistent with appropriate levels of risk and may warrant further scrutiny. The limits required under § ____.4(b)(2)(iii) and § ____.5(b)(1)(i) must meet the applicable requirements under § ____.4(b)(2)(iii) and § ____.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.

Under the proposal, the second set of quantitative measurements related to the source of revenues, and included Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution. A few commenters expressed support for Comprehensive Profit and Loss as a reasonable contextual metric and contended that the metric could inform the analysis of whether market-making revenues are from customer transactions.[2721]

As described above, a number of commenters expressed concern about a focus on revenues as part of evaluating market-making.[2722] For instance, one commenter argued that the rule should not require, even in guidance, that market making-related permitted activities be ''designed to generate revenues from fees, commissions, bid-asks spreads or other income,'' arguing that this prejudges appropriate results for revenue metrics and implies that a *bona fide* market maker is not permitted to benefit from revenues from market movements.[2723] One commenter expressed concern that the source-of-revenue metrics are subject to manipulation as these metrics depend on correctly classifying revenue into market bid-ask spreads as opposed to other sources of revenue.[2724] One commenter stated that this metric should serve as a secondary indication of risk levels because it could be subject to manipulation.[2725] Another commenter recommended use of the sub-metric in Comprehensive P&L Attribution.[2726] A different commenter recommended the adoption of clearer metrics to distinguish customer revenues from revenues from price

[2711] *See* Occupy.

[2712] *See* Occupy.

[2713] *See, e.g.,* Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading).

[2714] *See* Barclays.

[2715] *See* Occupy.

[2716] *See, e.g.,* AFR *et al.* (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *See also* Northern Trust; State Street (Feb. 2012).

[2717] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop.Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2718] *See* Joint Proposal, 76 FR 68,887.

[2719] The Agencies believe this clarification responds to one commenter's question regarding how risk and position limits will be used and assessed for purposes of the rule. *See* Occupy.

[2720] *See* Joint Proposal, 76 FR 68,887.

[2721] *See* Goldman (Prop.Trading); Japanese Bankers Ass'n; Occupy; *See also* Barclays.

[2722] *See supra* Part IV.A.3.c.7.b.

[2723] *See* SIFMA (May 2012).

[2724] *See* AFR (Nov. 2012).

[2725] *See* Occupy.

[2726] *See* Barclays.

movements.[2727] One commenter indicated that after-the-fact application of quantitative measurements such as Comprehensive Profit and Loss may cause firms to reconsider their commitment to market making and recommended that, to the extent this metric is used, it should be applied flexibly in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2728]

A few commenters supported Portfolio Profit and Loss as a reasonable contextual metric to inform whether revenues from market-making transactions are from customer transactions.[2729] However, one of these commenters argued that this metric would not necessarily be indicative of prohibited proprietary trading and profits may reflect *bona fide* market making-related, underwriting, and hedging activities.[2730] Another commenter argued that this metric should serve as a secondary indication of risk levels and may be subject to manipulation.[2731]

Some commenters felt that Fee Income and Expense was a useful metric.[2732] One of these commenters argued this metric has the potential to help distinguish permitted activities from prohibited proprietary trading.[2733] Another commenter felt this metric would be useful in liquid markets that trade with the convention of fees and commissions but less useful, but still indicative, in other markets that use inter-dealer brokers to conduct client-related activities.[2734] One commenter argued that it would be impracticable to produce Fee Income and Expense data for foreign exchange trading, which is predominantly based on bid/offer spread.[2735]

A few commenters thought that Spread P&L could be useful.[2736] One of these commenters argued that Spread P&L has the potential to help distinguish permitted activities from prohibited proprietary trading.[2737] This commenter suggested that the final rule remove the proposal's revenue requirement as part of market-making and instead rely on revenue metrics such as Spread P&L.[2738] This commenter argued, however, that it will not always be clear how to best calculate Spread P&L and it would be critical for the Agencies to be flexible and work with banking entities to determine the appropriate proxies for spreads on an asset-class-by-asset class and trading desk-by-trading-desk basis. One commenter contended that the proposed implementation in the proposal was more difficult than necessary and suggested End of Day Spread Proxy is sufficient. Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to calculate Spread P&L.[2739]

However, the majority of commenters recommended removal of Spread P&L as a metric.[2740] These commenters argued that a meaningful measure for Spread P&L cannot be calculated in the absence of a continuous bid-ask spread, making this metric misleading especially for illiquid positions and shallow markets.

A few commenters generally expressed support for the inclusion of Comprehensive Profit and Loss Attribution.[2741] One of these commenters stated that this metric was the most comprehensive metric for measuring sources of revenue and included other metrics as sub-metrics, such as Comprehensive Profit and Loss, Portfolio Profit and Loss, and Fee Income and Expense. Another commenter contended the mention of ''customer spreads'' and ''bid-ask spreads'' was unclear and that both of these terms should be removed from the calculation guidance. Other commenters argued that the benefits of this metric do not justify the costs of generating a report of Comprehensive P&L Attribution on a daily basis.[2742] One commenter urged the Agencies to ensure that each institution be permitted to calculate this metric in a way that reflects the institution's unique characteristics.[2743]

After carefully considering the comments received, the final rule maintains only a modified version of Comprehensive P&L Attribution metric and does not retain the proposed Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, or Spread Profit and Loss metrics. The final rule also requires volatility of comprehensive profit and loss to be reported. As pointed out by a number of commenters, Comprehensive Profit and Loss Attribution provides a holistic attribution of each trading desk's profit and loss and contains much of the information content that is provided by many of the other metrics, such as Fee Income and Expense.[2744] Accordingly, the use of Comprehensive Profit and Loss Attribution in the final rule greatly simplifies the metric reporting requirement and reduces burden while retaining much of the information and analysis that was provided in the full set of five metrics that were contained in the proposal. In addition, in response to commenters' concerns about the burdens of separately identifying specific revenue sources (*e.g.,* revenues from bid-ask spreads, revenues from price appreciation), the Agencies have modified the focus of the proposed source of revenue metrics to focus on when revenues are generated, rather than the specific sources of revenue.[2745] This approach should also help address one commenter's concern about the need for new, sophisticated systems to differentiate bid-ask spreads from price appreciation.[2746] The utility of this modified approach is discussed in more detail in the discussion of the market-making exemption.[2747] Finally, the Comprehensive Profit and Loss Attribution metric will ensure that all components of a trading desk's profit and loss are measured in a consistent and comprehensive fashion so that each individual component can be reliably compared against other components of a trading desk's profit and loss without being considered in isolation or taken out of context.

This measurement is intended to capture the extent, scope, and type of profits and losses generated by trading activities and provide important context for understanding how revenue is generated by trading activities. Because permitted market making-related

[2727] *See* Public Citizen.

[2728] *See* NYSE Euronext.

[2729] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2730] *See* Goldman (Prop. Trading).

[2731] *See* Occupy.

[2732] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2733] *See* Goldman (Prop. Trading). This commenter urged that fee income and expense should be considered together with Spread P&L arguing that these two both measures of customer revenues and, in practice, may function as substitutes for each other.

[2734] *See* Occupy.

[2735] *See* Northern Trust.

[2736] *See, e.g.,* Goldman (Prop. Trading); JPMC; UBS.

[2737] *See* Goldman (Prop. Trading).

[2738] *See* Goldman (Prop. Trading); *See also* Paul Volcker (supporting a metric considering the extent to which earnings are generated by pricing spreads rather than changes in price).

[2739] *See* JPMC; UBS; *See also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2740] *See* ABA *et al.;* BoA; Barclays; Credit Suisse (Seidel); Japanese Bankers Ass'n; Northern Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop.Trading); *See also* AFR *et al.* (Feb. 2012); Occupy.

[2741] *See* Barclays; Occupy.

[2742] *See* BOK; Goldman (Prop. Trading); SIFMA *et al.* (Prop Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2743] *See* SIFMA *et al.* (Prop Trading) (Feb. 2012).

[2744] *See* Barclays.

[2745] *See* JPMC; UBS; SIFMA *et al.* (Prop Trading) (Feb. 2012); ABA (Keating); BoA; Barclays; Credit Suisse (Seidel).

[2746] *See* BoA.

[2747] *See supra* Part IV.A.3.c.7.c.

activities seek to generate profits by providing customers with intermediation and related services while, managing, and to the extent practicable minimizing, the risks associated with any asset or risk inventory required to meet customer demands, these revenue measurements would appear to provide helpful information to banking entities and the Agencies regarding whether actual revenues are consistent with these expectations.

Under the proposal, the third set of measurements related to realized risks and revenue relative to realized risks, and includes Volatility of Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss, and Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss.

A few commenters indicated support for these metrics as appropriate, contextual metrics.[2748] These commenters indicated that these metrics may serve to highlight areas requiring further investigation, since high P&L volatility may indicate a deviation from traditional client related activities and that a well-structured trading operation should be able to obtain relatively high ratios of revenue-to-risk (as measured by various metrics), low volatility, and relatively high turnover.[2749] One commenter recommended that New Trades P&L be substituted for Portfolio P&L for purposes of computing Volatility of P&L because New Trades P&L captures customer revenues more completely and is therefore more useful for distinguishing market making from proprietary trading.[2750] Another commenter indicated that Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss incorporates (and therefore obviates the need for a separate calculation of) the metric Volatility of Portfolio Profit and Loss.[2751]

One commenter urged that after-the-fact application of Comprehensive Profit and Loss to Volatility Ratio may cause firms to reconsider their commitment to market making and argued that this metric should be applied flexibly in light of market conditions prevailing during the relevant time period and as one of many factors relevant to an assessment of overall bona fide market making.[2752] One commenter supported monitoring Portfolio Profit and Loss to Volatility Ratio and argued that the Agencies should establish a clear pattern of profit and loss results of individual trading units through iterative application of the metrics.[2753]

One commenter expressed support for Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss indicating that these metrics may serve to highlight areas requiring further investigation, since a significant number of unprofitable trading days may indicate a deviation from traditional client-related activities.[2754] Another commenter suggested that these metrics be removed as they would result in market makers being less likely to take client-facing positions due to reluctance to incur unprofitable trading days that could indicate the presence of impermissible activity despite the utility of such trades in providing liquidity to customers.[2755]

One commenter requested including Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss in the metrics set as the most comprehensive metric in the revenue-relative-to-risk category making other metrics unnecessary in this area.[2756] Another commenter argued that this metric would produce inconsistent results within and across trading units and would generally not support any meaningful conclusions regarding the permissibility or risk of trading activities.[2757]

After carefully considering the comments received, the final rule does not include any of the proposed revenue-relative-to-risk measurements. Each of these measures provides information that may generally be useful for characterizing the overall risk profile of the trading activities of each trading unit and evaluating the extent to which the quantitative profile of a trading unit's activities is consistent with permissible trading activities. The broad information content of these measures, however, can largely be reproduced from transformations of information that will be provided in the Comprehensive Profit and Loss Attribution and, as noted above, volatility of comprehensive profit and loss must be reported. Analogs to the other metrics such as Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss can be computed similarly from information that will be provided in the Comprehensive Profit and Loss Attribution. Accordingly, the information contained in these metrics is retained in the final rule while the burden associated with computing, auditing and reporting these additional metrics on an ongoing basis has been eliminated.

Under the proposal, the fourth set of quantitative measurements related to customer-facing activity measurements. These metrics include Inventory Risk Turnover, Inventory Aging, and Customer-facing Trade Ratio.

A few commenters supported the proposal's Inventory Risk Turnover metric though some of these commenters suggested modifications to the metric.[2758] One commenter argued that this metric could indicate whether a given trading unit holds risk and inventory consistently with the asset class in which such trading unit deals, the types of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading unit serves.[2759] Another commenter argued that the final rule should explicitly state that a trading unit's inventory management practices will be evaluated using this metric.[2760] Some commenters expressed the view that this metric might be useful in the case of liquid positions but not in the case of illiquid or difficult-to-hedge products, which naturally have lower risk turnover. Others noted support for this metric tailored on an asset-by-asset basis.[2761]

A few commenters requested that the final rule clarify that this metric will not be required to be calculated for every possible Risk Factor Sensitivity measurement for the applicable portfolio and that a banking entity and its regulator should determine one or two core risk factors per asset classes with respect to which this metric that will be calculated to strike a reasonable balance between costs of calculations

[2748] *See, e.g.,* Goldman (Prop. Trading); Volcker; John S. Reed; *See also* AFR *et al.* (Feb. 2012); Sen. Merkley; Occupy; Public Citizen.

[2749] *See* Occupy; Public Citizen; Sen. Merkley.

[2750] *See* Goldman (Prop. Trading) (also suggesting that New Trades P&L be substituted for Portfolio P&L in Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio and Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss).

[2751] *See* Barclays.

[2752] *See* NYSE Euronext.

[2753] *See* AFR *et al.* (Feb. 2012).

[2754] *See* Occupy.

[2755] *See* Barclays.

[2756] *See* Barclays.

[2757] *See* Goldman (Prop. Trading).

[2758] *See* Goldman (Prop. Trading); Barclays; John Reed; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2759] *See* Barclays.

[2760] *See* Goldman (Prop. Trading).

[2761] *See, e.g.,* Barclays; Goldman (Prop. Trading); JPMC; John Reed.

and benefits of this metric.[2762] Other commenters argued the Inventory Risk Turnover Metric was difficult to measure, burdensome, and would create uncertainty for derivatives counterparties.[2763]

A few commenters supported the Inventory Aging metric. One commenter argued it should be included in the metrics set to indicate whether a given trading desk holds risk and inventory consistently within the asset class in which such trading desk deals, the type of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading desk serves.[2764] This commenter suggested tailoring the metric based on the market for a particular asset class and market conditions because aging levels may be higher in less liquid markets. A number of commenters argued that application of the Inventory Aging metric is only appropriate for cash products and should not be used for trading units engaged in transactions in financial instruments such as derivatives.[2765] Another commenter argued that the Inventory Aging metric is generally not useful for derivatives, and for non-derivatives it provides essentially similar information to Inventory Risk Turnover.[2766] One commenter requested additional guidance on how to calculate this metric.[2767]

A few commenters indicated that the Customer-Facing Trade Ratio could be helpful in distinguishing prohibited proprietary trading from market making and would be more effective than the proposal's negative presumption against interdealer trading to evaluate the amount of interdealer trading that is consistent with market making-related or hedging activity in a particular business.[2768] Some commenters suggested that the metric could be improved and argued that the number of transactions executed over a calculation period does not provide an adequate measure for the level of customer-facing trading because it does not reflect the size of transactions or the amount of risk. These commenters suggested replacing the metric with a more risk-sensitive metric or defining the ratio so that it measures notional principal risk associated with customer transactions and is appropriately tailored to the relevant asset class or market.[2769]

A number of commenters raised concerns about the definition of customer for purposes of this metric. One commenter argued that a failure to define ''customer'' to differentiate between customers and non-customers would render this metric meaningless.[2770] Another commenter contended that the metric would be appropriate as long as banking entities have the flexibility to determine who is a customer.[2771] One commenter argued that using a definition of ''customer'' that is different between the market making-related activity and the reported metric could make legitimate market making-related activity with customers appear to be prohibited proprietary trading.[2772] This commenter argued that other dealers and other registered market participants should be recognized as customers of the banking entity. A few commenters contended that this metric would be burdensome if it required a banking entity to tag individual trades as customer or non-customer.[2773] A few commenters argued that interdealer trading should be allowed as part of market making and argued this metric would not provide a useful measure of customer-facing activity.[2774] Some commenters also expressed concern about the implications of such a metric for hedging activity, which may involve relatively less customer-facing activity.[2775]

After carefully considering the comments received, the final rule retains all three of the customer-facing activity measurements from the proposal, though each measure has been modified. A number of commenters raised issues regarding the complexities associated with computing the Inventory Risk Turnover metric. In particular, as noted above, some commenters argued that computing the metric for every reported risk factor sensitivity would be burdensome and would not be informative.[2776] The inventory metric required in the final rule, Inventory Turnover, is applied at the transaction level and not at the risk factor sensitivity level. Accordingly, for a given trading desk and calculation period, *e.g.,* 30 days, there is only one value of the Inventory Turnover metric rather than one value for each risk factor sensitivity that is managed and reported by the trading desk. In this sense, the turnover metric required in the final rule is similar to more traditional and common measures of inventory turnover. Moreover, the required turnover metric is simpler and less costly to track and record while still providing banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In addition, the description of Inventory Turnover in the final rule provides explicit guidance on how to apply the metric to derivative positions.[2777]

Inventory Aging provides banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In the case of Inventory Aging, the proposal required that the aging schedule be organized according to a specific set of age ranges (*i.e.,* 0–30 days, 30–60 days, 60–90 days, 90–180 days, 180–360 days, and more than 360 days). This requirement has not been adopted in the final rule in order to provide greater flexibility and to recognize that specific age ranges that may be relevant for one asset class may be less relevant for another asset class. Also, to address commenters' uncertainty about how this metric would apply to derivatives, the final rule's description of the Inventory Aging metric provides guidance on how to apply the metric to derivative positions.[2778]

The Customer Facing Trade Ratio provides directionally useful information regarding the extent to which trading transactions are conducted with customers. In the case of the Customer Facing Trade Ratio, the proposal required that customer trades be measured on a trade count basis. The final rule requires that the Customer Facing Trade Ratio be computed in two ways. As in the proposal, the metric must be computed by measuring trades on a trade count basis. Additionally, as suggested by some commenters, the

[2762] *See* Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *See also* Morgan Stanley.

[2763] *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2764] *See* Barclays; *See also* Invesco.

[2765] *See* Barclays; Goldman (Prop. Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

[2766] *See* Goldman (Prop. Trading).

[2767] *See* Société Générale.

[2768] *See* Goldman (Prop. Trading); *See also* Invesco.

[2769] *See* Barclays; Goldman (Prop. Trading); JPMC; SIFMA (Prop. Trading) (Feb. 2012); UBS.

[2770] *See* Occupy.

[2771] *See* Wells Fargo (Prop. Trading).

[2772] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2773] *See* SIFMA (Prop. Trading) (Feb. 2012); *See also* Goldman (Prop Trading).

[2774] *See* Barclays; Japanese Bankers Ass'n; Oliver Wyman (Dec. 2011); SIFMA (Prop. Trading) (Feb. 2012).

[2775] *See* Barclays; Wells Fargo (Prop. Trading).

[2776] *See* Goldman (Prop. Trading); JPMC; SIFMA (Prop. Trading) (Feb. 2012).

[2777] The Agencies believe that this should address commenters' uncertainty with respect to how the Inventory Risk Turnover metric would work for derivatives. *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2778] *See* Barclays; Goldman (Prop.Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

final rule requires that the metric be computed by measuring trades on a notional value basis. The value based approach is required to reflect the fact noted by some commenters, that a trade count based measure may not accurately represent the amount of customer facing activity if customer trade sizes systematically differ from the sizes of non-customer trades. In addition, the term ''customer'' for purposes of the Customer-Facing Trade Ratio is defined in the same manner as the terms client, customer, and counterparty used for purposes of the market-making exemption. This will ensure that the information provided by this metric is useful for purposes of monitoring compliance with the market-making exemption.[2779]

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

One commenter expressed concern that after-the-fact application of the Pay-to-Receive Spread Ratio could cause firms to reconsider their commitment to market making. This commenter suggested that if this measure is used, it be applied flexibly, in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2780] Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to the entire process of calculating Pay-to-Receive Spread Ratio.[2781] A number of commenters argued for removing this metric because its calculation incorporates the Spread P&L metric.[2782] Some of these commenters argued that the metric requires a trade-by-trade analysis which would be expensive to compute and would not provide any additional information that is not available from other metrics. One commenter alleged that this metric was not calculable by any methodology.[2783]

The Pay-to-Receive Spread Ratio has not been retained in the final rule. As noted by some commenters, the broad information content of this metric will largely be captured in the Comprehensive Profit and Loss Attribution measurement. In addition, the Comprehensive Profit and Loss Attribution will place such factors that are related to the proposed Pay-to-Receive Spread Ratio in context with other factors that determine total profitability. Accordingly, factors relating to the payment of fees, commissions and spreads will not be considered in isolation but will be viewed in a context that is appropriate to the entirety of the trading desk's activities. Finally, using the information contained in the Comprehensive Profit and Loss Attribution to holistically assess the range of factors that determine overall profitability, rather than requiring a large number of separate and distinct measurements, will reduce the resulting compliance burden while ensuring an integrated and holistic approach to assessing the activities of each trading desk.

Commenters also suggested a number of additional metrics be added to the final rule that were not contained in the proposal. One commenter, who advocated for an alternative framework for market making supported by structural and transactional metrics, suggested that structural metrics could include the ratio of salespeople to traders and the level of resources devoted to client research and trading content.[2784] Two commenters supported the use of a counterparty risk exposure measure, not only to the risk of counterparty default but also to potential gains and losses to major counterparties for each of a list of systemically important scenarios.[2785] One of these commenters suggested that entity-wide inflation risk assessments be produced on a daily basis.[2786] This commenter also argued that an important metric that is missing is a Liquidity Gap Risk metric that estimates the price change that occurs following a sudden disruption in liquidity for a product, arguing that there needs to be an industry-wide effort to more accurately measure and account for the significant effect that liquidity and changes in its prevailing level have on the valuation of each asset.

One commenter argued that the metrics regime was well-designed for market-making but lacking in other areas like hedging. This commenter recommended the addition of additional metrics more applicable to other non-market making activities like a net profit metric for hedging.[2787] Two commenters argued that quantitative measurement for underwriting was not included in the proposal and stated that in a bona fide underwriting, unsold balances should be relatively small so a marker for potential non-bona fide underwriting should be recognized if VaR (unhedged and uncovered) of the unsold balance that is allocated to a banking entity is large relative to the expected revenue measured by the pro rata underwriting spread.[2788]

After carefully considering the comments received, these and other proposed metrics have not been included as part of the final rule. One major concern raised by a range of commenters was the degree of complexity and burden that would be required by the metrics reporting regime. In light of these comments, the final rule includes a number of quantitative measurements that are expected to provide a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible trading activities in a cost effective and efficient manner while being appropriate for a range of different trading activities. Moreover, while many commenters suggested a number of different alternative metrics, many of

[2779] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2780] *See* NYSE Euronext.

[2781] *See* UBS.

[2782] *See* CH/ABASA; Goldman (Prop.Trading); Japanese Bankers Ass'n; Occupy; SIFMA (Prop.Trading) (Feb. 2012); Wells Fargo (Prop.Trading).

[2783] *See* Morgan Stanley.

[2784] *See* Morgan Stanley.

[2785] *See* Prof. Duffie; Occupy.

[2786] *See* Occupy.

[2787] *See* AFR *et al.* (Feb. 2012).

[2788] *See* AFR *et al.* (Feb. 2012); *See also* Public Citizen.

these alternatives are consistent with the broad themes, risk management, sources of revenues, customer facing activity, that inform the quantitative measurements that are retained in the final rule. Finally, banking entities will be expected to develop their own metrics, as appropriate, to further inform and improve their own monitoring and understanding of their trading activities. Many of the alternative metrics that were suggested by commenters, especially those that relate to a specific market or type of instrument, may be used by banking entities as they develop their own quantitative measurements.

For each individual quantitative measurement in the final rule, Appendix A describes the measurement, provides general guidance regarding how the measurement should be calculated and specifies the period over which each calculation should be made. The proposed quantitative measurements attempt to incorporate, wherever possible, measurements already used by banking entities to manage risks associated with their trading activities. Of the measurements proposed, the Agencies expect that a large majority of measurements proposed are either (i) already routinely calculated by banking entities or (ii) based solely on underlying data that are already routinely calculated by banking entities. However, calculating these measurements according to the specifications described in Appendix A and at the trading desk level mandated by the final rule may require banking entities to implement new processes to calculate and furnish the required data.[2789]

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

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

The Agencies expect to evaluate the data collected during the compliance period both for its usefulness as a barometer of impermissible trading activity and excessive risk-taking and for its costs. This evaluation will consider, among other things, whether all of the quantitative measurements are useful for all asset classes and markets, as well as for all the trading activities subject to the metrics requirement, or if further tailoring is warranted.[2790] The Agencies propose to revisit the metrics and determine, based on a review of the data collected by September 30, 2015, whether to modify, retain or replace the metrics. To allow firms to develop systems to calculate and report these metrics, the Agencies have delayed all reporting of the metrics until July 2014, phased in the reporting requirements over a multi-year period, and reduced the category of banking entities that must report the metrics to a smaller number of firms that engage in significant trading activity. These steps, combined with the reduction in the number of metrics required to be reported, are designed to reduce the cost and burden associated with compiling and reporting the metrics while retaining the usefulness of this data collection in helping to ensure that trading activities are conducted in compliance with section 13 of the BHC Act and the final rule and in a manner that monitors, assesses and controls the risks associated with these activities.

4. Section ____.21: Termination of Activities or Investments; Authorities for Violations

Section ____.21 implements section 13(e)(2) of the BHC Act, which authorizes an Agency to order a banking entity subject to its jurisdiction to terminate activities or investments that violate or function as an evasion of section 13 of the Act.[2791] Section 13(e)(2) further provides that this paragraph shall not be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.[2792]

The proposed rule implemented section 13(e)(2) in two parts. First, § ____.21(a) of the proposal required any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the proposed rule, or in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the proposed rule, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the proposed rule, to terminate the activity and, as relevant, dispose of the investment.[2793] Second, § ____.21(b) of the proposal provided that if, after due notice and an opportunity for hearing, the respective Agency finds reasonable cause to believe that any banking entity has engaged in an activity or made an investment described in paragraph (a), the Agency may, by order, direct the entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.[2794]

Several commenters urged the Agencies to strengthen the authorities provided for under § ____.21,[2795] with some commenters expressing concern that the proposed rule does not establish sufficient enforcement mechanisms and penalties for violations of the rule's requirements.[2796] Some commenters suggested the Agencies add language in § ____.21 authorizing the imposition of automatic and significant financial penalties—as significant as the potential gains from illegal proprietary trading—on traders, supervisors, executives, and firms for violating section 13 of the BHC Act and the final rule.[2797] These

[2789] *See* Credit Suisse (Seidel) ; Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale; Occupy; Paul Volcker; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen.

[2790] The Agencies believe this review, along with the fact that quantitative measurements will not be used as a dispositive tool for determining compliance and the removal of many of the proposed metrics, should help address commenters' concerns that some of the proposed quantitative measurements will not be as relevant for certain asset classes, markets, and activities. *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading); Stephen Roach.

[2791] *See* 12 U.S.C. 1851(e)(2).

[2792] *Id.*

[2793] *See* proposed rule § ____.21(a). The proposal noted that the Agencies included § ____.21(a), in addition to the provisions of § ____.21(b) of the proposed rule, to clarify that the requirement to terminate an activity or, as relevant, dispose of an investment would be triggered when a banking entity discovers the violation or evasion, regardless of whether an Agency order has been issued.

[2794] *See* proposed rule § ____.21(b).

[2795] *See* Sen. Merkley; Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[2796] *See, e.g.,* BEC *et al.* (Jan. 2012); John Reed; Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Sen. Merkley; Public Citizen.

[2797] *See, e.g.,* Form Letter Type A; Form Letter Type B; Sarah McKee; David R. Wilkes; Ben Leet; Karen Michaelis; Barry Rein; Allan Richardson; Ronald Gedrim; Susan Pashkoff; Joan Budd; Frances Vreman; Lisa Kazmier; Michael Wenger; Dyanne DiRosario; Alexander Clayton; James Ofsink; Richard Leining (arguing that violators should face

commenters suggested the Agencies incorporate reference to the Board's authority under section 8 of the BHC Act into the rule,[2798] and others encouraged the Agencies to rely on their inherent authority to impose automatic penalties and fines.[2799] A few commenters stated that traders, management, and banking entities should be held responsible for violations under certain circumstances.[2800] Finally, another commenter recommended that officers and directors of a banking entity be removed from office, be prohibited from being affiliated with a banking entity, and be subject to salary clawbacks for violations of section 13 of the BHC Act and the final rule.[2801]

The Agencies note that the authorities provided for in § ____.21 are not exclusive. The Agencies have a number of enforcement tools at their disposal to carry out their obligations to ensure compliance with section 13 of the BHC Act and the final rule, and need not reference them expressly in § ____.21 in order to exercise them. Specifically, the Agencies may rely on their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law.[2802] For example, a banking entity that violates section 13 of the BHC Act and the final rule may be subject to criminal and civil penalties under section 8 of the BHC Act. Banking entities may also be subject to formal enforcement actions under section 8 of the Federal Deposit Insurance Act (FDIA), such as cease and desist orders or civil money penalty actions,[2803] or safety and soundness orders under section 39 of the FDIA which may be enforceable through assessment of civil money penalties and through the federal court system. In addition, officers, directors, and other institution-affiliated parties[2804] may be subject to civil money penalties, prohibition or removal actions, and personal cease and desist orders under section 8 of the FDIA. Submission of late, false, or misleading reports, including false statements on compliance with section 13 of the BHC Act or the final rule, may also result in actions under applicable securities, commodities, banking, and criminal laws, including imposition of civil money and criminal penalties.[2805] Therefore, the final rule is consistent with the proposal and does not mention other enforcement actions available to address violations of section 13 of the BHC Act and this final rule.

Section 13 of the BHC Act and the final rule do not limit the reach or applicability of the antifraud and other provisions of the federal laws to banking entities, including, for example, section 17(a) of the Securities Act of 1933 or section 10(b) and 15(c) of the Exchange Act and the rules promulgated thereunder.

One commenter also suggested that the Agencies use their authority under section 13(d)(3) of the BHC Act to impose additional capital requirements and quantitative limitations on banking entities for repeat violations of the prohibition on proprietary trading.[2806] The Agencies believe they can rely on other inherent enforcement authorities to address repeat violations. The Agencies note that several other commenters also requested the Agencies to exercise their authority under section 13(d)(3).[2807] The Agencies do not believe that it is appropriate to exercise their authority under this section at this time, primarily because the capital treatment of banking entities' trading activities is currently being addressed through the Agencies' risk-based capital rulemakings.[2808] Additionally, the Agencies believe Congress intended section 13(d)(3) to serve the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider U.S. financial system. To the extent commenters suggested section 13(d)(3) be employed for a punitive purpose, the Agencies do not believe the provision was designed to serve such a purpose nor do the Agencies believe that would be an appropriate use of the provision. Thus, the Agencies believe section 13(d)(3) is more appropriately employed for the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider financial stability of the U.S. financial system.

Commenters also urged the Agencies to clearly delineate in the final rule the jurisdictional authority of each of the Agencies to enforce compliance with section 13 of the BHC Act and the implementing final rule. A number of commenters recommended approaches to coordinating examinations and enforcement among the Agencies, as well as to providing interpretive guidance.[2809] For example, some commenters observed that more than one Agency would have jurisdiction over a given banking entity, and recommended that supervision and enforcement of the final rule for all entities within a banking enterprise remain completely with one Agency.[2810] Further, some commenters recommended that a single Agency be appointed to provide interpretations, supervision, and enforcement of section 13 and the rules thereunder for all banking entities.[2811] Similarly, one commenter suggested that the Board be given initial authority to supervise the implementation of the rule because it is the primary enforcer of the BHC Act and the single regulator that can currently look across a banking group's entire global businesses, regardless of legal entity. This commenter stated that the Board could then determine whether an activity should be delegated to one of

penalties such as seizure and discharge of the board and executives); Lee Smith; *See also* Occupy; Public Citizen.

[2798] *See* Better Markets (Feb. 2012) (contending that penalties should include specific administrative penalties, including monetary penalties, bars, cease and desist orders, strengthened penalties for recurring violations, and sanctioning of employees involved in the violation and public reporting of such sanctions); AFR *et al.* (arguing that section 8 of the BHC Act provides civil penalties for violations by a company or individual and criminal penalties for willful violations of the BHC Act). *See also* Occupy (requesting the Agencies provide penalties that are specific to this rule in addition to the general framework for criminal and civil penalties in section 8 of the BHC Act).

[2799] *See* Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

[2800] *See* John Reed; Better Markets (Feb. 2012). *See also* BEC *et al.* (Jan. 2012) (arguing that CEOs and CFOs should be held fully responsible for any violations of the rule by any employees above the clerical level); Occupy (recommending that traders relying on an exemption in the proposed rule be held personally liable for any losses on trading positions).

[2801] *See* Occupy.

[2802] *See* 12 U.S.C. 1851(g)(3).

[2803] *See, e.g.,* 12 U.S.C. 1818(i) (authorizing imposition of civil money penalties up to the maximum daily amount of $1,000,000 for, among other things, knowing violations of law or regulation).

[2804] *See* 12 U.S.C. 1813(u) (defining ''institution-affiliated party'').

[2805] *See, e.g.,* 12 U.S.C. 164 (authorizing imposition of civil money penalties for, among other things, submitting false or misleading reports or information to the OCC); 18 U.S.C. 1005 (authorizing imposition of fines of not more than $1,000,000 or imprisonment not more than 30 years, or both, for, among other things, making a false entry in the books, reports or statements of a bank with intent to injure, defraud or deceive).

[2806] *See* Better Markets (Feb. 2012).

[2807] *See* Sen. Merkley; Public Citizen; Better Markets (Feb. 2012); Profs. Admati & Pfleiderer.

[2808] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule, 78 FR 62,017 (Friday, October 11, 2013).

[2809] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); Comm. on Capital Market Regulation; BEC *et al.;* ISDA (Apr. 2012).

[2810] *See* Barclays (arguing that ideally the umbrella federal regulator of the enterprise should take this role); Goldman (Prop. Trading).

[2811] *See* BoA; BEC *et al.*

the other Agencies for further examination or enforcement.[2812] In addition, with respect to interpretive authority, some commenters indicated that the Board should be given sole interpretive authority of the statute and the rules thereunder.[2813] Other commenters urged the Agencies to supervise and enforce the rule on a coordinated basis so as to minimize duplicative enforcement efforts, reduce costs, and promote certainty.[2814]

Section 13(e)(2) mandates that each Agency enforce compliance of section 13 with respect to a banking entity ''under the respective [A]gency's jurisdiction.'' [2815] This section provides the Agencies with the authority to order a banking entity to terminate activities or investments that violate or function as an evasion of section 13 of the BHC Act.[2816] Decisions about whether to issue such orders could be made after examinations or otherwise. Nothing in the final rule limits an Agency's inherent authority to conduct examinations or otherwise inspect banking entities to ensure compliance with the final rule. Section ____.1 of each Agency's proposed rule described the specific types of banking entities to which that Agency's rule applies. The Agencies acknowledge commenters' concerns about overlapping jurisdictional authority. The Agencies recognize that, on occasion, a banking entity may be subject to jurisdiction by more than one Agency. As is customary, the Agencies plan to coordinate their examination and enforcement proceedings under section 13, to the extent possible and practicable, so as to limit duplicative actions and undue costs and burdens for banking entities.[2817]

The Agencies are adopting § ____.21 substantially as proposed. Accordingly, § ____.21(a) of the final rule provides that any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the final rule or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the final rule, including through an abuse of any activity or investment permitted or expressly excluded by the terms of the final rule, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the final rule, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment. This provision allows the Agencies to enforce the rule's prohibitions against proprietary trading and sponsoring or owning interests in covered funds regardless of how banking entities classify their actions, while also providing banking entities the freedom to legitimately engage in those banking activities which are outside the scope of the statute.

V. Administrative Law Matters

A. Use of Plain Language

Section 722 of the Gramm-Leach Bliley Act (Pub. L. 106–102, 113 Stat. 1338, 1471, 12 U.S.C. 4809) requires the Federal banking agencies to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invited comment on whether the proposed rule was written plainly and clearly, or whether there were ways the Federal banking agencies could make the rule easier to understand. The Federal banking agencies received no comments on these matters and believe that the final rule is written plainly and clearly.

B. Paperwork Reduction Act Analysis

Certain provisions of the final rule contain ''collection of information'' requirements within the meaning of the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3501–3521). In accordance with the requirements of the PRA, the Agencies may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number. The OCC, FDIC, and Board will obtain OMB control numbers. The information collection requirements contained in this joint final rule, to the extent they apply to insured financial institutions that are not under a holding company, have been submitted to OMB for review and approval by the OCC and FDIC under section 3507(d) of the PRA and § 1320.11 of OMB's implementing regulations (5 CFR part 1320). The Board reviewed the final rule under the authority delegated to the Board by OMB.

PRA Submission to OMB

The Board will submit information collection burden estimates to OMB and the submission will include burden for Federal Reserve-supervised institutions, as well as burden for OCC-, FDIC-, SEC-, and CFTC-supervised institutions under a holding company. The OCC and the FDIC will take burden for banking entities that are not under a holding company.

The FDIC and OCC submitted these information collection estimates to OMB at the proposed rule stage as well. OMB filed comments instructing the OCC and FDIC to examine public comment in response to the notice of proposed rulemaking and include in the supporting statement of the next Information Collection Request (ICR), to be submitted to OMB at the final rule stage, a description of how the OCC and FDIC have responded to any public comments in response to the ICR.

Provisions Requiring PRA Clearance

The final rule contains requirements subject to the PRA. The reporting requirements are found in §§ ____.12(e) and ____.20(d); the recordkeeping requirements are found in §§ ____.3(d)(3), ____.4(b)(3)(i)(A), ____.5(c), ____.11(a)(2), and ____.20(b)-(f); and the disclosure requirements are found in § ____.11(a)(8)(i). The recordkeeping burden for §§ ____.4(a)(2)(iii), ____.4(b)(2)(iii), ____.5(b)(1), ____.5(b)(2)(i), ____.5(b)(2)(iv), ____.13(a)(2)(i), and ____.13(a)(2)(ii)(A) is accounted for in § ____.20(b); the recordkeeping burden for Appendix B is accounted for in § ____.20(c); the reporting and recordkeeping burden for Appendix A is accounted for in § ____.20(d); and the recordkeeping burden for §§ ____.10(c)(12)(i) and ____.10(c)(12)(iii) is accounted for in § ____.20(e). These information collection requirements would implement section 619 of the Dodd-Frank Act, as mentioned in the Abstract below. The respondent/

[2812] *See* Comm. on Capital Market Regulation.

[2813] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (recommending that the Board be responsible for resolving potentially conflicting supervisory recommendations or matters requiring attention arising from examinations as well); ISDA (Apr. 2012). *See also* ABA (Keating) (arguing that the Agencies should defer to the Board's sole authority to interpret provisions of Volcker that intersect with other statutory provisions subject to the Board's jurisdictional authority, such as Super 23A); JPMC (contending that the Agencies should adopt and *See*k comment on a protocol for supervision and enforcement that will ensure a given banking entity will face one set of rules and different banking entities will face the same set of rules). The Agencies decline to adopt the commenter's suggested approach of deferring to the Board's sole interpretive authority with respect to the provisions of the final rule. The Agencies believe at this time that such an approach would be neither appropriate nor effective given the different authorities and expertise of each Agency. *See* Part IV.C (discussing the Agencies' decision not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13).

[2814] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (stating that the Agencies should issue one set of exam findings under these circumstances); ISDA (Apr. 2012).

[2815] *See* 12 U.S.C. 1851(c)(2).

[2816] *See* 12 U.S.C. 1851(e)(2) (requiring ''due notice and opportunity for hearing'').

[2817] *See* 12 U.S.C. 1844 (establishing jurisdictional boundaries for regulation of bank holding companies); *See also* 12 U.S.C. 1828a (antievasion statute empowering OCC, FDIC, and the Board to impose restrictions on relationships or transactions between banks and their subsidiaries and affiliates).

recordkeepers are for-profit financial institutions, including small businesses. A covered entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [the Agency] on request.

Comments Received on PRA

Of the comments received in response to the proposed rule, three specifically referenced the PRA.[2818] They were received from five industry trade groups and focused on the analysis of the regulatory burden imposed by regulation. They referenced the PRA burden as an example of the significance of the burden imposed by the regulation but did not address burden in the context of the PRA. A number of other comments addressed reporting and recordkeeping requirements and the utility of the information to be collected outside the context of the PRA. As a result of these and other comments, the Agencies made changes to the rule. These comments are discussed throughout the release.

Proposed Information Collection

Title of Information Collection: Reporting, Recordkeeping, and Disclosure Requirements Associated with Proprietary Trading and Certain Interests in and Relationships with Covered Funds.

Frequency of Response: Annual, monthly, quarterly, and on occasion.

Affected Public: Businesses or other for-profit.

Respondents:

Board: State member banks, bank holding companies, savings and loan holding companies, mutual holding companies, foreign banking organizations, U.S. branches or agencies of foreign banks, and other holding companies that control an insured depository institution. The Board will take burden for all institutions under a holding company including:

- OCC-supervised institutions,
- FDIC-supervised institutions,
- Banking entities for which the CFTC is the primary financial regulatory agency, as defined in section 2(12)(C) of the Dodd-Frank Act, and
- Banking entities for which the SEC is the primary financial regulatory agency, as defined in section 2(12)(B) of the Dodd-Frank Act.

OCC: National banks, federal savings associations, federal savings banks not under a holding company, and their respective subsidiaries, and their affiliates not under a holding company, and U.S. branches or agencies of foreign banks. The OCC will take the burden with respect to registered investment advisers and commodity trading advisers and commodity pool operators that are subsidiaries of national banks, federal savings associations, and federal savings banks not under a bank holding company.

FDIC: Insured state nonmember banks not under a holding company; state savings associations and state savings banks not under a holding company; subsidiaries of state nonmember banks, state savings associations, and state savings banks not under a holding company; and foreign banks having an insured branch and their branches and agencies.

Abstract:

Section 619 of the Dodd-Frank Act added a new section 13 to the BHC Act (to be codified at 12 U.S.C. 1851) that generally prohibits any banking entity from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. As noted above, the final rule contains requirements subject to the PRA. The Agencies believe that the reporting, recordkeeping, and disclosure requirements associated with the rule will permit banking entities and the Agencies to enforce compliance with section 13 of the BHC Act and the final rule and to identify, monitor and limit risks of activities permitted under section 13, particularly involving banking entities posing the greatest risk to financial stability. Compliance with the information collections would be mandatory. As noted above, a number of commenters addressed reporting and recordkeeping requirements and the utility of the information to be collected outside the context of the PRA. As a result of these comments, the Agencies made changes to the rule, which are discussed throughout the release. The final burden estimates take these changes into account and reflect the anticipated burden under the final rules. As discussed in the release, in brief, the purpose for the recordkeeping, disclosure, and reporting requirements contained within the rule is to facilitate compliance with section 13 of the BHC and implementing rules.

Section-by-Section Analysis

PRA Reporting Requirements

Section ____.12(e) states that, upon application by a banking entity, the Board may extend the period of time to meet the requirements on ownership limitations in this section for up to 2 additional years, if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must (1) be submitted to the Board at least 90 days prior to expiration, (2) provide the reasons for application including information that addresses the factors in paragraph (e)(2) of § ____.12, and (3) explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods.

Section ____.20(d) provides that a banking entity engaged in proprietary trading activity must comply with the reporting requirements described in Appendix A, if (1) the banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the established threshold; (2) in the case of a foreign banking entity, the average gross sum of the trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the established threshold; or (3) the appropriate agency notifies the banking entity in writing that it must satisfy the reporting requirements contained in Appendix A of this part. The threshold for reporting is $50 billion beginning on June 30, 2014; $25 billion beginning on April 30, 2016; and $10 billion beginning on December 31, 2016. Unless the appropriate agency notifies the banking entity in writing that it must report on a different basis, a banking entity with $50 billion or more in trading assets and liabilities shall report the information required by Appendix A for each calendar month within 30 days of the end of the relevant calendar month; beginning with information for the month of January

[2818] *See* BoA (acknowledging that the Agencies performed an analysis of the information costs as required by the Paperwork Reduction Act); SIFMA *et al.* (Covered Funds) (Feb. 2012) (noting that the Agencies conducted a limited cost/benefit analysis of the information requirements of the proposed rules under the PRA); Chamber (Nov. 2013) (noting that the burden estimates for the proposed rule stand at almost 6,600,000 hours per year).

2015, such information shall be reported within 10 days of the end of that calendar month. Any other banking entity subject to Appendix A shall report the information required by Appendix A for each calendar quarter within 30 days of the end of that calendar quarter unless the appropriate agency notifies the banking entity in writing that it must report on a different basis. Appendix A requires banking entities to furnish the following quantitative measurements for each trading desk of the banking entity: (1) risk and position limits and usage; (2) risk factor sensitivities; (3) Value-at-Risk and stress VaR; (4) comprehensive profit and loss attribution; (5) inventory turnover; (6) inventory aging; and (7) customer facing trade ratio.

Recordkeeping Requirements

Section ____.3(d)(3) specifies that proprietary trading does not include any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan of the banking entity that (1) specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used; (2) requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes; (3) requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements; (4) limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan; (5) includes written policies and procedures, internal controls, analysis and independent testing to ensure that the purchase and sale of securities that are not permitted under § ____.6(a) or (b) of this part are for the purpose of liquidity management and in accordance with the liquidity management plan described in this paragraph; and (6) is consistent with the appropriate agency's supervisory requirements, guidance and expectations regarding liquidity management.

Section ____.4(b)(3)(i)(A) provides that a trading desk or other organizational unit of another entity with more than $50 billion in trading assets and liabilities is not a client, customer, or counterparty unless the trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of § ____.4(b). This modification responds to comments received on the proposal regarding the definition of client, customer, or counterparty for purposes of the market making exemption.

Section ____.5(c) requires documentation for any purchase or sale of a financial instrument for risk-mitigating hedging purposes that is: (1) not established by the specific trading desk establishing the underlying positions, contracts, or other holdings the risks of which the hedging activity is designed to reduce; (2) established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings but that is not specifically identified in the trading desk's written policies and procedures; or (3) established to hedge aggregated positions across two or more trading desks. In connection with any purchase or sale that meets these specified circumstances, a banking entity must, at a minimum and contemporaneously with the purchase or sale, document (1) the specific, identifiable risk(s) of the identified positions, contracts, or other holdings of the banking entity that the purchase or sale is designed to reduce; (2) the specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and (3) the trading desks or other business unit that is establishing and responsible for the hedge. The banking entity must also create and retain records sufficient to demonstrate compliance with this section for at least 5 years in a form that allows the banking entity to promptly produce such records to the appropriate agency on request, or such longer period as required under other law or this part.

Section ____.11(a)(2) requires that covered funds generally must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity, pursuant to a written plan or similar documentation outlining how the banking entity intends to provide advisory or other similar services to its customers through organizing and offering the covered fund.

Section ____.20(b) specifies the contents of the compliance program for a banking entity with total consolidated assets of $10 billion or more. It includes: (1) written policies and procedures reasonably designed to document, describe, monitor and limit trading activities, including setting and monitoring required limits set out in § ____.4 and § ____.5 and activities and investments with respect to a covered fund (including those permitted under §§ ____.3 through ____.6 or §§ ____.11 through ____.14) to ensure that all activities and investments conducted by the banking entity that are subject to section 13 of the BHC Act and this part comply with section 13 of the BHC Act and applicable regulations; (2) a system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and this part and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and applicable regulations; (3) a management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention; (4) independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party; (5) training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and (6) records sufficient to demonstrate compliance with section 13 of the BHC Act and applicable regulations, which a banking entity must promptly provide to the [Agency] upon request and retain for a period of no less than 5 years or such longer period as required by [Agency].

Section ____.20(c) specifies that the compliance program of a banking entity must satisfy the requirements and other standards contained in Appendix B, if (1) the banking entity engages in proprietary trading permitted under

subpart B and is required to comply with the reporting requirements of § ____.20(d); (2) the banking entity has reported total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States); or (3) the [Agency] notifies the banking entity in writing that it must satisfy the requirements and other standards contained in Appendix B. Appendix B provides enhanced minimum standards for compliance programs for banking entities that meet the thresholds in § ____.20(c) as described above. These include the establishment, maintenance, and enforcement of the enhanced compliance program and meeting the minimum written policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping. The program must: (1) be reasonably designed to identify, document, monitor and report the permitted trading and covered fund activities and investments; identify, monitor and promptly address the risk of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and this part; (2) establish and enforce appropriate limits on covered activities and investments, including limits on size, scope, complexity, and risks of individual activities or investments consistent with the requirements of section 13 of the BHC Act and this part; (3) subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent; (4) make senior management and others accountable for effective implementation of compliance program and ensure that board of directors and chief executive officer (or equivalent) of the banking entity review effectiveness of the compliance program; and (5) facilitate supervision and examination by Agencies of permitted trading and covered fund activities and investments.

Section ____.20(d) provides that certain banking entities engaged in certain proprietary trading activities must comply with the reporting requirements described in Appendix A. A banking entity must also, for any quantitative measurement furnished to the appropriate agency pursuant to § ____.20(d) and Appendix A, create and maintain records documenting the preparation and content of these reports, as well as such information as is necessary to permit the appropriate agency to verify the accuracy of such reports, for a period of 5 years from the end of the calendar year for which the measurement was taken.

Section ____.20(e) specifies additional documentation required for covered funds. Any banking entity that has more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years shall maintain records that include: (1) documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund is not a covered fund; (2) for each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided by §§ ____.10(c)(1),____.10(c)(5), ____.10(c)(8), ____.10(c)(9), or ____.10(c)(10) of subpart C, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions; (3) for each seeding vehicle described in §§ ____.10(c)(12)(i) or ____.10(c)(12)(iii) of subpart C that will become a registered investment company or SEC-regulated business development company, a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § ____.12(a)(2)(i)(B) of subpart C; and (4) for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interests in foreign public funds that are described in § ____.10(c)(1) of subpart C owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, documentation of the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized, calculated as of the end of each calendar quarter, which documentation must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters.

Section ____.20(f)(1) applies to banking entities with no covered activities. A banking entity that does not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § ____.6(a) of subpart B) may satisfy the requirements of this section by establishing the required compliance program prior to becoming engaged in such activities or making such investments (other than trading activities permitted pursuant to § ____.6(a) of subpart B).

Section ____.20(f)(2) applies to banking entities with modest activities. A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in activities or investments pursuant to subpart B or subpart C of this part (other than trading activities permitted under section ____.6(a)) may satisfy the requirements of this section by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and this part and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

Disclosure Requirements

Section ____.11(a)(8)(i) requires that a banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) (1) that "any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity]; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] in its capacity as investor in the [covered fund] or as

beneficiary of a restricted profit interest held by [the banking entity]''; (2) that such investor should read the fund offering documents before investing in the covered fund; (3) that the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and (4) the role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund.

PRA Burden Estimates

In determining the method for estimating the paperwork burden, the Agencies made the assumption that affiliated entities under a holding company would act in concert with one another to take advantage of efficiencies that may exist.

Estimated PRA Burden per Response:

Reporting Burden

§ ____.12(e)—20 hours (Initial set up 50 hours).

§ ____.20(d)—2 hours (Initial setup 6 hours).

PRA Recordkeeping Burden

§ ____.3(d)(3)—1 hour (Initial setup 3 hours).

§ ____.4(b)(3)(i)(A)—2 hours.

§ ____.5(c)—100 hours (Initial setup 50 hours).

§ ____.11(a)(2)—10 hours.

§ ____.20(b)—265 hours (Initial setup 795 hours).

§ ____.20(c)—1,200 hours (Initial setup 3,600 hours).

§ ____.20(d)—440 hours for entities with $50 billion or more in trading assets/liabilities; 350 hours for entities with $10 to $50 billion in trading assets/liabilities.

§ ____.20(e)—200 hours.

§ ____.20(f)(1)—8 hours.

§ ____.20(f)(2)—40 (Initial setup 100 hours).

PRA Disclosure Burden

§ ____.11(a)(8)(i)—0.1 hours.

Board

Number of respondents: 5,027.

Total estimated annual burden: 2,336,190 hours (968,488 hours for initial setup and 1,367,702 hours for ongoing compliance).

FDIC

Number of respondents: 797.

Total estimated annual burden: 28,234 hours (14,165 hours for initial setup and 14,069 hours for ongoing compliance).

OCC

Number of respondents: 381.

Total estimated annual burden: 28,016 hours (14,386 hours for initial setup and 13,630 hours for ongoing compliance).

C. Regulatory Flexibility Act Analysis

In general, section 4 of the Regulatory Flexibility Act (5 U.S.C. 604) (RFA) requires an agency to prepare a final regulatory flexibility analysis (FRFA) for a final rule unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined as of July 22, 2013, to include banking entities with total assets of $500 million or less (''small banking entities'').[2819] Pursuant to section 605(b) of the RFA, a FRFA is not required if an agency certifies that the final rule will not have a significant economic impact on a substantial number of small entities. The Agencies have considered the potential economic impact of the final rule on small banking entities in accordance with the RFA. The Agencies believe that the final rule will not have a significant economic impact on a substantial number of small banking entities for the reasons described below.

The Agencies previously considered the impact of the proposed rule for purposes of the RFA and concluded that the proposed rule would not appear to have a significant economic impact on a substantial number of small banking entities. In support of this conclusion, the proposed rule, among other things, noted that the thresholds for the metrics reporting requirements under § __.7 and Appendix A and for the enhanced and core compliance program requirements under § __.20 and Appendix C of the proposed rule would not capture small banking entities.[2820]

The Agencies received several comments on the impact of the proposed rule on small entities. Commenters argued that the Agencies incorrectly concluded that the proposed rule would not have a significant economic impact on a substantial number of small entities.[2821] Commenters asserted that the proposed rule would have a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services, including covered fund-linked products for investment and hedging purposes and underwriting and market-making related services.[2822]

The Agencies have carefully considered these comments in developing a final rule. To minimize burden on small banking entities, section ____.20(f)(1) of the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments. In addition, to minimize the burden on small banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity. Only those banking entities with total assets of greater than $10 billion will need to adopt more detailed or enhanced compliance requirements under the final rule. (For purposes of the enhanced compliance program in Appendix B of the final rule, the threshold for banking entities is total consolidated assets of $50 billion or more.) Accordingly, the compliance requirements under the final rule do not have a significant economic impact on a substantial number of small banking entities.

Likewise, the final rule raises the threshold for metrics reporting from the proposed rule to capture only firms that engage in significant trading activities. Specifically, the metrics reporting requirements under § __.20 and Appendix A of the final rule apply only to banking entities with average trading assets and liabilities on a consolidated, worldwide basis for the preceding year equal to or greater than $10 billion. Accordingly, the metrics reporting requirements under the final rule do not impact small banking entities.

Moreover, the Agencies have revised the definition of covered fund in the final rule to address many of the concerns raised by commenters regarding the unintended consequences

[2819] *See* 13 CFR 121.201; *See also* 13 CFR 121.103(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

[2820] *See* Joint Proposal, 76 FR 68,938–68,939.

[2821] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012); ABA (Keating).

[2822] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

of the proposed definition.[2823] The definition of covered fund under the final rule contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, acquisition vehicles, insurance company separate accounts, registered investments companies, and public welfare investment funds. The Agencies believe that these changes will further minimize the burden for small banking entities such as those that may use wholly owned subsidiaries for organizational convenience or make public welfare investments to achieve their financial and Community Reinvestment Act goals.

Finally, in response to commenters' assertion that the proposed rule would have had a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services,[2824] the Agencies note that the RFA does not require the Agencies to consider the impact of the final rule, including its indirect economic effects, on small entities that are not subject to the requirements of the final rule.[2825]

For the reasons stated above, the OCC, FDIC, SEC, and CFTC certify, for the banking entities subject to each such Agency's jurisdiction, that the final rule will not result in a significant economic impact on a substantial number of small entities. In light of the foregoing, the Board does not believe, for the banking entities subject to the Board's jurisdiction, that the final rule would have a significant economic impact on a substantial number of small entities.

D. OCC Unfunded Mandates Reform Act of 1995 Determination

The Unfunded Mandates Reform Act of 1995, Public Law 104–4 (2 U.S.C. 1532) (UMRA) requires a Federal agency to prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more (adjusted annually for inflation) in any one year. If a budgetary impact statement is required, Section 205 of the UMRA also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC previously determined that the proposed rule would not impose any Federal mandates resulting in expenditures by State, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more (adjusted annually for inflation) in any one year. Several commenters argued that the OCC failed to consider all relevant expenditures and that that the proposed rule should have qualified as a significant regulatory action under UMRA.[2826]

The OCC has carefully considered these comments in completing its UMRA analysis of the final rule. The OCC has determined that the final rule qualifies as a significant regulatory action under the UMRA because its Federal mandates may result in expenditures by the private sector in excess of $100 million or more (adjusted annually for inflation) in any one year.

Text of Common Rule

PART [____] PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

Subpart A Authority and Definitions

Sec.

____.1 Authority, purpose, scope, and relationship to other authorities [Reserved].

____.2 Definitions.

Subpart B Proprietary Trading

____.3 Prohibition on proprietary trading.

____.4 Permitted underwriting and market making-related activities.

____.5 Permitted risk-mitigating hedging activities.

____.6 Other permitted proprietary trading activities.

____.7 Limitations on permitted proprietary trading activities.

____.8 [Reserved]

____.9 [Reserved]

Subpart C Covered Fund Activities and Investments

____.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

____.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.

____.12 Permitted investment in a covered fund.

____.13 Other permitted covered fund activities and investments.

____.14 Limitations on relationships with a covered fund.

____.15 Other limitations on permitted covered fund activities and investments.

____.16 [Reserved]

____.17 [Reserved]

____.18 [Reserved]

____.19 [Reserved]

Subpart D Compliance Program Requirement; Violations

____.20 Program for compliance; reporting.

____.21 Termination of activities or investments; penalties for violations.

Appendix A Reporting and Recordkeeping Requirements for Covered Trading Activities

Appendix B Enhanced Minimum Standards for Compliance Programs

Subpart A—Authority and Definitions

§ ____.1 Authority, purpose, scope, and relationship to other authorities [Reserved]

§ ____.2 Definitions.

Unless otherwise specified, for purposes of this part:

(a) *Affiliate* has the same meaning as in section 2(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(k)).

(b) *Bank holding company* has the same meaning as in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

(c) *Banking entity.* (1) Except as provided in paragraph (c)(2) of this section, *banking entity* means:

(i) Any insured depository institution;

(ii) Any company that controls an insured depository institution;

(iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and

(iv) Any affiliate or subsidiary of any entity described in paragraphs (c)(1)(i), (ii), or (iii) of this section.

(2) Banking entity does not include:

(i) A covered fund that is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section;

(ii) A portfolio company held under the authority contained in section 4(k)(4)(H) or (I) of the BHC Act (12 U.S.C. 1843(k)(4)(H), (I)), or any portfolio concern, as defined under 13 CFR 107.50, that is controlled by a small business investment company, as

[2823] *See* Part IV.B.1. of this **SUPPLEMENTARY INFORMATION.**

[2824] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

[2825] *See e.g., In Mid-Tex Electric Cooperative* v. *FERC,* 773 F.2d 327 (D.C. Cir. 1985); *United Distribution Cos.* v. *FERC,* 88 F.3d 1105, 1170 (D.C. Cir. 1996); *Cement Kiln Recycling Coalition* v. *EPA,* 255 F.3d 855 (D.C. Cir. 2001). Commenters relied on *Aeronautical Repair Station Association* v. *Federal Aviation Administration,* 494 F.3d 161 (D.C. Cir 2007) to argue that the Agencies must consider the indirect economic effects of the final rule on small non-banking entities. This case is inapposite, however, because there the agency's own rulemaking release expressly stated that the rule *imposed responsibilities directly* on certain small business contractors. The court reaffirmed its prior holdings that the RFA limits its application to small entities ''which will be subject to the proposed regulation—that is, those small entities to which the proposed rule will apply.'' *Id.* at 176 (emphasis and internal quotations omitted).

[2826] *See* BoA; SIFMA *et al.* (Covered Funds); Chamber.

defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), so long as the portfolio company or portfolio concern is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section; or

(iii) The FDIC acting in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(d) *Board* means the Board of Governors of the Federal Reserve System.

(e) *CFTC* means the Commodity Futures Trading Commission.

(f) *Dealer* has the same meaning as in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)).

(g) *Depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

(h) *Derivative.* (1) Except as provided in paragraph (h)(2) of this section, *derivative* means:

(i) Any swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68));

(ii) Any purchase or sale of a commodity, that is not an excluded commodity, for deferred shipment or delivery that is intended to be physically settled;

(iii) Any foreign exchange forward (as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)) or foreign exchange swap (as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25));

(iv) Any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(C)(i));

(v) Any agreement, contract, or transaction in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and

(vi) Any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b));

(2) A derivative does not include:

(i) Any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)); or

(ii) Any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

(i) *Employee* includes a member of the immediate family of the employee.

(j) *Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(k) *Excluded commodity* has the same meaning as in section 1a(19) of the Commodity Exchange Act (7 U.S.C. 1a(19)).

(l) *FDIC* means the Federal Deposit Insurance Corporation.

(m) *Federal banking agencies* means the Board, the Office of the Comptroller of the Currency, and the FDIC.

(n) *Foreign banking organization* has the same meaning as in section 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)), but does not include a foreign bank, as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)), that is organized under the laws of the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, or the Commonwealth of the Northern Mariana Islands.

(o) *Foreign insurance regulator* means the insurance commissioner, or a similar official or agency, of any country other than the United States that is engaged in the supervision of insurance companies under foreign insurance law.

(p) *General account* means all of the assets of an insurance company except those allocated to one or more separate accounts.

(q) *Insurance company* means a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act (12 U.S.C. 1851).

(r) *Insured depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)), but does not include an insured depository institution that is described in section 2(c)(2)(D) of the BHC Act (12 U.S.C. 1841(c)(2)(D)).

(s) *Loan* means any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.

(t) *Primary financial regulatory agency* has the same meaning as in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)).

(u) *Purchase* includes any contract to buy, purchase, or otherwise acquire. For security futures products, purchase includes any contract, agreement, or transaction for future delivery. With respect to a commodity future, purchase includes any contract, agreement, or transaction for future delivery. With respect to a derivative, purchase includes the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(v) *Qualifying foreign banking organization* means a foreign banking organization that qualifies as such under section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c), or (e)).

(w) *SEC* means the Securities and Exchange Commission.

(x) *Sale* and *sell* each include any contract to sell or otherwise dispose of. For security futures products, such terms include any contract, agreement, or transaction for future delivery. With respect to a commodity future, such terms include any contract, agreement, or transaction for future delivery. With respect to a derivative, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(y) *Security* has the meaning specified in section 3(a)(10) of the Exchange Act (15 U.S.C. 78c(a)(10)).

(z) *Security-based swap dealer* has the same meaning as in section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)).

(aa) *Security future* has the meaning specified in section 3(a)(55) of the Exchange Act (15 U.S.C. 78c(a)(55)).

(bb) *Separate account* means an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(cc) *State* means any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

(dd) *Subsidiary* has the same meaning as in section 2(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(d)).

(ee) *State insurance regulator* means the insurance commissioner, or a similar official or agency, of a State that is engaged in the supervision of insurance companies under State insurance law.

(ff) *Swap dealer* has the same meaning as in section 1(a)(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)).

Subpart B—Proprietary Trading

§ ___.3 Prohibition on proprietary trading.

(a) *Prohibition.* Except as otherwise provided in this subpart, a banking entity may not engage in proprietary trading. *Proprietary trading* means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.

(b) *Definition of trading account.* (1) Trading account means any account that is used by a banking entity to:

(i) Purchase or sell one or more financial instruments principally for the purpose of:

(A) Short-term resale;

(B) Benefitting from actual or expected short-term price movements;

(C) Realizing short-term arbitrage profits; or

(D) Hedging one or more positions resulting from the purchases or sales of financial instruments described in paragraphs (b)(1)(i)(A), (B), or (C) of this section;

(ii) Purchase or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule; or

(iii) Purchase or sell one or more financial instruments for any purpose, if the banking entity:

(A) Is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

(B) Is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.

(2) *Rebuttable presumption for certain purchases and sales.* The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section.

(c) *Financial instrument.* (1) *Financial instrument* means:

(i) A security, including an option on a security;

(ii) A derivative, including an option on a derivative; or

(iii) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

(2) A financial instrument does not include:

(i) A loan;

(ii) A commodity that is not:

(A) An excluded commodity (other than foreign exchange or currency);

(B) A derivative;

(C) A contract of sale of a commodity for future delivery; or

(D) An option on a contract of sale of a commodity for future delivery; or

(iii) Foreign exchange or currency.

(d) *Proprietary trading.* Proprietary trading does not include:

(1) Any purchase or sale of one or more financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;

(2) Any purchase or sale of one or more financial instruments by a banking entity that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties;

(3) Any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan of the banking entity that:

(i) Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used;

(ii) Requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

(iii) Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit, and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;

(iv) Limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis, and independent testing to ensure that the purchase and sale of securities that are not permitted under §§ ____.6(a) or (b) of this subpart are for the purpose of liquidity management and in accordance with the liquidity management plan described in paragraph (d)(3) of this section; and

(vi) Is consistent with [Agency]'s supervisory requirements, guidance, and expectations regarding liquidity management;

(4) Any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency in connection with clearing financial instruments;

(5) Any excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(6) Any purchase or sale of one or more financial instruments by a banking entity, so long as:

(i) The purchase (or sale) satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity; or

(ii) The purchase (or sale) satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding;

(7) Any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker, or custodian;

(8) Any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity; or

(9) Any purchase or sale of one or more financial instruments by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the [Agency].

(e) *Definition of other terms related to proprietary trading.* For purposes of this subpart:

(1) *Anonymous* means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale.

(2) *Clearing agency* has the same meaning as in section 3(a)(23) of the Exchange Act (15 U.S.C. 78c(a)(23)).

(3) *Commodity* has the same meaning as in section 1a(9) of the Commodity Exchange Act (7 U.S.C. 1a(9)), except that a commodity does not include any security;

(4) *Contract of sale of a commodity for future delivery* means a contract of sale (as that term is defined in section 1a(13) of the Commodity Exchange Act (7 U.S.C. 1a(13)) for future delivery (as that term is defined in section 1a(27) of the Commodity Exchange Act (7 U.S.C. 1a(27))).

(5) *Derivatives clearing organization* means:

(i) A derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1);

(ii) A derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1); or

(iii) A foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

(6) *Exchange,* unless the context otherwise requires, means any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, or, for purposes of securities or security-based swaps, an exchange, as defined under section 3(a)(1) of the Exchange Act (15 U.S.C. 78c(a)(1)), or security-based swap execution facility, as defined under section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)).

(7) *Excluded clearing activities* means:

(i) With respect to customer transactions cleared on a derivatives clearing organization, a clearing agency, or a designated financial market utility, any purchase or sale necessary to correct trading errors made by or on behalf of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(ii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(iii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(iv) Any purchase or sale in connection with and related to the management of the default or threatened default of a clearing agency, a derivatives clearing organization, or a designated financial market utility; and

(v) Any purchase or sale that is required by the rules or procedures of a clearing agency, a derivatives clearing organization, or a designated financial market utility to mitigate the risk to the clearing agency, derivatives clearing organization, or designated financial market utility that would result from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

(8) *Designated financial market utility* has the same meaning as in section 803(4) of the Dodd-Frank Act (12 U.S.C. 5462(4)).

(9) *Issuer* has the same meaning as in section 2(a)(4) of the Securities Act of 1933 (15 U.S.C. 77b(a)(4)).

(10) *Market risk capital rule covered position and trading position* means a financial instrument that is both a covered position and a trading position, as those terms are respectively defined:

(i) In the case of a banking entity that is a bank holding company, savings and loan holding company, or insured depository institution, under the market risk capital rule that is applicable to the banking entity; and

(ii) In the case of a banking entity that is affiliated with a bank holding company or savings and loan holding company, other than a banking entity to which a market risk capital rule is applicable, under the market risk capital rule that is applicable to the affiliated bank holding company or savings and loan holding company.

(11) *Market risk capital rule* means the market risk capital rule that is contained in subpart F of 12 CFR part 3, 12 CFR parts 208 and 225, or 12 CFR part 324, as applicable.

(12) *Municipal security* means a security that is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.

(13) *Trading desk* means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

§ ___.4 Permitted underwriting and market making-related activities.

(a) *Underwriting activities*—(1) *Permitted underwriting activities.* The prohibition contained in § __.3(a) does not apply to a banking entity's underwriting activities conducted in accordance with this paragraph (a).

(2) *Requirements.* The underwriting activities of a banking entity are permitted under paragraph (a)(1) of this section only if:

(i) The banking entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution;

(ii) The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (a) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

(B) Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:

(*1*) Amount, types, and risk of its underwriting position;

(*2*) Level of exposures to relevant risk factors arising from its underwriting position; and

(*3*) Period of time a security may be held;

(C) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(D) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval;

(iv) The compensation arrangements of persons performing the activities described in this paragraph (a) are designed not to reward or incentivize prohibited proprietary trading; and

(v) The banking entity is licensed or registered to engage in the activity described in this paragraph (a) in accordance with applicable law.

(3) *Definition of distribution.* For purposes of this paragraph (a), a *distribution* of securities means:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

(4) *Definition of underwriter.* For purposes of this paragraph (a), *underwriter* means:

(i) A person who has agreed with an issuer or selling security holder to:

(A) Purchase securities from the issuer or selling security holder for distribution;

(B) Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or

(C) Manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

(5) *Definition of selling security holder.* For purposes of this paragraph (a), *selling security holder* means any person, other than an issuer, on whose behalf a distribution is made.

(6) *Definition of underwriting position.* For purposes of this paragraph (a), *underwriting position* means the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter.

(7) *Definition of client, customer, and counterparty.* For purposes of this paragraph (a), the terms *client, customer, and counterparty,* on a collective or individual basis, refer to market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.

(b) *Market making-related activities*—(1) *Permitted market making-related activities.* The prohibition contained in § ____.3(a) does not apply to a banking entity's market making-related activities conducted in accordance with this paragraph (b).

(2) *Requirements.* The market making-related activities of a banking entity are permitted under paragraph (b)(1) of this section only if:

(i) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(ii) The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on:

(A) The liquidity, maturity, and depth of the market for the relevant types of financial instrument(s); and

(B) Demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section;

(B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and

inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

(C) Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by paragraph (b)(2)(ii) of this section, on:

(*1*) The amount, types, and risks of its market-maker inventory;

(*2*) The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;

(*3*) The level of exposures to relevant risk factors arising from its financial exposure; and

(*4*) The period of time a financial instrument may be held;

(D) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(E) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of this paragraph (b), and independent review of such demonstrable analysis and approval;

(iv) To the extent that any limit identified pursuant to paragraph (b)(2)(iii)(C) of this section is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;

(v) The compensation arrangements of persons performing the activities described in this paragraph (b) are designed not to reward or incentivize prohibited proprietary trading; and

(vi) The banking entity is licensed or registered to engage in activity described in this paragraph (b) in accordance with applicable law.

(3) *Definition of client, customer, and counterparty.* For purposes of paragraph (b) of this section, the terms *client, customer, and counterparty,* on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that:

(i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § ____.20(d)(1) of subpart D, unless:

(A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of paragraph (b)(2) of this section; or

(B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

(4) *Definition of financial exposure.* For purposes of this paragraph (b), *financial exposure* means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.

(5) *Definition of market-maker inventory.* For the purposes of this paragraph (b), *market-maker inventory* means all of the positions in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section, that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.

§ ____.5 Permitted risk-mitigating hedging activities.

(a) *Permitted risk-mitigating hedging activities.* The prohibition contained in § ____.3(a) does not apply to the risk-mitigating hedging activities of a banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

(b) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under paragraph (a) of this section only if:

(1) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(i) Reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a particular trading desk may use in its risk-mitigating hedging activities, as well as position and aging limits with respect to such positions, contracts or other holdings;

(ii) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(iii) The conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged, and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged;

(2) The risk-mitigating hedging activity:

(i) Is conducted in accordance with the written policies, procedures, and internal controls required under this section;

(ii) At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;

(iii) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section;

(iv) Is subject to continuing review, monitoring and management by the banking entity that:

(A) Is consistent with the written hedging policies and procedures required under paragraph (b)(1) of this section;

(B) Is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying positions, contracts, and other holdings of the banking entity, based upon the facts and circumstances of the

underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof; and

(C) Requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(2) of this section and is not prohibited proprietary trading; and

(3) The compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.

(c) *Documentation requirement*—(1) A banking entity must comply with the requirements of paragraphs (c)(2) and (3) of this section with respect to any purchase or sale of financial instruments made in reliance on this section for risk-mitigating hedging purposes that is:

(i) Not established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the hedging activity is designed to reduce;

(ii) Established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the purchases or sales are designed to reduce, but that is effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures established under paragraph (b)(1) of this section or under § ____.4(b)(2)(iii)(B) of this subpart as a product, instrument, exposure, technique, or strategy such trading desk may use for hedging; or

(iii) Established to hedge aggregated positions across two or more trading desks.

(2) In connection with any purchase or sale identified in paragraph (c)(1) of this section, a banking entity must, at a minimum, and contemporaneously with the purchase or sale, document:

(i) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings of the banking entity that the purchase or sale is designed to reduce;

(ii) The specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and

(iii) The trading desk or other business unit that is establishing and responsible for the hedge.

(3) A banking entity must create and retain records sufficient to demonstrate compliance with the requirements of this paragraph (c) for a period that is no less than five years in a form that allows the banking entity to promptly produce such records to [Agency] on request, or such longer period as required under other law or this part.

§ ____.6 Other permitted proprietary trading activities.

(a) *Permitted trading in domestic government obligations.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale by a banking entity of a financial instrument that is:

(1) An obligation of, or issued or guaranteed by, the United States;

(2) An obligation, participation, or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*);

(3) An obligation of any State or any political subdivision thereof, including any municipal security; or

(4) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(b) *Permitted trading in foreign government obligations—(1) Affiliates of foreign banking entities in the United States.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of such foreign sovereign, by a banking entity, so long as:

(i) The banking entity is organized under or is directly or indirectly controlled by a banking entity that is organized under the laws of a foreign sovereign and is not directly or indirectly controlled by a top-tier banking entity that is organized under the laws of the United States;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign banking entity referred to in paragraph (b)(1)(i) of this section is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The purchase or sale as principal is not made by an insured depository institution.

(2) *Foreign affiliates of a U.S. banking entity.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign, by a foreign entity that is owned or controlled by a banking entity organized or established under the laws of the United States or any State, so long as:

(i) The foreign entity is a foreign bank, as defined in section 211.2(j) of the Board's Regulation K (12 CFR 211.2(j)), or is regulated by the foreign sovereign as a securities dealer;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign entity is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The financial instrument is owned by the foreign entity and is not financed by an affiliate that is located in the United States or organized under the laws of the United States or of any State.

(c) *Permitted trading on behalf of customers*—(1) *Fiduciary transactions.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as trustee or in a similar fiduciary capacity, so long as:

(i) The transaction is conducted for the account of, or on behalf of, a customer; and

(ii) The banking entity does not have or retain beneficial ownership of the financial instruments.

(2) *Riskless principal transactions.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.

(d) *Permitted trading by a regulated insurance company.* The prohibition contained in § ____.3(a) does not apply to the purchase or sale of financial instruments by a banking entity that is

an insurance company or an affiliate of an insurance company if:

(1) The insurance company or its affiliate purchases or sells the financial instruments solely for:

(i) The general account of the insurance company; or

(ii) A separate account established by the insurance company;

(2) The purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (d)(2) of this section is insufficient to protect the safety and soundness of the covered banking entity, or the financial stability of the United States.

(e) *Permitted trading activities of foreign banking entities.* (1) The prohibition contained in § ____.3(a) does not apply to the purchase or sale of financial instruments by a banking entity if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any State;

(ii) The purchase or sale by the banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; and

(iii) The purchase or sale meets the requirements of paragraph (e)(3) of this section.

(2) A purchase or sale of financial instruments by a banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (e)(1)(ii) of this section only if:

(i) The purchase or sale is conducted in accordance with the requirements of paragraph (e) of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) A purchase or sale by a banking entity is permitted for purposes of this paragraph (e) if:

(i) The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;

(iii) The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;

(iv) No financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(v) The purchase or sale is not conducted with or through any U.S. entity, other than:

(A) A purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale;

(B) A purchase or sale with an unaffiliated market intermediary acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

(C) A purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

(4) For purposes of this paragraph (e), a U.S. entity is any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this paragraph (e), a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(6) For purposes of this paragraph (e), *unaffiliated market intermediary* means an unaffiliated entity, acting as an intermediary, that is:

(i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such;

(ii) A swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such;

(iii) A security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or

(iv) A futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.

§ ____.7 Limitations on permitted proprietary trading activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ ____.4 through ____.6 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section,

a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§ ____.8 [Reserved]

§ ____.9 [Reserved]

Subpart C—Covered Funds Activities and Investments

§ ____.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

(a) *Prohibition.* (1) Except as otherwise provided in this subpart, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.

(2) Paragraph (a)(1) of this section does not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

(i) Acting solely as agent, broker, or custodian, so long as;

(A) The activity is conducted for the account of, or on behalf of, a customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest;

(ii) Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity (or an affiliate thereof);

(iii) In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such ownership interest for longer than such period permitted by the [Agency]; or

(iv) On behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as:

(A) The activity is conducted for the account of, or on behalf of, the customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

(b) *Definition of covered fund.* (1) Except as provided in paragraph (c) of this section, covered fund means:

(i) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), *but for* section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(1) or (7));

(ii) Any commodity pool under section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10)) for which:

(A) The commodity pool operator has claimed an exemption under 17 CFR 4.7; or

(B)(*1*) A commodity pool operator is registered with the CFTC as a commodity pool operator in connection with the operation of the commodity pool;

(*2*) Substantially all participation units of the commodity pool are owned by qualified eligible persons under 17 CFR 4.7(a)(2) and (3); and

(*3*) Participation units of the commodity pool have not been publicly offered to persons who are not qualified eligible persons under 17 CFR 4.7(a)(2) and (3); or

(iii) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, an entity that:

(A) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(B) Is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and

(C)(*1*) Has as its sponsor that banking entity (or an affiliate thereof); or

(*2*) Has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

(2) An issuer shall not be deemed to be a covered fund under paragraph (b)(1)(iii) of this section if, were the issuer subject to U.S. securities laws, the issuer could rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act.

(3) For purposes of paragraph (b)(1)(iii) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(c) Notwithstanding paragraph (b) of this section, unless the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine otherwise, a covered fund does not include:

(1) *Foreign public funds.* (i) Subject to paragraphs (ii) and (iii) below, an issuer that:

(A) Is organized or established outside of the United States;

(B) Is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and

(C) Sells ownership interests predominantly through one or more public offerings outside of the United States.

(ii) With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer unless ownership interests in the issuer are sold predominantly to persons other than:

(A) Such sponsoring banking entity;

(B) Such issuer;

(C) Affiliates of such sponsoring banking entity or such issuer; and

(D) Directors and employees of such entities.

(iii) For purposes of paragraph (c)(1)(i)(C) of this section, the term ''public offering'' means a distribution (as defined in § ____.4(a)(3) of subpart B) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

(A) The distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;

(B) The distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and

(C) The issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

(2) *Wholly-owned subsidiaries.* An entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that:

(i) Up to five percent of the entity's outstanding ownership interests, less any amounts outstanding under paragraph (c)(2)(ii) of this section, may be held by employees or directors of the banking entity or such affiliate (including former employees or directors if their ownership interest was acquired while employed by or in the service of the banking entity); and

(ii) Up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is acquired or retained by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

(3) *Joint ventures.* A joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons, provided that the joint venture:

(i) Is comprised of no more than 10 unaffiliated co-venturers;

(ii) Is in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and

(iii) Is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

(4) *Acquisition vehicles.* An issuer:

(i) Formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction; and

(ii) That exists only for such period as necessary to effectuate the transaction.

(5) *Foreign pension or retirement funds.* A plan, fund, or program providing pension, retirement, or similar benefits that is:

(i) Organized and administered outside the United States;

(ii) A broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and

(iii) Established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision thereof.

(6) *Insurance company separate accounts.* A separate account, provided that no banking entity other than the insurance company participates in the account's profits and losses.

(7) *Bank owned life insurance.* A separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities is beneficiary, provided that no banking entity that purchases the policy:

(i) Controls the investment decisions regarding the underlying assets or holdings of the separate account; or

(ii) Participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.

(8) *Loan securitizations.* (i) *Scope.* An issuing entity for asset-backed securities that satisfies all the conditions of this paragraph (c)(8) and the assets or holdings of which are comprised solely of:

(A) Loans as defined in § ____.2(s) of subpart A;

(B) Rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset meets the requirements of paragraph (c)(8)(iii) of this section;

(C) Interest rate or foreign exchange derivatives that meet the requirements of paragraph (c)(8)(iv) of this section; and

(D) Special units of beneficial interest and collateral certificates that meet the requirements of paragraph (c)(8)(v) of this section.

(ii) *Impermissible assets.* For purposes of this paragraph (c)(8), the assets or holdings of the issuing entity shall not include any of the following:

(A) A security, including an asset-backed security, or an interest in an equity or debt security other than as permitted in paragraph (c)(8)(iii) of this section;

(B) A derivative, other than a derivative that meets the requirements of paragraph (c)(8)(iv) of this section; or

(C) A commodity forward contract.

(iii) *Permitted securities.* Notwithstanding paragraph (c)(8)(ii)(A) of this section, the issuing entity may hold securities if those securities are:

(A) Cash equivalents for purposes of the rights and assets in paragraph (c)(8)(i)(B) of this section; or

(B) Securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities.

(iv) *Derivatives.* The holdings of derivatives by the issuing entity shall be limited to interest rate or foreign exchange derivatives that satisfy all of the following conditions:

(A) The written terms of the derivative directly relate to the loans, the asset-backed securities, or the contractual rights of other assets described in paragraph (c)(8)(i)(B) of this section; and

(B) The derivatives reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or other assets described in paragraph (c)(8)(i)(B) of this section.

(v) *Special units of beneficial interest and collateral certificates.* The assets or holdings of the issuing entity may

include collateral certificates and special units of beneficial interest issued by a special purpose vehicle, provided that:

(A) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate meets the requirements in this paragraph (c)(8);

(B) The special unit of beneficial interest or collateral certificate is used for the sole purpose of transferring to the issuing entity for the loan securitization the economic risks and benefits of the assets that are permissible for loan securitizations under this paragraph (c)(8) and does not directly or indirectly transfer any interest in any other economic or financial exposure;

(C) The special unit of beneficial interest or collateral certificate is created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization; and

(D) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate and the issuing entity are established under the direction of the same entity that initiated the loan securitization.

(9) *Qualifying asset-backed commercial paper conduits.* (i) An issuing entity for asset-backed commercial paper that satisfies all of the following requirements:

(A) The asset-backed commercial paper conduit holds only:

(*1*) Loans and other assets permissible for a loan securitization under paragraph (c)(8)(i) of this section; and

(*2*) Asset-backed securities supported solely by assets that are permissible for loan securitizations under paragraph (c)(8)(i) of this section and acquired by the asset-backed commercial paper conduit as part of an initial issuance either directly from the issuing entity of the asset-backed securities or directly from an underwriter in the distribution of the asset-backed securities;

(B) The asset-backed commercial paper conduit issues only asset-backed securities, comprised of a residual interest and securities with a legal maturity of 397 days or less; and

(C) A regulated liquidity provider has entered into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued by the asset-backed commercial paper conduit (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.

(ii) For purposes of this paragraph (c)(9), a regulated liquidity provider means:

(A) A depository institution, as defined in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c));

(B) A bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)), or a subsidiary thereof;

(C) A savings and loan holding company, as defined in section 10a of the Home Owners' Loan Act (12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)), or a subsidiary thereof;

(D) A foreign bank whose home country supervisor, as defined in § 211.21(q) of the Board's Regulation K (12 CFR 211.21(q)), has adopted capital standards consistent with the Capital Accord for the Basel Committee on banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or

(E) The United States or a foreign sovereign.

(10) *Qualifying covered bonds*—(i) *Scope.* An entity owning or holding a dynamic or fixed pool of loans or other assets as provided in paragraph (c)(8) of this section for the benefit of the holders of covered bonds, provided that the assets in the pool are comprised solely of assets that meet the conditions in paragraph (c)(8)(i) of this section.

(ii) *Covered bond.* For purposes of this paragraph (c)(10), a covered bond means:

(A) A debt obligation issued by an entity that meets the definition of foreign banking organization, the payment obligations of which are fully and unconditionally guaranteed by an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section; or

(B) A debt obligation of an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section, provided that the payment obligations are fully and unconditionally guaranteed by an entity that meets the definition of foreign banking organization and the entity is a wholly-owned subsidiary, as defined in paragraph (c)(2) of this section, of such foreign banking organization.

(11) *SBICs and public welfare investment funds.* An issuer:

(i) That is a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), or that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company, which notice or license has not been revoked; or

(ii) The business of which is to make investments that are:

(A) Designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or

(B) Qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

(12) *Registered investment companies and excluded entities.* An issuer:

(i) That is registered as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), or that is formed and operated pursuant to a written plan to become a registered investment company as described in § ____.20(e)(3) of subpart D and that complies with the requirements of section 18 of the Investment Company Act of 1940 (15 U.S.C. 80a–18);

(ii) That may rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act; or

(iii) That has elected to be regulated as a business development company pursuant to section 54(a) of that Act (15 U.S.C. 80a–53) and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company as described in § ____.20(e)(3) of subpart D and that complies with the requirements of section 61 of the Investment Company Act of 1940 (15 U.S.C. 80a–60).

(13) *Issuers in conjunction with the FDIC's receivership or conservatorship operations.* An issuer that is an entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(14) *Other excluded issuers.* (i) Any issuer that the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent with the purposes of section 13 of the BHC Act.

(ii) A determination made under paragraph (c)(14)(i) of this section will be promptly made public.

(d) *Definition of other terms related to covered funds.* For purposes of this subpart:

(1) *Applicable accounting standards* means U.S. generally accepted accounting principles, or such other accounting standards applicable to a banking entity that the [Agency] determines are appropriate and that the banking entity uses in the ordinary course of its business in preparing its consolidated financial statements.

(2) *Asset-backed security* has the meaning specified in Section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79).

(3) *Director* has the same meaning as provided in section 215.2(d)(1) of the Board's Regulation O (12 CFR 215.2(d)(1)).

(4) *Issuer* has the same meaning as in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(22)).

(5) *Issuing entity* means with respect to asset-backed securities the special purpose vehicle that owns or holds the pool assets underlying asset-backed securities and in whose name the asset-backed securities supported or serviced by the pool assets are issued.

(6) *Ownership interest*—(i) *Ownership interest* means any equity, partnership, or other similar interest. An ''other similar interest'' means an interest that:

(A) Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(B) Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

(C) Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(D) Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(E) Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(F) Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

(G) Any synthetic right to have, receive, or be allocated any of the rights in paragraphs (d)(6)(i)(A) through (F) of this section.

(ii) *Ownership interest* does not include: *Restricted profit interest.* An interest held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as:

(A) The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

(B) All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;

(C) Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits of § ____.12 of this subpart; and

(D) The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.

(7) *Prime brokerage transaction* means any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

(8) *Resident of the United States* means a person that is a ''U.S. person'' as defined in rule 902(k) of the SEC's Regulation S (17 CFR 230.902(k)).

(9) *Sponsor* means, with respect to a covered fund:

(i) To serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund as defined in (b)(1)(ii) of this section;

(ii) In any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or

(iii) To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

(10) *Trustee.* (i) For purposes of paragraph (d)(9) of this section and § ____.11 of subpart C, a trustee does not include:

(A) A trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or

(B) A trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (d)(10)(i)(A) of this section;

(ii) Any entity that directs a person described in paragraph (d)(10)(i) of this section, or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee, shall be considered to be a trustee of such covered fund.

§ ____.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.

(a) *Organizing and offering a covered fund in general.* Notwithstanding § ____ .10(a) of this subpart, a banking entity

is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee, or commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing, only if:

(1) The banking entity (or an affiliate thereof) provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(2) The covered fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;

(3) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § ____.12 of this subpart;

(4) The banking entity and its affiliates comply with the requirements of § ____.14 of this subpart;

(5) The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(6) The covered fund, for corporate, marketing, promotional, or other purposes:

(i) Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and

(ii) Does not use the word ''bank'' in its name;

(7) No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

(8) The banking entity:

(i) Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

(A) That ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate'';

(B) That such investor should read the fund offering documents before investing in the covered fund;

(C) That the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and

(D) The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and

(ii) Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, as provided in section 13(b)(2) of the BHC Act, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.

(b) *Organizing and offering an issuing entity of asset-backed securities.* (1) Notwithstanding § ____.10(a) of this subpart, a banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund that is an issuing entity of asset-backed securities in connection with, directly or indirectly, organizing and offering that issuing entity, so long as the banking entity and its affiliates comply with all of the requirements of paragraph (a)(3) through (8) of this section.

(2) For purposes of this paragraph (b), organizing and offering a covered fund that is an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78*o*–11(a)(3)) of the issuing entity, or acquiring or retaining an ownership interest in the issuing entity as required by section 15G of that Act (15 U.S.C.78*o*–11) and the implementing regulations issued thereunder.

(c) *Underwriting and market making in ownership interests of a covered fund.* The prohibition contained in § ____.10(a) of this subpart does not apply to a banking entity's underwriting activities or market making-related activities involving a covered fund so long as:

(1) Those activities are conducted in accordance with the requirements of § ____.4(a) or § ____.4(b) of subpart B, respectively;

(2) With respect to any banking entity (or any affiliate thereof) that: Acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on paragraph (a) of this section; acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78o–11(a)(3)), or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act (15 U.S.C.78o–11) and the implementing regulations issued thereunder each as permitted by paragraph (b) of this section; or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § ____.12(a)(2)(ii) and § ____.12(d) of this subpart; and

(3) With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § ____.11 of this subpart, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities permitted under this paragraph (c), are included in the calculation of all ownership interests under § ____.12(a)(2)(iii) and § ____.12(d) of this subpart.

§ ____.12 Permitted investment in a covered fund.

(a) *Authority and limitations on permitted investments in covered funds.* (1) Notwithstanding the prohibition contained in § ____.10(a) of this subpart, a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers pursuant to § ____.11, for the purposes of:

(i) *Establishment.* Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to the limits contained in paragraphs (a)(2)(i) and (iii) of this section; or

(ii) *De minimis investment.* Making and retaining an investment in the covered fund subject to the limits contained in paragraphs (a)(2)(ii) and (iii) of this section.

(2) *Investment limits*—(i) *Seeding period.* With respect to an investment in any covered fund made or held pursuant to paragraph (a)(1)(i) of this section, the banking entity and its affiliates:

(A) Must actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund to the amount permitted in paragraph (a)(2)(i)(B) of this section; and

(B) Must, no later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section), conform its ownership interest in the covered fund to the limits in paragraph (a)(2)(ii) of this section;

(ii) *Per-fund limits.* (A) Except as provided in paragraph (a)(2)(ii)(B) of this section, an investment by a banking entity and its affiliates in any covered fund made or held pursuant to paragraph (a)(1)(ii) of this section may not exceed 3 percent of the total number or value of the outstanding ownership interests of the fund.

(B) An investment by a banking entity and its affiliates in a covered fund that is an issuing entity of asset-backed securities may not exceed 3 percent of the total fair market value of the ownership interests of the fund measured in accordance with paragraph (b)(3) of this section, unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act (15 U.S.C. 78*o*–11) and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder.

(iii) *Aggregate limit.* The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this section may not exceed 3 percent of the tier 1 capital of the banking entity, as provided under paragraph (c) of this section, and shall be calculated as of the last day of each calendar quarter.

(iv) *Date of establishment.* For purposes of this section, the date of establishment of a covered fund shall be:

(A) *In general.* The date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund;

(B) *Issuing entities of asset-backed securities.* In the case of an issuing entity of asset-backed securities, the date on which the assets are initially transferred into the issuing entity of asset-backed securities.

(b) *Rules of construction*—(1) *Attribution of ownership interests to a covered banking entity.* (i) For purposes of paragraph (a)(2) of this section, the amount and value of a banking entity's permitted investment in any single covered fund shall include any ownership interest held under § ___.12 directly by the banking entity, including any affiliate of the banking entity.

(ii) *Treatment of registered investment companies, SEC-regulated business development companies and foreign public funds.* For purposes of paragraph (b)(1)(i) of this section, a registered investment company, SEC-regulated business development companies or foreign public fund as described in § ___.10(c)(1) of this subpart will not be considered to be an affiliate of the banking entity so long as the banking entity:

(A) Does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or fund; and

(B) Provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund in compliance with the limitations under applicable regulation, order, or other authority.

(iii) *Covered funds.* For purposes of paragraph (b)(1)(i) of this section, a covered fund will not be considered to be an affiliate of a banking entity so long as the covered fund is held in compliance with the requirements of this subpart.

(iv) *Treatment of employee and director investments financed by the banking entity.* For purposes of paragraph (b)(1)(i) of this section, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.

(2) *Calculation of permitted ownership interests in a single covered fund.* Except as provided in paragraph (b)(3) or (4), for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (a)(2)(ii)(A) of this section:

(i) The aggregate number of the outstanding ownership interests held by the banking entity shall be the total number of ownership interests held under this section by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment);

(ii) The aggregate value of the outstanding ownership interests held by the banking entity shall be the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment). If fair market value cannot be determined, then the value shall be the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;

(iii) For purposes of the calculation under paragraph (b)(2)(ii) of this section, once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.

(3) *Issuing entities of asset-backed securities.* In the case of an ownership interest in an issuing entity of asset-backed securities, for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (a)(2)(ii)(B) of this section:

(i) For securitizations subject to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11), the calculations shall be made as of the date and according to the valuation methodology applicable pursuant to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11) and

the implementing regulations issued thereunder; or

(ii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the calculations shall be made as of the date of establishment as defined in paragraph (a)(2)(iv)(B) of this section or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund, and thereafter only upon the date on which additional securities of the issuing entity of asset-backed securities are priced for purposes of the sales of ownership interests to unaffiliated investors.

(iii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the aggregate value of the outstanding ownership interests in the covered fund shall be the fair market value of the assets transferred to the issuing entity of the securitization and any other assets otherwise held by the issuing entity at such time, determined in a manner that is consistent with its determination of the fair market value of those assets for financial statement purposes.

(iv) For purposes of the calculation under paragraph (b)(3)(iii) of this section, the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all others in the covered fund in the same manner and according to the same standards.

(4) *Multi-tier fund investments*—(i) *Master-feeder fund investments.* If the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the investment limitations in paragraphs (a)(2)(i)(B) and (a)(2)(ii) of this section, the banking entity's permitted investment in such funds shall be measured only by reference to the value of the master fund. The banking entity's permitted investment in the master fund shall include any investment by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund; and

(ii) *Fund-of-funds investments.* If a banking entity organizes and offers a covered fund pursuant to § __.11 of this subpart for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity is permitted to own, then the banking entity's permitted investment in that other fund shall include any investment by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the fund that is held through the fund of funds. The investment of the banking entity may not represent more than 3 percent of the amount or value of any single covered fund.

(c) *Aggregate permitted investments in all covered funds.* (1) For purposes of paragraph (a)(2)(iii) of this section, the aggregate value of all ownership interests held by a banking entity shall be the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ___.10(d)(6)(ii) of this subpart), on a historical cost basis.

(2) *Calculation of tier 1 capital.* For purposes of paragraph (a)(2)(iii) of this section:

(i) *Entities that are required to hold and report tier 1 capital.* If a banking entity is required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be equal to the amount of tier 1 capital of the banking entity as of the last day of the most recent calendar quarter, as reported to its primary financial regulatory agency; and

(ii) If a banking entity is not required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be determined to be equal to:

(A) In the case of a banking entity that is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, be equal to the amount of tier 1 capital reported by such controlling depository institution in the manner described in paragraph (c)(2)(i) of this section;

(B) In the case of a banking entity that is not controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital:

(*1*) *Bank holding company subsidiaries.* If the banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, be equal to the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital in the manner described in paragraph (c)(2)(i) of this section; and

(*2*) *Other holding companies and any subsidiary or affiliate thereof.* If the banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, be equal to the total amount of shareholders' equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.

(iii) *Treatment of foreign banking entities*—(A) *Foreign banking entities.* Except as provided in paragraph (c)(2)(iii)(B) of this section, with respect to a banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the tier 1 capital of the banking entity shall be the consolidated tier 1 capital of the entity as calculated under applicable home country standards.

(B) *U.S. affiliates of foreign banking entities.* With respect to a banking entity that is located or organized under the laws of the United States or of any State and is controlled by a foreign banking entity identified under paragraph (c)(2)(iii)(A) of this section, the banking entity's tier 1 capital shall be as calculated under paragraphs (c)(2)(i) or (ii) of this section.

(d) *Capital treatment for a permitted investment in a covered fund.* For purposes of calculating compliance with the applicable regulatory capital requirements, a banking entity shall deduct from the banking entity's tier 1 capital (as determined under paragraph (c)(2) of this section) the greater of:

(1) The sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ___.10(d)(6)(ii) of subpart C), on a historical cost basis, plus any earnings received; and

(2) The fair market value of the banking entity's ownership interests in the covered fund as determined under paragraph (b)(2)(ii) or (b)(3) of this section (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § ___.10(d)(6)(ii) of subpart C), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.

(e) *Extension of time to divest an ownership interest.* (1) Upon application by a banking entity, the Board may extend the period under paragraph (a)(2)(i) of this section for up to 2 additional years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must:

(i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for application, including information that addresses the factors in paragraph (e)(2) of this section; and

(iii) Explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2) of this section.

(2) *Factors governing Board determinations.* In reviewing any application under paragraph (e)(1) of this section, the Board may consider all the facts and circumstances related to the permitted investment in a covered fund, including:

(i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(ii) The contractual terms governing the banking entity's interest in the covered fund;

(iii) The date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in paragraph (a)(2)(i) of this section;

(iv) The total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States;

(v) The cost to the banking entity of divesting or disposing of the investment within the applicable period;

(vi) Whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty;

(vi) The banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund;

(viii) Market conditions; and

(ix) Any other factor that the Board believes appropriate.

(3) *Authority to impose restrictions on activities or investment during any extension period.* The Board may impose such conditions on any extension approved under paragraph (e)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the BHC Act and this part.

(4) *Consultation.* In the case of a banking entity that is primarily regulated by another Federal banking agency, the SEC, or the CFTC, the Board will consult with such agency prior to acting on an application by the banking entity for an extension under paragraph (e)(1) of this section.

§ __.13 Other permitted covered fund activities and investments.

(a) *Permitted risk-mitigating hedging activities.* (1) The prohibition contained in § ___.10(a) of this subpart does not apply with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund.

(2) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under this paragraph (a) only if:

(i) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(A) Reasonably designed written policies and procedures; and

(B) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(ii) The acquisition or retention of the ownership interest:

(A) Is made in accordance with the written policies, procedures and internal controls required under this section;

(B) At the inception of the hedge, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund;

(C) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section; and

(D) Is subject to continuing review, monitoring and management by the banking entity.

(iii) The compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate has acquired an ownership interest pursuant to this paragraph and such compensation arrangement provides that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement.

(b) *Certain permitted covered fund activities and investments outside of the United States.* (1) The prohibition contained in § __.10(a) of this subpart does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) The activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity or investment occurs solely outside of the United States.

(2) An activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (b)(1)(ii) of this section only if:

(i) The activity or investment is conducted in accordance with the requirements of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of section 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of one or more States and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues

derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States.

(4) An activity or investment occurs solely outside of the United States for purposes of paragraph (b)(1)(iv) of this section only if:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(iv) No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this section, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

(c) *Permitted covered fund interests and activities by a regulated insurance company.* The prohibition contained in § __.10(a) of this subpart does not apply to the acquisition or retention by an insurance company, or an affiliate thereof, of any ownership interest in, or the sponsorship of, a covered fund only if:

(1) The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company;

(2) The acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (c)(2) of this section is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

§ __.14 Limitations on relationships with a covered fund.

(a) *Relationships with a covered fund.* (1) Except as provided for in paragraph (a)(2) of this section, no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund pursuant to § __.11 of this subpart, or that continues to hold an ownership interest in accordance with § __.11(b) of this subpart, and no affiliate of such entity, may enter into a transaction with the covered fund, or with any other covered fund that is controlled by such covered fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.

(2) Notwithstanding paragraph (a)(1) of this section, a banking entity may:

(i) Acquire and retain any ownership interest in a covered fund in accordance with the requirements of § __.11, § __.12, or § __.13 of this subpart; and

(ii) Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate thereof) has taken an ownership interest, if:

(A) The banking entity is in compliance with each of the limitations set forth in § __.11 of this subpart with respect to a covered fund organized and offered by such banking entity (or an affiliate thereof);

(B) The chief executive officer (or equivalent officer) of the banking entity certifies in writing annually to [Agency] (with a duty to update the certification if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; and

(C) The Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

(b) *Restrictions on transactions with covered funds.* A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to § __.11 of this subpart, or that continues to hold an ownership interest in accordance with § __.11(b) of this subpart, shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1), as if such banking entity were a member bank and such covered fund were an affiliate thereof.

(c) *Restrictions on prime brokerage transactions.* A prime brokerage transaction permitted under paragraph (a)(2)(ii) of this section shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1) as if the counterparty were an affiliate of the banking entity.

§ __.15 Other limitations on permitted covered fund activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ __.11 through __.13 of this subpart if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section, a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with

respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§ ____.16 [Reserved]

§ ____.17 [Reserved]

§ ____.18 [Reserved]

§ ____.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

§ ____.20 Program for compliance; reporting

(a) *Program requirement.* Each banking entity shall develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part. The terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity.

(b) *Contents of compliance program.* Except as provided in paragraph (f) of this section, the compliance program required by paragraph (a) of this section, at a minimum, shall include:

(1) Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities subject to subpart B (including those permitted under §§ ____.3 to ____.6 of subpart B), including setting, monitoring and managing required limits set out in § ____4 and § ____5, and activities and investments with respect to a covered fund subject to subpart C (including those permitted under §§ ____.11 through ____.14 of subpart C) conducted by the banking entity to ensure that all activities and investments conducted by the banking entity that are subject to section 13 of the BHC Act and this part comply with section 13 of the BHC Act and this part;

(2) A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and this part and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;

(3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention;

(4) Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a banking entity must promptly provide to [Agency] upon request and retain for a period of no less than 5 years or such longer period as required by [Agency].

(c) *Additional standards.* In addition to the requirements in paragraph (b) of this section, the compliance program of a banking entity must satisfy the requirements and other standards contained in Appendix B, if:

(1) The banking entity engages in proprietary trading permitted under subpart B and is required to comply with the reporting requirements of paragraph (d) of this section;

(2) The banking entity has reported total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States); or

(3) [Agency] notifies the banking entity in writing that it must satisfy the requirements and other standards contained in Appendix B to this part.

(d) *Reporting requirements under Appendix A to this part.* (1) A banking entity engaged in proprietary trading activity permitted under subpart B shall comply with the reporting requirements described in Appendix A, if:

(i) The banking entity (other than a foreign banking entity as provided in paragraph (d)(1)(ii) of this section) has, together with its affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section;

(ii) In the case of a foreign banking entity, the average gross sum of the trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity

operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section; or

(iii) [Agency] notifies the banking entity in writing that it must satisfy the reporting requirements contained in Appendix A.

(2) The threshold for reporting under paragraph (d)(1) of this section shall be $50 billion beginning on June 30, 2014; $25 billion beginning on April 30, 2016; and $10 billion beginning on December 31, 2016.

(3) Frequency of reporting: Unless [Agency] notifies the banking entity in writing that it must report on a different basis, a banking entity with $50 billion or more in trading assets and liabilities (as calculated in accordance with paragraph (d)(1) of this section) shall report the information required by Appendix A for each calendar month within 30 days of the end of the relevant calendar month; beginning with information for the month of January 2015, such information shall be reported within 10 days of the end of each calendar month. Any other banking entity subject to Appendix A shall report the information required by Appendix A for each calendar quarter within 30 days of the end of that calendar quarter unless [Agency] notifies the banking entity in writing that it must report on a different basis.

(e) *Additional documentation for covered funds.* Any banking entity that has more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years shall maintain records that include:

(1) Documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund is not a covered fund;

(2) For each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided by §§ ____.10(c)(1), ____.10(c)(5), ____.10(c)(8), ____.10(c)(9), or ____.10(c)(10) of subpart C, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions;

(3) For each seeding vehicle described in § ____.10(c)(12)(i) or (iii) of subpart C that will become a registered investment company or SEC-regulated business development company, a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § ____.12(a)(2)(i)(B) of subpart C;

(4) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interests in foreign public funds that are described in § ____.10(c)(1) of subpart C owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, documentation of the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized, calculated as of the end of each calendar quarter, which documentation must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters; and

(5) For purposes of paragraph (e)(4) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(f) *Simplified programs for less active banking entities*—(1) *Banking entities with no covered activities.* A banking entity that does not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § ____.6(a) of subpart B) may satisfy the requirements of this section by establishing the required compliance program prior to becoming engaged in such activities or making such investments (other than trading activities permitted pursuant to § ____.6(a) of subpart B).

(2) *Banking entities with modest activities.* A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted under § ____.6(a) of subpart B) may satisfy the requirements of this section by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 of the BHC Act and this part and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

§ ____.21 Termination of activities or investments; penalties for violations.

(a) Any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or this part, or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or this part, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or this part, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment.

(b) Whenever [Agency] finds reasonable cause to believe any banking entity has engaged in an activity or made an investment in violation of section 13 of the BHC Act or this part, or engaged in any activity or made any investment that functions as an evasion of the requirements of section 13 of the BHC Act or this part, [Agency] may take any action permitted by law to enforce compliance with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.

Appendix A to Part ____—Reporting and Recordkeeping Requirements for Covered Trading Activities

I. Purpose

a. This appendix sets forth reporting and recordkeeping requirements that certain banking entities must satisfy in connection with the restrictions on proprietary trading set forth in subpart B (''proprietary trading restrictions''). Pursuant to § ____.20(d), this appendix generally applies to a banking entity that, together with its affiliates and subsidiaries, has significant trading assets and liabilities. These entities are required to

(i) furnish periodic reports to [Agency] regarding a variety of quantitative measurements of their covered trading activities, which vary depending on the scope and size of covered trading activities, and (ii) create and maintain records documenting the preparation and content of these reports. The requirements of this appendix must be incorporated into the banking entity's internal compliance program under § ____.20 and Appendix B.

b. The purpose of this appendix is to assist banking entities and [Agency] in:

(i) Better understanding and evaluating the scope, type, and profile of the banking entity's covered trading activities;

(ii) Monitoring the banking entity's covered trading activities;

(iii) Identifying covered trading activities that warrant further review or examination by the banking entity to verify compliance with the proprietary trading restrictions;

(iv) Evaluating whether the covered trading activities of trading desks engaged in market making-related activities subject to § ____.4(b) are consistent with the requirements governing permitted market making-related activities;

(v) Evaluating whether the covered trading activities of trading desks that are engaged in permitted trading activity subject to §§ ____.4, ____.5, or ____.6(a)-(b) (i.e., underwriting and market making-related related activity, risk-mitigating hedging, or trading in certain government obligations) are consistent with the requirement that such activity not result, directly or indirectly, in a material exposure to high-risk assets or high-risk trading strategies;

(vi) Identifying the profile of particular covered trading activities of the banking entity, and the individual trading desks of the banking entity, to help establish the appropriate frequency and scope of examination by [Agency] of such activities; and

(vii) Assessing and addressing the risks associated with the banking entity's covered trading activities.

c. The quantitative measurements that must be furnished pursuant to this appendix are *not* intended to serve as a dispositive tool for the identification of permissible or impermissible activities.

d. In order to allow banking entities and the Agencies to evaluate the effectiveness of these metrics, banking entities must collect and report these metrics for all trading desks beginning on the dates established in § ____.20 of the final rule. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

e. In addition to the quantitative measurements required in this appendix, a banking entity may need to develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and this part and to have an effective compliance program, as required by § ____.20 and Appendix B to this part. The effectiveness of particular quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading desk, including types of instruments traded, trading activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure that the activities are within risk tolerances established by the banking entity, and to monitor and examine for compliance with the proprietary trading restrictions in this part.

f. On an ongoing basis, banking entities must carefully monitor, review, and evaluate all furnished quantitative measurements, as well as any others that they choose to utilize in order to maintain compliance with section 13 of the BHC Act and this part. All measurement results that indicate a heightened risk of impermissible proprietary trading, including with respect to otherwise-permitted activities under §§ ____.4 through ____.6(a) and (b), or that result in a material exposure to high-risk assets or high-risk trading strategies, must be escalated within the banking entity for review, further analysis, explanation to [Agency], and remediation, where appropriate. The quantitative measurements discussed in this appendix should be helpful to banking entities in identifying and managing the risks related to their covered trading activities.

II. Definitions

The terms used in this appendix have the same meanings as set forth in §§ ____.2 and ____.3. In addition, for purposes of this appendix, the following definitions apply:

Calculation period means the period of time for which a particular quantitative measurement must be calculated.

Comprehensive profit and loss means the net profit or loss of a trading desk's material sources of trading revenue over a specific period of time, including, for example, any increase or decrease in the market value of a trading desk's holdings, dividend income, and interest income and expense.

Covered trading activity means trading conducted by a trading desk under §§ ____.4, ____.5, ____.6(a), or ____.6(b). A banking entity may include trading under §§ ____.3(d), ____.6(c), ____.6(d) or ____.6(e).

Measurement frequency means the frequency with which a particular quantitative metric must be calculated and recorded.

Trading desk means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

III. Reporting and Recordkeeping of Quantitative Measurements

a. Scope of Required Reporting

General scope. Each banking entity made subject to this part by § ____.20 must furnish the following quantitative measurements for each trading desk of the banking entity, calculated in accordance with this appendix:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer-Facing Trade Ratio

b. Frequency of Required Calculation and Reporting

A banking entity must calculate any applicable quantitative measurement for each trading day. A banking entity must report each applicable quantitative measurement to [Agency] on the reporting schedule established in § ____.20 unless otherwise requested by [Agency]. All quantitative measurements for any calendar month must be reported within the time period required by § ____.20.

c. Recordkeeping

A banking entity must, for any quantitative measurement furnished to [Agency] pursuant to this appendix and § ____.20(d), create and maintain records documenting the preparation and content of these reports, as well as such information as is necessary to permit [Agency] to verify the accuracy of such reports, for a period of 5 years from the end of the calendar year for which the measurement was taken.

IV. Quantitative Measurements

a. Risk-Management Measurements

1. Risk and Position Limits and Usage

i. *Description:* For purposes of this appendix, Risk and Position Limits are the constraints that define the amount of risk that a trading desk is permitted to take at a point in time, as defined by the banking entity for a specific trading desk. Usage represents the portion of the trading desk's limits that are accounted for by the current activity of the desk. Risk and position limits and their usage are key risk management tools used to control and monitor risk taking and include, but are not limited, to the limits set out in § ____.4 and § ____.5. A number of the metrics that are described below, including ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk,'' relate to a trading desk's risk and position limits and are useful in evaluating and setting these limits in the broader context of the trading desk's overall activities, particularly for the market making activities under § ____.4(b) and hedging activity under § ____.5. Accordingly, the limits required under § ____.4(b)(2)(iii) and § ____.5(b)(1)(i) must meet the applicable requirements under § ____.4(b)(2)(iii) and § ____.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.

ii. *General Calculation Guidance:* Risk and Position Limits must be reported in the format used by the banking entity for the purposes of risk management of each trading

desk. Risk and Position Limits are often expressed in terms of risk measures, such as VaR and Risk Factor Sensitivities, but may also be expressed in terms of other observable criteria, such as net open positions. When criteria other than VaR or Risk Factor Sensitivities are used to define the Risk and Position Limits, both the value of the Risk and Position Limits and the value of the variables used to assess whether these limits have been reached must be reported.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

2. Risk Factor Sensitivities

i. *Description:* For purposes of this appendix, Risk Factor Sensitivities are changes in a trading desk's Comprehensive Profit and Loss that are expected to occur in the event of a change in one or more underlying variables that are significant sources of the trading desk's profitability and risk.

ii. *General Calculation Guidance:* A banking entity must report the Risk Factor Sensitivities that are monitored and managed as part of the trading desk's overall risk management policy. The underlying data and methods used to compute a trading desk's Risk Factor Sensitivities will depend on the specific function of the trading desk and the internal risk management models employed. The number and type of Risk Factor Sensitivities that are monitored and managed by a trading desk, and furnished to [Agency], will depend on the explicit risks assumed by the trading desk. In general, however, reported Risk Factor Sensitivities must be sufficiently granular to account for a preponderance of the expected price variation in the trading desk's holdings.

A. Trading desks must take into account any relevant factors in calculating Risk Factor Sensitivities, including, for example, the following with respect to particular asset classes:

• *Commodity derivative positions:* risk factors with respect to the related commodities set out in 17 CFR 20.2, the maturity of the positions, volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;

• *Credit positions:* risk factors with respect to credit spreads that are sufficiently granular to account for specific credit sectors and market segments, the maturity profile of the positions, and risk factors with respect to interest rates of all relevant maturities;

• *Credit-related derivative positions:* risk factor sensitivities, for example credit spreads, shifts (parallel and non-parallel) in credit spreads—volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;

• *Equity derivative positions:* risk factor sensitivities such as equity positions, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;

• *Equity positions:* risk factors for equity prices and risk factors that differentiate between important equity market sectors and segments, such as a small capitalization equities and international equities;

• *Foreign exchange derivative positions:* risk factors with respect to major currency pairs and maturities, exposure to interest rates at relevant maturities, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), as well as the maturity profile of the positions; and

• *Interest rate positions, including interest rate derivative positions:* risk factors with respect to major interest rate categories and maturities and volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and shifts (parallel and non-parallel) in the interest rate curve, as well as the maturity profile of the positions.

B. The methods used by a banking entity to calculate sensitivities to a common factor shared by multiple trading desks, such as an equity price factor, must be applied consistently across its trading desks so that the sensitivities can be compared from one trading desk to another.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Value-at-Risk and Stress Value-at-Risk

i. *Description:* For purposes of this appendix, Value-at-Risk (''VaR'') is the commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on current market conditions. For purposes of this appendix, Stress Value-at-Risk (''Stress VaR'') is the percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on market conditions during a period of significant financial stress.

ii. *General Calculation Guidance:* Banking entities must compute and report VaR and Stress VaR by employing generally accepted standards and methods of calculation. VaR should reflect a loss in a trading desk that is expected to be exceeded less than one percent of the time over a one-day period. For those banking entities that are subject to regulatory capital requirements imposed by a Federal banking agency, VaR and Stress VaR must be computed and reported in a manner that is consistent with such regulatory capital requirements. In cases where a trading desk does not have a standalone VaR or Stress VaR calculation but is part of a larger aggregation of positions for which a VaR or Stress VaR calculation is performed, a VaR or Stress VaR calculation that includes only the trading desk's holdings must be performed consistent with the VaR or Stress VaR model and methodology used for the larger aggregation of positions.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

b. Source-of-Revenue Measurements

1. Comprehensive Profit and Loss Attribution

i. *Description:* For purposes of this appendix, Comprehensive Profit and Loss Attribution is an analysis that attributes the daily fluctuation in the value of a trading desk's positions to various sources. First, the daily profit and loss of the aggregated positions is divided into three categories: (i) profit and loss attributable to a trading desk's existing positions that were also positions held by the trading desk as of the end of the prior day (''existing positions''); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions. The sum of (i), (ii), and (iii) must equal the trading desk's comprehensive profit and loss at each point in time. In addition, profit and loss measurements must calculate volatility of comprehensive profit and loss (i.e., the standard deviation of the trading desk's one-day profit and loss, in dollar terms) for the reporting period for at least a 30-, 60- and 90-day lag period, from the end of the reporting period, and any other period that the banking entity deems necessary to meet the requirements of the rule.

A. The comprehensive profit and loss associated with existing positions must reflect changes in the value of these positions on the applicable day. The comprehensive profit and loss from existing positions must be further attributed, as applicable, to changes in (i) the specific Risk Factors and other factors that are monitored and managed as part of the trading desk's overall risk management policies and procedures; and (ii) any other applicable elements, such as cash flows, carry, changes in reserves, and the correction, cancellation, or exercise of a trade.

B. The comprehensive profit and loss attributed to new positions must reflect commissions and fee income or expense and market gains or losses associated with transactions executed on the applicable day. New positions include purchases and sales of financial instruments and other assets/liabilities and negotiated amendments to existing positions. The comprehensive profit and loss from new positions may be reported in the aggregate and does not need to be further attributed to specific sources.

C. The portion of comprehensive profit and loss that cannot be specifically attributed to known sources must be allocated to a residual category identified as an unexplained portion of the comprehensive profit and loss. Significant unexplained profit and loss must be escalated for further investigation and analysis.

ii. *General Calculation Guidance:* The specific categories used by a trading desk in the attribution analysis and amount of detail for the analysis should be tailored to the type and amount of trading activities undertaken by the trading desk. The new position attribution must be computed by calculating the difference between the prices at which instruments were bought and/or sold and the prices at which those instruments are marked to market at the close of business on that day multiplied by the notional or principal amount of each purchase or sale. Any fees, commissions, or other payments received (paid) that are associated with transactions executed on that day must be added (subtracted) from such difference. These factors must be measured consistently over time to facilitate historical comparisons.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

c. Customer-Facing Activity Measurements

1. Inventory Turnover

i. *Description:* For purposes of this appendix, Inventory Turnover is a ratio that measures the turnover of a trading desk's inventory. The numerator of the ratio is the absolute value of all transactions over the reporting period. The denominator of the ratio is the value of the trading desk's inventory at the beginning of the reporting period.

ii. *General Calculation Guidance:* For purposes of this appendix, for derivatives, other than options and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

2. Inventory Aging

i. *Description:* For purposes of this appendix, Inventory Aging generally describes a schedule of the trading desk's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held. Inventory Aging should measure the age profile of the trading desk's assets and liabilities.

ii. *General Calculation Guidance:* In general, Inventory Aging must be computed using a trading desk's trading activity data and must identify the value of a trading desk's aggregate assets and liabilities. Inventory Aging must include two schedules, an asset-aging schedule and a liability-aging schedule. Each schedule must record the value of assets or liabilities held over all holding periods. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value and, for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Customer-Facing Trade Ratio—Trade Count Based and Value Based

i. *Description:* For purposes of this appendix, the Customer-Facing Trade Ratio is a ratio comparing (i) the transactions involving a counterparty that is a customer of the trading desk to (ii) the transactions involving a counterparty that is not a customer of the trading desk. A trade count based ratio must be computed that records the number of transactions involving a counterparty that is a customer of the trading desk and the number of transactions involving a counterparty that is not a customer of the trading desk. A value based ratio must be computed that records the value of transactions involving a counterparty that is a customer of the trading desk and the value of transactions involving a counterparty that is not a customer of the trading desk.

ii. *General Calculation Guidance:* For purposes of calculating the Customer-Facing Trade Ratio, a counterparty is considered to be a customer of the trading desk if the counterparty is a market participant that makes use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services. However, a trading desk or other organizational unit of another banking entity would not be a client, customer, or counterparty of the trading desk if the other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § ____.20(d)(1) unless the trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk. Transactions conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants would be considered transactions with customers of the trading desk. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

Appendix B to Part ____—Enhanced Minimum Standards for Compliance Programs

I. Overview

Section ____.20(c) requires certain banking entities to establish, maintain, and enforce an enhanced compliance program that includes the requirements and standards in this Appendix as well as the minimum written policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping provisions outlined in § ____.20. This Appendix sets forth additional minimum standards with respect to the establishment, oversight, maintenance, and enforcement by these banking entities of an enhanced internal compliance program for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part.

a. This compliance program must:

1. Be reasonably designed to identify, document, monitor, and report the permitted trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and this part;

2. Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and this part;

3. Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;

4. Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and chief executive officer (or equivalent) of the banking entity review the effectiveness of the compliance program; and

5. Facilitate supervision and examination by the Agencies of the banking entity's permitted trading and covered fund activities and investments.

II. Enhanced Compliance Program

a. *Proprietary Trading Activities.* A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities. The compliance program may be tailored to the types of trading activities conducted by the banking entity, and must include a detailed description of controls established by the banking entity to reasonably ensure that its trading activities are conducted in accordance with the requirements and limitations applicable to those trading activities under section 13 of the BHC Act and this part, and provide for appropriate revision of the compliance program before expansion of the trading activities of the banking entity. A banking entity must devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its trading activities, and promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program, and changes in legal, regulatory or other requirements.

1. *Trading Desks:* The banking entity must have written policies and procedures governing each trading desk that include a description of:

i. The process for identifying, authorizing and documenting financial instruments each trading desk may purchase or sell, with separate documentation for market making-related activities conducted in reliance on § ____.4(b) and for hedging activity conducted in reliance on § ____.5;

ii. A mapping for each trading desk to the division, business line, or other organizational structure that is responsible for managing and overseeing the trading desk's activities;

iii. The mission (*i.e.,* the type of trading activity, such as market-making, trading in sovereign debt, etc.) and strategy (*i.e.,* methods for conducting authorized trading activities) of each trading desk;

iv. The activities that the trading desk is authorized to conduct, including (i) authorized instruments and products, and (ii) authorized hedging strategies, techniques and instruments;

v. The types and amount of risks allocated by the banking entity to each trading desk to

implement the mission and strategy of the trading desk, including an enumeration of material risks resulting from the activities in which the trading desk is authorized to engage (including but not limited to price risks, such as basis, volatility and correlation risks, as well as counterparty credit risk). Risk assessments must take into account both the risks inherent in the trading activity and the strength and effectiveness of controls designed to mitigate those risks;

vi. How the risks allocated to each trading desk will be measured;

vii. Why the allocated risks levels are appropriate to the activities authorized for the trading desk;

viii. The limits on the holding period of, and the risk associated with, financial instruments under the responsibility of the trading desk;

ix. The process for setting new or revised limits, as well as escalation procedures for granting exceptions to any limits or to any policies or procedures governing the desk, the analysis that will be required to support revising limits or granting exceptions, and the process for independently reviewing and documenting those exceptions and the underlying analysis;

x. The process for identifying, documenting and approving new products, trading strategies, and hedging strategies;

xi. The types of clients, customers, and counterparties with whom the trading desk may trade; and

xii. The compensation arrangements, including incentive arrangements, for employees associated with the trading desk, which may not be designed to reward or incentivize prohibited proprietary trading or excessive or imprudent risk-taking.

2. *Description of risks and risk management processes:* The compliance program for the banking entity must include a comprehensive description of the risk management program for the trading activity of the banking entity. The compliance program must also include a description of the governance, approval, reporting, escalation, review and other processes the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and this part. Trading activity in similar financial instruments should be subject to similar governance, limits, testing, controls, and review, unless the banking entity specifically determines to establish different limits or processes and documents those differences. Descriptions must include, at a minimum, the following elements:

i. A description of the supervisory and risk management structure governing all trading activity, including a description of processes for initial and senior-level review of new products and new strategies;

ii. A description of the process for developing, documenting, testing, approving and reviewing all models used for valuing, identifying and monitoring the risks of trading activity and related positions, including the process for periodic independent testing of the reliability and accuracy of those models;

iii. A description of the process for developing, documenting, testing, approving and reviewing the limits established for each trading desk;

iv. A description of the process by which a security may be purchased or sold pursuant to the liquidity management plan, including the process for authorizing and monitoring such activity to ensure compliance with the banking entity's liquidity management plan and the restrictions on liquidity management activities in this part;

v. A description of the management review process, including escalation procedures, for approving any temporary exceptions or permanent adjustments to limits on the activities, positions, strategies, or risks associated with each trading desk; and

vi. The role of the audit, compliance, risk management and other relevant units for conducting independent testing of trading and hedging activities, techniques and strategies.

3. Authorized risks, instruments, and products. The banking entity must implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and this part and with the banking entity's written policies and procedures. The banking entity must establish and enforce risk limits appropriate for the activity of each trading desk. These limits should be based on probabilistic and non-probabilistic measures of potential loss (*e.g.,* Value-at-Risk and notional exposure, respectively), and measured under normal and stress market conditions. At a minimum, these internal controls must monitor, establish and enforce limits on:

i. The financial instruments (including, at a minimum, by type and exposure) that the trading desk may trade;

ii. The types and levels of risks that may be taken by each trading desk; and

iii. The types of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged.

4. Hedging policies and procedures. The banking entity must establish, maintain, and enforce written policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that, at a minimum, describe:

i. The positions, techniques and strategies that each trading desk may use to hedge the risk of its positions;

ii. The manner in which the banking entity will identify the risks arising in connection with and related to the individual or aggregated positions, contracts or other holdings of the banking entity that are to be hedged and determine that those risks have been properly and effectively hedged;

iii. The level of the organization at which hedging activity and management will occur;

iv. The manner in which hedging strategies will be monitored and the personnel responsible for such monitoring;

v. The risk management processes used to control unhedged or residual risks; and

vi. The process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § ____.5.

5. Analysis and quantitative measurements. The banking entity must perform robust analysis and quantitative measurement of its trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. Analysis and models used to determine, measure and limit risk must be rigorously tested and be reviewed by management responsible for trading activity to ensure that trading activities, limits, strategies, and hedging activities do not understate the risk and exposure to the banking entity or allow prohibited proprietary trading. This review should include periodic and independent back-testing and revision of activities, limits, strategies and hedging as appropriate to contain risk and ensure compliance. In addition to the quantitative measurements reported by any banking entity subject to Appendix A to this part, each banking entity must develop and implement, to the extent appropriate to facilitate compliance with this part, additional quantitative measurements specifically tailored to the particular risks, practices, and strategies of its trading desks. The banking entity's analysis and quantitative measurements must incorporate the quantitative measurements reported by the banking entity pursuant to Appendix A (if applicable) and include, at a minimum, the following:

i. Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;

ii. Ongoing, timely monitoring and review of calculated quantitative measurements;

iii. The establishment of numerical thresholds and appropriate trading measures for each trading desk and heightened review of trading activity not consistent with those thresholds to ensure compliance with section 13 of the BHC Act and this part, including analysis of the measurement results or other information, appropriate escalation procedures, and documentation related to the review; and

iv. Immediate review and compliance investigation of the trading desk's activities, escalation to senior management with oversight responsibilities for the applicable trading desk, timely notification to [Agency], appropriate remedial action (*e.g.,* divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when quantitative measurements or other information, considered together with the facts and circumstances, or findings of internal audit, independent testing or other review suggest a reasonable likelihood that the trading desk has violated any part of section 13 of the BHC Act or this part.

6. Other Compliance Matters. In addition to the requirements specified above, the banking entity's compliance program must:

i. Identify activities of each trading desk that will be conducted in reliance on

exemptions contained in §§ ____.4 through ____.6, including an explanation of:

A. How and where in the organization the activity occurs; and

B. Which exemption is being relied on and how the activity meets the specific requirements for reliance on the applicable exemption;

ii. Include an explanation of the process for documenting, approving and reviewing actions taken pursuant to the liquidity management plan, where in the organization this activity occurs, the securities permissible for liquidity management, the process for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading, and the process for ensuring that securities purchased as part of the liquidity management plan are highly liquid and conform to the requirements of this part;

iii. Describe how the banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by each trading desk that relies on the exemptions contained in §§ ____.3(d)(3), and ____.4 through ____.6, which must take into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in value cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;

iv. Establish responsibility for compliance with the reporting and recordkeeping requirements of subpart B and § ____.20; and

v. Establish policies for monitoring and prohibiting potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties.

7. Remediation of violations. The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any trading activity that may indicate potential violations of section 13 of the BHC Act and this part and to prevent actual violations of section 13 of the BHC Act and this part. The compliance program must describe procedures for identifying and remedying violations of section 13 of the BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

b. *Covered Fund Activities or Investments.* A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

1. Identification of covered funds. The banking entity's compliance program must provide a process, which must include appropriate management review and independent testing, for identifying and documenting covered funds that each unit within the banking entity's organization sponsors or organizes and offers, and covered funds in which each such unit invests. In addition to the documentation requirements for covered funds, as specified under § __ .20(e), the documentation must include information that identifies all pools that the banking entity sponsors or has an interest in and the type of exemption from the Commodity Exchange Act (whether or not the pool relies on section 4.7 of the regulations under the Commodity Exchange Act), and the amount of ownership interest the banking entity has in those pools.

2. Identification of covered fund activities and investments. The banking entity's compliance program must identify, document and map each unit within the organization that is permitted to acquire or hold an interest in any covered fund or sponsor any covered fund and map each unit to the division, business line, or other organizational structure that will be responsible for managing and overseeing that unit's activities and investments.

3. Explanation of compliance. The banking entity's compliance program must explain how:

i. The banking entity monitors for and prohibits potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties related to its covered fund activities and investments;

ii. The banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness of the banking entity related to its covered fund activities and investments; and

iii. The banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by its covered fund activities and investments, taking into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in values cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that expose the banking entity to large and significant concentrations with respect to sectors, risk factors, or counterparties;

4. Description and documentation of covered fund activities and investments. For each organizational unit engaged in covered fund activities and investments, the banking entity's compliance program must document:

i. The covered fund activities and investments that the unit is authorized to conduct;

ii. The banking entity's plan for actively seeking unaffiliated investors to ensure that any investment by the banking entity conforms to the limits contained in § __.12 or registered in compliance with the securities laws and thereby exempt from those limits within the time periods allotted in§ __.12; and

iii. How it complies with the requirements of subpart C.

5. Internal Controls. A banking entity must establish, maintain, and enforce internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and this part and are appropriate given the limits on risk established by the banking entity. These written internal controls must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part. The internal controls must, at a minimum require:

i. Monitoring and limiting the banking entity's individual and aggregate investments in covered funds;

ii. Monitoring the amount and timing of seed capital investments for compliance with the limitations under subpart C (including but not limited to the redemption, sale or disposition requirements) of § __.12, and the effectiveness of efforts to seek unaffiliated investors to ensure compliance with those limits;

iii. Calculating the individual and aggregate levels of ownership interests in one or more covered fund required by § __.12;

iv. Attributing the appropriate instruments to the individual and aggregate ownership interest calculations above;

v. Making disclosures to prospective and actual investors in any covered fund organized and offered or sponsored by the banking entity, as provided under § __.11(a)(8);

vi Monitoring for and preventing any relationship or transaction between the banking entity and a covered fund that is prohibited under § __.14, including where the banking entity has been designated as the sponsor, investment manager, investment

adviser, or commodity trading advisor to a covered fund by another banking entity; and

vii. Appropriate management review and supervision across legal entities of the banking entity to ensure that services and products provided by all affiliated entities comply with the limitation on services and products contained in § __.14.

6. Remediation of violations. The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part and to prevent actual violations of section 13 of the BHC Act and this part. The banking entity's compliance program must describe procedures for identifying and remedying violations of section 13 of the BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, including § __.21, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity or investment indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

III. Responsibility and Accountability for the Compliance Program

a. A banking entity must establish, maintain, and enforce a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and this part. A banking entity must have an appropriate management framework reasonably designed to ensure that: appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program; a clear reporting line with a chain of responsibility is delineated; and the compliance program is reviewed periodically by senior management. The board of directors (or equivalent governance body) and senior management should have the appropriate authority and access to personnel and information within the organizations as well as appropriate resources to conduct their oversight activities effectively.

1. Corporate governance. The banking entity must adopt a written compliance program approved by the board of directors, an appropriate committee of the board, or equivalent governance body, and senior management.

2. Management procedures. The banking entity must establish, maintain, and enforce a governance framework that is reasonably designed to achieve compliance with section 13 of the BHC Act and this part, which, at a minimum, provides for:

i. The designation of appropriate senior management or committee of senior management with authority to carry out the management responsibilities of the banking entity for each trading desk and for each organizational unit engaged in covered fund activities;

ii. Written procedures addressing the management of the activities of the banking entity that are reasonably designed to achieve compliance with section 13 of the BHC Act and this part, including:

A. A description of the management system, including the titles, qualifications, and locations of managers and the specific responsibilities of each person with respect to the banking entity's activities governed by section 13 of the BHC Act and this part; and

B. Procedures for determining compensation arrangements for traders engaged in underwriting or market making-related activities under § __.4 or risk-mitigating hedging activities under § __.5 so that such compensation arrangements are designed not to reward or incentivize prohibited proprietary trading and appropriately balance risk and financial results in a manner that does not encourage employees to expose the banking entity to excessive or imprudent risk.

3. Business line managers. Managers with responsibility for one or more trading desks of the banking entity are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desk(s).

4. Board of directors, or similar corporate body, and senior management. The board of directors, or similar corporate body, and senior management are responsible for setting and communicating an appropriate culture of compliance with section 13 of the BHC Act and this part and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with section 13 of the BHC Act and this part. The board of directors or similar corporate body (such as a designated committee of the board or an equivalent governance body) must ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with this part in light of the organization's business activities and the expectations of the board of directors. The board of directors or similar corporate body must also ensure that senior management has established appropriate incentives and adequate resources to support compliance with this part, including the implementation of a compliance program meeting the requirements of this appendix into management goals and compensation structures across the banking entity.

5. Senior management. Senior management is responsible for implementing and enforcing the approved compliance program. Senior management must also ensure that effective corrective action is taken when failures in compliance with section 13 of the BHC Act and this part are identified. Senior management and control personnel charged with overseeing compliance with section 13 of the BHC Act and this part should review the compliance program for the banking entity periodically and report to the board, or an appropriate committee thereof, on the effectiveness of the compliance program and compliance matters with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading activities and covered fund activities or investments, which shall be at least annually.

6. *CEO attestation.* Based on a review by the CEO of the banking entity, the CEO of the banking entity must, annually, attest in writing to [Agency] that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established under this Appendix and § __.20 of this part in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this part. In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the United States operations of the foreign banking entity who is located in the United States.

IV. Independent Testing

a. Independent testing must occur with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading and covered fund activities or investments, which shall be at least annually. This independent testing must include an evaluation of:

1. The overall adequacy and effectiveness of the banking entity's compliance program, including an analysis of the extent to which the program contains all the required elements of this appendix;

2. The effectiveness of the banking entity's internal controls, including an analysis and documentation of instances in which such internal controls have been breached, and how such breaches were addressed and resolved; and

3. The effectiveness of the banking entity's management procedures.

b. A banking entity must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties. A banking entity must promptly take appropriate action to remedy any significant deficiencies or material weaknesses in its compliance program and to terminate any violations of section 13 of the BHC Act or this part.

V. Training

Banking entities must provide adequate training to personnel and managers of the banking entity engaged in activities or investments governed by section 13 of the BHC Act or this part, as well as other appropriate supervisory, risk, independent testing, and audit personnel, in order to effectively implement and enforce the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking

entity's trading activities and covered fund activities or investments.

VI. Recordkeeping

Banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A banking entity must retain these records for a period that is no less than 5 years or such longer period as required by [Agency] in a form that allows it to promptly produce such records to [Agency] on request.

End of Common Rule

List of Subjects

12 CFR Part 44

Banks, Banking, Capital Compensation, Credit, Derivatives, Government securities, Insurance, Investments, National banks, Federal savings associations, Federal branches and agencies, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Trusts and trustees

12 CFR Part 248

Administrative practice and procedure, Banks and banking, Capital, Compensation, Conflict of interests, Credit, Derivatives, Foreign banking, Government securities, Holding companies, Insurance, Insurance companies, Investments, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Trusts and trustees.

12 CFR Part 351

Banks, Banking, Capital, Compensation, Conflicts of interest, Credit, Derivatives, Government securities, Insurance, Insurance companies, Investments, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, State nonmember banks, State savings associations, Trusts and trustees.

17 CFR Part 255

Banks, Brokers, Dealers, Investment advisers, Recordkeeping, Reporting, Securities.

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

Authority and Issuance

For the reasons stated in the Common Preamble, the Office of the Comptroller of the Currency hereby amends chapter I of Title 12, Code of Federal Regulations as follows:

PART 44—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 1. The authority for part 44 is added to read as follows:

Authority: 7 U.S.C. 27 *et seq.,* 12 U.S.C. 1, 24, 92a, 93a, 161, 1461, 1462a, 1463, 1464, 1467a, 1813(q), 1818, 1851, 3101 3102, 3108, 5412.

■ 2. Part 44 is added as set forth at the end of the Common Preamble.

■ 3. Part 44 is amended by:

■ a. Removing ''[Agency]'' wherever it appears and adding in its place ''the OCC''; and

■ b. Removing ''the [Agency]'' wherever it appears and adding in its place ''the OCC''.

■ 4. Section 44.1 is revised to read as follows:

§ 44.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the OCC under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading and on investments in or relationships with covered funds by certain banking entities, including national banks, Federal branches and agencies of foreign banks, Federal savings associations, and certain subsidiaries thereof. This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and on investments in or relationships with covered funds, and explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to banking entities for which the OCC is authorized to issue regulations under section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)) and take actions under section 13(e) of that Act (12 U.S.C. 1851(e)). These include national banks, Federal branches and Federal agencies of foreign banks, Federal savings associations, Federal savings banks, and any of their respective subsidiaries (except a subsidiary for which there is a different primary financial regulatory agency, as that term is defined in this part).

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the Bank Holding Company Act or this part, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of the Bank Holding Company Act and this part shall apply to the activities and investments of a banking entity identified in paragraph (c) of this section, even if such activities and investments are authorized for the banking entity under other applicable provisions of law.

(e) *Preservation of authority.* Nothing in this part limits in any way the authority of the OCC to impose on a banking entity identified in paragraph (c) of this section additional requirements or restrictions with respect to any activity, investment, or relationship covered under section 13 of the Bank Holding Company Act or this part, or additional penalties for violation of this part provided under any other applicable provision of law.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System is adding the text of the common rule as set forth at the end of the **SUPPLEMENTARY INFORMATION** as Part 248 to 12 CFR Chapter II as follows:

PART 248—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS (Regulation VV)

■ 5. The authority for part 248 is added to read as follows:

Authority: 12 U.S.C. 1851, 12 U.S.C. 221 *et seq.,* 12 U.S.C. 1818, 12 U.S.C. 1841 *et seq.,* and 12 U.S.C. 3103 *et seq.*

■ 6. Part 248 is added as set forth at the end of the Common Preamble.

■ 7. Part 248 is amended by removing ''[Agency]'' wherever it appears and adding in its place ''the Board.''

■ 8. Part 248 is amended by removing ''the [Agency]'' wherever it appears and adding in its place ''the Board.''

■ 9. Section 248.1 is revised to read as follows:

§ 248.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part (Regulation VV) is issued by the Board under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*); and

the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading and on investments in or relationships with covered funds by certain banking entities, including state member banks, bank holding companies, savings and loan holding companies, other companies that control an insured depository institution, foreign banking organizations, and certain subsidiaries thereof. This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and on investments in or relationships with covered funds, and explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to banking entities for which the Board is authorized to issue regulations under section 13(b)(2) of the Bank Holding Company Act (12 U.S.C. 1851(b)(2)) and take actions under section 13(e) of that Act (12 U.S.C. 1851(e)). These include any state bank that is a member of the Federal Reserve System, any company that controls an insured depository institution (including a bank holding company and savings and loan holding company), any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act (12 U.S.C. 3106), and any subsidiary of the foregoing other than a subsidiary for which the OCC, FDIC, CFTC, or SEC is the primary financial regulatory agency (as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5301(12)).

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the BHC Act or this part, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of BHC Act and this part shall apply to the activities of a banking entity, even if such activities are authorized for the banking entity under other applicable provisions of law.

(e) *Preservation of authority.* Nothing in this part limits in any way the authority of the Board to impose on a banking entity identified in paragraph (c) of this section additional requirements or restrictions with respect to any activity, investment, or relationship covered under section 13 of the Bank Holding Company Act or this part, or additional penalties for violation of this part provided under any other applicable provision of law.

FEDERAL DEPOSIT INSURANCE CORPORATION

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation is adding the text of the common rule as set forth at the end of the Supplementary Information as Part 351 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 351—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 10. The authority for part 351 is added to read as follows:

Authority: 12 U.S.C. 1851; 1811 *et seq.;* 3101 *et seq.;* and 5412.

■ 11. Part 351 is added as set forth at the end of the Common Preamble.

■ 12. Part 351 is amended by:

■ a. Removing ''[Agency]'' wherever it appears and adding in its place ''the FDIC;'' and

■ b. Removing ''the [Agency]'' wherever it appears and adding in its place ''the FDIC.''

■ 13. Section 351.1 is revised to read as follows:

§ 351.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the FDIC under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds by certain banking entities, including any insured depository institution as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2)) and certain subsidiaries thereof for which the FDIC is the appropriate Federal banking agency as defined in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)). This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds, and explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to insured depository institutions for which the FDIC is the appropriate Federal banking agency, as defined in section 3(q) of the Federal Deposit Insurance Act, and certain subsidiaries of the foregoing.

(d) *Relationship to other authorities.* Except as otherwise provided in under section 13 of the Bank Holding Company Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of Bank Holding Company Act shall apply to the activities and investments of a banking entity, even if such activities and investments are authorized for a banking entity under other applicable provisions of law.

(e) *Preservation of authority.* Nothing in this part limits in any way the authority of the FDIC to impose on a banking entity identified in paragraph (c) of this section additional requirements or restrictions with respect to any activity, investment, or relationship covered under section 13 of the Bank Holding Company Act or this part, or additional penalties for violation of this part provided under any other applicable provision of law.

SECURITIES AND EXCHANGE COMMISSION

Authority and Issuance

For the reasons stated in the Common Preamble, the Securities and Exchange Commission is adding the text of the common rule as set forth at the end of the Supplementary Information as Part 255 to chapter II of Title 17, Code of Federal Regulations, modified as follows:

PART 255—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 14. The authority for part 255 is added to read as follows:

Authority: 12 U.S.C. 1851.

■ 15. Part 255 is added as set forth at the end of the Common Preamble.

■ 16. Part 255 is amended by:

■ a. Removing ''[Agency]'' wherever it appears and adding in its place ''the SEC;'' and

■ b. Removing ''the [Agency]'' wherever it appears and adding in its place ''the SEC.''

■ 17. Section 255.1 is revised to read as follows:

§ 255.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the SEC under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes

prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds by certain banking entities, including registered broker-dealers, registered investment advisers, and registered security-based swap dealers, among others identified in section 2(12)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5301(12)(B)). This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds, and explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to banking entities for which the SEC is the primary financial regulatory agency, as that term is defined in this part.

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the Bank Holding Company Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of Bank Holding Company Act shall apply to the activities and investments of a banking entity identified in paragraph (c) of this section, even if such activities and investments are authorized for the banking entity under other applicable provisions of law.

(e) *Preservation of authority.* Nothing in this part limits in any way the authority of the SEC to impose on a banking entity identified in paragraph (c) of this section additional requirements or restrictions with respect to any activity, investment, or relationship covered under section 13 of the Bank Holding Company Act or this part, or additional penalties for violation of this part provided under any other applicable provision of law.

Dated: December 10, 2013.

Thomas J. Curry,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, December 23, 2013.

Robert deV. Frierson,

Secretary of the Board.

By order of the Board of Directors.

Dated at Washington, DC this 10th day of December, 2013.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary

By the Securities and Exchange Commission.

Dated: December 10, 2013.

Elizabeth M. Murphy,

Secretary.

[FR Doc. 2013–31511 Filed 1–30–14; 8:45 am]

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Part III

Commodity Futures Trading Commission

17 CFR Part 75

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 75

RIN 3038–AD05

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'' or ''Commission'') is adopting a final rule to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act''), which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the ''Board'') to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund. Section 619 also requires the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission to also issue regulations implementing section 619 and directs the CFTC and those four agencies to consult and coordinate with each other, as appropriate, in developing and issuing the implementing rules, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation. To that end, although the Commission is adopting a final rule that is not a joint rule with the other agencies, the CFTC and the other agencies have worked closely together to develop the same rule text and supplementary information, except for information specific to the CFTC or the other agencies, as applicable. In particular, the CFTC's final rule is numbered as part 75 of the Commission's regulations, the rule text refers to the ''Commission'' instead of the ''[Agency]'' and one section of the regulations addresses authority, purpose, scope, and relationship to other authorities with respect to the Commission. Furthermore, it is noted that the supplementary information generally refers to the ''Agencies'' collectively when referring to deliberations and considerations in developing the final rule by the CFTC together with the other four agencies and references to the ''final rule'' should be deemed to refer to the final rule of the Commission as herein adopted.

DATES: The final rule is effective April 1, 2014.

FOR FURTHER INFORMATION CONTACT: Erik Remmler, Deputy Director, Division of Swap Dealer and Intermediary Oversight (''DSIO''), (202) 418–7630, *eremmler@cftc.gov*; Paul Schlichting, Assistant General Counsel, Office of the General Counsel (''OGC''), (202) 418–5884, *pschlichting@cftc.gov*; Mark Fajfar, Assistant General Counsel, OGC, (202) 418–6636, *mfajfar@cftc.gov*; Michael Barrett, Attorney-Advisor, DSIO, (202) 418–5598, *mbarrett@cftc.gov*; Stephen Kane, Research Economist, Office of the Chief Economist (''OCE''), (202) 418–5911, *skane@cftc.gov*; or Stephanie Lau, Research Economist, OCE, (202) 418–5218, *slau@cftc.gov*; Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW., Washington, DC 20581.

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I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (''BHC Act'') (codified at 12 U.S.C. 1851) that generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (''covered fund''), subject to certain exemptions.[2] New section 13 of the BHC Act also provides that a nonbank financial company designated by the Financial Stability Oversight Council (''FSOC'') for supervision by the Board (while not a banking entity under section 13 of the BHC Act) would be subject to additional capital requirements, quantitative limits, or other restrictions if the company engages in certain proprietary trading or covered fund activities.[3]

Section 13 of the BHC Act generally prohibits banking entities from engaging as principal in proprietary trading for the purpose of selling financial instruments in the near term or otherwise with the intent to resell in order to profit from short-term price movements.[4] Section 13(d)(1) expressly exempts from this prohibition, subject to conditions, certain activities, including:

- Trading in U.S. government, agency and municipal obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activities;
- Trading on behalf of customers;
- Trading for the general account of insurance companies; and
- Foreign trading by non-U.S. banking entities.[5]

Section 13 of the BHC Act also generally prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, a hedge fund or private equity fund. Section 13 contains several exemptions that permit banking entities to make limited investments in hedge funds and private equity funds, subject to a number of restrictions designed to ensure that banking entities do not rescue investors in these funds from loss and are not themselves exposed to significant losses from investments or other relationships with these funds.

Section 13 of the BHC Act does not prohibit a nonbank financial company supervised by the Board from engaging in proprietary trading, or from having the types of ownership interests in or relationships with a covered fund that a banking entity is prohibited or restricted from having under section 13 of the BHC Act. However, section 13 of the BHC Act provides that these activities be subject to additional capital charges, quantitative limits, or other restrictions.[6]

II. Notice of Proposed Rulemaking: Summary of General Comments

Authority for developing and adopting regulations to implement the prohibitions and restrictions of section 13 of the BHC Act is divided among the Board, the Federal Deposit Insurance Corporation (''FDIC''), the Office of the Comptroller of the Currency (''OCC''), the Securities and Exchange Commission (''SEC''), and the Commodity Futures Trading Commission (''CFTC'').[7] As required by

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] *See* 12 U.S.C. 1851.

[3] *See* 12 U.S.C. 1851(a)(2) and (f)(4). The Agencies note that two of the three companies currently designated by FSOC for supervision by the Board are affiliated with insured depository institutions, and are therefore currently banking entities for purposes of section 13 of the BHC Act. The Agencies are continuing to review whether the remaining company engages in any activity subject to section 13 of the BHC Act and what, if any, requirements apply under section 13.

[4] *See* 12 U.S.C. 1851(a)(1)(A) and (B).

[5] *See id.* at 1851(d)(1).

[6] *See* 12 U.S.C. 1851(a)(2) and (d)(4).

[7] *See* 12 U.S.C. 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13's prohibitions and restrictions must be issued by: (i) The appropriate Federal banking agencies (*i.e.,* the Board, the OCC, and the FDIC), jointly, with respect to insured depository institutions; (ii) the Board, with respect to any

section 13(b)(2) of the BHC Act, the Board, OCC, FDIC, and SEC in October 2011 invited the public to comment on proposed rules implementing that section's requirements.[8] The period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012.[9] In January 2012, the CFTC requested comment on a proposal for the same common rule to implement section 13 with respect to those entities for which it is the primary financial regulatory agency and invited public comment on its proposed implementing rule through April 16, 2012.[10] The statute requires the Agencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act.[11]

The proposed rules invited comment on a multi-faceted regulatory framework to implement section 13 consistent with the statutory language. In addition, the Agencies invited comments on the potential economic impacts of the proposed rule and posed a number of questions seeking information on the costs and benefits associated with each aspect of the proposal, as well as on any significant alternatives that would minimize the burdens or amplify the benefits of the proposal in a manner consistent with the statute. The Agencies also encouraged commenters to provide quantitative information and data about the impact of the proposal on entities subject to section 13, as well as on their clients, customers, and counterparties, specific markets or asset classes, and any other entities potentially affected by the proposed rule, including non-financial small and mid-size businesses.

The Agencies received over 18,000 comments addressing a wide variety of aspects of the proposal, including definitions used by the proposal and the exemptions for market making-related activities, risk-mitigating hedging activities, covered fund activities and investments, the use of quantitative metrics, and the reporting proposals. The vast majority of these comments were from individuals using a version of a short form letter to express support for the proposed rule. More than 600 comment letters were unique comment letters, including from members of Congress, domestic and foreign banking entities and other financial services firms, trade groups representing banking, insurance, and the broader financial services industry, U.S. state and foreign governments, consumer and public interest groups, and individuals. To improve understanding of the issues raised by commenters, the Agencies met with a number of these commenters to discuss issues relating to the proposed rule, and summaries of these meetings are available on each of the Agency's public Web sites.[12] The CFTC staff also hosted a public roundtable on the proposed rule.[13] Many of the commenters generally expressed support for the broader goals of the proposed rule. At the same time, many commenters expressed concerns about various aspects of the proposed rule. Many of these commenters requested that one or more aspects of the proposed rule be modified in some manner in order to reflect their viewpoints and to better accommodate the scope of activities that they argued were encompassed within section 13 of the BHC Act. The comments addressed all major sections of the proposed rule.

Section 13 of the BHC Act also required the FSOC to conduct a study (''FSOC study'') and make recommendations to the Agencies by January 21, 2011 on the implementation of section 13 of the BHC Act. The FSOC study was issued on January 18, 2011. The FSOC study included a detailed discussion of key issues related to implementation of section 13 and recommended that the Agencies consider taking a number of specified actions in issuing rules under section 13 of the BHC Act.[14] The FSOC study also recommended that the Agencies adopt a four-part implementation and supervisory framework for identifying and preventing prohibited proprietary trading, which included a programmatic compliance regime requirement for banking entities, analysis and reporting of quantitative metrics by banking entities, supervisory review and oversight by the Agencies, and enforcement procedures for violations.[15] The Agencies carefully considered the FSOC study and its recommendations.

In formulating this final rule, the Agencies carefully reviewed all comments submitted in connection with the rulemaking and considered the suggestions and issues they raise in light of the statutory restrictions and provisions as well as the FSOC study. The Agencies have sought to reasonably respond to all of the significant issues commenters raised. The Agencies believe they have succeeded in doing so notwithstanding the complexities involved. The Agencies also carefully considered different options suggested by commenters in light of potential costs and benefits in order to effectively implement section 13 of the BHC Act. The Agencies made numerous changes to the final rule in response to the issues and information provided by commenters. These modifications to the rule and explanations that address comments are described in more detail in the section-by-section description of the final rule. To enhance uniformity in both rules that implement section 13 and administration of the requirements of that section, the Agencies have been regularly consulting with each other in the development of this final rule.

Some commenters requested that the Agencies repropose the rule and/or delay adoption pending the collection of

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

[8] *See* 76 FR 68846 (Nov. 7, 2011) (''Joint Proposal'').

[9] *See* 77 FR 23 (Jan. 23, 2012) (extending the comment period to February 13, 2012).

[10] *See* 77 FR 8332 (Feb 14, 2012) (''CFTC Proposal'').

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

[12] *See http://www.regulations.gov/#!docketDetail;D=OCC-2011-0014* (OCC); *http://www.federalreserve.gov/newsevents/reform_systemic.htm (Board); http://www.fdic.gov/regulations/laws/federal/2011/11comAD85.html* (FDIC); *http://www.sec.gov/comments/s7-41-11/s74111.shtml* (SEC); and *http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm* (CFTC).

[13] *See* Commodity Futures Trading Commission, CFTC Staff to Host a Public Roundtable to Discuss the Proposed Volcker Rule (May 24, 2012), available at *http://www.cftc.gov/PressRoom/PressReleases/pr6263-12*; transcript available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript053112.pdf.*

[14] *See* Financial Stability Oversight Counsel, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011), available at *http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf.* (''FSOC study''). *See* 12 U.S.C. 1851(b)(1). Prior to publishing its study, FSOC requested public comment on a number of issues to assist in conducting its study. *See* 75 FR 61758 (Oct. 6, 2010). Approximately 8,000 comments were received from the public, including from members of Congress, trade associations, individual banking entities, consumer groups, and individuals.

[15] *See* FSOC study at 5–6.

additional information.[16] As described in part above, the Agencies have provided many and various types of opportunities for commenters to provide input on implementation of section 13 of the BHC Act and have collected substantial information in the process. In addition to the official comment process described above, members of the public submitted comment letters in advance of the official comment period for the proposed rules and met with staff of the Agencies to explain issues of concern; the public also provided substantial comment in response to a request for comment from the FSOC regarding its findings and recommendations for implementing section 13.[17] The Agencies provided a detailed proposal and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. In addition, the Agencies have continued to receive comment letters after the extended comment period deadline, which the Agencies have considered. Thus, the Agencies believe interested parties have had ample opportunity to review the proposed rules, as well as the comments made by others, and to provide views on the proposal, other comment letters, and data to inform our consideration of the final rules.

In addition, the Agencies have been mindful of the importance of providing certainty to banking entities and financial markets and of providing sufficient time for banking entities to understand the requirements of the final rule and to design, test, and implement compliance and reporting systems. The further substantial delay that would necessarily be entailed by reproposing the rule would extend the uncertainty that banking entities would face, which could prove disruptive to banking entities and the financial markets.

The Agencies note, as discussed more fully below, that the final rule incorporates a number of modifications designed to address the issues raised by commenters in a manner consistent with the statute. The preamble below also discusses many of the issues raised by commenters and explains the Agencies' response to those comments.

To achieve the purpose of the statute, without imposing unnecessary costs, the final rule builds on the multi-faceted approach in the proposal, which includes development and implementation of a compliance program at each banking entity engaged in trading activities or that makes investments subject to section 13 of the BHC Act; the collection and evaluation of data regarding these activities as an indicator of areas meriting additional attention by the banking entity and the relevant agency; appropriate limits on trading, hedging, investment and other activities; and supervision by the Agencies. To allow banking entities sufficient time to develop appropriate systems, the Agencies have provided for a phased-in schedule for the collection of data, limited data reporting requirements only to banking entities that engage in significant trading activity, and agreed to review the merits of the data collected and revise the data collection as appropriate over the next 21 months. Importantly, as explained in detail below, the Agencies have also reduced the compliance burden for banking entities with total assets of less than $10 billion. The final rule also eliminates compliance burden for firms that do not engage in covered activities or investments beyond investing in U.S. government obligations, agency guaranteed obligations, or municipal obligations.

Moreover, the Agencies believe the data that will be collected in connection with the final rule, as well as the compliance efforts made by banking entities and the supervisory experience that will be gained by the Agencies in reviewing trading and investment activity under the final rule, will provide valuable insights into the effectiveness of the final rule in achieving the purpose of section 13 of the BHC Act. The Agencies remain committed to implementing the final rule, and revisiting and revising the rule as appropriate, in a manner designed to ensure that the final rule faithfully implements the requirements and purposes of the statute.[18]

Finally, the Board has determined, in accordance with section 13 of the BHC Act, to provide banking entities with additional time to conform their activities and investments to the statute and the final rule. The restrictions and prohibitions of section 13 of the BHC Act became effective on July 21, 2012.[19] The statute provided banking entities a period of two years to conform their activities and investments to the requirement of the statute, until July 21, 2014. Section 13 also permits the Board to extend this conformance period, one year at a time, for a total of no more than three additional years.[20] Pursuant to this authority and in connection with this rulemaking, the Board has in a separate action extended the conformance period for an additional year until July 21, 2015.[21] The Board will continue to monitor developments to determine whether additional extensions of the conformance period are in the public interest, consistent with the statute. Accordingly, the Agencies do not believe that a reproposal or further delay is necessary or appropriate.

Commenters have differing views on the overall economic impacts of section 13 of the BHC Act.

Some commenters remarked that proprietary trading restrictions will have detrimental impacts on the economy such as: Reduction in efficiency of markets, economic growth, and in employment due to a loss in liquidity.[22] In particular, a commenter expressed concern that there may be high transition costs as non-banking entities replace some of the trading activities currently performed by banking entities.[23] Another commenter focused on commodity markets remarked about the potential reduction in commercial output and curtailed resource exploration due to a lack of hedging counterparties.[24] Several commenters stated that section 13 of the BHC Act will reduce access to debt markets—especially for smaller companies—raising the costs of capital for firms and lowering the returns on certain investments.[25] Further, some commenters mentioned that U.S. banks may be competitively disadvantaged relative to foreign banks due to proprietary trading restrictions and compliance costs.[26]

[16] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); Chamber (Nov. 2011); Chamber (Nov. 2013); Members of Congress (Dec. 2011); IIAC; Real Estate Roundtable; Ass'n. of German Banks; Allen & Overy (Clearing); JPMC; Goldman (Prop. Trading); BNY Mellon *et al.;* State Street (Feb. 2012); ICI Global; Chamber (Feb. 2012); Société Générale; HSBC; Western Asset Mgmt.; Abbott Labs *et al.* (Feb. 2012); PUC Texas; Columbia Mgmt.; ICI (Feb. 2012); IIB/EBF; British Bankers' Ass'n.; ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Ralph Saul (Apr. 2012); BPC.

[17] *See* 75 FR 61758 (Oct. 6, 2010).

[18] If any provision of this rule, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

[19] *See* 12 U.S.C. 1851(c)(1).

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

[21] *See,* Board Order Approving Extension of Conformance Period, available at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.*

[22] *See, e.g.,* Oliver Wyman (Dec. 2011); Chamber (Dec. 2011); Thakor Study; Prof. Duffie; IHS.

[23] *See* Prof. Duffie.

[24] *See* IHS.

[25] *See, e.g.,* Chamber (Dec. 2011); Thakor Study; Oliver Wyman (Dec. 2011); IHS.

[26] *See, e.g.,* RBC; Citigroup (Feb. 2012); Goldman (Covered Funds).

On the other hand, other commenters stated that restricting proprietary trading activity by banking entities may reduce systemic risk emanating from the financial system and help to lower the probability of the occurrence of another financial crisis.[27] One commenter contended that large banking entities may have a moral hazard incentive to engage in risky activities without allocating sufficient capital to them, especially if market participants believe these institutions will not be allowed to fail.[28] Commenters argued that large banking entities may engage in activities that increase the upside return at the expense of downside loss exposure which may ultimately be borne by Federal taxpayers [29] and that subsidies associated with bank funding may create distorted economic outcomes.[30] Furthermore, some commenters remarked that non-banking entities may fill much of the void in liquidity provision left by banking entities if banking entities reduce their current trading activities.[31] Finally, some commenters mentioned that hyper-liquidity that arises from, for instance, speculative bubbles, may harm the efficiency and price discovery function of markets.[32]

The Agencies have taken these concerns into account in the final rule. As described below with respect to particular aspects of the final rule, the Agencies have addressed these issues by reducing burdens where appropriate, while at the same time ensuring that the final rule serves its purpose of promoting healthy economic activity. In that regard, the Agencies have sought to achieve the balance intended by Congress under section 13 of the BHC Act. Several comments suggested that a costs and benefits analysis be performed by the Agencies.[33] On the other hand, some commenters[34] correctly stated that a costs and benefits analysis is not legally required.[35] However, the Agencies find certain of the information submitted by commenters concerning costs and benefits and economic effects to be relevant to consideration of the rule, and so have considered this information as appropriate, and, on the basis of these and other considerations, sought to achieve the balance intended by Congress in section 619 of the Dodd-Frank Act. The relevant comments are addressed therein.[36]

III. Scope

Under section 13 of the BHCA, the CFTC's final rule will be applicable to a banking entity for which the CFTC is a ''primary financial regulatory agency'' for that banking entity, as the term is defined by section 2(12) of the Dodd-Frank Act. Accordingly, the final rule may apply to banking entities [37] that are, for example, registered swap dealers,[38] futures commission merchants, commodity trading advisors and commodity pool operators. The CFTC's final rule may also apply to other types of CFTC registrants that are banking entities, but it is likely that many such other registrants will have little or no activities that would implicate the provisions of the final rule. For example, registered introducing brokers are not likely to undertake proprietary trading or invest in covered funds because their activities are generally limited to brokering. Furthermore, the CFTC's final rule will not apply to CFTC registrants who are not banking entities. In addition, it is noted that the CFTC may have overlapping jurisdiction with other Agencies in exercising authority under each Agency's respective final rules. Finally, it is important to note that the jurisdictional scope of the final rule does not limit the regulatory authority of the CFTC or the other Agencies under other applicable provisions of law.

The CFTC believes that many affiliated banking entities would undertake some or all of the compliance activities under the final rule on an affiliated enterprise-wide basis. As of the adoption of the final rule, the CFTC estimates that there are approximately 110 registered swap dealers and futures commission merchants that would be banking entities individually and that grouping these banking entities together based on legal affiliation would result in about 45 different business enterprises.

IV. CFTC-specific comments

In addition to the information sought both by the other Agencies and the CFTC, the CFTC's proposal [39] included 15 additional questions specifically regarding the approach the CFTC should take in regards to certain sections of the rule. The relevant sections included provisions that were either directly related to the CFTC (e.g., definition of commodity pool, clearing exemption) and others that appeared not to be (e.g., underwriting, market making of SEC entities, securitization). Many commenters sent general responses that touched on issues related to these 15 CFTC-specific questions, while other commenters organized their responses by question.[40] The CFTC has considered these commenters' views, and has responded as set forth in the relevant sections below.

V. Overview of Final Rule

The Agencies are adopting this final rule to implement section 13 of the BHC Act with a number of changes to the proposal, as described further below. The final rule adopts a risk-based approach to implementation that relies on a set of clearly articulated characteristics of both prohibited and permitted activities and investments and is designed to effectively accomplish the statutory purpose of reducing risks posed to banking entities by proprietary trading activities and investments in or relationships with covered funds. As explained more fully below in the section-by-section analysis, the final rule has been designed to ensure that banking entities do not engage in prohibited activities or investments and to ensure that banking entities engage in permitted trading and investment activities in a manner designed to identify, monitor and limit the risks posed by these activities and investments. For instance, the final rule requires that any banking entity that is engaged in activity subject to section 13 develop and administer a compliance program that is appropriate to the size,

[27] *See, e.g.,* Profs. Admati & Pfleiderer; AFR (Nov. 2012); Better Markets (Dec. 2011); Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[28] *See* Occupy.

[29] *See* Profs. Admati & Pfleiderer; Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[30] *See* Profs. Admati & Pfleiderer; Johnson & Prof. Stiglitz.

[31] *See* AFR *et al.* (Feb. 2012); Better Markets (Apr. 16, 2012); David McClean; Public Citizen; Occupy.

[32] *See* Johnson & Prof. Stiglitz (citing Thomas Phillipon (2011)); AFR *et al.* (Feb. 2012); Occupy.

[33] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; ABA (Keating); Chamber (Feb. 2012); Société Générale; FTN; SVB; ISDA (Feb. 2012); Comm. on Capital Market Regulation; Real Estate Roundtable.

[34] *See, e.g.,* Better Markets (Feb. 2012); Randel Pilo.

[35] For example, with respect to the CFTC, Section 15(a) of the CEA requires such consideration only when ''promulgating a regulation under this [Commodity Exchange] Act.'' This final rule is not promulgated under the CEA, but under the BHC Act. CEA section 15(a), therefore, does not apply.

[36] This CFTC Rule is being promulgated exclusively under section 13 of the BHC. Therefore, the Commission did not conduct a cost benefit consideration under Section 15(a) of the Commodity Exchange Act. Similarly, Executive Orders 12866 and 13563, referenced by some commenters, do not impose obligations on the CFTC.

[37] See final rule § 75.2(c).

[38] The CFTC notes that provisionally registered swap dealers are registered swap dealers subject to all of the regulatory requirements applicable to registered swap dealers except as may otherwise be expressly provided in the CFTC's regulations.

[39] *See* 77 FR 8332 (Feb 14, 2012).

[40] *See, e.g.,* SIFMA (March Letter); Alfred Brock; Occupy the SEC.

scope and risk of its activities and investments. The rule requires the largest firms engaged in these activities to develop and implement enhanced compliance programs and regularly report data on trading activities to the Agencies. The Agencies believe this will permit banking entities to effectively engage in permitted activities, and the Agencies to enforce compliance with section 13 of the BHC Act. In addition, the enhanced compliance programs will help both the banking entities and the Agencies identify, monitor, and limit risks of activities permitted under section 13, particularly involving banking entities posing the greatest risk to financial stability.

A. General Approach and Summary of Final Rule

The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act, which include prohibiting banking entities from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that are critical to capital generation for businesses of all sizes, households and individuals, and that facilitate liquid markets. These client-oriented financial services, which include underwriting, market making, and asset management services, are important to the U.S. financial markets and the participants in those markets. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions.

As noted above, the final rule takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the final rule includes a framework that clearly describes the key characteristics of both prohibited and permitted activities. The final rule also requires banking entities to establish a comprehensive compliance program designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the banking entity's activities, size, scope and complexity. With respect to proprietary trading, the final rule also requires the large firms that are active participants in trading activities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities.

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

- Subpart A of the final rule describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;
- Subpart B of the final rule prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;
- Subpart C of the final rule prohibits or restricts acquiring or retaining an ownership interest in, and certain relationships with, a covered fund, defines terms relevant to covered fund activities and investments, as well as establishes exemptions from the restrictions on covered fund activities and investments and limitations on those exemptions;
- Subpart D of the final rule generally requires banking entities to establish a compliance program regarding compliance with section 13 of the BHC Act and the final rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;
- Appendix A of the final rule details the quantitative measurements that certain banking entities may be required to compute and report with respect to certain trading activities;
- Appendix B of the final rule details the enhanced minimum standards for programmatic compliance that certain banking entities must meet with respect to their compliance program, as required under subpart D.

B. Proprietary Trading Restrictions

Subpart B of the final rule implements the statutory prohibition on proprietary trading and the various exemptions to this prohibition included in the statute. Section 75.3 of the final rule contains the core prohibition on proprietary trading and defines a number of related terms, including ''proprietary trading'' and ''trading account.'' The final rule's definition of proprietary trading generally parallels the statutory definition and covers engaging as principal for the trading account of a banking entity in any transaction to purchase or sell specified types of financial instruments.[41]

The final rule's definition of trading account also is consistent with the statutory definition.[42] In particular, the definition of trading account in the final rule includes three classes of positions. First, the definition includes the purchase or sale of one or more financial instruments taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[43] For purposes of this part of the definition, the final rule also contains a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for the trading account of the banking entity if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase (or sale).[44] Second, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, the definition includes the purchase or sale of one or more financial instruments subject to the prohibition on proprietary trading that are treated as ''covered positions and trading positions'' (or hedges of other market risk capital rule covered positions) under those capital rules, other than certain foreign exchange and commodities positions.[45] Third, the definition includes the purchase or sale of one or more financial instruments by a banking entity that is licensed or registered or required to be licensed or registered to engage in the business of a dealer, swap dealer, or security-based swap dealer to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such or is engaged in those businesses outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[46]

The definition of proprietary trading also contains clarifying exclusions for certain purchases and sales of financial instruments that generally do not involve the requisite short-term trading intent, such as the purchase and sale of financial instruments arising under certain repurchase and reverse repurchase arrangements or securities

[41] *See* final rule § 75.3(a).
[42] *See* final rule § 75.3(b).
[43] *See* final rule § 75.3(b)(1)(i).
[44] *See* final rule § 75.3(b)(2).
[45] *See* final rule § 75.3(b)(1)(ii).
[46] *See* final rule § 75.3(b)(1)(iii).

lending transactions and securities acquired or taken for *bona fide* liquidity management purposes.[47]

In section 75.3, the final rule also defines a number of other relevant terms, including the term ''financial instrument.'' This term is used to define the scope of financial instruments subject to the prohibition on proprietary trading. Consistent with the statutory language, such financial instruments include securities, derivatives, commodity futures, and options on such instruments, but do not include loans, spot foreign exchange or spot physical commodities.[48]

In section 75.4, the final rule implements the statutory exemptions for underwriting and market making-related activities. For each of these permitted activities, the final rule defines the exempt activity and provides a number of requirements that must be met in order for a banking entity to rely on the applicable exemption. As more fully discussed below, these include establishment and enforcement of a compliance program targeted to the activity; limits on positions, inventory and risk exposure addressing the requirement that activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; limits on the duration of holdings and positions; defined escalation procedures to change or exceed limits; analysis justifying established limits; internal controls and independent testing of compliance with limits; senior management accountability and limits on incentive compensation. In addition, the final rule requires firms with significant market-making or underwriting activities to report data involving several metrics that may be used by the banking entity and the Agencies to identify trading activity that may warrant more detailed compliance review.

These requirements are generally designed to ensure that the banking entity's trading activity is limited to underwriting and market making-related activities and does not include prohibited proprietary trading.[49] These requirements are also intended to work together to ensure that banking entities identify, monitor and limit the risks associated with these activities.

In section 75.5, the final rule implements the statutory exemption for risk-mitigating hedging. As with the underwriting and market-making exemptions, § 75.5 of the final rule contains a number of requirements that must be met in order for a banking entity to rely on the exemption. These requirements are generally designed to ensure that the banking entity's hedging activity is limited to risk-mitigating hedging in purpose and effect.[50] Section 75.5 also requires banking entities to document, at the time the transaction is executed, the hedging rationale for certain transactions that present heightened compliance risks.[51] As with the exemptions for underwriting and market making-related activity, these requirements form part of a broader implementation approach that also includes the compliance program requirement and the reporting of quantitative measurements.

In section 75.6, the final rule implements statutory exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside of the United States. Section 75.6(a) of the final rule describes the government obligations in which a banking entity may trade, which include U.S. government and agency obligations, obligations and other instruments of specified government sponsored entities, and State and municipal obligations.[52] Section 75.6(b) of the final rule permits trading in certain foreign government obligations by affiliates of foreign banking entities in the United State and foreign affiliates of a U.S. banking entity abroad.[53] Section 75.6(c) of the final rule describes permitted trading on behalf of customers and identifies the types of transactions that would qualify for the exemption.[54] Section 75.6(d) of the final rule describes permitted trading by a regulated insurance company or an affiliate thereof for the general account of the insurance company, and also permits those entities to trade for a separate account of the insurance company.[55] Finally, § 75.6(e) of the final rule describes trading permitted outside of the United States by a foreign banking entity.[56] The exemption in the final rule clarifies when a foreign banking entity will qualify to engage in such trading pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity not currently subject to the BHC Act. As explained in detail below, the exemption also provides that the risk as principal, the decision-making, and the accounting for this activity must occur solely outside of the United States, consistent with the statute.

In section 75.7, the final rule prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[57] This section also describes the terms material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

C. Restrictions on Covered Fund Activities and Investments

Subpart C of the final rule implements the statutory prohibition on, directly or indirectly, acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section 75.10 of the final rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including ''covered fund'' and ''ownership interest.''[58] The definition of covered fund contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, foreign pension or retirement funds, insurance company separate accounts, and public welfare investment funds. The final rule also implements the statutory rule of construction in section 13(g)(2) and provides that a securitization of loans, which would include loan securitization, qualifying asset backed commercial paper conduit, and qualifying covered bonds, is not covered by section 13 or the final rule.[59]

[47] *See* final rule § 75.3(d).

[48] *See* final rule § 75.3(c).

[49] *See* final rule § 75.4(a), (b).

[50] *See* final rule § 75.5.

[51] *See* final rule § 75.5(c).

[52] *See* final rule § 75.6(a).

[53] *See* final rule § 75.6(b).

[54] *See* final rule § 75.6(c).

[55] *See* final rule § 75.6(d).

[56] *See* final rule § 75.6(e).

[57] *See* final rule § 75.7.

[58] *See* final rule § 75.10(b).

[59] The Agencies believe that most securitization transactions are currently structured so that the issuing entity with respect to the securitization is not an affiliate of a banking entity under the BHC Act. However, with respect to any securitization that is an affiliate of a banking entity and that does not meet the requirements of the loan securitization exclusion, the related banking entity will need to

Continued

The definition of ''ownership interest'' in the final rule provides further guidance regarding the types of interests that would be considered to be an ownership interest in a covered fund.[60] As described in this Supplementary Information, these interests may take various forms. The definition of ownership interest also explicitly excludes from the definition ''restricted profit interest'' that is solely performance compensation for services provided to the covered fund by the banking entity (or an employee or former employee thereof), under certain circumstances.[61] Section 75.10 of the final rule also defines a number of other relevant terms, including the terms ''prime brokerage transaction,'' ''sponsor,'' and ''trustee.''

In section 75.11, the final rule implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. Section 75.11(a) of the final rule outlines the conditions that must be met in order for a banking entity to organize and offer a covered fund under this authority. These requirements are contained in the statute and are intended to allow a banking entity to engage in certain traditional asset management and advisory businesses, subject to certain limits contained in section 13 of the BHC Act.[62] The requirements are discussed in detail in Part VI.B.2. of this Supplementary Information. Section 75.11 also explains how these requirements apply to covered funds that are issuing entities of asset-backed securities, as well as implements the statutory exemption for underwriting and market-making ownership interests of a covered fund, including explaining the limitations imposed on such activities under the final rule.

In section 75.12, the final rule permits a banking entity to acquire and retain, as an investment in a covered fund, an ownership interest in a covered fund that the banking entity organizes and offers or holds pursuant to other authority under § 75.11.[63] This section implements section 13(d)(4) of the BHC Act and related provisions. Section 13(d)(4)(A) of the BHC Act permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section 75.12 of the final rule implements this authority and related limitations, including limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments. In addition, § 75.12 requires that the aggregate value of all investments in covered funds, plus any earnings on these investments, be deducted from the capital of the banking entity for purposes of the regulatory capital requirements, and explains how that deduction must occur. Section 75.12 of the final rule also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from applicable capital, as relevant), and sets forth how a banking entity may request an extension of the period of time within which it must conform an investment in a single covered fund. This section also explains how a banking entity must apply the covered fund investment limits to a covered fund that is an issuing entity of asset backed securities or a covered fund that is part of a master-feeder or fund-of-funds structure.

In section 75.13, the final rule implements the statutory exemptions described in sections 13(d)(1)(C), (D), (F), and (I) of the BHC Act that permit a banking entity: (i) To acquire and retain an ownership interest in a covered fund as a risk-mitigating hedging activity related to employee compensation; (ii) in the case of a non-U.S. banking entity, to acquire and retain an ownership interest in, or act as sponsor to, a covered fund solely outside the United States; and (iii) to acquire and retain an ownership interest in, or act as sponsor to, a covered fund by an insurance company for its general or separate accounts.[64]

In section 75.14, the final rule implements section 13(f) of the BHC Act and generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act.[65] Section 75.14(a)(2) of the final rule describes the transactions between a banking entity and a covered fund that remain permissible under the statute and the final rule. Section 75.14(b) of the final rule implements the statute's requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and a covered fund is subject to section 23B of the Federal Reserve Act,[66] which, in general, requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

In section 75.15, the final rule prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[67] This section also describes material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

D. Metrics Reporting Requirement

Under the final rule, a banking entity that meets relevant thresholds specified in the rule must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

The final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in approach based on the size of trading assets and liabilities. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the

determine how to bring the securitization into compliance with this rule.

[60] *See* final rule § 75.10(d)(6).

[61] *See* final rule § 75.10(b)(6)(ii).

[62] *See* 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

[63] *See* final rule § 75.12.

[64] *See* final rule § 75.13(a)–(c).

[65] *See* 12 U.S.C. 371c; *see also* final rule § 75.14.

[66] 12 U.S.C. 371c–1.

[67] *See* final rule § 75.15.

United States or any agency of the United States). Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in the final rule unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion in consolidated trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis. All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by the final rule unless another time is requested by the primary supervisory Agency for the entity except for a transitional six month period during which reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[68]

E. Compliance Program Requirement

Subpart D of the final rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the final rule.[69] To reduce the overall burden of the rule, the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments.[70] In addition, to reduce the burden on smaller banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities or investments may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.[71]

For banking entities with total assets greater than $10 billion and less than $50 billion, the final rule specifies six elements that each compliance program established under subpart D must, at a minimum, include. These requirements focus on written policies and procedures reasonably designed to ensure compliance with the final rules, including limits on underwriting and market-making; a system of internal controls; clear accountability for compliance and review of limits, hedging, incentive compensation, and other matters; independent testing and audits; additional documentation for covered funds; training; and recordkeeping requirements.

A banking entity with $50 billion or more total consolidated assets (or a foreign banking entity that has total U.S. assets of $50 billion or more) or that is required to report metrics under Appendix A is required to adopt an enhanced compliance program with more detailed policies, limits, governance processes, independent testing and reporting. In addition, the Chief Executive Officer of these larger banking entities must attest that the banking entity has in place a program reasonably designed to achieve compliance with the requirements of section 13 of the BHC Act and the final rule.

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

VI. Final Rule

A. Subpart B—Proprietary Trading Restrictions

1. Section 75.3: Prohibition on Proprietary Trading and Related Definitions

Section 13(a)(1)(A) of the BHC Act prohibits a banking entity from engaging in proprietary trading unless otherwise permitted in section 13.[72] Section 13(h)(4) of the BHC Act defines proprietary trading, in relevant part, as engaging as principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, a security, derivative, contract of sale of a commodity for future delivery, or other financial instrument that the Agencies include by rule.[73]

Section 75.3(a) of the proposed rule implemented section 13(a)(1)(A) of the BHC Act by prohibiting a banking entity from engaging in proprietary trading unless otherwise permitted under §§ 75.4 through 75.6 of the proposed rule. Section 75.3(b)(1) of the proposed rule defined proprietary trading in accordance with section 13(h)(4) of the BHC Act and clarified that proprietary trading does not include acting solely as agent, broker, or custodian for an unaffiliated third party. The preamble to the proposed rule explained that acting in these types of capacities does not involve trading as principal.[74]

Several commenters expressed concern about the breadth of the ban on proprietary trading.[75] Some of these commenters stated that proprietary trading must be carefully and narrowly defined to avoid prohibiting activities that Congress did not intend to limit and to preclude significant, unintended consequences for capital markets, capital formation, and the broader economy.[76] Some commenters asserted that the proposed definition could result in banking entities being unwilling to take principal risk to provide liquidity for institutional investors; could unnecessarily constrain liquidity in secondary markets, forcing asset managers to service client needs through alternative non-U.S. markets; could impose substantial costs for all institutions, especially smaller and mid-size institutions; and could drive risk-

[68] *See* final rule § 75.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

[69] *See* final rule § 75.20.

[70] *See* final rule § 75.20(f)(1).

[71] *See* final rule § 75.20(f)(2).

[72] 12 U.S.C. 1851(a)(1)(A).

[73] 12 U.S.C. 1851(h)(4).

[74] *See* Joint Proposal, 76 FR at 68857.

[75] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); Capital Group; Comm. on Capital Markets Regulation; IAA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Chamber (Feb. 2012); Wellington.

[76] *See* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012).

taking to the shadow banking system.[77] Others urged the Agencies to determine that trading as agent, broker, or custodian for an affiliate was not proprietary trading.[78]

Commenters also suggested alternative approaches for defining proprietary trading. In general, these approaches sought to provide a bright-line definition to provide increased certainty to banking entities [79] or make the prohibition easier to apply in practice.[80] One commenter stated the Agencies should focus on the economics of banking entities' transactions and ban trading if the banking entity is exposed to market risk for a significant period of time or is profiting from changes in the value of the asset.[81] Several commenters, including individual members of the public, urged the Agencies to prohibit banking entities from engaging in any kind of proprietary trading and require separation of trading from traditional banking activities.[82] After carefully considering comments, the Agencies are defining proprietary trading as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.[83] The Agencies believe this effectively restates the statutory definition. The Agencies are not adopting commenters' suggested modifications to the proposed definition of proprietary trading or the general prohibition on proprietary trading because they generally appear to be inconsistent with Congressional intent. For instance, some commenters appeared to suggest an approach to defining proprietary trading that would capture only bright-line, speculative proprietary trading and treat the activities covered by the statutory exemptions as completely outside the rule.[84] However, such an approach would appear to be inconsistent with Congressional intent because, for instance, it would not give effect to the limitations on permitted activities in section 13(d) of the BHC Act.[85] For similar reasons, the Agencies are not adopting a bright-line definition of proprietary trading.[86]

A number of commenters expressed concern that, as a whole, the proposed rule may result in certain negative economic impacts, including: (i) Reduced market liquidity; [87] (ii) wider spreads or otherwise increased trading costs; [88] (iii) higher borrowing costs for businesses or increased cost of capital; [89] and/or (iv) greater market volatility.[90] The Agencies have carefully considered commenters' concerns about the proposed rule's potential impact on overall market liquidity and quality. As discussed in more detail in Parts VI.A.2. and VI.A.3., the final rule will permit banking entities to continue to provide beneficial market-making and underwriting services to customers, and therefore provide liquidity to customers and facilitate capital-raising. However, the statute upon which the final rule is based prohibits proprietary trading activity that is not exempted. As such, the termination of non-exempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants.[91] Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

To respond to concerns raised by commenters while remaining consistent with Congressional intent, the final rule has been modified to provide that certain purchases and sales are not proprietary trading as described in more detail below.[92]

a. Definition of ''Trading Account''

As explained above, section 13 defines proprietary trading as engaging as principal ''for the trading account of the banking entity'' in certain types of transactions. Section 13(h)(6) of the BHC Act defines trading account as any account used for acquiring or taking positions in financial instruments principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the Agencies may, by rule, determine.[93]

The proposed rule defined trading account to include three separate accounts. First, the proposed definition

[77] *See* Chamber (Feb. 2012).

[78] *See* Japanese Bankers Ass'n.

[79] *See, e.g.,* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[80] *See* Public Citizen.

[81] *See* Sens. Merkley & Levin (Feb. 2012).

[82] *See generally* Occupy; Public Citizen; AFR *et al.* (Feb. 2012). The Agencies received over fifteen thousand form letters in support of a rule with few exemptions, many of which expressed a desire to return to the regulatory scheme as governed by the Glass-Steagall affiliation provisions of the U.S. Banking Act of 1933, as repealed through the Graham-Leach-Bliley Act of 1999. *See generally* Sarah McGee; Christopher Wilson; Michael Itlis; Barry Rein; Edward Bright. Congress rejected such an approach, however, opting instead for the more narrowly tailored regulatory approach embodied in section 13 of the BHC Act.

[83] *See* final rule § 75.3(a). The final rule also replaces all references to the proposed term ''covered financial position'' with the term ''financial instrument.'' This change has no substantive impact because the definition of ''financial instrument'' is substantially identical to the proposed definition of ''covered financial position.'' Consistent with this change, the final rule replaces the undefined verbs ''acquire'' or ''take'' with the defined terms ''purchase'' or ''sale'' and ''sell.'' *See* final rule §§ 75.3(c), 75.2(u), (x).

[84] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012); JPMC.

[85] *See* 156 Cong. Rec. S5895–96 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating the statute ''permits underwriting and market-making-related transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services.'').

[86] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[87] *See, e.g.,* AllianceBernstein; Obaid Syed; Rep. Bachus *et al.;* EMTA; NASP; Sen. Hagan; Investure; Lord Abbett; Sumitomo Trust; EFAMA; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); STANY; ABA (Keating); ICE; ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Capital Group; RBC; Columbia Mgmt.; SSgA (Feb. 2012); Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Clearing House Ass'n.; Thakor Study. *See also* CalPERS (acknowledging that the systemic protections afforded by the Volcker Rule come at a price, including reduced liquidity to all markets).

[88] *See,* e.g., AllianceBernstein; Obaid Syed; NASP; Investure; Lord Abbett; CalPERS; Credit Suisse (Seidel); Citigroup (Feb. 2012); ABA (Keating); SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[89] *See, e.g.,* Rep. Bachus *et al.;* Members of Congress (Dec. 2011); Lord Abbett; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); ABA (Abernathy); ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ACLI (Feb. 2012); UBS; Wells Fargo (Prop. Trading); Capital Group; Sen. Carper *et al.;* Fidelity; Invesco; Clearing House Ass'n.; Thakor Study.

[90] *See, e.g.,* CalPERS (expressing the belief that a decline in banking entity proprietary trading will increase the volatility of the corporate bond market, especially during times of economic weakness or periods where risk taking declines, but noting that portfolio managers have experienced many different periods of market illiquidity and stating that the market will adapt post-implementation (*e.g.,* portfolio managers will increase their use of CDS to reduce economic risk to specific bond positions as the liquidation process of cash bonds takes more time, alternative market matching networks will be developed)); Morgan Stanley; Capital Group; Fidelity; British Bankers' Ass'n.; Invesco.

[91] *See* David McClean; Public Citizen; Occupy. In response to commenters who expressed concern about risks associated with proprietary trading activities moving to non-banking entities, the Agencies note that section 13's prohibition on proprietary trading and related exemptions apply only to banking entities. *See, e.g.,* Chamber (Feb. 2012).

[92] *See* final rule § 75.3(d).

[93] *See* 12 U.S.C. 1851(h)(6).

of trading account included, consistent with the statute, any account that is used by a banking entity to acquire or take one or more covered financial positions for short-term trading purposes (the ''short-term trading account'').[94] The proposed rule identified four purposes that would indicate short-term trading intent: (i) Short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more positions described in (i), (ii) or (iii). The proposed rule presumed that an account is a trading account if it is used to acquire or take a covered financial position (other than a position in the market risk rule trading account or the dealer trading account) that the banking entity holds for 60 days or less.[95]

Second, the proposed definition of trading account included, for certain entities, any account that contains positions that qualify for trading book capital treatment under the banking agencies' market risk capital rules other than positions that are foreign exchange derivatives, commodity derivatives or contracts of sale of a commodity for delivery (the ''market risk rule trading account'').[96] ''Covered positions'' under the banking agencies' market-risk capital rules are positions that are generally held with the intent of sale in the short-term.

Third, the proposed definition of trading account included any account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer to acquire or take positions in connection with its dealing activities (the ''dealer trading account'').[97] The proposed rule also included as a trading account any account used to acquire or take any covered financial position by a banking entity in connection with the activities of a dealer, swap dealer, or security-based swap dealer outside of the United States.[98] Covered financial positions held by banking entities that register or file notice as securities or derivatives dealers as part of their dealing activity were included because such positions are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions).[99]

The proposed rule also set forth four clarifying exclusions from the definition of trading account. The proposed rule provided that no account is a trading account to the extent that it is used to acquire or take certain positions under repurchase or reverse repurchase arrangements, positions under securities lending transactions, positions for *bona fide* liquidity management purposes, or positions held by derivatives clearing organizations or clearing agencies.[100]

Overall, commenters did not raise significant concerns with or objections to the short-term trading account. Several commenters argued that the definition of trading account should be limited to only this portion of the proposed definition of trading account.[101] However, a few commenters raised concerns regarding the treatment of arbitrage trading under the proposed rule.[102] Several commenters asserted that the proposed definition of trading account was too broad and covered trading not intended to be covered by the statute.[103] Some of these commenters maintained that the Agencies exceeded their statutory authority under section 13 of the BHC Act in defining trading account to include the market risk rule trading account and dealer trading account, and argued that the definition should be limited to the short-term trading account definition.[104] Commenters argued, for example, that an overly broad definition of trading account may cause traditional bank activities important to safety and soundness of a banking entity to fall within the prohibition on proprietary trading to the detriment of banking organizations, customers, and financial markets.[105] A number of commenters suggested modifying and narrowing the trading account definition to remove the implicit negative presumption that any position creates a trading account, or that all principal trading constitutes prohibited proprietary trading unless it qualifies for a narrowly tailored exemption, and to clearly exempt activities important to safety and soundness.[106] For example, one commenter recommended that a covered financial position be considered a trading account position only if it qualifies as a GAAP trading position.[107] A few commenters requested the Agencies define the phrase ''short term'' in the rule.[108]

Several commenters argued that the market risk rule should not be referenced as part of the definition of trading account.[109] A few of these commenters argued instead that the capital treatment of a position be used only as an indicative factor rather than a dispositive test.[110] One commenter thought that the market risk rule trading account was redundant because it includes only positions that have short-term trading intent.[111] Commenters also contended that it was difficult to consider and comment on this aspect of the proposal because the market risk capital rules had not been finalized.[112]

A number of commenters objected to the dealer trading account prong of the definition.[113] Commenters asserted that this prong was an unnecessary and unhelpful addition that went beyond the requirements of section 13 of the BHC Act, and that it made the trading account determination more complex and difficult.[114] In particular, commenters argued that the dealer trading account was too broad and introduced uncertainty because it presumed that dealers always enter into positions with short-term intent.[115] Commenters also expressed concern about the difficulty of applying this test outside the United States and requested that, if this account is retained, the final rule be explicit about how it applies to a swap dealer outside the United States

[94] *See* proposed rule § 75.3(b)(2)(i)(A).

[95] *See* proposed rule § 75.3(b)(2)(ii).

[96] *See* proposed rule §§ 75.3(b)(2)(i)(B); 75.3(b)(3).

[97] *See* proposed rule § 75.3(b)(2)(i)(C).

[98] *See* proposed rule § 75.3(b)(2)(i)(C)(5).

[99] *See* Joint Proposal, 76 FR 68860.

[100] *See* proposed rule § 75.3(b)(2)(iii).

[101] *See* ABA (Keating); JPMC.

[102] *See* AFR *et al.* (Feb. 2012); Paul Volcker; Credit Suisse (Seidel); ISDA (Feb. 2012); Japanese Bankers Ass'n.

[103] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[104] *See* ABA (Keating); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[105] *See* ABA (Keating); Credit Suisse (Seidel).

[106] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Wellington.

[107] *See* ABA (Keating).

[108] *See* NAIB *et al.;* Occupy; *but see* Alfred Brock.

[109] *See* ABA; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[110] *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[111] *See* ISDA (Feb. 2012).

[112] *See* ABA (Keating); BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC. The banking agencies adopted a final rule that amends their respective market risk capital rules on August 30, 2012. *See* 77 FR 53060 (Aug. 30, 2012). The Agencies continued to receive and consider comments on the proposed rule to implement section 13 of the BHC Act after that time.

[113] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[114] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); JPMC; State Street (Feb. 2012); ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[115] *See* ABA (Keating); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC.

and treat U.S. swap dealers consistently.[116]

In contrast, other commenters contended that the proposed rule's definition of trading account was too narrow, particularly in its focus on short-term positions,[117] or should be simplified.[118] One commenter argued that the breadth of the trading account definition was critical because positions excluded from the trading account definition would not be subject to the proposed rule.[119] One commenter supported the proposed definition of trading account.[120] Other commenters believed that reference to the market-risk rule was an important addition to the definition of trading account. Some expressed the view that it should include all market risk capital rule covered positions and not just those requiring short-term trading intent.[121]

Certain commenters proposed alternate definitions. Several commenters argued against using the term ''account'' and instead advocated applying the prohibition on proprietary trading to trading positions.[122] Foreign banks recommended applying the definition of trading account applicable to such banks in their home country, if the home country provided a clear definition of this term.[123] These commenters argued that new definitions in the proposed rule, like trading account, would require foreign banking entities to develop new and complex procedures and expensive systems.[124]

Commenters also argued that various types of trading activities should be excluded from the trading account definition. For example, one commenter asserted that arbitrage trading should not be considered trading account activity,[125] while other commenters argued that arbitrage positions and strategies are proprietary trading and should be included in the definition of trading account and prohibited by the final rule.[126] Another commenter argued that the trading account should include only positions primarily intended, when the position is entered into, to profit from short-term changes in the value of the assets, and that liquidity investments that do not have price changes and that can be sold whenever the banking entity needs cash should be excluded from the trading account definition.[127]

After carefully reviewing the comments, the Agencies have determined to retain in the final rule the proposed approach for defining trading account that includes the short-term, market risk rule, and dealer trading accounts with modifications to address issues raised by commenters. The Agencies believe that this multi-prong approach is consistent with both the language and intent of section 13 of the BHC Act, including the express statutory authority to include ''any such other account'' as determined by the Agencies.[128] The final definition effectuates Congress's purpose to generally focus on short-term trading while addressing commenters' desire for greater certainty regarding the definition of the trading account.[129] In addition, the Agencies believe commenters' concerns about the scope of the proposed definition of trading account are substantially addressed by the refined exemptions in the final rule for customer-oriented activities, such as market making-related activities, and the exclusions from proprietary trading.[130] Moreover, the Agencies believe that it is appropriate to focus on the economics of a banking entity's trading activity to help determine whether it is engaged in proprietary trading, as discussed further below.[131]

As explained above, the short-term trading prong of the definition largely incorporates the statutory provisions. This prong covers trading involving short-term resale, price movements, and arbitrage profits, and hedging positions that result from these activities. Specifically, the reference to short-term resale is taken from the statute's definition of trading account. The Agencies continue to believe it is also appropriate to include in the short-term trading prong an account that is used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions captured by the short-term trading prong. The provisions regarding price movements and arbitrage focus on the intent to engage in transactions to benefit from short-term price movements (*e.g.,* entering into a subsequent transaction in the near term to offset or close out, rather than sell, the risks of a position held by the banking entity to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction) or to benefit from differences in multiple market prices, including scenarios where movement in those prices is not necessary to realize the intended profit.[132] These types of transactions are economically equivalent to transactions that are principally for the purpose of selling in the near term or with the intent to resell to profit from short-term price movements, which are expressly covered by the statute's definition of trading account. Thus, the Agencies believe it is necessary to include these provisions in the final rule's short-term trading prong to provide clarity about the scope of the definition and to prevent evasion of the statute and final rule.[133] In addition, like the proposed rule, the final rule's short-term trading prong includes hedging one or more of the positions captured by this prong because the Agencies assume that a banking entity generally intends to hold the hedging position for only so long as the underlying position is held.

The remaining two prongs to the trading account definition apply to types of entities that engage actively in trading activities. Each prong focuses on analogous or parallel short-term trading activities. A few commenters stated these prongs were duplicative of the short-term trading prong, and argued the Agencies should not include these prongs in the definition of trading

[116] *See* Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; JPMC.

[117] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[118] *See, e.g.,* Public Citizen.

[119] *See* AFR *et al.* (Feb. 2012).

[120] *See* Alfred Brock.

[121] *See* AFR *et al.* (Feb. 2012).

[122] *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[123] *See* Japanese Bankers Ass'n.; Norinchukin.

[124] *See* Japanese Bankers Ass'n.

[125] *See* Alfred Brock.

[126] *See* AFR *et al.* (Feb. 2012); Paul Volcker.

[127] *See* NAIB *et al. See infra* Part VI.A.1.d.2. (discussing the liquidity management exclusion).

[128] 12 U.S.C. 1851(h)(6).

[129] In response to commenters' concerns about the meaning of account, the Agencies note the term ''trading account'' is a statutory concept and does not necessarily refer to an actual account. Trading account is simply nomenclature for the set of transactions that are subject to the final rule's restrictions on proprietary trading. *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[130] For example, several commenters' concerns about the potential impact of the proposed definition of trading account were tied to the perceived narrowness of the proposed exemptions. *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Wellington.

[131] *See* Sens. Merkley & Levin (Feb. 2012). However, as discussed in this **SUPPLEMENTARY INFORMATION**, the Agencies are not prohibiting any trading that involves profiting from changes in the value of the asset, as suggested by this commenter, because permitted activities, such as market making, can involve price appreciation-related revenues. *See infra* Part VI.A.3. (discussing the final market-making exemption).

[132] *See* Joint Proposal, 76 FR at 68857–68858.

[133] As a result, the Agencies are not excluding arbitrage trading from the trading account definition, as suggested by at least one commenter. *See, e.g.,* Alfred Brock.

account, or should only consider them as non-determinative factors.[134] To the extent that an overlap exists between the prongs of this definition, the Agencies believe they are mutually reinforcing, strengthen the rule's effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the trading account.[135]

The market risk capital prong covers trading positions that are covered positions for purposes of the banking agency market-risk capital rules, as well as hedges of those positions. Trading positions under those rules are positions held by the covered entity ''for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or to lock-in arbitrage profits.'' [136] This definition largely parallels the provisions of section 13(h)(4) of the BHC Act and mirrors the short-term trading account prong of both the proposed and final rules. Covered positions are trading positions under the rule that subject the covered entity to risks and exposures that must be actively managed and limited—a requirement consistent with the purposes of the section 13 of the BHC Act.

Incorporating this prong into the trading account definition reinforces the consistency between governance of the types of positions that banking entities identify as ''trading'' for purposes of the market risk capital rules and those that are trading for purposes of the final rule under section 13 of the BHC Act. Moreover, this aspect of the final rule reduces the compliance burden on banking entities with substantial trading activities by establishing a clear, bright-line rule for determining that a trade is within the trading account.[137]

After reviewing comments, the Agencies also continue to believe that financial instruments purchased or sold by registered dealers in connection with their dealing activity are generally held with short-term intent and should be captured within the trading account. The Agencies believe the scope of the dealer prong is appropriate because, as noted in the proposal, positions held by a registered dealer in connection with its dealing activity are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions), which is indicative of short-term intent.[138] Moreover, the final rule includes a number of exemptions for the activities in which securities dealers, swap dealers, and security-based swap dealers typically engage, such as market making, hedging, and underwriting. Thus, the Agencies believe the broad scope of the dealer trading account is balanced by the exemptions that are designed to permit dealer entities to continue to engage in customer-oriented trading activities, consistent with the statute. This approach is designed to ensure that registered dealer entities are engaged in permitted trading activities, rather than prohibited proprietary trading.

The final rule adopts the dealer trading account substantially as proposed,[139] with streamlining that eliminates the specific references to different types of securities and derivatives dealers. The final rule adopts the proposed approach to covering trading accounts of banking entities that regularly engage in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States. In the case of both domestic and foreign entities, this provision applies only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily *all* of the activities of that banking entity.[140] Activities of a banking entity that are not covered by the dealer prong may, however, be covered by the short-term or market risk rule trading accounts if the purchase or sale satisfies the requirements of §§ 75.3(b)(1)(i) or (ii).[141]

A few commenters stated that they do not currently analyze whether a particular activity would require dealer registration, so the dealer prong of the trading account definition would require banking entities to engage in a new type of analysis.[142] The Agencies recognize that banking entities that are registered dealers may not currently engage in such an analysis with respect to their current trading activities and, thus, this may represent a new regulatory requirement for these entities. If the regulatory analysis otherwise engaged in by banking entities is substantially similar to the dealer prong analysis required under the trading account definition, then any increased compliance burden could be small or insubstantial.[143]

In response to commenters' concerns regarding the application of this prong to banking entities acting as dealers in jurisdictions outside the United States,[144] the Agencies continue to believe including the activities of a banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business, is appropriate. As noted above, dealer activity generally involves short-term trading. Further, the Agencies are concerned that differing requirements for U.S. and foreign dealers may lead to regulatory arbitrage. For foreign banking entities acting as dealers outside of the United States that are eligible for the exemption for trading conducted by foreign banking entities, the Agencies believe the risk-based approach to this exemption in the final rule should help address the concerns about the scope of this prong of the definition.[145]

In response to one commenter's suggestion that the Agencies define the term trading account to allow a foreign banking entity to use of the relevant foreign regulator's definition of this term, where available, the Agencies are concerned such an approach could lead to regulatory arbitrage and otherwise inconsistent applications of the rule.[146] The Agencies believe this commenter's general concern about the impact of the statute and rule on foreign banking entities' activities outside the United States should be substantially addressed by the exemption for trading conducted by foreign banking entities under § 75.6(e) of the final rule.

[134] *See* ISDA (Feb. 2012); JPMC; ABA (Keating); BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[135] *See* Occupy.

[136] 12 CFR 225, Appendix E.

[137] Accordingly, the Agencies are not using a position's capital treatment as merely an indicative factor, as suggested by a few commenters.

[138] *See* Joint Proposal, 76 FR at 68860.

[139] *See* final rule § 75.3(b)(1)(iii).

[140] An insured depository institution may be registered as a swap dealer, but only the swap dealing activities that require it to be so registered are covered by the dealer trading account. If an insured depository institution purchases or sells a financial instrument in connection with activities of the insured depository institution that do not trigger registration as a swap dealer, such as lending, deposit-taking, the hedging of business risks, or other end-user activity, the financial instrument is included in the trading account only if the instrument falls within the statutory trading account under § 75.3(b)(1)(i) or the market risk rule trading account under § 75.3(b)(1)(ii) of the final rule.

[141] *See* final rule §§ 75.3(b)(1)(i) and (ii).

[142] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[143] *See, e.g.,* Goldman (Prop. Trading) (''For instance, a banking entity's market making-related activities with respect to credit trading may involve making a market in bonds (traded in a broker-dealer), single-name CDSs (in a security-based swap dealer) and CDS indexes (in a swap dealer). For regulatory or other reasons, these transactions could take place in different legal entities . . .'').

[144] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations).

[145] *See* final rule § 75.6(e).

[146] *See* Japanese Bankers Ass'n.

Finally, the Agencies have declined to adopt one commenter's recommendation that a position in a financial instrument be considered a trading account position only if it qualifies as a GAAP trading position.[147] The Agencies continue to believe that formally incorporating accounting standards governing trading securities is not appropriate because: (i) The statutory proprietary trading provisions under section 13 of the BHC Act applies to financial instruments, such as derivatives, to which the trading security accounting standards may not apply; (ii) these accounting standards permit companies to classify, at their discretion, assets as trading securities, even where the assets would not otherwise meet the definition of trading securities; and (iii) these accounting standards could change in the future without consideration of the potential impact on section 13 of the BHC Act and these rules.[148]

b. Rebuttable Presumption for the Short-Term Trading Account

The proposed rule included a rebuttable presumption clarifying when a covered financial position, by reason of its holding period, is traded with short-term intent for purposes of the short-term trading account. The Agencies proposed this presumption primarily to provide guidance to banking entities that are not subject to the market risk capital rules or are not covered dealers or swap entities and accordingly may not have experience evaluating short-term trading intent. In particular, § 75.3(b)(2)(ii) of the proposed rule provided that an account would be presumed to be a short-term trading account if it was used to acquire or take a covered financial position that the banking entity held for a period of 60 days or less.

Several commenters supported the rebuttable presumption, but suggested either shortening the holding period to 30 days or less,[149] or extending the period to 90 days,[150] to several months,[151] or to one year.[152] Some of these commenters argued that specifying an overly short holding period would be contrary to the statute, invite gamesmanship,[153] and miss speculative positions held for longer than the specified period.[154] Commenters also suggested turning the presumption into a safe harbor[155] or into guidance.[156]

Other commenters opposed the inclusion of the rebuttable presumption for a number of reasons and requested that it be removed.[157] For example, these commenters argued that the presumption had no statutory basis;[158] was arbitrary;[159] was not supported by data, facts, or analysis;[160] would dampen market-making and underwriting activity;[161] or did not take into account the nature of trading in different types of securities.[162] Some commenters also questioned whether the Agencies would interpret rebuttals of the presumption consistently,[163] and stressed the difficulty and costliness of rebutting the presumption,[164] such as enhanced documentation or other administrative burdens.[165] One foreign banking association also argued that requiring foreign banking entities to rebut a U.S. regulatory requirement would be costly and inappropriate given that the trading activities of the banking entity are already reviewed by home country supervisors.[166] This commenter also contended that the presumption could be problematic for financial instruments purchased for long-term investment purposes that are closed within 60 days due to market fluctuations or other changed circumstances.[167]

After carefully considering the comments received, the Agencies continue to believe the rebuttable presumption is appropriate to generally define the meaning of ''short-term'' for purposes of the short-term trading account, especially for small and regional banking entities that are not subject to the market risk capital rules and are not registered dealers or swap entities. The range of comments the Agencies received on what ''short-term'' should mean—from 30 days to one year—suggests that a clear presumption would ensure consistency in interpretation and create a level playing field for all banking entities with covered trading activities subject to the short-term trading account. Based on their supervisory experience, the Agencies find that 60 days is an appropriate cut off for a regulatory presumption.[168] Further, because the purpose of the rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the trading account, the Agencies believe that implementing different holding periods based on the type of financial instrument would insert unnecessary complexity into the presumption.[169] The Agencies are not providing a safe harbor or a reverse presumption (*i.e.,* a presumption for positions that are outside of the trading account), as suggested by some commenters, in recognition that some proprietary trading could occur outside of the 60 day period.[170]

Adopting a presumption allows the Agencies and affected banking entities to evaluate all the facts and circumstances surrounding trading activity in determining whether the activity implicates the purpose of the statute. For example, trading in a financial instrument for long-term investment that is disposed of within 60 days because of unexpected developments (*e.g.,* an unexpected increase in the financial instrument's volatility or a need to liquidate the instrument to meet unexpected liquidity demands) may not be trading activity covered by the statute. To reduce the costs and burdens of rebutting the

[147] *See* ABA (Keating).

[148] *See* Joint Proposal, 76 FR at 68859.

[149] *See* Japanese Bankers Ass'n.

[150] *See* Capital Group.

[151] *See* AFR *et al.* (Feb. 2012).

[152] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen (arguing that one-year demarks tax law covering short term capital gains).

[153] *See* Sens. Merkley & Levin (Feb. 2012).

[154] *See* Occupy.

[155] *See* Capital Group.

[156] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[157] *See* ABA (Keating); Am. Express; Business Roundtable; Capital Group; ICI (Feb. 2012); Investure; JPMC; Liberty Global; STANY; Chamber (Feb. 2012).

[158] *See* ABA (Keating); JPMC; Chamber (Feb. 2012).

[159] *See* Am. Express; ICI (Feb. 2012).

[160] *See* ABA (Keating); Chamber (Feb. 2012).

[161] *See* AllianceBernstein; Business Roundtable; ICI (Feb. 2012); Investure; Liberty Global; STANY. Because the rebuttable presumption does not impact the availability of the exemptions for underwriting, market making, and other permitted activities, the Agencies do not believe this provision creates any additional burdens on permissible activities.

[162] *See* Am. Express (noting that most foreign exchange forward transactions settle in less than one week and are used as commercial payment instruments, and not speculative trades); Capital Group.

[163] *See* ABA (Keating). As discussed below in Part VI.C., the Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.

[164] *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC.

[165] *See* NAIB *et al.;* Capital Group.

[166] *See* Japanese Bankers Ass'n. As noted above, the Agencies believe concerns about the impacts of the definition of trading account on foreign banking entity trading activity outside of the United States are substantially addressed by the final rule's exemption for proprietary trading conducted by foreign banking entities in final rule § 75.6(e).

[167] *Id.*

[168] *See* final rule § 75.3(b)(2). Commenters did not provide persuasive evidence of the benefits associated with a rebuttable presumption for positions held for greater or fewer than 60 days.

[169] *See, e.g.,* Am. Express; Capital Group; Sens. Merkley & Levin (Feb. 2012).

[170] *See* Capital Group; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

presumption, the Agencies will allow a banking entity to rebut the presumption for a group of related positions.[171]

The final rule provides three clarifying changes to the proposed rebuttable presumption. First, in response to comments, the final rule replaces the reference to an ''account'' that is presumed to be a trading account with the purchase or sale of a ''financial instrument.'' [172] This change clarifies that the presumption only applies to the purchase or sale of a financial instrument that is held for fewer than 60 days, and not the entire account that is used to make the purchase or sale. Second, the final rule clarifies that basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk), are subject to the rebuttable presumption.[173] Third, in order to maintain consistency with definitions used throughout the final rule, the references to ''acquire'' or ''take'' a financial position have been replaced with references to ''purchase'' or ''sell'' a financial instrument.[174]

c. Definition of ''Financial Instrument''

Section 13 of the BHC Act generally prohibits proprietary trading, which is defined in section 13(h)(4) to mean engaging as principal for the trading account in any purchase or sale of any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instruments that the Agencies may, by rule, determine.[175] The proposed rule defined the term ''covered financial position'' to reference the instruments listed in section 13(h)(4), including: (i) A security, including an option on a security; (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or an option on such a contract.[176] To provide additional clarity, the proposed rule also provided that, consistent with the statute, any position that is itself a loan, a commodity, or foreign exchange or currency was not a covered financial position.[177]

The proposal also defined a number of other terms used in the definition of covered financial position, including commodity, derivative, loan, and security.[178] These terms were generally defined by reference to the Federal securities laws or the Commodity Exchange Act because these existing definitions are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities, commodities, and derivatives trading.

As noted above, the proposed rule included derivatives within the definition of covered financial position. Derivative was defined to include any swap (as that term is defined in the Commodity Exchange Act) and security-based swap (as that term is defined in the Exchange Act), in each case as further defined by the CFTC and SEC by joint regulation, interpretation, guidance, or other action, in consultation with the Board pursuant to section 712(d) of the Dodd-Frank Act.[179] The proposed rule also included within the definition of derivative certain other transactions that, although not included within the definition of swap or security-based swap, also appear to be, or operate in economic substance as, derivatives, and which if not included could permit banking entities to engage in proprietary trading that is inconsistent with the purpose of section 13 of the BHC Act. Specifically, the proposed definition also included: (i) Any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as those terms are defined in the Commodity Exchange Act); [180] (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act; [181] (iv) any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act; [182] and (v) any transactions authorized under section 19 of the Commodity Exchange Act.[183] In addition, the proposed rule excluded from the definition of derivative (i) any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap or security-based swap, and (ii) any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

Commenters expressed a variety of views regarding the definition of covered financial position, as well as other defined terms used in that definition. For instance, some commenters argued that the definition should be expanded to include transactions in spot commodities or foreign currency, even though those instruments are not included by the statute.[184] Other commenters strongly supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute, arguing that these instruments are part of the traditional business of banking and do not represent the types of instruments that Congress designed section 13 to address. These commenters argued that including spot commodities and foreign exchange within the definition of covered financial position in the final rule would put U.S. banking entities at a competitive disadvantage and prevent them from conducting routine banking operations.[185] One commenter argued that the proposed definition of covered financial position was effective and recommended that the definition should not be expanded.[186] Another commenter argued that an instrument be considered to be a spot foreign exchange transaction, and thus not a covered financial position, if it settles within 5 days of purchase.[187] Another commenter argued that covered financial positions used in interaffiliate transactions should expressly be excluded because they are used for

[171] The Agencies believe this should help address commenters' concerns about the burdens associated with rebutting the presumption. *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC; NAIB *et al.;* Capital Group.

[172] *See, e.g.,* ABA (Keating); Clearing House Ass'n.; JPMC.

[173] The rebuttable presumption covered these trades in the proposal, but the final rule's use of ''financial instrument'' rather than ''covered financial position'' necessitated clarifying this point in the rule text. *See* final rule § 75.3(b)(2). *See also* Public Citizen.

[174] The Agencies do not believe these revisions have a substantive effect on the operation or scope of the final rule in comparison to the statute or proposed rule.

[175] *See* 12 U.S.C. 1851(h)(4).

[176] *See* proposed rule § 75.3(c)(3)(i).

[177] *See* proposed rule § 75.3(c)(3)(ii).

[178] *See* proposed rule § 75.2(l), (q), (w); § 75.3(c)(1) and (2).

[179] *See* 7 U.S.C. 1a(47) (defining ''swap''); 15 U.S.C. 78c(a)(68) (defining ''security-based swap'').

[180] 7 U.S.C. 1a(24), (25).

[181] 7 U.S.C. 2(c)(2)(C)(i).

[182] 7 U.S.C. 2(c)(2)(D)(i).

[183] 7 U.S.C. 23.

[184] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[185] *See* Northern Trust; Morgan Stanley; JPMC; Credit Suisse (Seidel); Am. Express; *see also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange).

[186] *See* Alfred Brock.

[187] *See* Credit Suisse (Seidel).

internal risk management purposes and not for proprietary trading.[188]

Some commenters requested that the final rule exclude additional instruments from the definition of covered financial position. For instance, some commenters requested that the Agencies exclude commodity and foreign exchange futures, forwards, and swaps, arguing that these instruments typically have a commercial and not financial purpose and that making them subject to the prohibitions of section 13 would negatively affect the spot market for these instruments.[189] A few commenters also argued that foreign exchange swaps and forwards are used in many jurisdictions to provide U.S. dollar-funding for foreign banking entities and that these instruments should be excluded since they contribute to the stability and liquidity of the market for spot foreign exchange.[190] Other commenters contended that foreign exchange swaps and forwards should be excluded because they are an integral part of banking entities' ability to provide trust and custody services to customers and are necessary to enable banking entities to deal in the exchange of currencies for customers.[191]

One commenter argued that the inclusion of certain instruments within the definition of derivative, such as purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled, was inappropriate.[192] This commenter alleged that these instruments are not derivatives but should instead be viewed as contracts for purchase of specific commodities to be delivered at a future date. This commenter also argued that the Agencies do not have authority under section 13 to include these instruments as ''other securities or financial instruments'' subject to the prohibition on proprietary trading.[193]

Some commenters also argued that, because the CFTC and SEC had not yet finalized their definitions of swap and security-based swap, it was inappropriate to use those definitions as part of the proposed definition of derivative.[194] One commenter argued that the definition of derivative was effective, although this commenter argued that the final rule should not cross-reference the definition of swap and security-based swap under the Federal commodities and securities laws.[195]

After carefully considering the comments received on the proposal, the final rule continues to apply the prohibition on proprietary trading to the same types of instruments as listed in the statute and the proposal, which the final rule defines as ''financial instrument.'' Under the final rule, a financial instrument is defined as: (i) A security, including an option on a security;[196] (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[197] The final rule excludes from the definition of financial instrument: (i) A loan;[198] (ii) a commodity that is not an excluded commodity (other than foreign exchange or currency), a derivative, a contract of sale of a commodity for future delivery, or an option on a contract of sale of a commodity for future delivery; or (iii) foreign exchange or currency.[199] An excluded commodity is defined to have the same meaning as in section 1a(19) of the Commodity Exchange Act.

The Agencies continue to believe that these instruments and transactions, which are consistent with those referenced in section 13(h)(4) of the BHC Act as part of the statutory definition of proprietary trading, represent the type of financial instruments which the proprietary trading prohibition of section 13 was designed to cover. While some commenters requested that this definition be expanded to include spot transactions[200] or loans,[201] the Agencies do not believe that it is appropriate at this time to expand the scope of instruments subject to the ban on proprietary trading.[202] Similarly, while some commenters requested that certain other instruments, such as foreign exchange swaps and forwards, be excluded from the definition of financial instrument,[203] the Agencies believe that these instruments appear to be, or operate in economic substance as, derivatives (which are by statute included within the scope of instruments subject to the prohibitions of section 13). If these instruments were not included within the definition of financial instrument, banking entities could use them to engage in proprietary trading that is inconsistent with the purpose and design of section 13 of the BHC Act.

As under the proposal, loans, commodities, and foreign exchange or currency are not included within the scope of instruments subject to section 13. The exclusion of these types of instruments is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities, and foreign exchange or currency—none of which are referred to in section 13(h)(4) of the BHC Act—are outside the scope of transactions to which the proprietary trading restrictions apply. For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.

The final rule also adopts the definitions of security and derivative as proposed.[204] These definitions, which reference existing definitions under the Federal securities and commodities laws, are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities and commodities trading activities. While some commenters argued that it would be inappropriate to use the definition of swap and security-based swap because those terms had not yet been finalized pursuant to public notice and comment,[205] the CFTC and SEC have subsequently finalized those definitions after receiving extensive public comment on the rulemakings.[206] The

[188] *See* GE (Feb. 2012).

[189] *See* JPMC; BoA; Citigroup (Feb. 2012).

[190] *See* Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; *see also* Norinchukin.

[191] *See* Northern Trust; Citigroup (Feb. 2012).

[192] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[193] *See id.*

[194] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[195] *See* Alfred Brock.

[196] The definition of security under the final rule is the same as under the proposal. *See* final rule § 75.2(y).

[197] *See* final rule § 75.3(c)(1).

[198] The definition of loan, as well as comments received regarding that definition, is discussed in detail below in Part VI.B.1.c.8.a.

[199] *See* final rule § 75.3(c)(2).

[200] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[201] *See* Occupy.

[202] Several commenters supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute. *See* Northern Trust; Morgan Stanley; State Street (Feb. 2012); JPMC; Credit Suisse (Seidel); Am. Express; *see also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange). One commenter stated that the proposed definition should not be expanded. *See* Alfred Brock. With respect to the exclusion for loans, the Agencies note this is generally consistent with the rule of statutory construction regarding the sale and securitization of loans. *See* 12 U.S.C. 1851(g)(2).

[203] *See* JPMC; BAC; Citigroup (Feb. 2012); Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; Northern Trust; *see also* Norinchukin.

[204] *See* final rule § 75.2(h), (y).

[205] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[206] *See* CFTC and SEC, Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed swaps; Security Based Swap Agreement Recordkeeping, 78 FR 48208 (Aug. 13, 2012).

Agencies believe that this notice and comment process provided adequate opportunity for market participants to comment on and understand those terms, and as such they are incorporated in the definition of derivative under this final rule.

While some commenters requested that foreign exchange swaps and forwards be excluded from the definition of derivative or financial instrument, the Agencies have not done so for the reasons discussed above. However, as explained below in Part VI.A.1.d., the Agencies note that to the extent a banking entity purchases or sells a foreign exchange forward or swap, or any other financial instrument, in a manner that meets an exclusion from proprietary trading, that transaction would not be considered to be proprietary trading and thus would not be subject to the requirements of section 13 of the BHC Act and the final rule. This includes, for instance, the purchase or sale of a financial instrument by a banking entity acting solely as agent, broker, or custodian, or the purchase or sale of a security as part of a *bona fide* liquidity management plan.

d. Proprietary Trading Exclusions

The proposed rule contained four exclusions from the definition of trading account for categories of transactions that do not fall within the scope of section 13 of the BHC Act because they do not involve short-term trading activities subject to the statutory prohibition on proprietary trading. These exclusions covered the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending arrangements, for *bona fide* liquidity management purposes, and by a clearing agency or derivatives clearing organization in connection with clearing activities.

As discussed below, the final rule provides exclusions for the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending agreements; for *bona fide* liquidity management purposes; by certain clearing agencies, derivatives clearing organizations in connection with clearing activities; by a member of a clearing agency, derivatives clearing organization, or designated financial market utility engaged in excluded clearing activities; to satisfy existing delivery obligations; to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding; solely as broker, agent, or custodian; through a deferred compensation or similar plan; and to satisfy a debt previously contracted. After considering comments on these issues, which are discussed in more detail below, the Agencies believe that providing clarifying exclusions for these non-proprietary activities will likely promote more cost-effective financial intermediation and robust capital formation. Overly narrow exclusions for these activities would potentially increase the cost of core banking services, while overly broad exclusions would increase the risk of allowing the types of trades the statute was designed to prohibit. The Agencies considered these issues in determining the appropriate scope of these exclusions. Because the Agencies do not believe these excluded activities involve proprietary trading, as defined by the statute and the final rule, the Agencies do not believe it is necessary to use our exemptive authority in section 13(d)(1)(J) of the BHC Act to deem these activities a form of permitted proprietary trading.

1. Repurchase and Reverse Repurchase Arrangements and Securities Lending

The proposed rule's definition of trading account excluded an account used to acquire or take one or more covered financial positions that arise under (i) a repurchase or reverse repurchase agreement pursuant to which the banking entity had simultaneously agreed, in writing at the start of the transaction, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty,[207] or (ii) a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.[208] Positions held under these agreements operate in economic substance as a secured loan and are not based on expected or anticipated movements in asset prices. Accordingly, these types of transactions do not appear to be of the type the statutory definition of trading account was designed to cover.[209]

Several commenters expressed support for these exclusions and requested that the Agencies expand them.[210] For example, one commenter requested clarification that all types of repurchase transactions qualify for the exclusion.[211] Some commenters requested expanding this exclusion to cover all positions financed by, or transactions related to, repurchase and reverse repurchase agreements.[212] Other commenters requested that the exclusion apply to all transactions that are analogous to extensions of credit and are not based on expected or anticipated movements in asset prices, arguing that the exclusion would be too limited in scope to achieve its objective if it is based on the legal form of the underlying contract.[213] Additionally, some commenters suggested expanding the exclusion to cover transactions that are for funding purposes, including prime brokerage transactions, or for the purpose of asset-liability management.[214] Commenters also recommended expanding the exclusion to include re-hypothecation of customer securities, which can produce financing structures that, like a repurchase agreement, are functionally loans.[215]

In contrast, other commenters argued that there was no statutory or policy justification for excluding repurchase and reverse repurchase agreements from the trading account, and requested that this exclusion be removed from the final rule.[216] Some of these commenters argued that repurchase agreements could be used for prohibited proprietary trading[217] and suggested that, if repurchase agreements are excluded from the trading account, documentation detailing the use of liquidity derived from repurchase agreements should be required.[218] These

[207] *See* proposed rule § 75.3(b)(2)(iii)(A).

[208] *See* proposed rule § 75.3(b)(2)(iii)(B). The language that described securities lending transactions in the proposed rule generally mirrored that contained in Rule 3a5–3 under the Exchange Act. *See* 17 CFR 240.3a5–3.

[209] *See* Joint Proposal, 76 FR at 68862.

[210] *See generally* ABA (Keating); Alfred Brock; Citigroup (Feb. 2012); GE (Feb. 2012); Goldman (Prop. Trading); ICBA; Japanese Bankers Ass'n.; JPMC; Norinchukin; RBC; RMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012); T. Rowe Price; UBS; Wells Fargo (Prop. Trading). *See infra* Part VI.A.d.10. for the discussion of commenters' requests for additional exclusions from the trading account.

[211] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[212] *See* FIA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[213] *See* Goldman (Prop. Trading); JPMC; UBS.

[214] *See* Goldman (Prop. Trading); UBS. For example, one commenter suggested that fully collateralized swap transactions should be exempted from the definition of trading account because they serve as funding transactions and are economically similar to repurchase agreements. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[215] *See* Goldman (Prop. Trading).

[216] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[217] *See* AFR *et al.* (Feb. 2012).

[218] *See* Public Citizen.

commenters suggested that unless the liquidity is used to secure a position for a willing customer, repurchase agreements should be regarded as a strong indicator of proprietary trading.[219] As an alternative, commenters suggested that the Agencies instead use their exemptive authority pursuant to section 13(d)(1)(J) of the BHC Act to permit repurchase and reverse repurchase transactions so that such transactions must comply with the statutory limits on material conflicts of interests and high-risks assets and trading strategies, and compliance requirements under the final rule.[220] These commenters urged the Agencies to specify permissible collateral types, haircuts, and contract terms for securities lending agreements and require that the investment of proceeds from securities lending transactions be limited to high-quality liquid assets in order to limit potential risks of these activities.[221]

After considering the comments received, the Agencies have determined to exclude repurchase and reverse repurchase agreements and securities lending agreements from the definition of proprietary trading under the final rule. The final rule defines these terms subject to the same conditions as were in the proposal. This determination recognizes that repurchase and reverse repurchase agreements and securities lending agreements excluded from the definition operate in economic substance as secured loans and do not in normal practice represent proprietary trading.[222] The Agencies will, however, monitor these transactions to ensure this exclusion is not used to engage in prohibited proprietary trading activities.

To avoid evasion of the rule, the Agencies note that, in contrast to certain commenters' requests,[223] only the transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement are excluded. For example, the collateral or position that is being financed by the repurchase or reverse repurchase agreement is not excluded and may involve proprietary trading. The Agencies further note that if a banking entity uses a repurchase or reverse repurchase agreement to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion.[224] Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.

Additionally, the Agencies have determined not to exclude all transactions, in whatever legal form that may be construed to be an extension of credit, as suggested by commenters, because such a broad exclusion would be too difficult to assess for compliance and would provide significant opportunity for evasion of the prohibitions in section 13 of the BHC Act.

2. Liquidity Management Activities

The proposed definition of trading account excluded an account used to acquire or take a position for the purpose of *bona fide* liquidity management, subject to certain requirements.[225] The preamble to the proposed rule explained that *bona fide* liquidity management seeks to ensure that the banking entity has sufficient, readily-marketable assets available to meet its expected near-term liquidity needs, not to realize short-term profit or benefit from short-term price movements.[226]

To curb abuse, the proposed rule required that a banking entity acquire or take a position for liquidity management in accordance with a documented liquidity management plan that meets five criteria.[227] Moreover, the Agencies stated in the preamble that liquidity management positions that give rise to appreciable profits or losses as a result of short-term price movements would be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be considered proprietary trading.[228]

The Agencies received a number of comments regarding the exclusion. Many commenters supported the exclusion of liquidity management activities from the definition of trading account as appropriate and necessary. At the same time, some commenters expressed the view that the exclusion was too narrow and should be replaced with a broader exclusion permitting trading activity for asset-liability management (''ALM''). Commenters argued that two aspects of the proposed rule's definition of ''trading account'' would cause ALM transactions to fall within the prohibition on proprietary trading—the 60-day rebuttable presumption and the reference to the market risk rule trading account.[229] For example, commenters expressed concern that hedging transactions associated with a banking entity's residential mortgage pipeline and mortgage servicing rights, and managing credit risk, earnings at risk, capital, asset-liability mismatches, and foreign exchange risks would be among positions that may be held for 60 days or less.[230] These commenters contended that the exclusion for liquidity management and the activity exemptions for risk-mitigating hedging and trading in U.S. government obligations would not be sufficient to permit a wide variety of ALM activities.[231] These commenters contended that prohibiting trading for ALM purposes would be contrary to the goals of enhancing sound risk management, the safety and soundness of banking entities, and U.S. financial stability,[232] and would limit banking entities' ability to manage liquidity.[233]

Some commenters argued that the requirements of the exclusion would not provide a banking entity with sufficient flexibility to respond to liquidity needs arising from changing economic conditions.[234] Some commenters argued the requirement that any position taken for liquidity management purposes be limited to the banking entity's near-term funding needs failed to account for longer-term liquidity management requirements.[235] These commenters further argued that the requirements of the liquidity management exclusion might not be synchronized with the Basel III framework, particularly with respect to the liquidity coverage ratio if ''near-term'' is considered less than 30 days.[236]

[219] *See* Public Citizen.

[220] *See* AFR *et al.* (Feb. 2012); Occupy.

[221] *See* AFR *et al.* (Feb. 2012); Occupy.

[222] Congress recognized that repurchase agreements and securities lending agreements are loans or extensions of credit by including them in the legal lending limit. *See* Dodd–Frank Act section 610 (amending 12 U.S.C. 84b). The Agencies believe the conditions of the final rule's exclusions for repurchase agreements and securities lending agreements identify those activities that do not in normal practice represent proprietary trading and, thus, the Agencies decline to provide additional requirements for these activities, as suggested by some commenters. *See* Public Citizen; AFR *et al.* (Feb. 2012); Occupy.

[223] *See* Goldman (Prop. Trading); JPMC; UBS.

[224] *See* CFTC Proposal, 77 FR at 8348.

[225] *See* proposed rule § 75.3(b)(2)(iii)(C).

[226] *Id.*

[227] *See* proposed rule § 75.3(b)(2)(iii)(C)(*1*)–(*5*).

[228] *See* Joint Proposal, 76 FR at 68862.

[229] *See* ABA (Keating); BoA; CH/ABASA; JPMC. *See supra* Part VI.A.1.b. (discussing the rebuttable presumption under § 75.3(b)(2) of the final rule); *see also supra* Part VI.A.1.a. (discussing the market risk rule trading account under § 75.3(b)(1)(ii) of the final rule).

[230] *See* CH/ABASA; Wells Fargo (Prop. Trading).

[231] *See* CH/ABASA; JPMC; State Street (Feb. 2012); Wells Fargo (Prop. Trading). *See also* BaFin/Deutsche Bundesbank.

[232] *See* BoA; JPMC; RBC.

[233] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); JPMC; NAIB *et al.;* State Street (Feb. 2012); T. Rowe Price.

[234] *See* ABA (Keating); CH/ABASA; JPMC.

[235] *See* ABA (Keating); BoA; CH/ABASA; JPMC.

[236] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); BoA; CH/ABASA.

Commenters also requested clarification on a number of other issues regarding the exclusion. For example, one commenter requested clarification that purchases and sales of U.S. registered mutual funds sponsored by a banking entity would be permissible.[237] Another commenter requested clarification that the deposits resulting from providing custodial services that are invested largely in high-quality securities in conformance with the banking entity's ALM policy would not be presumed to be ''short-term trading'' under the final rule.[238] Commenters also urged that the final rule not prohibit interaffiliate transactions essential to the ALM function.[239]

In contrast, other commenters supported the liquidity management exclusion criteria[240] and suggested tightening these requirements. For example, one commenter recommended that the rule require that investments made under the liquidity management exclusion consist only of high-quality liquid assets.[241] Other commenters argued that the exclusion for liquidity management should be eliminated.[242] One commenter argued that there was no need to provide a special exemption for liquidity management or ALM activities given the exemptions for trading in government obligations and risk-mitigating hedging activities.[243]

After carefully reviewing the comments received, the Agencies have adopted the proposed exclusion for liquidity management with several important modifications. As limited below, liquidity management activity serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act and in rules and guidance of the Agencies, of ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs.[244]

To ensure that this exclusion is not misused for the purpose of proprietary trading, the final rule imposes a number of requirements. First, the liquidity management plan of the banking entity must be limited to securities (in keeping with the liquidity management requirements proposed by the Federal banking agencies) and specifically contemplate and authorize the particular securities to be used for liquidity management purposes; describe the amount, types, and risks of securities that are consistent with the entity's liquidity management; and the liquidity circumstances in which the particular securities may or must be used.[245] Second, any purchase or sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes. Third, the plan must require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to instruments the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements.[246] Fourth, the plan must limit any securities purchased or sold for liquidity management purposes to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan.[247] Fifth, the banking entity must incorporate into its compliance program internal controls, analysis and independent testing designed to ensure that activities undertaken for liquidity management purposes are conducted in accordance with the requirements of the final rule and the entity's liquidity management plan. Finally, the plan must be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Agency responsible for regulating the banking entity.

The final rule retains the provision that the financial instruments purchased and sold as part of a liquidity management plan be highly liquid and not reasonably expected to give rise to appreciable profits or losses as a result of short-term price movements. This requirement is consistent with the Agencies' expectation for liquidity management plans in the supervisory context. It is not intended to prevent firms from recognizing profits (or losses) on instruments purchased and sold for liquidity management purposes. Instead, this requirement is intended to underscore that the purpose of these transactions must be liquidity management. Thus, the timing of purchases and sales, the types and duration of positions taken and the incentives provided to managers of these purchases and sales must all indicate that managing liquidity, and not taking short-term profits (or limiting short-term losses), is the purpose of these activities.

The exclusion as adopted does not apply to activities undertaken with the stated purpose or effect of hedging aggregate risks incurred by the banking entity or its affiliates related to asset-liability mismatches or other general market risks to which the entity or affiliates may be exposed. Further, the exclusion does not apply to any trading activities that expose banking entities to substantial risk from fluctuations in market values, unrelated to the management of near-term funding needs, regardless of the stated purpose of the activities.[248]

Overall, the Agencies do not believe that the final rule will stand as an obstacle to or otherwise impair the ability of banking entities to manage the

[237] *See* T. Rowe Price.

[238] *See* State Street (Feb. 2012).

[239] *See* State Street (Feb. 2012); JPMC. *See also* Part VI.A.1.d.10. (discussing commenter requests to exclude inter-affiliate transactions).

[240] *See* AFR *et al.* (Feb. 2012); Occupy.

[241] *See* Occupy.

[242] *See* Sens. Merkley & Levin (Feb. 2012).

[243] *See* Sens. Merkley & Levin (Feb. 2012).

[244] *See* section 165(b)(1)(A)(ii) of the Dodd-Frank Act; Enhanced Prudential Standards, 77 FR 644 at 645 (Jan. 5, 2012), available at *http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf*; *see also* Enhanced Prudential Standards, 77 FR 76678 at 76682 (Dec. 28, 2012), available at *http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.*

[245] To ensure sufficient flexibility to respond to liquidity needs arising from changing economic times, a banking entity should envision and address a range of liquidity circumstances in its liquidity management plan, and provide a mechanism for periodically reviewing and revising the liquidity management plan.

[246] The requirement to use highly liquid instruments is consistent with the focus of the clarifying exclusion on a banking entity's near-term liquidity needs. Thus, the final rules do not include commenters' suggested revisions to this requirement. *See* Clearing House Ass'n.; *see also* Occupy; Sens. Merkley & Levin (Feb. 2012). The Agencies decline to identify particular types of securities that will be considered highly liquid for purposes of the exclusion, as requested by some commenters, in recognition that such a determination will depend on the facts and circumstances. *See* T. Rowe Price; State Street (Feb. 2012).

[247] The Agencies plan to construe ''near-term funding needs'' in a manner that is consistent with the laws, regulations, and issuances related to liquidity risk management. *See, e.g.,* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 FR 71818 (Nov. 29, 2013); Basel Committee on Bank Supervision, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Management Tools (January 2013) available at *http://www.bis.org/publ/bcbs238.htm.* The Agencies believe this should help address commenters' concerns about the proposed requirement. *See, e.g.,* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); CH/ABASA; BoA; JPMC.

[248] *See, e.g.,* Staff of S. Comm. on Homeland Sec. & Governmental Affairs Permanent Subcomm. on Investigations, 113th Cong., Report: JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses (Apr. 11, 2013), available at *http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.*

risks of their businesses and operate in a safe and sound manner. Banking entities engaging in *bona fide* liquidity management activities generally do not purchase or sell financial instruments for the purpose of short-term resale or to benefit from actual or expected short-term price movements. The Agencies have determined, in contrast to certain commenters' requests, not to expand this liquidity management provision to broadly allow asset-liability management, earnings management, or scenario hedging.[249] To the extent these activities are for the purpose of profiting from short-term price movements or to hedge risks not related to short-term funding needs, they represent proprietary trading subject to section 13 of the BHC Act and the final rule; the activity would then be permissible only if it meets all of the requirements for an exemption, such as the risk-mitigating hedging exemption, the exemption for trading in U.S. government securities, or another exemption.

3. Transactions of Derivatives Clearing Organizations and Clearing Agencies

A banking entity that is a central counterparty for clearing and settlement activities engages in the purchase and sale of financial instruments as an integral part of clearing and settling those instruments. The proposed definition of trading account excluded an account used to acquire or take one or more covered financial positions by a derivatives clearing organization registered under the Commodity Exchange Act or a clearing agency registered under the Securities Exchange Act of 1934 in connection with clearing derivatives or securities transactions.[250] The preamble to the proposed rule noted that the purpose of these transactions is to provide a clearing service to third parties, not to profit from short-term resale or short-term price movements.[251]

Several commenters supported the proposed exclusion for derivatives clearing organizations and urged the Agencies to expand the exclusion to cover a banking entity's clearing-related activities, such as clearing a trade for a customer, trading with a clearinghouse, or accepting positions of a defaulting member, on grounds that these activities are not proprietary trades and reduce systemic risk.[252] One commenter recommended expanding the exclusion to non-U.S. central counterparties[253] In contrast, one commenter argued that the exclusion for derivatives clearing organizations and clearing agencies had no statutory basis and should instead be a permitted activity under section 13(d)(1)(J).[254]

After considering the comments received, the final rule retains the exclusion for purchases and sales of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with its clearing activities.[255] In response to comments,[256] the Agencies have also incorporated two changes to the rule. First, the final rule applies the exclusion to the purchase and sale of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with clearing financial instrument transactions. Second, in response to comments,[257] the exclusion in the final rule is not limited to clearing agencies or derivatives clearing organizations that are subject to SEC or CFTC registration requirements and, instead, certain foreign clearing agencies and foreign derivatives clearing organizations will be permitted to rely on the exclusion if they are banking entities.

The Agencies believe that clearing and settlement activity is not designed to create short-term trading profits. Moreover, excluding clearing and settlement activities prevents the final rule from inadvertently hindering the Dodd–Frank Act's goal of promoting central clearing of financial transactions. The Agencies have narrowly tailored this exclusion by allowing only central counterparties to use it and only with respect to their clearing and settlement activity.

4. Excluded Clearing-Related Activities of Clearinghouse Members

In addition to the exclusion for trading activities of a derivatives clearing organization or clearing agency, some commenters requested an additional exclusion from the definition of ''trading account'' for clearing-related activities of members of these entities.[258] These commenters noted that the proposed definition of ''trading account'' provides an exclusion for positions taken by registered derivatives clearing organizations and registered clearing agencie s[259] and requested a corresponding exclusion for certain clearing-related activities of banking entities that are members of a clearing agency or members of a derivatives clearing organization (collectively, ''clearing members'').[260]

Several commenters argued that certain aspects of the clearing process may require a clearing member to engage in principal transactions. For example, some commenters argued that a clearinghouse's default management process may require clearing members to take positions in financial instruments upon default of another clearing member.[261] According to commenters, default management processes can involve: (i) Collection of initial and variation margin from customers under an ''agency model'' of clearing; (ii) porting, where a defaulting clearing member's customer positions and margin are transferred to another non-defaulting clearing member;[262] (iii) hedging, where the clearing house looks to clearing members and third parties to enter into risk-reducing transactions and to flatten the market risk associated with the defaulting clearing member's house positions and non-ported customer positions; (iv) unwinding, where the defaulting member's open positions may be allocated to other clearing members, affiliates, or third parties pursuant to a mandatory auction process or forced allocation;[263] and (v) imposing certain obligations on clearing members upon exhaustion of a guaranty fund.[264]

Commenters argued that, absent an exclusion from the definition of ''trading account,'' some of these clearing-related activities could be considered prohibited proprietary trading under the proposal. Two commenters specifically contended that

[249] *See, e.g.,* ABA (Keating); BoA; CH/ABASA; JPMC.

[250] *See* proposed rule § 75.3(b)(2)(iii)(D).

[251] *See* Joint Proposal, 76 FR at 68863.

[252] *See* Allen & Overy (Clearing); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[253] *See* IIB/EBF.

[254] *See* Sens. Merkley & Levin (Feb. 2012).

[255] ''Clearing agency'' is defined in the final rule with reference to the definition of this term in the Exchange Act. *See* final rule § 75.3(e)(2). ''Derivatives clearing organization'' is defined in the final rule as (i) a derivatives clearing organization registered under section 5b of the Commodity Exchange Act; (ii) a derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act; or (iii) a foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

[256] *See* IIB/EBF; BNY Mellon *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading).

[257] *See* IIB/EBF; Allen & Overy (Clearing).

[258] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[259] *See* proposed rule § 75.3(b)(2)(iii)(D).

[260] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[261] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[262] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing).

[263] *See* Allen & Overy (Clearing).

[264] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

the dealer prong of the definition of ''trading account'' may cause certain of these activities to be considered proprietary trading.[265] Some commenters suggested alternative avenues for permitting such clearing-related activity under the rules.[266] Commenters argued that such clearing-related activities of banking entities should not be subject to the rule because they are risk-reducing, beneficial for the financial system, required by law under certain circumstances (*e.g.,* central clearing requirements for swaps and security-based swaps under Title VII of the Dodd-Frank Act), and not used by banking entities to engage in proprietary trading.[267]

Commenters further argued that certain activities undertaken as part of a clearing house's daily risk management process may be impacted by the rule, including unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired credit default swap (''CDS'') protection on itself as a result of a merger with another firm) [268] and trade crossing, a mechanism employed by certain clearing houses to ensure the accuracy of the price discovery process in the course of, among other things, calculating settlement prices and margin requirements.[269]

The Agencies do not believe that certain core clearing-related activities conducted by a clearing member, often as required by regulation or the rules and procedures of a clearing agency, derivatives clearing organization, or designated financial market utility, represent proprietary trading as contemplated by the statute. For example, the clearing and settlement activities discussed above are not conducted for the purpose of profiting from short-term price movements. The Agencies believe that these clearing-related activities provide important benefits to the financial system.[270] In particular, central clearing reduces counterparty credit risk,[271] which can lead to a host of other benefits, including lower hedging costs, increased market participation, greater liquidity, more efficient risk sharing that promotes capital formation, and reduced operational risk.[272]

Accordingly, in response to comments, the final rule provides that proprietary trading does not include specified excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility.[273] ''Excluded clearing activities'' is defined in the rule to identify particular core clearing-related activities, many of which were raised by commenters.[274] Specifically, the final rule will exclude the following activities by clearing members: (i) Any purchase or sale necessary to correct error trades made by or on behalf of customers with respect to customer transactions that are cleared, provided the purchase or sale is conducted in accordance with certain regulations, rules, or procedures; (ii) any purchase or sale related to the management of a default or threatened imminent default of a customer, subject to certain conditions, another clearing member, or the clearing agency, derivatives clearing organization, or designated financial market utility itself; [275] and (iii) any purchase or sale required by the rules or procedures of a clearing agency, derivatives clearing organization, or designated financial market utility that mitigates risk to such agency, organization, or utility that would result from the clearing by a clearing member of security-based swaps that references the member or an affiliate of the member.[276]

The Agencies are identifying specific activities in the rule to limit the potential for evasion that may arise from a more generalized approach. However, the relevant supervisory Agencies will be prepared to provide further guidance or relief, if appropriate, to ensure that the terms of the exclusion do not limit the ability of clearing agencies, derivatives clearing organizations, or designated financial market utilities to effectively manage their risks in accordance with their rules and procedures. In response to commenters requesting that the exclusion be available when a clearing member is required by rules of a clearing agency, derivatives clearing organization, or designated financial market utility to purchase or sell a financial instrument as part of establishing accurate prices to be used by the clearing agency, derivatives clearing organization, or designated financial market utility in its end of day settlement process,[277] the Agencies note that whether this is an excluded clearing activity depends on the facts and circumstances. Similarly, the availability of other exemptions to the rule, such as the market-making exemption, depend on the facts and circumstances. This exclusion applies only to excluded clearing activities of clearing members. It does not permit a banking entity to engage in proprietary trading and claim protection for that activity because trades are cleared or settled through a central counterparty.

5. Satisfying an Existing Delivery Obligation

A few commenters requested additional or expanded exclusions from the definition of ''trading account'' for covering short sales or failures to deliver.[278] These commenters alleged that a banking entity engages in this activity for purposes other than to

[265] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (arguing that the SEC has suggested that entities that collect margins from customers for cleared swaps may be required to be registered as broker-dealers); State Street (Feb. 2012).

[266] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[267] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); State Street (Feb. 2012); Allen & Overy (Clearing).

[268] *See* Allen & Overy (Clearing).

[269] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop. Trading) (Feb. 2012). These commenters stated that, in order to ensure that a clearing member is providing accurate end-of-day prices for its open positions, a clearing house may require the member to provide firm bids for such positions, which may be tested through a ''forced trade'' with another member. *See id.; see also* ISDA (Feb. 2012).

[270] For example, Title VII of the Dodd-Frank Act mandates the central clearing of swaps and security-based swaps, and requires that banking entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants collect variation margin from many counterparties on a daily basis for their swap or security-based swap activity. *See* 7 U.S.C. 2(h); 15 U.S.C. 78c–3; 7 U.S.C. 6s(e); 15 U.S.C. 78o–10(e); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011). Additionally, the SEC's Rule 17Ad–22(d)(11) requires that each registered clearing agency establish, implement, maintain and enforce policies and procedures that set forth the clearing agency's default management procedures. *See* 17 CFR 240.17Ad–22(d)(11). *See also* Exchange Act Release No. 68,080 (Oct. 12, 2012), 77 FR 66220, 66,283 (Nov. 2, 2012).

[271] Centralized clearing affects counterparty risk in three basic ways. First, it redistributes counterparty risk among members through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. Second, margin requirements and monitoring reduce moral hazard, reducing counterparty risk. Finally, clearing may reallocate counterparty risk outside of the clearing agency because netting may implicitly subordinate outside creditors' claims relative to other clearing member claims.

[272] *See* Proposed Rule, Cross-Border Security-Based Swap Activities, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968, 31,162–31,163 (May 23, 2013).

[273] *See* final rule § 75.3(d)(5).

[274] *See* final rule § 75.3(e)(7).

[275] A number of commenters discussed the default management process and requested an exclusion for such activities. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[276] *See* Allen & Overy (Clearing) (discussing rules that require unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired CDS protection on itself as a result of a merger with another firm)).

[277] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ISDA (Feb. 2012).

[278] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

benefit from short term price movements and that it is not proprietary trading as defined in the statute. In response to these comments, the final rule provides that a purchase or sale by a banking entity that satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity is not proprietary trading.

Among other things, this exclusion will allow a banking entity that is an SEC-registered broker-dealer to take action to address failures to deliver arising from its own trading activity or the trading activity of its customers.[279] In certain circumstances, SEC-registered broker-dealers are required to take such action under SEC rules.[280] In addition, buy-in procedures of a clearing agency, securities exchange, or national securities association may require a banking entity to deliver securities if a party with a fail to receive position takes certain action.[281] When a banking entity purchases securities to meet an existing delivery obligation, it is engaging in activity that facilitates timely settlement of securities transactions and helps provide a purchaser of the securities with the benefits of ownership (*e.g.,* voting and lending rights). In addition, a banking entity has limited discretion to determine when and how to take action to meet an existing delivery obligation.[282] Providing a limited exclusion for this activity will avoid the potential for SEC-registered broker-dealers being subject to conflicting or inconsistent regulatory requirements with respect to activity required to meet the broker-dealer's existing delivery obligations.

6. Satisfying an Obligation in Connection With a Judicial, Administrative, Self-Regulatory Organization, or Arbitration Proceeding

The Agencies recognize that, under certain circumstances, a banking entity may be required to purchase or sell a financial instrument at the direction of a judicial or regulatory body. For example, an administrative agency or self-regulatory organization (''SRO'') may require a banking entity to purchase or sell a financial instrument in the course of disciplinary proceedings against that banking entity.[283] A banking entity may also be obligated to purchase or sell a financial instrument in connection with a judicial or arbitration proceeding.[284] Such transactions do not represent trading for short-term profit or gain and do not constitute proprietary trading under the statute.

Accordingly, the Agencies have determined to adopt a provision clarifying that a purchase or sale of one or more financial instruments that satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding is not proprietary trading for purposes of these rules. This clarification will avoid the potential for conflicting or inconsistent legal requirements for banking entities.

7. Acting Solely as Agent, Broker, or Custodian

The proposal clarified that proprietary trading did not include acting solely as agent, broker, or custodian for an unaffiliated third party.[285] Commenters generally supported this aspect of the proposal. One commenter suggested that acting as agent, broker, or custodian for affiliates should be explicitly excluded from the definition of proprietary trading in the same manner as acting as agent, broker, or custodian for unaffiliated third parties.[286]

Like the proposal, the final rule expressly provides that the purchase or sale of one or more financial instruments by a banking entity acting solely as agent, broker, or custodian is not proprietary trading because acting in these types of capacities does not involve trading as principal, which is one of the requisite aspects of the statutory definition of proprietary trading.[287] The final rule has been modified to include acting solely as agent, broker, or custodian on behalf of an affiliate. However, the affiliate must comply with section 13 of the BHC Act and the final implementing rule; and may not itself engage in prohibited proprietary trading. To the extent a banking entity acts in both a principal and agency capacity for a purchase or sale, it may only use this exclusion for the portion of the purchase or sale for which it is acting as agent. The banking entity must use a separate exemption or exclusion, if applicable, to the extent it is acting in a principal capacity.

8. Purchases or Sales Through a Deferred Compensation or Similar Plan

While the proposed rule provided that the prohibition on covered fund activities and investments did not apply to certain instances where the banking entity acted through or on behalf of a pension or similar deferred compensation plan, no such similar treatment was given for proprietary trading. One commenter argued that the proposal restricted a banking entity's ability to engage in principal-based trading as an asset manager that serves the needs of the institutional investors, such as through ERISA pension and 401(k) plans.[288]

To address these concerns, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established

[279] In order to qualify for this exclusion, a banking entity's principal trading activity that results in its own failure to deliver must have been conducted in compliance with these rules.

[280] *See, e.g.,* 17 CFR 242.204 (requiring, among other things, that a participant of a registered clearing agency or, upon reasonable allocation, a broker-dealer for which the participant clears trades or from which the participant receives trades for settlement, take action to close out a fail to deliver position in any equity security by borrowing or purchasing securities of like kind and quantity); 17 CFR 240.15c3–3(m) (providing that, if a broker-dealer executes a sell order of a customer and does not obtain possession of the securities from the customer within 10 business days after settlement, the broker-dealer must immediately close the transaction with the customer by purchasing securities of like kind and quantity).

[281] *See, e.g.,* NSCC Rule 11, NASDAQ Rule 11810, FINRA Rule 11810.

[282] *See, e.g.,* 17 CFR 242.204 (requiring action to close out a fail to deliver position in an equity security within certain specified timeframes); 17 CFR 240.15c3–3(m) (requiring a broker-dealer to ''immediately'' close a transaction under certain circumstances).

[283] For example, an administrative agency or SRO may require a broker-dealer to offer to buy securities back from customers where the agency or SRO finds the broker-dealer fraudulently sold securities to those customers. *See, e.g.,* In re Raymond James & Assocs., Exchange Act Release No. 64767, 101 S.E.C. Docket 1749 (June 29, 2011); FINRA Dep't of Enforcement v. Pinnacle Partners Fin. Corp., Disciplinary Proceeding No. 2010021324501 (Apr. 25, 2012); FINRA Dep't of Enforcement v. Fifth Third Sec., Inc., No. 2005002244101 (Press Rel. Apr. 14, 2009).

[284] For instance, section 29 of the Exchange Act may require a broker-dealer to rescind a contract with a customer that was made in violation of the Exchange Act. Such rescission relief may involve the broker-dealer's repurchase of a financial instrument from a customer. *See* 15 U.S.C. 78cc; Reg'l Props., Inc. v. Fin. & Real Estate Consulting Co., 678 F.2d 552 (5th Cir. 1982); Freeman v. Marine Midland Bank N.Y., 419 F.Supp. 440 (E.D.N.Y. 1976).

[285] *See* proposed rule § 75.3(b)(1).

[286] *See* Japanese Bankers Ass'n.

[287] *See* 12 U.S.C. 1851(h)(4). A common or collective investment fund that is an investment company under section 3(c)(3) or 3(c)(11) will not be deemed to be acting as principal within the meaning of § 75.3(a) because the fund is performing a traditional trust activity and purchases and sells financial instruments solely on behalf of customers as trustee or in a similar fiduciary capacity, as evidenced by its regulation under 12 CFR part 9 (Fiduciary Activities of National Banks) or similar state laws.

[288] *See* Ass'n. of Institutional Investors (Nov. 2012).

and administered in accordance with the laws of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of the employees of the banking entity or members of their immediate family. Banking entities often establish and act as trustee to pension or similar deferred compensation plans for their employees and, as part of managing these plans, may engage in trading activity. The Agencies believe that purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute.

The Agencies note that if a banking entity engages in trading activity for an unaffiliated pension or similar deferred compensation plan, the trading activity of the banking entity would not be proprietary trading under the final rule to the extent the banking entity was acting solely as agent, broker, or custodian.

9. Collecting a Debt Previously Contracted

Several commenters argued that the final rule should exclude collecting and disposing of collateral in satisfaction of debts previously contracted from the definition of proprietary trading.[289] Commenters argued that acquiring and disposing of collateral in satisfaction of debt previously contracted does not involve trading with the intent of profiting from short-term price movements and, thus, should not be proprietary trading for purposes of this rule. Rather, this activity is a prudent and desirable part of lending and debt collection activities.

The Agencies believe that the purchase and sale of a financial instrument in satisfaction of a debt previously contracted does not constitute proprietary trading. The Agencies believe an exclusion for purchases and sales in satisfaction of debts previously contracted is necessary for banking entities to continue to lend to customers, because it allows banking entities to continue lending activity with the knowledge that they will not be penalized for recouping losses should a customer default. Accordingly, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable within the time period permitted or required by the appropriate financial supervisory agency.[290]

As a result of this exclusion, banking entities, including SEC-registered broker-dealers, will be able to continue providing margin loans to their customers and may take possession of margined collateral following a customer's default or failure to meet a margin call under applicable regulatory requirements.[291] Similarly, a banking entity that is a CFTC-registered swap dealer or SEC-registered security-based swap dealer may take, hold, and exchange any margin collateral as counterparty to a cleared or uncleared swap or security-based swap transaction, in accordance with the rules of the Agencies.[292] This exclusion will allow banking entities to comply with existing regulatory requirements regarding the divestiture of collateral taken in satisfaction of a debt.

10. Other Requested Exclusions

Commenters requested a number of additional exclusions from the trading account and, in turn, the prohibition on proprietary trading. In order to avoid potential evasion of the final rule, the Agencies decline to adopt any exclusions from the trading account other than the exclusions described above.[293] The Agencies believe that various modifications to the final rule, including in particular to the exemption for market-making related activities, address many of commenters' concerns regarding unintended consequences of the prohibition on proprietary trading.

2. Section 75.4(a): Underwriting Exemption

a. Introduction

After carefully considering comments on the proposed underwriting exemption, the Agencies are adopting the proposed underwriting exemption substantially as proposed, but with certain refinements and clarifications to the proposed approach to better reflect the range of securities offerings that an underwriter may help facilitate on behalf of an issuer or selling security holder and the types of activities an underwriter may undertake in connection with a distribution of securities to facilitate the distribution process and provide important benefits to issuers, selling security holders, or purchasers in the distribution. The Agencies are adopting such an approach because the statute specifically permits banking entities to continue providing these beneficial services to clients, customers, and counterparties. At the same time, to reduce the potential for evasion of the general prohibition on proprietary trading, the Agencies are requiring, among other things, that the trading desk make reasonable efforts to sell or otherwise reduce its underwriting position (accounting for the liquidity, maturity, and depth of the market for the relevant type of security) and be subject to a robust risk limit structure that is designed to prevent a trading desk from having an underwriting position that exceeds the reasonably expected near term demands of clients, customers, or counterparties.

b. Overview

1. Proposed Underwriting Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities and certain other instruments in connection with underwriting activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[294]

Section 75.4(a) of the proposed rule would have implemented this exemption by requiring that a banking entity's underwriting activities comply with seven requirements. As discussed

[289] *See* LSTA (Feb. 2012); JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[290] *See* final rule § 75.3(d)(9).

[291] For example, if any margin call is not met in full within the time required by Regulation T, then Regulation T requires a broker-dealer to liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less. *See* 12 CFR 220.4(d).

[292] *See* SEC Proposed Rule, Capital, Margin, Segregation, Reporting and Recordkeeping Requirements for Security-Based Swap Dealers, Exchange Act Release No. 68071, 77 FR 70214 (Nov. 23, 2012); CFTC Proposed Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011); Banking Agencies' Proposed Rule, Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011).

[293] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (transactions that are not based on expected or anticipated movements in asset prices, such as fully collateralized swap transactions that serve funding purposes); Norinchukin and Wells Fargo (Prop. Trading) (derivatives that qualify for hedge accounting); GE (Feb. 2012) (transactions related to commercial contracts); Citigroup (Feb. 2012) (FX swaps and FX forwards); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (interaffiliate transactions); T. Rowe Price (purchase and sale of shares in sponsored mutual funds); RMA (cash collateral pools); Alfred Brock (arbitrage trading); ICBA (securities traded pursuant to 12 U.S.C. 1831a(f)). The Agencies are concerned that these exclusions could be used to conduct impermissible proprietary trading, and the Agencies believe some of these exclusions are more appropriately addressed by other provisions of the rule. For example, derivatives qualifying for hedge accounting may be permitted under the hedging exemption.

[294] 12 U.S.C. 1851(d)(1)(B).

in more detail below, the proposed underwriting exemption required that: (i) A banking entity establish a compliance program under § 75.20; (ii) the covered financial position be a security; (iii) the purchase or sale be effected solely in connection with a distribution of securities for which the banking entity is acting as underwriter; (iv) the banking entity meet certain dealer registration requirements, where applicable; (v) the underwriting activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; (vi) the underwriting activities be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or to hedging of covered financial positions; and (vii) the compensation arrangements of persons performing underwriting activities be designed not to reward proprietary risk-taking.[295] The proposal explained that these seven criteria were proposed so that any banking entity relying on the underwriting exemption would be engaged in *bona fide* underwriting activities and would conduct those activities in a way that would not be susceptible to abuse through the taking of speculative, proprietary positions as part of, or mischaracterized as, underwriting activity.[296]

2. Comments on Proposed Underwriting Exemption

As a general matter, a few commenters expressed overall support for the proposed underwriting exemption.[297] Some commenters indicated that the proposed exemption is too narrow and may negatively impact capital markets.[298] As discussed in more detail below, many commenters expressed views on the effectiveness of specific requirements of the proposed exemption. Further, some commenters requested clarification or expansion of the proposed exemption for certain activities that may be conducted in the course of underwriting.

Several commenters suggested alternative approaches to implementing the statutory exemption for underwriting activities.[299] More specifically, commenters recommended that the Agencies: (i) Provide a safe harbor for low risk, standard underwritings;[300] (ii) better incorporate the statutory limitations on high-risk activity or conflicts of interest;[301] (iii) prohibit banking entities from underwriting illiquid securities;[302] (iv) prohibit banking entities from participating in private placements;[303] (v) place greater emphasis on adequate internal compliance and risk management procedures;[304] or (vi) make the exemption as broad as possible.[305]

3. Final Underwriting Exemption

After considering the comments received, the Agencies are adopting the underwriting exemption substantially as proposed, but with important modifications to clarify provisions or to address commenters' concerns. As discussed above, some commenters were generally supportive of the proposed approach to implementing the underwriting exemption, but noted certain areas of concern or uncertainty. The underwriting exemption the Agencies are adopting addresses these issues by further clarifying the scope of activities that qualify for the exemption. In particular, the Agencies are refining the proposed exemption to better capture the broad range of capital-raising activities facilitated by banking entities acting as underwriters on behalf of issuers and selling security holders.

The final underwriting exemption includes the following components:

- A framework that recognizes the differences in underwriting activities across markets and asset classes by establishing criteria that will be applied flexibly based on the liquidity, maturity, and depth of the market for the particular type of security.
- A general focus on the ''underwriting position'' held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with the distribution of securities for which such banking entity or affiliate is acting as an underwriter.[306]
- A definition of the term ''trading desk'' that focuses on the functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a banking entity or across two or more affiliates.[307]
- Five standards for determining whether a banking entity is engaged in permitted underwriting activities. Many of these criteria have similarities to those included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - The banking entity act as an ''underwriter'' for a ''distribution'' of securities and the trading desk's underwriting position be related to such distribution. The final rule includes refined definitions of ''distribution'' and ''underwriter'' to better capture the broad scope of securities offerings used by issuers and selling security holders and the range of roles that a banking entity may play as intermediary in such offerings.[308]
  - The amount and types of securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[309]

[295] *See* proposed rule § 75.4(a).

[296] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[297] *See* Barclays (stating that the proposed exemption generally effectuates the aims of the statute while largely avoiding undue interference, although the commenter also requested certain technical changes to the rule text); Alfred Brock.

[298] *See, e.g.,* Lord Abbett; BoA; Fidelity; Chamber (Feb. 2012).

[299] *See* Sens. Merkley & Levin (Feb. 2012); BoA; Fidelity; Occupy; AFR *et al.* (Feb. 2012).

[300] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting a safe harbor for underwriting efforts that meet certain low-risk criteria, including that: The underwriting be in plain vanilla stock or bond offerings, including commercial paper, for established business and governments; and the distribution be completed within relevant time periods, as determined by asset classes, with relevant factors being the size of the issuer and the market served); Johnson & Prof. Stiglitz (expressing support for a narrow safe harbor for underwriting of basic stocks and bonds that raise capital for real economy firms).

[301] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting that, for example, the exemption plainly prevent high-risk, conflict ridden underwritings of securitizations and structured products and cross-reference Section 621 of the Dodd-Frank Act, which prohibits certain material conflicts of interest in connection with asset-backed securities).

[302] *See* AFR *et al.* (Feb. 2012) (recommending that the Agencies prohibit banking entities from acting as underwriter for assets classified as Level 3 under FAS 157, which would prohibit underwriting of illiquid and opaque securities without a genuine external market, and representing that such a restriction would be consistent with the statutory limitation on exposures to high-risk assets).

[303] *See* Occupy.

[304] *See* BoA (recommending that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rules as long as the banking entity has adequate compliance and risk management procedures).

[305] *See* Fidelity (suggested that the rules be revised to ''provide the broadest exemptions possible under the statute'' for underwriting and certain other permitted activities).

[306] *See infra* Part VI.A.2.c.1.c.

[307] *See infra* Part VI.A.2.c.1.c. The term ''trading desk'' is defined in final rule § 75.3(e)(13) as ''the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.''

[308] *See* final rule §§ 75.4(a)(2)(i), 75.4(a)(3), 75.4(a)(4); *see also infra* Part VI.A.2.c.1.c.

[309] *See* final rule § 75.4(a)(2)(ii); *see also infra* Part VI.A.2.c.2.c.

○ The banking entity establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

▪ The products, instruments, or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

▪ Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the amount, types, and risk of the trading desk's underwriting position, level of exposures to relevant risk factors arising from the trading desk's underwriting position, and period of time a security may be held;

▪ Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

▪ Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval.[310]

○ The compensation arrangements of persons performing the banking entity's underwriting activities are designed not to reward or incentivize prohibited proprietary trading.[311]

○ The banking entity is licensed or registered to engage in the activity described in the underwriting exemption in accordance with applicable law.[312]

After considering commenters' suggested alternative approaches to implementing the statute's underwriting exemption, the Agencies have determined to retain the general structure of the proposed underwriting exemption. For instance, two commenters suggested providing a safe harbor for ''plain vanilla'' or ''basic'' underwritings of stocks and bonds.[313] The Agencies do not believe that a safe harbor is necessary to provide certainty that a banking entity may act as an underwriter in these particular types of offerings. This is because ''plain vanilla'' or ''basic'' underwriting activity should be able to meet the requirements of the final rule. For example, the final definition of ''distribution'' includes any offering of securities made pursuant to an effective registration statement under the Securities Act.[314]

Further, in response to one commenter's request that the final rule prohibit a banking entity from acting as an underwriter in illiquid assets that are determined to not have observable price inputs under accounting standards,[315] the Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule.[316] Moreover, the Agencies do not believe it is necessary to differentiate between liquid and less liquid securities for purposes of determining whether a banking entity may underwrite a distribution of securities because, in either case, a banking entity must have a reasonable expectation of purchaser demand for the securities and must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period under the final rule.[317]

Another commenter suggested that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rule as long as the banking entity has adequate compliance and risk management procedures.[318] While strong compliance and risk management procedures are important for banking entities' permitted activities, the Agencies believe that an approach focused solely on the establishment of a compliance program would likely increase the potential for evasion of the general prohibition on proprietary trading. Similarly, the Agencies are not adopting an exemption that is unlimited, as requested by one commenter, because the Agencies believe controls are necessary to prevent potential evasion of the statute through, among other things, retaining an unsold allotment when there is sufficient customer interest for the securities and to limit the risks associated with these activities.[319]

Underwriters play an important role in facilitating issuers' access to funding, and thus underwriters are important to the capital formation process and economic growth.[320] Obtaining new financing can be expensive for an issuer because of the natural information advantage that less well-known issuers have over investors about the quality of their future investment opportunities. An underwriter can help reduce these costs by mitigating the information asymmetry between an issuer and its potential investors. The underwriter does this based in part on its familiarity with the issuer and other similar issuers as well as by collecting information about the issuer. This allows investors to look to the reputation and experience of the underwriter as well as its ability to provide information about the issuer and the underwriting. For these and other reasons, most U.S. issuers rely on the services of an underwriter when raising funds through public offerings. As recognized in the statute, the exemption is intended to permit banking entities to continue to perform the underwriting function, which contributes to capital formation and its positive economic effects.

c. Detailed Explanation of the Underwriting Exemption

1. Acting as an Underwriter for a Distribution of Securities

a. Proposed Requirements That the Purchase or Sale Be Effected Solely in Connection With a Distribution of Securities for Which the Banking Entity Acts as an Underwriter and That the Covered Financial Position Be a Security

Section 75.4(a)(2)(iii) of the proposed rule required that the purchase or sale be effected solely in connection with a distribution of securities for which a banking entity is acting as

[310] *See* final rule § 75.4(a)(2)(iii); *see also infra* Part VI.A.2.c.3.c.

[311] *See* final rule § 75.4(a)(2)(iv); *see also infra* Part VI.A.2.c.4.c.

[312] *See* final rule § 75.4(a)(2)(v); *see also infra* Part VI.A.2.c.5.c.

[313] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz. One of these commenters also suggested that the Agencies better incorporate the statutory limitations on material conflicts of interest and high-risk activities in the underwriting exemption by including additional provisions in the exemption to refer to these limitations. *See* Sens. Merkley & Levin (Feb. 2012). The Agencies note that these limitations are adopted in § 75.7 of the final rules, and this provision will apply to underwriting activities, as well as all other exempted activities.

[314] *See* final rule § 75.4(a)(3).

[315] *See* AFR *et al.* (Feb. 2012).

[316] *See* Joint Proposal, 76 FR at 68859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR at 8344 n.107.

[317] *See infra* Part VI.A.2.c.2.c.

[318] *See* BoA.

[319] *See* Fidelity.

[320] *See, e.g.,* BoA (''The underwriting activities of U.S. banking entities are essential to capital formation and, therefore, economic growth and job creation.''); Goldman (Prop. Trading); Sens. Merkley & Levin (Feb. 2012).

underwriter.[321] As discussed below, the Agencies proposed to define the terms ''distribution'' and ''underwriter'' in the proposed rule. The proposed rule also required that the covered financial position being purchased or sold by the banking entity be a security.[322]

i. Proposed Definition of ''Distribution''

The proposed definition of ''distribution'' mirrored the definition of this term used in the SEC's Regulation M under the Exchange Act.[323] More specifically, the proposed rule defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.'' [324] The Agencies did not propose to define the terms ''magnitude'' and ''special selling efforts and selling methods,'' but stated that the Agencies would expect to rely on the same factors considered in Regulation M for assessing these elements.[325] The Agencies noted that ''magnitude'' does not imply that a distribution must be large and, therefore, this factor would not preclude small offerings or private placements from qualifying for the proposed underwriting exemption.[326]

ii. Proposed Definition of ''Underwriter''

Like the proposed definition of ''distribution,'' the Agencies proposed to define ''underwriter'' in a manner similar to the definition of this term in the SEC's Regulation M.[327] The definition of ''underwriter'' in the proposed rule was: (i) Any person who has agreed with an issuer or selling security holder to: (a) Purchase securities for distribution; (b) engage in a distribution of securities for or on behalf of such issuer or selling security holder; or (c) manage a distribution of securities for or on behalf of such issuer or selling security holder; and (ii) a person who has an agreement with another person described in the preceding provisions to engage in a distribution of such securities for or on behalf of the issuer or selling security holder.[328]

In connection with this proposed requirement, the Agencies noted that the precise activities performed by an underwriter may vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. To determine whether a banking entity is acting as an underwriter as part of a distribution of securities, the Agencies proposed to take into consideration the extent to which a banking entity is engaged in the following activities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[329]

The proposal recognized that there may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. The Agencies stated that if the unsold securities were acquired in connection with underwriting under the proposed exemption, then the underwriter would be able to dispose of such securities at a later time.[330]

iii. Proposed Requirement That the Covered Financial Position Be a Security

Pursuant to § 75.4(a)(2)(ii) of the proposed exemption, a banking entity would be permitted to purchase or sell a covered financial position that is a security only in connection with its underwriting activities.[331] The proposal stated that this requirement was meant to reflect the common usage and understanding of the term ''underwriting.'' [332] It was noted, however, that a derivative or commodity future transaction may be otherwise permitted under another exemption (*e.g.,* the exemptions for market making-related or risk-mitigating hedging activities).[333]

b. Comments on the Proposed Requirements That the Trade Be Effected Solely in Connection With a Distribution for Which the Banking Entity Is Acting as an Underwriter and That the Covered Financial Position Be a Security

In response to the proposed requirement that a purchase or sale be ''effected solely in connection with a distribution of securities'' for which the ''banking entity is acting as underwriter,'' commenters generally focused on the proposed definitions of ''distribution'' and ''underwriter'' and the types of activities that should be permitted under the ''in connection with'' standard. Commenters did not directly address the requirement in § 75.4(a)(2)(ii) of the proposed rule, which provided that the covered financial position purchased or sold under the exemption must be a security. A number of commenters expressed general concern that the proposed underwriting exemption's references to a ''purchase or sale of a covered financial position'' could be interpreted to require compliance with the proposed rule on a transaction-by-transaction basis. These commenters indicated that such an approach would be overly burdensome.[334]

i. Definition of ''Distribution''

Several commenters stated that the proposed definition of ''distribution'' is too narrow,[335] while one commenter stated that the proposed definition is too broad.[336] Commenters who viewed the proposed definition as too narrow stated that it may exclude important capital-raising and financing transactions that do not appear to involve ''special selling

[321] *See* proposed rule § 75.4(a)(2)(iii).

[322] *See* proposed rule § 75.4(a)(2)(ii).

[323] *See* Joint Proposal, 76 FR at 68866–68867; CFTC Proposal, 77 FR at 8352; 17 CFR 242.101; proposed rule § 75.4(a)(3).

[324] *See* proposed rule § 75.4(a)(3).

[325] *See* Joint Proposal, 76 FR at 68867 (''For example, the number of shares to be sold, the percentage of the outstanding shares, public float, and trading volume that those shares represent are all relevant to an assessment of magnitude. In addition, delivering a sales document, such as a prospectus, and conducting road shows are generally indicative of special selling efforts and selling methods. Another indicator of special selling efforts and selling methods is compensation that is greater than that for secondary trades but consistent with underwriting compensation for an offering.''); CFTC Proposal, 77 FR at 8352; Review of Antimanipulation Regulation of Securities Offering, Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681, 21684–21685 (Apr. 26, 1994).

[326] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[327] *See* Joint Proposal, 76 FR at 68866–68867; CFTC Proposal, 77 FR at 8352; 17 CFR 242.101; proposed rule § 75.4(a)(4).

[328] *See* proposed rule § 75.4(a)(4). As noted in the proposal, the proposed rule's definition differed from the definition in Regulation M because the proposed rule's definition would also include a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder. *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[329] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[330] *See id.*

[331] *See* proposed rule § 75.4(a)(2)(ii).

[332] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[333] *See* Joint Proposal, 76 FR at 68866 n.132; CFTC Proposal, 77 FR at 8352 n.138.

[334] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[335] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[336] *See* Occupy.

efforts and selling methods'' or ''magnitude.''[337] In particular, these commenters stated that the proposed definition of ''distribution'' may preclude a banking entity from participating in commercial paper issuances,[338] bridge loans,[339] ''at-the-market'' offerings or ''dribble out'' programs conducted off issuer shelf registrations,[340] offerings in response to reverse inquiries,[341] offerings through an automated execution system,[342] small private offerings,[343] or selling security holders' sales of securities of issuers with large market capitalizations that are executed as underwriting transactions in the normal course.[344]

Several commenters suggested that the proposed definition be modified to include some or all of these types of offerings.[345] For example, two commenters requested that the definition explicitly include all offerings of securities by an issuer.[346] One of these commenters further requested a broader definition that would include any offering by a selling security holder that is registered under the Securities Act or that involves an offering document prepared by the issuer.[347] Another commenter suggested that the rule explicitly authorize certain forms of offerings, such as offerings under Rule 144A, Regulation S, Rule 101(b)(10) of Regulation M, or the so-called ''section 4(1½)'' of the Securities Act, as well as transactions on behalf of selling security holders.[348] Two commenters proposed approaches that would include the resale of notes or other debt securities received by a banking entity from a borrower to replace or refinance a bridge loan.[349] One of these commenters stated that permitting a banking entity to receive and resell notes or other debt securities from a borrower to replace or refinance a bridge loan would preserve the ability of a banking entity to extend credit and offer customers a range of financing options. This commenter further represented that such an approach would be consistent with the exclusion of loans from the proposed definition of ''covered financial position'' and the commenter's recommended exclusion from the definition of ''trading account'' for collecting debts previously contracted.[350]

One commenter, however, stated that the proposed definition of ''distribution'' is too broad. This commenter suggested that the underwriting exemption should only be available for registered offerings, and the rule should preclude a banking entity from participating in a private placement. According to the commenter, permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading.[351]

ii. Definition of ''Underwriter''

Several commenters stated that the proposed definition of ''underwriter'' is too narrow.[352] Other commenters, however, stated that the proposed definition is too broad, particularly due to the proposed inclusion of selling group members.[353]

Commenters requesting a broader definition generally stated that the Agencies should instead use the Regulation M definition of ''distribution participant'' or otherwise revise the definition of ''underwriter'' to incorporate the concept of a ''distribution participant,'' as defined under Regulation M.[354] According to these commenters, using the term ''distribution participant'' would better reflect current market practice and would include dealers that participate in an offering but that do not deal directly with the issuer or selling security holder and do not have a written agreement with the underwriter.[355] One commenter further represented that the proposed provision for selling group members may be less inclusive than the Agencies intended because individual selling dealers or dealer groups may or may not have written agreements with an underwriter in privity of contract with the issuer.[356] Another commenter requested that, if the ''distribution participant'' concept is not incorporated into the rule, the proposed definition of ''underwriter'' be modified to include a person who has an agreement with an affiliate of an issuer or selling security holder (*e.g.,* an agreement with a parent company to distribute the issuer's securities).[357]

Other commenters opposed the inclusion of selling group members in the proposed definition of ''underwriter.'' These commenters stated that because selling group members do not provide a price guarantee to an issuer, they do not provide services to a customer and their activities should not qualify for the underwriting exemption.[358]

A number of commenters stated that it is unclear whether the proposed underwriting exemption would permit a banking entity to act as an authorized participant (''AP'') to an ETF issuer, particularly with respect to the creation and redemption of ETF shares or ''seeding'' an ETF for a short period of

[337] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[338] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). In addition, one commenter expressed general concern that the proposed rule would cause a reduction in underwriting services with respect to commercial paper, which would reduce liquidity in commercial paper markets and raise the costs of capital in already tight credit markets. *See* Chamber (Feb. 2012).

[339] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC; LSTA (Feb. 2012).

[340] *See* Goldman (Prop. Trading).

[341] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[342] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[343] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[344] *See* RBC.

[345] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[346] *See* Goldman (Prop. Trading) (stating that this would capture, among other things, commercial paper issuances, issuer ''dribble out'' programs, and small private offerings, which involve the purchase of securities directly from an issuer with a view toward resale, but may not always be clearly distinguished by ''special selling efforts and selling methods'' or by ''magnitude''); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[347] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter indicated that expanding the definition of ''distribution'' to include both offerings of securities by an issuer and offerings by a selling security holder that are registered under the Securities Act or that involve an offering document prepared by the issuer would ''include, for example, an offering of securities by an issuer or a selling security holder where securities are sold through an automated order execution system, offerings in response to reverse inquiries and commercial paper issuances.'' *Id.*

[348] *See* RBC.

[349] *See* Goldman (Prop. Trading); RBC. In addition, one commenter requested the Agencies clarify that permitted underwriting activities include the acquisition and resale of securities issued in lieu of or to refinance bridge loan facilities, irrespective of whether such activities qualify as ''distributions'' under the proposal. *See* LSTA (Feb. 2012).

[350] *See* Goldman (Prop. Trading).

[351] *See* Occupy.

[352] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[353] *See* AFR *et al.* (Feb. 2012); Public Citizen; Occupy (suggesting that the Agencies exceeded their statutory authority by incorporating the Regulation M definition of ''underwriter,'' rather than the Securities Act definition of ''underwriter'').

[354] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). The term ''distribution participant'' is defined in Rule 100 of Regulation M as ''an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.'' 17 CFR 242.100.

[355] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[356] *See* Goldman (Prop. Trading).

[357] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also requested a technical amendment to proposed rule § 75.4(a)(4)(ii) to clarify that the person is ''participating'' in a distribution, not ''engaging'' in a distribution. *See id.*

[358] *See* AFR *et al.* (Feb. 2012); Public Citizen.

time when it is initially launched.[359] For example, a few commenters noted that APs typically do not perform some or all of the activities that the Agencies proposed to consider to help determine whether a banking entity is acting as an underwriter in connection with a distribution of securities, including due diligence, advising an issuer on market conditions and assisting in preparation of a registration statement or offering documents, and participating in or organizing a syndicate of investment banks.[360]

However, one commenter appeared to oppose applying the underwriting exemption to certain AP activities. According to this commenter, APs are generally reluctant to concede that they are statutory underwriters because they do not perform all the activities associated with the underwriting of an operating company's securities. Further, this commenter expressed concern that, if an AP had to rely on the proposed underwriting exemption, the AP could be subject to heightened risk of incurring underwriting liability on the issuance of ETF shares traded by the AP. As a result of these considerations, the commenter believed that a banking entity may be less willing to act as an AP for an ETF issuer if it were required to rely on the underwriting exemption.[361]

iii. ''Solely in Connection With'' Standard

To qualify for the underwriting exemption, the proposed rule required a purchase or sale of a covered financial position to be effected ''solely in connection with'' a distribution of securities for which the banking entity is acting as underwriter. Several commenters expressed concern that the word ''solely'' in this provision may result in an overly narrow interpretation of permissible activities. In particular, these commenters indicated that the ''solely in connection with'' standard creates uncertainty about certain activities that are currently conducted in the course of an underwriting, such as customary underwriting syndicate activities.[362] One commenter represented that such activities are traditionally undertaken to: Support the success of a distribution; mitigate risk to issuers, investors, and underwriters; and facilitate an orderly aftermarket.[363] A few commenters further stated that requiring a trade to be ''solely'' in connection with a distribution by an underwriter would be inconsistent with the statute,[364] may reduce future innovation in the capital-raising process,[365] and could create market disruptions.[366]

A number of commenters stated that it is unclear whether certain activities would qualify for the proposed underwriting exemption and requested that the Agencies adopt an exemption that is broad enough to permit such activities.[367] Commenters stated that there are a number of activities that should be permitted under the underwriting exemption, including: (i) Creating a naked or covered syndicate short position in connection with an offering;[368] (ii) creating a stabilizing bid;[369] (iii) acquiring positions via overallotments[370] or trading in the market to close out short positions in connection with an overallotment option or in connection with other stabilization activities;[371] (iv) using call spread options in a convertible debt offering to mitigate dilution of existing shareholders;[372] (v) repurchasing existing debt securities of an issuer in the course of underwriting a new series of debt securities in order to stimulate demand for the new issuance;[373] (vi) purchasing debt securities of comparable issuers as a price discovery mechanism in connection with underwriting a new debt security;[374] (vii) hedging the underwriter's exposure to a derivative strategy engaged in with an issuer;[375] (viii) organizing and assembling a resecuritized product, including, for example, sourcing bond collateral over a period of time in anticipation of issuing new securities;[376] and (ix) selling a security to an intermediate entity as part of the creation of certain structured products.[377]

c. Final Requirement That the Banking Entity Act as an Underwriter for a Distribution of Securities and the Trading Desk's Underwriting Position Be Related to Such Distribution

The final rule requires that the banking entity act as an underwriter for a distribution of securities and the trading desk's underwriting position be related to such distribution.[378] This requirement is substantially similar to the proposed rule,[379] but with five key refinements. First, to address commenters' confusion about whether

[359] *See* BoA; ICI Global; Vanguard; ICI (Feb. 2012); SSgA (Feb. 2012). As one commenter explained, an AP may ''seed'' an ETF for a short period of time at its inception by entering into several initial creation transactions with the ETF issuer and refraining from selling those shares to investors or redeeming them for a period of time to facilitate the ETF achieving its liquidity launch goals. *See* BoA.

[360] *See* ICI Global; ICI (Feb. 2012); Vanguard.

[361] *See* SSgA (Feb. 2012).

[362] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[363] *See* Goldman (Prop. Trading).

[364] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[365] *See* Goldman (Prop. Trading).

[366] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[367] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[368] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''The reason for creating the short positions (covered and naked) is to facilitate an orderly aftermarket and to reduce price volatility of newly offered securities. This provides significant value to issuers and selling security holders, as well as to investors, by giving the syndicate buying power that helps protect against immediate volatility in the aftermarket.''); RBC; Goldman (Prop. Trading).

[369] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''Underwriters may also engage in stabilization activities under Regulation M by creating a stabilizing bid to prevent or slow a decline in the market price of a security. These activities should be encouraged rather than restricted by the Volcker Rule because they reduce price volatility and facilitate the orderly pricing and aftermarket trading of underwritten securities, thereby contributing to capital formation.'').

[370] *See* RBC.

[371] *See* Goldman (Prop. Trading).

[372] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (stating that the call spread arrangement ''may make a wider range of financing options feasible for the issuer of the convertible debt'' and ''can help it to raise more capital at more attractive prices'').

[373] *See* Wells Fargo (Prop. Trading). The commenter further stated that the need to purchase the issuer's other debt securities from investors may arise if an investor has limited risk tolerance to the issuer's credit or has portfolio restrictions. According to the commenter, the underwriter would typically sell the debt securities it purchased from existing investors to new investors. *See id.*

[374] *See* Wells Fargo (Prop. Trading).

[375] *See* Goldman (Prop. Trading).

[376] *See* ASF (Feb. 2012) (stating that, for example, a banking entity may respond to customer or general market demand for highly-rated mortgage paper by accumulating residential mortgage-backed securities over time and holding such securities in inventory until the transaction can be organized and assembled).

[377] *See* ICI (Feb. 2012) (stating that the sale of assets to an intermediate asset-backed commercial paper or tender option bond program should be permitted under the underwriting exemption if the sale is part of the creation of a structured security). *See also* AFR *et al.* (Feb. 2012) (stating that the treatment of a sale to an intermediate entity should depend on whether the banking entity or an external client is the driver of the demand and, if the banking entity is the driver of the demand, then the near term demand requirement should not be met). Two commenters stated that the underwriting exemption should not permit a banking entity to sell a security to an intermediate entity in the course of creating a structured product. *See* Occupy; Alfred Brock. These commenters were generally responding to a question on this issue in the proposal. *See* Joint Proposal, 76 FR at 68868–68869 (question 78); CFTC Proposal, 77 FR at 8354 (question 78).

[378] Final rule § 75.4(a)(2)(i). The terms ''distribution'' and ''underwriter'' are defined in final rule § 75.4(a)(3) and § 75.4(a)(4), respectively.

[379] Proposed rule § 75.4(a)(2)(iii) required that ''[t]he purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter.''

the underwriting exemption applies on a transaction-by-transaction basis, the phrase ''purchase or sale'' has been modified to instead refer to the trading desk's ''underwriting position.'' Second, to balance this more aggregated position-based approach, the final rule specifies that the trading desk is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed. Third, the Agencies have made important modifications to the definition of ''distribution'' to better capture the various types of private and registered offerings a banking entity may be asked to underwrite by an issuer or selling security holder. Fourth, the definition of ''underwriter'' has been refined to clarify that both members of the underwriting syndicate and selling group members may qualify as underwriters for purposes of this exemption. Finally, the word ''solely'' has been removed to clarify that a broader scope of activities conducted in connection with underwriting (*e.g.,* stabilization activities) are permitted under this exemption. These issues are discussed in turn below.

i. Definition of ''Underwriting Position''

In response to commenters' concerns about transaction-by-transaction analyses,[380] the Agencies are modifying the exemption to clarify the level at which compliance with certain provisions will be assessed. The proposal was not intended to impose a transaction-by-transaction approach, and the final rule's requirements generally focus on the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or its affiliate is acting as an underwriter. Like § 75.4(a)(2)(ii) of the proposed rule, the definition of ''underwriting position'' is limited to positions in securities because the common usage and understanding of the term ''underwriting'' is limited to activities in securities.

A trading desk's underwriting position constitutes the securities positions that are acquired in connection with a single distribution for which the relevant banking entity is acting as an underwriter. A trading desk may not aggregate securities positions acquired in connection with two or more distributions to determine its ''underwriting position.'' A trading desk may, however, have more than one ''underwriting position'' at a particular point in time if the banking entity is acting as an underwriter for more than one distribution. As a result, the underwriting exemption's requirements pertaining to a trading desk's underwriting position will apply on a distribution-by-distribution basis.

A trading desk's underwriting position can include positions in securities held at different affiliated legal entities, provided the banking entity is able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section 13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's underwriting position for purposes of the underwriting exemption. Banking entities should be prepared to provide all records that identify all of the positions included in a trading desk's underwriting position and where such positions are held.

The Agencies believe that a distribution-by-distribution approach is appropriate due to the relatively distinct nature of underwriting activities for a single distribution on behalf of an issuer or selling security holder. The Agencies do not believe that a narrower transaction-by-transaction analysis is necessary to determine whether a banking entity is engaged in permitted underwriting activities. The Agencies also decline to take a broader approach, which would allow a banking entity to aggregate positions from multiple distributions for which it is acting as an underwriter, because it would be more difficult for the banking entity's internal compliance personnel and Agency supervisors and examiners to review the trading desk's positions to assess the desk's compliance with the underwriting exemption. A more aggregated approach would increase the number of positions in different types of securities that could be included in the underwriting position, which would make it more difficult to determine that an individual position is related to a particular distribution of securities for which the banking entity is acting as an underwriter and, in turn, increase the potential for evasion of the general prohibition on proprietary trading.

ii. Definition of ''Trading Desk''

The proposed underwriting exemption would have applied certain requirements across an entire banking entity. To promote consistency with the market-making exemption and address potential evasion concerns, the final rule applies the requirements of the underwriting exemption at the trading desk level of organization.[381] This approach will result in the requirements of the underwriting exemption applying to the aggregate trading activities of a relatively limited group of employees on a single desk. Applying requirements at the trading desk level should facilitate banking entity and Agency monitoring and review of compliance with the exemption by limiting the location where underwriting activity may occur and allowing better identification of the aggregate trading volume that must be reviewed to determine whether the desk's activities are being conducted in a manner that is consistent with the underwriting exemption, while also allowing adequate consideration of the particular facts and circumstances of the desk's trading activities.

The trading desk should be managed and operated as an individual unit and should reflect the level at which the profit and loss of employees engaged in underwriting activities is attributed. The term ''trading desk'' in the underwriting context is intended to encompass what is commonly thought of as an underwriting desk. A trading desk engaged in underwriting activities would not necessarily be an active market participant that engages in frequent trading activities.

A trading desk may manage an underwriting position that includes positions held by different affiliated legal entities.[382] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. The geographic location of individual traders is not dispositive for purposes of determining whether the employees are engaged in activities for a single trading desk.

iii. Definition of ''Distribution''

The term ''distribution'' is defined in the final rule as: (i) An offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act.[383] In response to comments, the proposed definition has been revised to eliminate the need to consider the ''magnitude'' of an offering and instead supplements the definition

[380] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[381] *See infra* Part VI.A.3.c. (discussing the final market-making exemption).

[382] *See supra* note 307 and accompanying text.

[383] Final rule § 75.4(a)(3).

with an alternative prong for registered offerings under the Securities Act.[384]

The proposed definition's reference to magnitude caused some commenter concern with respect to whether it could be interpreted to preclude a banking entity from intermediating a small private placement. After considering comments, the Agencies have determined that the requirement to have special selling efforts and selling methods is sufficient to distinguish between permissible securities offerings and prohibited proprietary trading, and the additional magnitude factor is not needed to further this objective.[385] As proposed, the Agencies will rely on the same factors considered under Regulation M to analyze the presence of special selling efforts and selling methods.[386] Indicators of special selling efforts and selling methods include delivering a sales document (*e.g.,* a prospectus), conducting road shows, and receiving compensation that is greater than that for secondary trades but consistent with underwriting compensation.[387] For purposes of the final rule, each of these factors need not be present under all circumstances. Offerings that qualify as distributions under this prong of the definition include, among others, private placements in which resales may be made in reliance on the SEC's Rule 144A or other available exemptions [388] and, to the extent the commercial paper being offered is a security, commercial paper offerings that involve the underwriter receiving special compensation.[389]

The Agencies are also adopting a second prong to this definition, which will independently capture all offerings of securities that are made pursuant to an effective registration statement under the Securities Act.[390] The registration prong of the definition is intended to provide another avenue by which an offering of securities may be conducted under the exemption, absent other special selling efforts and selling methods or a determination of whether such efforts and methods are being conducted. The Agencies believe this prong reduces potential administrative burdens by providing a bright-line test for what constitutes a distribution for purposes of the final rule. In addition, this prong is consistent with the purpose and goals of the statute because it reflects a common type of securities offering and does not raise evasion concerns as it is unlikely that an entity would go through the registration process solely to facilitate or engage in speculative proprietary trading.[391] This prong would include, among other things, the following types of registered securities offerings: Offerings made pursuant to a shelf registration statement (whether on a continuous or delayed basis),[392] bought deals,[393] at the market offerings,[394] debt offerings, asset-backed security offerings, initial public offerings, and other registered offerings. An offering can be a distribution for purposes of either § 75.4(a)(3)(i) or § 75.4(a)(3)(ii) of the final rule regardless of whether the offering is issuer driven, selling security holder driven, or arises as a result of a reverse inquiry.[395] Provided the definition of distribution is met, an offering can be a distribution for purposes of this rule regardless of how it is conducted, whether by direct communication, exchange transactions, or automated execution system.[396]

As discussed above, some commenters expressed concern that the proposed definition of ''distribution'' would prevent a banking entity from acquiring and reselling securities issued in lieu of or to refinance bridge loan facilities in reliance on the underwriting exemption. Bridge financing arrangements can be structured in many different ways, depending on the context and the specific objectives of the parties involved. As a result, the treatment of securities acquired in lieu of or to refinance a bridge loan and the subsequent sale of such securities under the final rule depends on the facts and circumstances. A banking entity may meet the terms of the underwriting exemption for its bridge loan activity, or it may be able to rely on the market-making exemption. If the banking entity's bridge loan activity does not qualify for an exemption under the rule, then it would not be permitted to engage in such activity.

[384] Proposed rule § 75.4(a)(3) defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.''

[385] The policy goals of this rule differ from those of the SEC's Regulation M, which is an anti-manipulation rule. The focus on magnitude is appropriate for that regulation because it helps identify offerings that can give rise to an incentive to condition the market for the offered security. To the contrary, this rule is intended to allow banking entities to continue to provide client-oriented financial services, including underwriting services. The SEC emphasizes that this rule does not have any impact on Regulation M.

[386] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[387] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352; Review of Antimanipulation Regulation of Securities Offering, Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681, 21684–21685 (Apr. 26, 1994).

[388] The final rule does not provide safe harbors for particular distribution techniques. A safe harbor-based approach would provide certainty for specific types of offerings, but may not account for evolving market practices and distribution techniques that could technically satisfy a safe harbor but that might implicate the concerns that led Congress to enact section 13 of the BHC Act. *See* RBC.

[389] This clarification is intended to address commenters' concern regarding potential limitations on banking entities' ability to facilitate commercial paper offerings under the proposed underwriting exemption. *See supra* Part VI.A.2.c.1.b.i.

[390] *See, e.g.,* Form S–1 (17 CFR 239.11); Form S–3 (17 CFR 239.13); Form S–8 (17 CFR 239.16b); Form F–1 (17 CFR 239.31); Form F–3 (17 CFR 239.33).

[391] Although the Agencies are providing an additional prong to the definition of ''distribution'' for registered offerings, the final rule does not limit the availability of the underwriting exemption to registered offerings, as suggested by one commenter. The statute does not include such an express limitation, and the Agencies decline to construe the statute to require such an approach. In response to the commenter stating that permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading, the Agencies believe this concern is addressed by the provision in the final rule requiring that a trading desk have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution and make reasonable efforts to sell its underwriting position within a reasonable period. As discussed below, the Agencies believe this requirement in the final rule appropriately addresses evasion concerns that a banking entity may retain an unsold allotment for purely speculative purposes. Further, the Agencies believe that preventing a banking entity from facilitating a private offering could unnecessarily hinder capital-raising without providing commensurate benefits because issuers use private offerings to raise capital in a variety of situations and the underwriting exemption's requirements limit the potential for evasion for both registered and private offerings, as noted above.

[392] *See* Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (Aug. 3, 2005); 17 CFR 230.405 (defining ''automatic shelf registration statement'' as a registration statement filed on Form S–3 (17 CFR 239.13) or Form F–3 (17 CFR 239.33) by a well-known seasoned issuer pursuant to General Instruction I.D. or I.C. of such forms, respectively); 17 CFR 230.415.

[393] A bought deal is a distribution technique whereby an underwriter makes a bid for securities without engaging in a preselling effort, such as book building or distribution of a preliminary prospectus. *See, e.g.,* Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 6470 (June 9, 1983), n.5.

[394] *See, e.g.,* 17 CFR 230.415(a)(4) (defining ''at the market offering'' as ''an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price''). At the market offerings may also be referred to as ''dribble out'' programs.

[395] Under the ''reverse inquiry'' process, an investor may be allowed to purchase securities from the issuer through an underwriter that is not designated in the prospectus as the issuer's agent by having such underwriter approach the issuer with an interest from the investor. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012).

[396] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

iv. Definition of ''Underwriter''

In response to comments, the Agencies are adopting certain modifications to the proposed definition of ''underwriter'' to better capture selling group members and to more closely resemble the definition of ''distribution participant'' in Regulation M. In particular, the Agencies are defining ''underwriter'' as: (i) A person who has agreed with an issuer or selling security holder to: (A) Purchase Securities from the issuer or selling security holder for distribution; (B) engage in a distribution of securities for or on behalf of the issuer or selling security holder; or (C) manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.[397]

A number of commenters requested that the Agencies broaden the underwriting exemption to permit activities in connection with a distribution of securities by any distribution participant. A few of these commenters interpreted the proposed definition of ''underwriter'' as requiring a selling group member to have a written agreement with the underwriter to participate in the distribution.[398] These commenters noted that such a written agreement may not exist under all circumstances. The Agencies did not intend to require that members of the underwriting syndicate or the lead underwriter have a written agreement with all selling group members for each offering or that they be in privity of contract with the issuer or selling security holder. To provide clarity on this issue, the Agencies have modified the language of subparagraph (ii) of the definition to include firms that, while not members of the underwriting syndicate, have agreed to participate or are participating in a distribution of securities for or on behalf of the issuer or selling security holder.

The final rule does not adopt a narrower definition of ''underwriter,'' as suggested by two commenters.[399] Although selling group members do not have a direct relationship with the issuer or selling security holder, they do help facilitate the successful distribution of securities to a wider variety of purchasers, such as regional or retail purchasers that members of the underwriting syndicate may not be able to access as easily. Thus, the Agencies believe it is consistent with the purpose of the statutory underwriting exemption and beneficial to recognize and allow the current market practice of an underwriting syndicate and selling group members collectively facilitating a distribution of securities. The Agencies note that because banking entities that are selling group members will be underwriters under the final rule, they will be subject to all the requirements of the underwriting exemption.

As provided in the preamble to the proposed rule, engaging in the following activities may indicate that a banking entity is acting as an underwriter under § 75.4(a)(4) as part of a distribution of securities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[400]

The Agencies continue to take the view that the precise activities performed by an underwriter will vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. A banking entity is not required to engage in each of the above-noted activities to be considered an underwriter for purposes of this rule. In addition, the Agencies note that, to the extent a banking entity does not meet the definition of ''underwriter'' in the final rule, it may be able to rely on the market-making exemption in the final rule for its trading activity. In response to comments noting that APs for ETFs do not engage in certain of these activities and inquiring whether an AP would be able to qualify for the underwriting exemption for certain of its activities, the Agencies believe that many AP activities, such as conducting general creations and redemptions of ETF shares, are better suited for analysis under the market-making exemption because they are driven by the demands of other market participants rather than the issuer, the ETF.[401] Whether an AP may rely on the underwriting exemption for its activities in an ETF will depend on the facts and circumstances, including, among other things, whether the AP meets the definition of ''underwriter'' and the offering of ETF shares qualifies as a ''distribution.''

To provide further clarity about the scope of the definition of ''underwriter,'' the Agencies are defining the terms ''selling security holder'' and ''issuer'' in the final rule. The Agencies are using the definition of ''issuer'' from the Securities Act because this definition is commonly used in the context of securities offerings and is well understood by market participants.[402] A ''selling security holder'' is defined as ''any person, other than an issuer, on whose behalf a distribution is made.''[403] This definition is consistent with the

[397] *See* final rule § 75.4(a)(4).

[398] The basic documents in firm commitment underwritten securities offerings generally are: (i) The agreement among underwriters, which establishes the relationship among the managing underwriter, any co-managers, and the other members of the underwriting syndicate; (ii) the underwriting (or ''purchase'') agreement, in which the underwriters commit to purchase the securities from the issuer or selling security holder; and (iii) the selected dealers agreement, in which selling group members agree to certain provisions relating to the distribution. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012), Ch. 2. The Agencies understand that two firms may enter into a master agreement that governs all offerings in which both firms participate as members of the underwriting syndicate or as a member of the syndicate and a selling group member. *See, e.g.,* SIFMA Master Selected Dealers Agreement (June 10, 2011), available at *www.sifma.org*.

[399] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[400] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352. Post-issuance secondary market activity is expected to be conducted in accordance with the market-making exemption.

[401] *See infra* Part VI.A.3.

[402] *See* final rule § 75.3(e)(9) (defining the term ''issuer'' for purposes of the proprietary trading provisions in subpart B of the final rule). Under section 2(a)(4) of the Securities Act, ''issuer'' is defined as ''every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term 'issuer' means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.'' 15 U.S.C. 77b(a)(4).

[403] Final rule § 75.4(a)(5).

definition of ''selling security holder'' found in the SEC's Regulation M.[404]

v. Activities Conducted ''in Connection With'' a Distribution

As discussed above, several commenters expressed concern that the proposed underwriting exemption would not allow a banking entity to engage in certain auxiliary activities that may be conducted in connection with acting as an underwriter for a distribution of securities in the normal course. These commenters' concerns generally arose from the use of the word ''solely'' in § 75.4(a)(2)(iii) of the proposed rule, which commenters noted was not included in the statute's underwriting exemption.[405] In addition, a number of commenters discussed particular activities they believed should be permitted under the underwriting exemption and indicated the term ''solely'' created uncertainty about whether such activities would be permitted.[406]

To reduce uncertainty in response to comments, the final rule requires a trading desk's underwriting position to be ''held . . . and managed . . . in connection with'' a single distribution for which the relevant banking entity is acting as an underwriter, rather than requiring that a purchase or sale be ''effected solely in connection with'' such a distribution. Importantly, for purposes of establishing an underwriting position in reliance on the underwriting exemption, a trading desk may only engage in activities that are related to a particular distribution of securities for which the banking entity is acting as an underwriter. Activities that may be permitted under the underwriting exemption include stabilization activities,[407] syndicate shorting and aftermarket short covering,[408] holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so,[409] and helping the issuer mitigate its risk exposure arising from the distribution of its securities (*e.g.,* entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).[410] Such activities should be intended to effectuate the distribution process and provide benefits to issuers, selling security holders, or purchasers in the distribution. Existing laws, regulations, and self-regulatory organization rules limit or place certain requirements around many of these activities. For example, an underwriter's subsequent sale of an unsold allotment must comply with applicable provisions of the Federal securities laws and the rules thereunder. Moreover, any position resulting from these activities must be included in the trading desk's underwriting position, which is subject to a number of restrictions in the final rule. Specifically, as discussed in more detail below, the trading desk must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period,[411] and each trading desk must have robust limits on, among other things, the amount, types, and risks of its underwriting position and the period of time a security may be held.[412] Thus, in general, the underwriting exemption would not permit a trading desk, for example, to acquire a position as part of its stabilization activities and hold that position for an extended period.

This approach does not mean that any activity that is arguably connected to a distribution of securities is permitted under the underwriting exemption. Certain activities noted by commenters are not core to the underwriting function and, thus, are not permitted under the final underwriting exemption. However, a banking entity may be able to rely on another exemption for such activities (*e.g.,* the market-making or hedging exemptions), if applicable. For example, a trading desk would not be able to use the underwriting exemption to purchase a financial instrument from a customer to facilitate the customer's ability to buy securities in the distribution.[413] Further, purchasing another financial instrument to help determine how to price the securities that are subject to a distribution would not be permitted under the underwriting exemption.[414] These two activities may be permitted under the market-making exemption, depending on the facts and circumstances. In response to one commenter's suggestion that hedging the underwriter's risk exposure be permissible under this exemption, the Agencies emphasize that hedging the underwriter's risk exposure is not permitted under the underwriting exemption.[415] A banking entity must comply with the hedging exemption for such activity.

In response to comments about the sale of a security to an intermediate entity in connection with a structured

[404] *See* 17 CFR 242.100(b).

[405] *See supra* Part VI.A.2.c.1.b.iii.

[406] *See supra* notes 362, 363, 368–77 and accompanying text.

[407] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See* Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520, 535 (Jan. 3, 1997) (''Although stabilization is price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.'').

[408] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). *See* Proposed Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 50831 (Dec. 9, 2004), 69 FR 75774, 75780 (Dec. 17, 2004) (''In the typical offering, the syndicate agreement allows the managing underwriter to 'oversell' the offering, *i.e.,* establish a short position beyond the number of shares to which the underwriting commitment relates. The underwriting agreement with the issuer often provides for an 'overallotment option' whereby the syndicate can purchase additional shares from the issuer or selling shareholders in order to cover its short position. To the extent that the syndicate short position is in excess of the overallotment option, the syndicate is said to have taken an 'uncovered' short position. The syndicate short position, up to the amount of the overallotment option, may be covered by exercising the option or by purchasing shares in the market once secondary trading begins.'').

[409] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; BoA; BDA (Feb. 2012).

[410] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading).

[411] *See* final rule § 75.4(a)(2)(ii); *infra* Part VI.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[412] *See* final rule § 75.4(a)(2)(iii)(B); *infra* Part VI.A.2.c.3.c. (discussing the required limits for trading desks engaged in underwriting activity).

[413] *See* Wells Fargo (Prop. Trading). The Agencies do not believe this activity is consistent with underwriting activity because it could result in an underwriting desk holding a variety of positions over time that are not directly related to a distribution of securities the desk is conducting on behalf of an issuer or selling security holder. Further, the Agencies believe this activity may be more appropriately analyzed under the market-making exemption because market makers generally purchase or sell a financial instrument at the request of customers and otherwise routinely stand ready to purchase and sell a variety of related financial instruments.

[414] *See id.* The Agencies view this activity as inconsistent with underwriting because underwriters typically engage in other activities, such as book-building and other marketing efforts, to determine the appropriate price for a security and these activities do not involve taking positions that are unrelated to the securities subject to distribution. *See infra* VI.A.2.c.2.

[415] Although one commenter suggested that an underwriter's hedging activity be permitted under the underwriting exemption, we do not believe the requirements in the proposed hedging exemption would be unworkable or overly burdensome in the context of an underwriter's hedging activity. *See* Goldman (Prop. Trading). As noted above, underwriting activity is of a relatively distinct nature, which is substantially different from market-making activity, which is more dynamic and involves more frequent trading activity giving rise to a variety of positions that may naturally hedge the risks of certain other positions. The Agencies believe it is appropriate to require that a trading desk comply with the requirements of the hedging exemption when it is hedging the risks of its underwriting position, while allowing a trading desk's market making-related hedging under the market-making exemption.

finance product,[416] the Agencies have not modified the underwriting exemption. Underwriting is distinct from product development. Thus, parties must adjust activities associated with developing structured finance products or meet the terms of other available exemptions. Similarly, the accumulation of securities or other assets in anticipation of a securitization or resecuritization is not an activity conducted ''in connection with'' underwriting for purposes of the exemption.[417] This activity is typically engaged in by an issuer or sponsor of a securitized product in that capacity, rather than in the capacity of an underwriter. The underwriting exemption only permits a banking entity's activities when it is acting as an underwriter.

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Like the statute, § 75.4(a)(2)(v) of the proposed rule required that the underwriting activities of the banking entity with respect to the covered financial position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[418]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

Both the statute and the proposed rule require a banking entity's underwriting activity to be ''designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.'' [419] Several commenters requested that this standard be interpreted in a flexible manner to allow a banking entity to participate in an offering that may require it to retain an unsold allotment for a period of time.[420] In addition, one commenter stated that the final rule should provide flexibility in this standard by recognizing that the concept of ''near term'' differs between asset classes and depends on the liquidity of the market.[421] Two commenters expressed views on how the near term customer demand requirement should work in the context of a securitization or creating what the commenters characterized as ''structured products'' or ''structured instruments.''[422]

Many commenters expressed concern that the proposed requirement, if narrowly interpreted, could prevent an underwriter from holding a residual position for which there is no immediate demand from clients, customers, or counterparties.[423] Commenters noted that there are a variety of offerings that present some risk of an underwriter having to hold a residual position that cannot be sold in the initial distribution, including ''bought deals,'' [424] rights offerings,[425] and fixed-income offerings.[426] A few commenters noted that similar scenarios can arise in the case of an AP creating more shares of an ETF than it can sell[427] and bridge loans.[428] Two commenters indicated that if the rule does not provide greater clarity and flexibility with respect to the near term customer demand requirement, a banking entity may be less inclined to participate in a distribution where there is the potential risk of an unsold allotment, may price such risk into the fees charged to underwriting clients, or may be forced into a ''fire sale'' of the unsold allotment.[429]

Several other commenters provided views on whether a banking entity should be able to hold a residual position from an offering pursuant to the underwriting exemption, although they did not generally link their comments to the proposed near term demand requirement.[430] Many of these commenters expressed concern about permitting a banking entity to retain a portion of an underwriting and noted potential risks that may arise from such activity.[431] For example, some of these commenters stated that retention or warehousing of underwritten securities can be an indication of impermissible proprietary trading intent (particularly if systematic), or may otherwise result in high-risk exposures or conflicts of interests.[432] One of these commenters recommended the Agencies use a metric to monitor the size of residual positions retained by an underwriter,[433] while another commenter suggested adding a requirement to the proposed exemption to provide that a ''substantial'' unsold or retained allotment would be an indication of prohibited proprietary trading.[434] Similarly, one commenter recommended that the Agencies consider whether there are sufficient provisions in the proposed rule to reduce the risks posed by banking entities retaining or warehousing underwritten instruments, such as subprime mortgages, collateralized debt obligation tranches, and high yield debt of leveraged buyout issuers, which

[416] *See* ICI (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Alfred Brock.

[417] A banking entity may accumulate loans in anticipation of securitization because loans are not financial instruments under the final rule. *See supra* Part VI.A.1.c.

[418] *See* proposed rule § 75.4(a)(2)(v); Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353.

[419] *See supra* Part VI.A.2.c.2.a.

[420] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC. Another commenter requested that this requirement be eliminated or changed to ''underwriting activities of the banking entity with respect to the covered financial position must be designed to meet the near-term demands of clients, customers, or counterparties.'' *See* Japanese Bankers Ass'n.

[421] *See* RBC (stating that the Board has found acceptable the retention of assets acquired in connection with underwriting activities for a period of 90 to 180 days and has further permitted holding periods of up to a year in certain circumstances, such as for less liquid securities).

[422] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[423] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[424] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC. These commenters generally stated that an underwriter for a ''bought deal'' may end up with an unsold allotment because, pursuant to this type of offering, an underwriter makes a commitment to purchase securities from an issuer or selling security holder, without pre-commitment marketing to gauge customer interest, in order to provide greater speed and certainty of execution. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[425] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (representing that because an underwriter generally backstops a rights offering by committing to exercise any rights not exercised by shareholders, the underwriter may end up holding a residual portion of the offering if investors do not exercise all of the rights).

[426] *See* BDA (Feb. 2012). This commenter stated that underwriters frequently underwrite bonds in the fixed-income market knowing that they may need to retain unsold allotments in their inventory. The commenter indicated that this scenario arises because the fixed-income market is not as deep as other markets, so underwriters frequently cannot sell bonds when they go to market; instead, the underwriters will retain the bonds until a sufficient amount of liquidity is available in the market. *See id.*

[427] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[428] *See* BoA; RBC; LSTA (Feb. 2012). One of these commenters stated that, in the case of securities issued in lieu of or to refinance bridge loan facilities, market conditions or investor demand may change during the period of time between extension of the bridge commitment and when the bridge loan is required to be funded or such securities are required to be issued. As a result, this commenter requested that the near term demands of clients, customers, or counterparties be measured at the time of the initial extension of the bridge commitment. *See* LSTA (Feb. 2012).

[429] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[430] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Goldman (Prop. Trading); Fidelity; Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[431] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[432] *See* AFR *et al.* (Feb. 2012) (recognizing, however, that a small portion of an underwriting may occasionally be ''hung''); CalPERS; Occupy (stating that a banking entity's retention of unsold allotments may result in potential conflicts of interest).

[433] *See* AFR *et al.* (Feb. 2012).

[434] *See* Occupy (stating that the meaning of the term ''substantial'' would depend on the circumstances of the particular offering).

poses heightened financial risk at the top of economic cycles.[435]

Other commenters indicated that undue restrictions on an underwriter's ability to retain a portion of an offering may result in certain harms to the capital-raising process. These commenters represented that unclear or negative treatment of residual positions will make banking entities averse to the risk of an unsold allotment, which may result in banking entities underwriting smaller offerings, less capital generation for issuers, or higher underwriting discounts, which would increase the cost of raising capital for businesses.[436] One of these commenters suggested that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions.[437]

In addition, in response to a question in the proposal, one commenter expressed the view that the rule should not require documentation with respect to residual positions held by an underwriter.[438] In the case of securitizations, one commenter stated that if the underwriter wishes to retain some of the securities or bonds in its longer-term investment book, such decisions should be made by a separate officer, subject to different standards and compensation.[439]

Two commenters discussed how the near term customer demand requirement should apply in the context of a banking entity acting as an underwriter for a securitization or structured product.[440] One of these commenters indicated that the near term demand requirement should be interpreted to require that a distribution of securities facilitate pre-existing client demand. This commenter stated that a banking entity should not be considered to meet the terms of the proposed requirement if, on the firm's own initiative, it designs and structures a complex, novel instrument and then seeks customers for the instrument, while retaining part of the issuance on its own book. The commenter further emphasized that underwriting should involve two-way demand—clients who want assistance in marketing their securities and customers who may wish to purchase the securities—with the banking entity serving as an intermediary.[441] Another commenter indicated that an underwriting should likely be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding any amount required for credit risk retention purposes) along a time line designed not to exceed reasonably expected near term demands of clients, customers, or counterparties. According to the commenter, this approach would serve to minimize the arbitrage and risk concentration possibilities that can arise through the securitization and sale of some tranches and the retention of other tranches.[442]

One commenter expressed concern that the proposed near term customer demand requirement may impact a banking entity's ability to act as primary dealer because some primary dealers are obligated to bid on each issuance of a government's sovereign debt, without regard to expected customer demand.[443] Two other commenters expressed general concern that the proposed underwriting exemption may be too narrow to permit banking entities that act as primary dealers in or for foreign jurisdictions to continue to meet the relevant jurisdiction's primary dealer requirements.[444]

c. Final Near Term Customer Demand Requirement

The final rule requires that the amount and types of the securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[445] As noted above, the near term demand standard originates from section 13(d)(1)(B) of the BHC Act, and a similar requirement was included in the proposed rule.[446] The Agencies are making certain modifications to the proposed approach in response to comments.

In particular, the Agencies are clarifying the operation of this requirement, particularly with respect to unsold allotments.[447] Under this requirement, a trading desk must have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[448] Such reasonable expectation may be based on factors such as current market conditions and prior experience with similar offerings of securities. A banking entity is not required to engage in book-building or similar marketing efforts to determine investor demand for the securities pursuant to this requirement, although such efforts may form the basis for the trading desk's reasonable expectation of demand. While an issuer or selling security holder can be considered to be a client, customer, or counterparty of a banking entity acting as an underwriter for its distribution of securities, this requirement cannot be met by accounting solely for the issuer's or selling security holder's desire to sell the securities.[449] However, the

[435] *See* CalPERS.

[436] *See* Goldman (Prop. Trading); Fidelity (expressing concern that this may result in a more concentrated supply of securities and, thus, decrease the opportunity for diversification in the portfolios of shareholders' funds).

[437] *See* Goldman (Prop. Trading).

[438] *See* Japanese Bankers Ass'n.

[439] *See* Sens. Merkley & Levin (Feb. 2012).

[440] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[441] *See* AFR *et al.* (Feb. 2012).

[442] *See* Sens. Merkley & Levin (Feb. 2012).

[443] *See* Banco de México.

[444] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIB/EBF. One of these commenters represented that many banking entities serve as primary dealers in jurisdictions in which they operate, and primary dealers often: (i) Are subject to minimum purchase and other obligations in the jurisdiction's foreign sovereign debt; (ii) play important roles in underwriting and market making in State, provincial, and municipal debt issuances; and (iii) act as intermediaries through which a government's financial and monetary policies operate. This commenter stated that, due to these considerations, restrictions on the ability of banking entities to act as primary dealer are likely to harm the governments they serve. *See* IIB/EBF.

[445] Final rule § 75.4(a)(2)(ii).

[446] The proposed rule required the underwriting activities of the banking entity with respect to the covered financial position to be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § 75.4(a)(2)(v).

[447] *See supra* Part VI.A.2.c.2.b. (discussing commenters' concerns that the proposed near term customer demand requirement may limit a banking entity's ability to retain an unsold allotment).

[448] A banking entity may not structure a complex instrument on its own initiative using the underwriting exemption. It may use the underwriting exemption only with respect to distributions of securities that comply with the final rule. The Agencies believe this requirement addresses one commenter's concern that a banking entity could rely on the underwriting exemption without regard to anticipated customer demand. *See* AFR *et al.* (Feb. 2012) In addition, a trading desk hedging the risks of an underwriting position in a complex, novel instrument must comply with the hedging exemption in the final rule.

[449] An issuer or selling security holder for purposes of this rule may include, among others, corporate issuers, sovereign issuers for which the banking entity acts as primary dealer (or functional equivalent), or any other person that is an issuer, as defined in final rule § 75.3(e)(9), or a selling security holder, as defined in final rule § 75.4(a)(5). The Agencies believe that the underwriting exemption in the final rule should generally allow a primary dealer (or functional equivalent) to act as an underwriter for a sovereign government's issuance of its debt because, similar to other underwriting activities, this involves a banking entity agreeing to distribute securities for an issuer (in this case, the foreign sovereign) and engaging in a distribution of such securities. *See* SIFMA *et al.*

expectation of demand does not require a belief that the securities will be placed immediately. The time it takes to carry out a distribution may differ based on the liquidity, maturity, and depth of the market for the type of security.[450]

This requirement is not intended to prevent a trading desk from distributing an offering over a reasonable time consistent with market conditions or from retaining an unsold allotment of the securities acquired from an issuer or selling security holder where holding such securities is necessary due to circumstances such as less-than-expected purchaser demand at a given price.[451] An unsold allotment is, however, subject to the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position.[452] The definition of ''underwriting position'' includes, among other things, any residual position from the distribution that is managed by the trading desk. The final rule includes the requirement to make reasonable efforts to sell or otherwise reduce the trading desk's underwriting position in order to respond to comments on the issue of when a banking entity may retain an unsold allotment when it is acting as an underwriter, as discussed in more detail below, and ensure that the exemption is available only for activities that involve underwriting activities, and not prohibited proprietary trading.[453]

As a general matter, commenters expressed differing views on whether an underwriter should be permitted to hold an unsold allotment for a certain period of time after the initial distribution. For example, a few commenters suggested that limitations on retaining an unsold allotment would increase the cost of raising capital[454] or would negatively impact certain types of securities offerings (*e.g.,* bought deals, rights offerings, and fixed-income offerings).[455] Other commenters, however, expressed concern that the proposed exemption would allow a banking entity to retain a portion of a distribution for speculative purposes.[456]

The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position appropriately addresses both sets of comments. More specifically, this standard clarifies that an underwriter generally may retain an unsold allotment that it was unable to sell to purchasers as part of the initial distribution of securities, provided it had a reasonable expectation of buying interest and engaged in reasonable selling efforts.[457] This should reduce the potential for the negative impacts of a more stringent approach predicted by commenters, such as increased fees for underwriting, greater costs to businesses for raising capital, and potential fire sales of unsold allotments.[458] However, to address concerns that a banking entity may retain an unsold allotment for purely speculative purposes, the Agencies are requiring that reasonable efforts be made to sell or otherwise

(Prop. Trading) (Feb. 2012); IIB/EBF; Banco de México. A banking entity acting as primary dealer (or functional equivalent) may also be able to rely on the market-making exemption or other exemptions for some of its activities. *See infra* Part VI.A.3.c.2.c. The final rule defines ''client, customer, or counterparty'' for purposes of the underwriting exemption as ''market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.'' Final rule § 75.4(a)(7).

[450] One commenter stated that, in the case of a securitization, an underwriting should be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding the amount required for credit risk retention purposes) along a time line designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* Sens. Merkley & Levin (Feb. 2012). The final rule's near term customer demand requirement considers the liquidity, maturity, and depth of the market for the type of security and recognizes that the amount of time a trading desk may need to hold an underwriting position may vary based on these factors. The final rule does not, however, adopt a standard that applies differently based solely on the particular type of security being distributed (*e.g.,* an asset-backed security versus an equity security) or that precludes certain types of securities from being distributed by a banking entity acting as an underwriter in accordance with the requirements of this exemption because the Agencies believe the statute is best read to permit a banking entity to engage in underwriting activity to facilitate distributions of securities by issuers and selling security holders, regardless of type, to provide client-oriented financial services. That reading is consistent with the statute's language and finds support in the legislative history. *See* 156 Cong. Rec. S5895–S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the underwriting exemption permits ''transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services''). In addition, with respect to this commenter's statement regarding credit risk retention requirements, the Agencies note that compliance with the credit risk retention requirements of Section 15G of the Exchange Act would not impact the availability of the underwriting exemption in the final rule.

[451] This approach should help address commenters' concerns that an inflexible interpretation of the near term demand requirement could result in fire sales, higher fees for underwriting services, or reluctance to act as an underwriter for certain types of distributions that present a greater risk of unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. Further, the Agencies believe this should reduce commenters' concerns that, to the extent a delayed distribution of securities, which are acquired as a result of an outstanding bridge loan, is able to qualify for the underwriting exemption, a stringent interpretation of the near term demand requirement could prevent a banking entity from retaining such securities if market conditions are suboptimal or marketing efforts are not entirely successful. *See* RBC; BoA; LSTA (Feb. 2012). In response to one commenter's request that the Agencies allow a banking entity to assess near term demand at the time of the initial extension of the bridge commitment, the Agencies believe it could be appropriate to determine whether the banking entity has a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired at that time, but note that the trading desk would continue to be subject to the requirement to make reasonable efforts to sell the resulting underwriting position at the time of the initial distribution and for the remaining time the securities are in its inventory. *See* LSTA (Feb. 2012).

[452] The Agencies believe that requiring a trading desk to make reasonable efforts to sell or otherwise reduce its underwriting position addresses commenters' concerns about the risks associated with unsold allotments or the retention of underwritten instruments because this requirement is designed to prevent a trading desk from retaining an unsold allotment for speculative purposes when there is customer buying interest for the relevant security at commercially reasonable prices. Thus, the Agencies believe this obviates the need for certain additional requirements suggested by commenters. *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); CalPERS. The final rule strikes an appropriate balance between the concerns raised by these commenters and those noted by other commenters regarding the potential market impacts of strict requirements against holding an unsold allotment, such as higher fees to underwriting clients, fire sales of unsold allotments, or general reluctance to participate in any distribution that presents a risk of an unsold allotment. The requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should not cause the market impacts predicted by these commenters because it does not prevent an underwriter from retaining an unsold allotment for a reasonable period or impose strict holding period limits on unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading); Fidelity.

[453] This approach is generally consistent with one commenter's suggested approach to addressing the issue of unsold allotments. *See, e.g.,* Goldman (Prop. Trading) (suggesting that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions). In addition, allowing an underwriter to retain an unsold allotment under certain circumstances is consistent with the proposal. *See* Joint Proposal, 76 FR at 68867 (''There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.''); CFTC Proposal, 77 FR at 8352. A number of commenters raised questions about whether the rule would permit retaining an unsold allotment. *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC; AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[454] *See* Goldman (Prop. Trading); Fidelity.

[455] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC.

[456] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[457] To the extent that an AP for an ETF is able to meet the terms of the underwriting exemption for its activity, it may be able to retain ETF shares that it created if it had a reasonable expectation of buying interest in the ETF shares and engages in reasonable efforts to sell the ETF shares. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[458] *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

reduce the underwriting position, which includes any unsold allotment, within a reasonable period. The Agencies agree with these commenters that systematic retention of an underwriting position, without engaging in efforts to sell the position and without regard to whether the trading desk is able to sell the securities at a commercially reasonable price, would be indicative of impermissible proprietary trading intent.[459] The Agencies recognize that the meaning of ''reasonable period'' may differ based on the liquidity, maturity, and depth of the market for the relevant type of securities. For example, an underwriter may be more likely to retain an unsold allotment in a bond offering because liquidity in the fixed-income market is generally not as deep as that in the equity market. If a trading desk retains an underwriting position for a period of time after the distribution, the trading desk must manage the risk of its underwriting position in accordance with its inventory and risk limits and authorization procedures. As discussed above, hedging transactions undertaken in connection with such risk management activities must be conducted in compliance with the hedging exemption in § 75.5 of the final rule.

The Agencies emphasize that the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position applies to the entirety of the trading desk's underwriting position. As a result, this requirement applies to a number of different scenarios in which an underwriter may hold a long or short position in the securities that are the subject of a distribution for a period of time. For example, if an underwriter is facilitating a distribution of securities for which there is sufficient investor demand to purchase the securities at the offering price, this requirement would prevent the underwriter from retaining a portion of the allotment for its own account instead of selling the securities to interested investors. If instead there was insufficient investor demand at the time of the initial offering, this requirement would recognize that it may be appropriate for the underwriter to hold an unsold allotment for a reasonable period of time. Under these circumstances, the underwriter would need to make reasonable efforts to sell the unsold allotment when there is sufficient market demand for the securities.[460] This requirement would also apply in situations where the underwriters sell securities in excess of the number of securities to which the underwriting commitment relates, resulting in a syndicate short position in the same class of securities that were the subject of the distribution.[461] This provision of the final exemption would require reasonable efforts to reduce any portion of the syndicate short position attributable to the banking entity that is acting as an underwriter. Such reduction could be accomplished if, for example, the managing underwriter exercises an overallotment option or shares are purchased in the secondary market to cover the short position.

The near term demand requirement, including the requirement to make reasonable efforts to reduce the underwriting position, represents a new regulatory requirement for banking entities engaged in underwriting. At the margins, this requirement could alter the participation decision for some banking entities with respect to certain types of distributions, such as distributions that are more likely to result in the banking entity retaining an underwriting position for a period of time.[462] However, the Agencies recognize that liquidity, maturity, and depth of the market vary across types of securities, and the Agencies expect that the express recognition of these differences in the rule should help mitigate any incentive to exit the underwriting business for certain types of securities or types of distributions.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

Section 75.4(a)(2)(i) of the proposed exemption required a banking entity to establish an internal compliance program, as required by § 75.20 of the proposed rule, that is designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, and independent testing.[463] This requirement was proposed so that any banking entity relying on the underwriting exemption would have reasonably designed written policies and procedures, internal controls, and independent testing in place to support its compliance with the terms of the exemption.[464]

b. Comments on the Proposed Compliance Program Requirement

Commenters did not directly address the proposed compliance program requirement in the underwriting exemption. Comments on the proposed compliance program requirement of § 75.20 of the proposed rule are discussed in Part VI.C., below.

c. Final Compliance Program Requirement

The final rule includes a compliance program requirement that is similar to the proposed requirement, but the Agencies are making certain enhancements to emphasize the importance of a strong internal compliance program. More specifically, the final rule requires that a banking entity's compliance program specifically include reasonably designed written policies and procedures, internal controls, analysis and independent testing[465] identifying and addressing: (i) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;[466] (ii) limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties;[467] (iii) internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits;[468] and (iv) authorization procedures, including escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis of the basis for any temporary or permanent increase to one or more of a trading desk's limits, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of

[459] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy.

[460] The trading desk's retention and sale of the unsold allotment must comply with the Federal securities laws and regulations, but is otherwise permitted under the underwriting exemption.

[461] *See supra* note 408.

[462] For example, some commenters suggested that the proposed underwriting exemption could have a chilling effect on banking entities' willingness to engage in underwriting activities. *See, e.g.,* Lord Abbett; Fidelity. Further, some commenters expressed concern that the proposed near term customer demand requirement might negatively impact certain forms of capital-raising if the requirement is interpreted narrowly or inflexibly. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[463] *See* proposed rule § 75.4(a)(2)(i).

[464] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[465] The independent testing standard is discussed in more detail in Part VI.C., which discusses the compliance program requirement in § 75.20 of the final rule.

[466] *See* final rule § 75.4(a)(2)(iii)(A).

[467] *See* final rule § 75.4(a)(2)(iii)(B). A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. *See id.*

[468] *See* final rule § 75.4(a)(2)(iii)(C).

such demonstrable analysis and approval.[469]

As noted above, the proposed compliance program requirement did not include the four specific elements listed above in the proposed underwriting exemption, although each of these provisions was included in some form in the detailed compliance program requirement under Appendix C of the proposed rule.[470] The Agencies are moving these particular requirements, with certain enhancements, into the underwriting exemption because the Agencies believe these are core elements of a program to ensure compliance with the underwriting exemption. These compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in underwriting activity under § 75.4(a) of the final rule. Each of the requirements in paragraphs (a)(2)(iii)(A) through (D) must be appropriately tailored to the individual trading activities and strategies of each trading desk.

The compliance program requirement in the underwriting exemption is substantially similar to the compliance program requirement in the market-making exemption, except that the Agencies are requiring more detailed risk management procedures in the market-making exemption due to the nature of that activity.[471] The Agencies believe including similar compliance program requirements in the underwriting and market-making exemptions may reduce burdens associated with building and maintaining compliance programs for each trading desk.

Identifying in the compliance program the relevant products, instruments, and exposures in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the underwriting exemption. For example, this requirement should prevent an individual trader on an underwriting desk from establishing positions in instruments that are unrelated to the desk's underwriting function. Further, the identification of permissible products, instruments, and exposures will help form the basis for the specific types of position and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, maturity, and depth of the market for the relevant type of security.

A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. Limits established under this provision, and any modifications to these limits made through the required escalation procedures, must account for the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties. Among other things, these limits should be designed to prevent a trading desk from systematically retaining unsold allotments even when there is customer demand for the positions that remain in the trading desk's inventory. The Agencies recognize that trading desks' limits may differ across types of securities and acknowledge that trading desks engaged in underwriting activities in less liquid securities, such as corporate bonds, may require different inventory, risk exposure, and holding period limits than trading desks engaged in underwriting activities in more liquid securities, such as certain equity securities. A trading desk hedging the risks of an underwriting position must comply with the hedging exemption, which provides for compliance procedures regarding risk management.[472]

Furthermore, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits.[473] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes).

As noted above, a banking entity's compliance program for trading desks engaged in underwriting activity must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval.[474] Thus, to increase a limit of a trading desk, there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § 75.20(b)(6).

As discussed in more detail in Part VI.C., the Agencies recognize that the compliance program requirements in the final rule will impose certain costs on banking entities but, on balance, the Agencies believe such requirements are necessary to facilitate compliance with the statute and the final rule and to reduce the risk of evasion.[475]

4. Compensation Requirement

a. Proposed Compensation Requirement

Another provision of the proposed underwriting exemption required that the compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking.[476] In connection with this requirement, the proposal clarified that although a banking entity relying on the underwriting exemption may appropriately take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the banking entity should provide compensation incentives that primarily reward client revenues and effective client service, not proprietary risk-taking.[477]

b. Comments on the Proposed Compensation Requirement

A few commenters expressed general support for the proposed requirement, but suggested certain modifications that they believed would enhance the requirement and make it more effective.[478] Specifically, one

[469] *See* final rule § 75.4(a)(2)(iii)(D).

[470] *See* Joint Proposal, 76 FR at 68963–68967 (requiring certain banking entities to establish, maintain, and enforce compliance programs with, among other things: (i) Written policies and procedures that describe a trading unit's authorized instruments and products; (ii) internal controls for each trading unit, including risk limits for each trading unit and surveillance procedures; and (iii) a management framework, including management procedures for overseeing compliance with the proposed rule).

[471] *See* final rule §§ 75.4(a)(2)(iii), 75.4(b)(2)(iii).

[472] *See* final rule § 75.5.

[473] *See* final rule § 75.4(a)(2)(iii)(C).

[474] *See* final rule § 75.4(a)(2)(iii)(D).

[475] *See* Part VI.C. (discussing the compliance program requirement in § 75.20 of the final rule).

[476] *See* proposed rule § 75.4(a)(2)(vii); Joint Proposal, 76 FR at 68868; CFTC Proposal, 77 FR at 8353.

[477] *See id.*

[478] *See* Occupy; AFR *et al.* (Feb. 2012); Better Markets (Feb. 2012).

commenter suggested tailoring the requirement to underwriting activity by, for example, ensuring that personnel involved in underwriting are given compensation incentives for the successful distribution of securities off the firm's balance sheet and are not rewarded for profits associated with securities that are not successfully distributed (although losses from such positions should be taken into consideration in determining the employee's compensation). This commenter further recommended that bonus compensation for a deal be withheld until all or a high percentage of the relevant securities are distributed.[479] Finally, one commenter suggested that the term ''designed'' should be removed from this provision.[480]

c. Final Compensation Requirement

Similar to the proposed rule, the underwriting exemption in the final rule requires that the compensation arrangements of persons performing the banking entity's underwriting activities, as described in the exemption, be designed not to reward or incentivize prohibited proprietary trading.[481] The Agencies do not intend to preclude an employee of an underwriting desk from being compensated for successful underwriting, which involves some risk-taking.

Consistent with the proposal, activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of securities underwritten by the banking entity are inconsistent with the underwriting exemption. A banking entity may, however, take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk. The banking entity should provide compensation incentives that primarily reward client revenues and effective client services, not prohibited proprietary trading. For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the underwriting exemption.

The Agencies are not adopting an approach that prevents an employee from receiving any compensation related to profits arising from an unsold allotment, as suggested by one commenter, because the Agencies believe the final rule already includes sufficient controls to prevent a trading desk from intentionally retaining an unsold allotment to make a speculative profit when such allotment could be sold to customers.[482] The Agencies also are not requiring compensation to be vested for a period of time, as recommended by one commenter to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement because a banking entity must establish limits for a trading desk's underwriting position and the trading desk must make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period.[483] The Agencies continue to believe it is appropriate to focus on the design of a banking entity's compensation structure, so the Agencies are not removing the term ''designed'' from this provision.[484] This retains an objective focus on actions that the banking entity can control—the design of its incentive compensation program—and avoids a subjective focus on whether an employee feels incentivized by compensation, which may be more difficult to assess. In addition, the framework of the final compensation requirement will allow banking entities to better plan and control the design of their compensation arrangements, which should reduce costs and uncertainty and enhance monitoring, than an approach focused solely on individual outcomes.

5. Registration Requirement

a. Proposed Registration Requirement

Section 75.4(a)(2)(iv) of the proposed rule would have required that a banking entity have the appropriate dealer registration or be exempt from registration or excluded from regulation as a dealer to the extent that, in order to underwrite the security at issue, a person must generally be a registered securities dealer, municipal securities dealer, or government securities dealer.[485] Further, if the banking entity was engaged in the business of a dealer outside the United States in a manner for which no U.S. registration is required, the proposed rule would have required the banking entity to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.

b. Comments on Proposed Registration Requirement

Commenters generally did not address the proposed dealer requirement in the underwriting exemption. However, as discussed below in Part VI.A.3.c.2.b., a number of commenters addressed a similar requirement in the proposed market-making exemption.

c. Final Registration Requirement

The requirement in § 75.4(a)(2)(vi) of the underwriting exemption, which provides that the banking entity must be licensed or registered to engage in underwriting activity in accordance with applicable law, is substantively similar to the proposed dealer registration requirement in § 75.4(a)(2)(iv) of the proposed rule. The primary difference between the proposed requirement and the final requirement is that the Agencies have simplified the language of the rule. The Agencies have also made conforming changes to the corresponding requirement in the market-making exemption to promote consistency across the exemptions, where appropriate.[486]

As was proposed, this provision will require a U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[487] To the extent that a banking entity relies on the underwriting exemption in

[479] *See* AFR *et al.* (Feb. 2012).

[480] *See* Occupy.

[481] *See* final rule § 75.4(a)(2)(iv); proposed rule § 75.4(a)(2)(vii). This is consistent with the final compensation requirements in the market-making and hedging exemptions. *See* final rule § 75.4(b)(2)(v); final rule § 75.5(b)(3).

[482] *See* AFR *et al.* (Feb. 2012); *supra* Part VI.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[483] *See* AFR *et al.* (Feb. 2012).

[484] *See* Occupy.

[485] *See* proposed rule § 75.4(a)(2)(iv); Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353. The proposal clarified that, in the case of a financial institution that is a government securities dealer, such institution must have filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act. *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353.

[486] *See* Part VI.A.3.c.6. (discussing the registration requirement in the market-making exemption).

[487] For example, if a banking entity is a bank engaged in underwriting asset-backed securities for which it would be required to register as a securities dealer but for the exclusion contained in section 3(a)(5)(C)(iii) of the Exchange Act, the final rule would not require the banking entity to be a registered securities dealer to underwrite the asset-backed securities. *See* 15 U.S.C. 78c(a)(5)(C)(iii).

connection with a distribution of municipal securities or government securities, rather than the exemption in § 75.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer, if required by applicable law. However, this provision does not require a banking entity to register in order to qualify for the underwriting exemption if the banking entity is not otherwise required to register by applicable law.

The Agencies have determined that, for purposes of the underwriting exemption, rather than require a banking entity engaged in the business of a securities dealer outside the United States to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration provisions if required under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). In response to comments, the final rule recognizes that certain foreign jurisdictions may not provide for substantive regulation of dealing businesses.[488] The Agencies do not believe it is necessary to preclude banking entities from engaging in underwriting activities in such foreign jurisdictions to achieve the goals of section 13 of the BHC Act because these banking entities would continue to be subject to the other requirements of the underwriting exemption.

6. Source of Revenue Requirement

a. Proposed Source of Revenue Requirement

Under § 75.4(a)(2)(vi) of the proposed rule, the underwriting activities of a banking entity would have been required to be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions.[489] The proposal clarified that underwriting spreads would include any ''gross spread'' (*i.e.,* the difference between the price an underwriter sells securities to the public and the price it purchases them from the issuer) designed to compensate the underwriter for its services.[490] This requirement provided that activities conducted in reliance on the underwriting exemption should demonstrate patterns of revenue generation and profitability consistent with, and related to, the services an underwriter provides to its customers in bringing securities to market, rather than changes in the market value of the underwritten securities.[491]

b. Comments on the Proposed Source of Revenue Requirement

A few commenters requested certain modifications to the proposed source of revenue requirement. These commenters' suggested revisions were generally intended either to refine the standard to better account for certain activities or to make it more stringent.[492] Three commenters expressed concern that the proposed source of revenue requirement would negatively impact a banking entity's ability to act as a primary dealer or in a similar capacity.[493]

With respect to suggested modifications, one commenter recommended that ''customer revenue'' include revenues attributable to syndicate activities, hedging activities, and profits and losses from sales of residual positions, as long as the underwriter makes a reasonable effort to dispose of any residual position in light of existing market conditions.[494] Another commenter indicated that the rule would better address securitization if it required compensation to be linked in part to risk minimization for the securitizer and in part to serving customers. This commenter suggested that such a framework would be preferable because, in the context of securitizations, fee-based compensation structures did not previously prevent banking entities from accumulating large and risky positions with significant market exposure.[495]

To strengthen the proposed requirement, one commenter requested that the terms ''designed'' and ''primarily'' be removed and replaced by the word ''solely.''[496] Two other commenters requested that this requirement be interpreted to prevent a banking entity from acting as an underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price.[497]

c. Final Rule's Approach To Assessing Source of Revenue

The Agencies believe the final rule includes sufficient controls around an underwriter's source of revenue and have determined not to adopt the additional requirement included in proposed rule § 75.4(a)(2)(vi). The Agencies believe that removing this requirement addresses commenters' concerns that the proposed requirement did not appropriately reflect certain revenue sources from underwriting activity[498] or may impact primary dealer activities.[499] At the same time, the final rule continues to include provisions that focus on whether an underwriter is generating underwriting-related revenue and that should limit an underwriter's ability to generate revenues purely from price appreciation. In particular, the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period, which was not included in the proposed rule, should limit an underwriter's ability to gain revenues purely from price appreciation related to its underwriter position. Similarly, the determination of whether an underwriter receives special compensation for purposes of the definition of ''distribution'' takes into account whether a banking entity is generating underwriting-related revenue.

The final rule does not adopt a requirement that prevents an underwriter from generating any revenue from price appreciation out of concern that such a requirement could prevent an underwriter from retaining an unsold allotment under any

[488] *See infra* Part VI.A.3.c.6.c. (discussing comments on this issue with respect to the proposed dealer registration requirement in the market-making exemption).

[489] *See* proposed rule § 75.4(a)(2)(vi); Joint Proposal, 76 FR at 68867–68868; CFTC Proposal, 77 FR at 8353.

[490] *See* Joint Proposal, 76 FR at 68867–68868 n.142; CFTC Proposal, 77 FR at 8353 n.148.

[491] *See* Joint Proposal, 76 FR at 68867–68868; CFTC Proposal, 77 FR at 8353.

[492] *See* Goldman (Prop. Trading); Occupy; Sens. Merkley & Levin (Feb. 2012).

[493] *See* Banco de México (stating that primary dealers need to profit from resulting proprietary positions in foreign sovereign debt, including by holding significant positions in anticipation of future price movements, in order to make the primary dealer business financially attractive); IIB/EBF (noting that primary dealers may actively seek to profit from price and interest rate movements of their holdings, which the relevant sovereign entity supports because such activity provides much-needed liquidity for securities that are otherwise largely purchased pursuant to buy-and-hold strategies by institutional investors and other entities seeking safe returns and liquidity buffers); Japanese Bankers Ass'n.

[494] *See* Goldman (Prop. Trading).

[495] *See* Sens. Merkley & Levin (Feb. 2012).

[496] *See* Occupy (requesting that the rule require automatic disgorgement of any profits arising from appreciation in the value of positions in connection with underwriting activities).

[497] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[498] *See* Goldman (Prop. Trading).

[499] *See* Banco de México; IIB/EBF; Japanese Bankers Ass'n.

circumstances, which would be inconsistent with other provisions of the exemption.[500] Similarly, the Agencies are not adopting a source of revenue requirement that would prevent a banking entity from acting as underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price, as suggested by two commenters.[501] The Agencies believe these commenters' concern is mitigated by the near term demand requirement, which requires a trading desk to have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[502] Further, one commenter recommended a revenue requirement directed at securitization activities to prevent banking entities from accumulating large and risky positions with significant market exposure.[503] The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should achieve this stated goal and, thus, the Agencies do not believe an additional revenue requirement for securitization activity is needed.[504]

3. Section 75.4(b): Market-Making Exemption

a. Introduction

In adopting the final rule, the Agencies are striving to balance two goals of section 13 of the BHC Act: To allow market making, which is important to well-functioning markets as well as to the economy, and simultaneously to prohibit proprietary trading, unrelated to market making or other permitted activities, that poses significant risks to banking entities and the financial system. In response to comments on the proposed market-making exemption, the Agencies are adopting certain modifications to the proposed exemption to better account for the varying characteristics of market making-related activities across markets and asset classes, while requiring that banking entities maintain a robust set of risk controls for their market making-related activities. A flexible approach to this exemption is appropriate because the activities a market maker undertakes to provide important intermediation and liquidity services will differ based on the liquidity, maturity, and depth of the market for a given type of financial instrument. The statute specifically permits banking entities to continue to provide these beneficial services to their clients, customers, and counterparties.[505] Thus, the Agencies are adopting an approach that recognizes the full scope of market making-related activities banking entities currently undertake and requires that these activities be subject to clearly defined, verifiable, and monitored risk parameters.

b. Overview

1. Proposed Market-Making Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities, derivatives, contracts of sale of a commodity for future delivery, and options on any of the foregoing in connection with market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[506]

Section 75.4(b) of the proposed rule would have implemented this statutory exemption by requiring that a banking entity's market making-related activities comply with seven standards. As discussed in the proposal, these standards were designed to ensure that any banking entity relying on the exemption would be engaged in *bona fide* market making-related activities and, further, would conduct such activities in a way that was not susceptible to abuse through the taking of speculative, proprietary positions as a part of, or mischaracterized as, market making-related activities. The Agencies proposed to use additional regulatory and supervisory tools in conjunction with the proposed market-making exemption, including quantitative measurements for banking entities engaged in significant covered trading activity in proposed Appendix A, commentary on how the Agencies proposed to distinguish between permitted market making-related activity and prohibited proprietary trading in proposed Appendix B, and a compliance regime in proposed § 75.20 and, where applicable, Appendix C of the proposal. This multi-faceted approach was intended to address the complexities of differentiating permitted market making-related activities from prohibited proprietary trading.[507]

2. Comments on the Proposed Market-Making Exemption

The Agencies received significant comment regarding the proposed market-making exemption. In this Part, the Agencies highlight the main issues, concerns, and suggestions raised by commenters with respect to the proposed market-making exemption. As discussed in greater detail below, commenters' views on the effectiveness of the proposed exemption varied. Commenters discussed a broad range of topics related to the proposed market-making exemption including, among others: The overall scope of the proposed exemption and potential restrictions on market making in certain markets or asset classes; the potential market impact of the proposed market-making exemption; the appropriate level of analysis for compliance with the proposed exemption; the effectiveness of the individual requirements of the proposed exemption; and specific activities that should or should not be considered permitted market making-related activity under the rule.

a. Comments on the Overall Scope of the Proposed Exemption

With respect to the general scope of the exemption, a number of commenters expressed concern that the proposed approach to implementing the market-making exemption is too narrow or restrictive, particularly with respect to less liquid markets. These commenters expressed concern that the proposed exemption would not be workable in many markets and asset classes and does not take into account how market-making services are provided in those markets and asset classes.[508] Some

[500] *See* Occupy; *supra* Part VI.A.2.c.2. (discussing comments on unsold allotments and the requirement in the final rule to make reasonable efforts to sell or otherwise reduce the underwriting position).

[501] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[502] *See supra* Part VI.A.2.c.2.

[503] *See* Sens. Merkley & Levin (Feb. 2012).

[504] *See* final rule § 75.4(a)(2)(ii). Further, as noted above, this exemption does not permit the accumulation of assets for securitization. *See supra* Part VI.A.2.c.1.c.v.

[505] As discussed in Part VI.A.3.c.2.c.i., *infra,* the terms ''client,'' ''customer,'' and ''counterparty'' are defined in the same manner in the final rule. Thus, the Agencies use these terms synonymously throughout this discussion and sometimes use the term ''customer'' to refer to all entities that meet the definition of ''client, customer, and counterparty'' in the final rule's market-making exemption.

[506] 12 U.S.C. 1851(d)(1)(B).

[507] *See* Joint Proposal, 76 FR at 68869; CFTC Proposal, 77 FR at 8354–8355.

[508] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that the proposed exemption ''seems to view market making based on a liquid, exchange-traded equity model in which market makers are simple intermediaries akin to agents'' and that ''[t]his view does not fit market making even in equity markets and widely misses the mark for the vast majority of markets and asset classes''); SIFMA (Asset Mgmt.) (Feb. 2012); Credit Suisse (Seidel); ICI (Feb. 2012); BoA; Columbia Mgmt.; Comm. on Capital Markets Regulation; Invesco; ASF (Feb. 2012) (''The seven criteria in the proposed rule, and

commenters expressed particular concern that the proposed exemption may restrict or limit certain activities currently conducted by market makers (*e.g.,* holding inventory or interdealer trading).[509] Several commenters stated that the proposed exemption would create too much uncertainty regarding compliance [510] and, further, may have a chilling effect on banking entities' market making-related activities.[511] Due to the perceived restrictions and burdens of the proposed exemption, many commenters indicated that the rule may change the way in which market-making services are provided.[512] A number of commenters expressed the view that the proposed exemption is inconsistent with Congressional intent because it would restrict and reduce banking entities' current market making-related activities.[513]

Other commenters, however, stated that the proposed exemption was too broad and recommended that the rule place greater restrictions on market making, particularly in illiquid, nontransparent markets.[514] Many of these commenters suggested that the exemption should only be available for traditional market-making activity in relatively safe, ''plain vanilla'' instruments.[515] Two commenters represented that the proposed exemption would have little to no impact on banking entities' current market making-related services.[516]

Commenters expressed differing views regarding the ease or difficulty of distinguishing permitted market making-related activity from prohibited proprietary trading. A number of commenters represented that it is difficult or impossible to distinguish prohibited proprietary trading from permitted market making-related activity.[517] With regard to this issue, several commenters recommended that the Agencies not try to remove all aspects of proprietary trading from market making-related activity because doing so would likely restrict certain legitimate market-making activity.[518]

Other commenters were of the view that it is possible to differentiate between prohibited proprietary trading and permitted market making-related activity.[519] For example, one commenter stated that, while the analysis may involve subtle distinctions, the fundamental difference between a banking entity's market-making activities and proprietary trading activities is the emphasis in market making on seeking to meet customer needs on a consistent and reliable basis throughout a market cycle.[520] According to another commenter, holding substantial securities in a trading book for an extended period of time assumes the character of a proprietary position and, while there may be occasions when a customer-oriented purchase and subsequent sale extend over days and cannot be more quickly executed or hedged, substantial holdings of this character should be relatively rare and limited to less liquid markets.[521]

Several commenters expressed general concern that the proposed exemption may be applied on a transaction-by-transaction basis and explained the burdens that may result from such an approach.[522] Commenters appeared to attribute these concerns to language in the proposed exemption referring to a ''purchase or sale of a [financial instrument]'' [523] or to language in Appendix B indicating that the Agencies may assess certain factors and criteria at different levels, including a ''single significant transaction.'' [524] With respect to the burdens of a transaction-by-transaction analysis,

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the related criterion for identifying permitted hedging, are overly restrictive and will make it impractical for dealers to continue making markets in most securitized products.''); Chamber (Feb. 2012) (expressing particular concern about the commercial paper market).

[509] Several commenters stated that the proposed rule would limit a market maker's ability to maintain inventory. *See, e.g.,* NASP; Oliver Wyman (Dec. 2011); Wellington; Prof. Duffie; Standish Mellon; MetLife; Lord Abbett; NYSE Euronext; CIEBA; British Columbia; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Shadow Fin. Regulatory Comm.; Credit Suisse (Seidel); Morgan Stanley; Goldman (Prop. Trading); BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); IRSG; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); Australian Bankers Ass'n. (Feb. 2012); FEI; ASF (Feb. 2012); RBC; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; IHS; Oliver Wyman (Feb. 2012); Thakor Study (stating that by artificially constraining the security holdings that a banking entity can have in its inventory for market making or proprietary trading purposes, section 13 of the BHC Act will make bank risk management less efficient and may adversely impact the diversified financial services business model of banks). However, some commenters stated that market makers should seek to minimize their inventory or should not need large inventories. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz. Other commenters expressed concern that the proposed rule could limit interdealer trading. *See, e.g.,* Prof. Duffie; Credit Suisse (Seidel); JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); Oliver Wyman (Dec. 2011).

[510] *See, e.g.,* BlackRock; Putnam; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); MetLife; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Sen. Bennet; Sen. Corker; PUC Texas; Fidelity; ICI (Feb. 2012); Invesco.

[511] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Commissioner Barnier; NYSE Euronext; BoA; Citigroup (Feb. 2012); STANY; ICE; Chamber (Feb. 2012); BDA (Feb. 2012); Putnam; FTN; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; CME Group; Capital Group; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; ICI (Feb. 2012); Invesco; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Thakor Study.

[512] For example, some commenters stated that market makers may revert to an agency or ''special order'' model. *See, e.g.,* Barclays; Goldman (Prop. Trading); ACLI (Feb. 2012); Vanguard; RBC. In addition, some commenters stated that new systems will be developed, such as alternative market matching networks, but these commenters disagreed about whether such changes would happen in the near term. *See, e.g.,* CalPERS; BlackRock; Stuyvesant; Comm. on Capital Markets Regulation. Other commenters stated that it is unlikely that new systems will be developed. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012). One commenter stated that the proposed rule may cause a banking organization that engages in significant market-making activity to give up its banking charter or spin off its market-making operations to avoid compliance with the proposed exemption. *See* Prof. Duffie.

[513] *See, e.g.,* NASP; Wellington; JPMC; Morgan Stanley; Credit Suisse (Seidel); BoA; Goldman (Prop. Trading); Citigroup (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ICI (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Sen. Corker; Invesco.

[514] *See, e.g.,* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[515] *See, e.g.,* Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[516] *See* Occupy (''[I]t is unclear that this rule, as written, will markedly alter the current customer-serving business. Indeed, this rule has gone to excessive lengths to protect the covered banking entities' ability to maintain responsible customer-facing business.''); Alfred Brock.

[517] *See, e.g.,* Rep. Bachus *et al.;* IIF; Morgan Stanley (stating that beyond walled-off proprietary trading, the line is hard to draw, particularly because both require principal risk-taking and the features of market making vary across markets and asset classes and become more pronounced in times of market stress); CFA Inst. (representing that the distinction is particularly difficult in the fixed-income market); ICFR; Prof. Duffie; WR Hambrecht.

[518] *See, e.g.,* Chamber (Feb. 2012) (citing an article by Stephen Breyer stating that society should not expend disproportionate resources trying to reduce or eliminate ''the last 10 percent'' of the risks of a certain problem); JPMC; RBC; ICFR; Sen. Hagan. One of these commenters indicated that any concerns that banking entities would engage in speculative trading as a result of an expansive market-making exemption would be addressed by other reform initiatives (*e.g.,* Basel III implementation will provide laddered disincentives to holding positions as principal as a result of capital and liquidity requirements). *See* RBC.

[519] *See* Wellington; Paul Volcker; Better Markets (Feb. 2012); Occupy.

[520] *See* Wellington.

[521] *See* Paul Volcker.

[522] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); HSBC; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); PUC Texas; ERCOT; Invesco. *See also* IAA (stating that it is unclear whether the requirements must be applied on a transaction-by-transaction basis or if compliance with the requirements is based on overall activities). This issue is addressed in Part VI.A.3.c.1.c., *infra.*

[523] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading) (Feb. 2012). As explained above, the term ''covered financial position'' from the proposal has been replaced by the term ''financial instrument'' in the final rule. Because the types of instruments included in both definitions are identical, the term ''financial instrument'' is used throughout this Part.

[524] *See, e.g.,* Goldman (Prop. Trading); Wellington.

some commenters noted that banking entities can engage in a large volume of market-making transactions daily, which would make it burdensome to apply the exemption to each trade.[525] A few commenters indicated that, even if the Agencies did not intend to require transaction-by-transaction analysis, the proposed rule's language can be read to imply such a requirement. These commenters indicated that ambiguity on this issue could have a chilling effect on market making or could allow some examiners to rigidly apply the requirements of the exemption on a trade-by-trade basis.[526] Other commenters indicated that it would be difficult to determine whether a particular trade was or was not a market-making trade without consideration of the relevant unit's overall activities.[527] One commenter elaborated on this point by stating that ''an analysis that seeks to characterize specific transactions as either market making . . . or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.'' [528] This commenter noted that a position entered into as part of market making-related activities may serve multiple functions at one time, such as responding to customer demand, hedging a risk, and building inventory. The commenter also expressed concern that individual transactions or positions may not be severable or separately identifiable as serving a market-making purpose.[529] Two commenters suggested that the requirements in the market-making exemption be applied at the portfolio level rather than the trade level.[530]

Moreover, commenters also set forth their views on the organizational level at which the requirements of the proposed market-making exemption should apply.[531] The proposed exemption generally applied requirements to a ''trading desk or other organizational unit'' of a banking entity. In response to this proposed approach, commenters stated that compliance should be assessed at each trading desk or aggregation unit[532] or at each trading unit.[533]

Several commenters suggested alternative or additive means of implementing the statutory exemption for market making-related activity.[534] Commenters' recommended approaches varied, but a number of commenters requested approaches involving one or more of the following elements: (i) Safe harbors,[535] bright lines,[536] or presumptions of compliance with the exemption based on the existence of certain factors (*e.g.,* compliance program, metrics, general customer focus or orientation, providing liquidity, and/or exchange registration as a market maker); [537] (ii) a focus on metrics or other objective factors; [538] (iii) guidance on permitted market making-related activity, rather than rule requirements; [539] (iv) risk management structures and/or risk limits; [540] (v) adding a new customer-facing criterion or focusing on client-related activities; [541] (vi) capital and liquidity requirements; [542] (vii) development of individualized plans for each banking entity, in coordination with regulators; [543] (viii) ring fencing affiliates engaged in market making-related activity; [544] (ix) margin requirements; [545] (x) a compensation-focused approach; [546] (xi) permitting all swap dealing activity; [547] (xii) additional provisions regarding material conflicts of interest and high-risk assets and trading strategies; [548] and/or (xiii) making the exemption as broad as possible under the statute.[549]

[525] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays (stating that ''hundreds or thousands of trades can occur in a single day in a single trading unit'').

[526] *See, e.g.,* ICI (Feb. 2012); Barclays; Goldman (Prop. Trading).

[527] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[528] SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[529] *See id.* (suggesting that the Agencies ''give full effect to the statutory intent to allow market making by viewing the permitted activity on a holistic basis'').

[530] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable.

[531] *See* Wellington; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable. The Agencies address this topic in Part VI.A.3.c.1.c., *infra.*

[532] *See* Wellington. This commenter did not provide greater specificity about how it would define ''trading desk'' or ''aggregation unit.'' *See id.*

[533] *See* Morgan Stanley (stating that ''trading unit'' should be defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity''); SIFMA *et al.* (Prop. Trading) (Feb. 2012). One of these commenters discussed its suggested definition of ''trading unit'' in the context of the proposed requirement to record and report certain quantitative measurements, but it is unclear that the commenter was also suggesting that this definition be used for purposes of the market-making exemption. For example, this commenter expressed support for a multi-level approach to defining ''trading unit,'' and it is not clear how a definition that captures multiple organizational levels across a banking organization would work in the context of the market-making exemption. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggested that ''trading unit'' be defined ''at a level that presents its activities in the context of the whole'' and noting that the appropriate level may differ depending on the structure of the banking entity).

[534] *See, e.g.,* Wellington; Japanese Bankers Ass'n.; Prof. Duffie; IR&M; G2 FinTech; MetLife; NYSE Euronext; Anthony Flynn and Koral Fusselman; IIF; CalPERS; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Shadow Fin. Regulatory Comm.; John Reed; Prof. Richardson; Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Johnson & Prof. Stiglitz; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); WR Hambrecht; Vanguard; Capital Group; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Fidelity; Occupy; AFR *et al.* (Feb. 2012); Invesco; ISDA (Feb. 2012); Stephen Roach; Oliver Wyman (Feb. 2012). The Agencies respond to these comments in Part VI.A.3.b.3., *infra.*

[535] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Feb. 2012) (Oct. 2012) (suggesting a safe harbor for any trading desk that effects more than 50 percent of its transactions through sales representatives).

[536] *See, e.g.,* Flynn & Fusselman; Prof. Colesanti *et al.*

[537] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading) (suggesting that the rule: (i) Provide a general grant of authority to engage in any transactions entered into as part of a banking entity's market-making business, where ''market making'' is defined as ''the business of being willing to facilitate customer purchases and sales of [financial instruments] as an intermediary over time and in size, including by holding positions in inventory;'' and (ii) allow banking entities to monitor compliance with this exemption internally through their compliance and risk management infrastructure); PNC *et al.;* Oliver Wyman (Feb. 2012).

[538] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[539] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[540] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[541] *See, e.g.,* Morgan Stanley; Stephen Roach.

[542] *See, e.g.,* Prof. Duffie; CalPERS; STANY; ICE; Vanguard; Capital Group.

[543] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[544] *See, e.g.,* Prof. Duffie; Shadow Fin. Regulatory Comm. *See also* Wedbush.

[545] *See* WR Hambrecht.

[546] *See* G2 FinTech.

[547] *See* ISDA (Feb. 2012); ISDA (Apr. 2012).

[548] *See* Sens. Merkley & Levin (Feb. 2012) (stating that the exemption should expressly mention the conflicts provision and provide examples to warn against particular conflicts, such as recommending clients buy poorly performing assets in order to remove them from the banking entity's book or attempting to move market prices in favor of trading positions a banking entity has built up in order to make a profit); Stephen Roach (suggesting that the exemption integrate the limitations on permitted activities).

[549] *See* Fidelity (stating that the exemption needs to be as broad as possible to account for customer-facing principal trades, block trades, and market making in OTC derivatives). *See also* STANY (stating that it is better to make the exemption too broad than too narrow).

b. Comments Regarding the Potential Market Impact of the Proposed Exemption

As discussed above, several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity. Many of these commenters represented that, as a result, the proposed exemption would likely result in reduced liquidity,[550] wider bid-ask spreads,[551] increased market volatility,[552] reduced price discovery or price transparency,[553] increased costs of raising capital or higher financing costs,[554] greater costs for investors or consumers,[555] and slower execution times.[556] Some commenters expressed particular concern about potential impacts on institutional investors (*e.g.,* mutual funds and pension funds)[557] or on small or midsized companies.[558] A number of commenters discussed the interrelationship between primary and secondary market activity and indicated that restrictions on market making would impact the underwriting process.[559]

A few commenters expressed the view that reduced liquidity would not necessarily be a negative result.[560] For example, two commenters noted that liquidity is vulnerable to liquidity spirals, in which a high level of market liquidity during one period feeds a sharp decline in liquidity during the next period by initially driving asset prices upward and supporting increased leverage. The commenters explained that liquidity spirals lead to ''fire sales'' by market speculators when events reveal that assets are overpriced and speculators must sell their assets to reduce their leverage.[561] According to another commenter, banking entities' access to the safety net allows them to distort market prices and, arguably, produce excess liquidity. The commenter further represented that it would be preferable to allow the discipline of the market to choose the pricing of securities and the amount of liquidity.[562] Some commenters cited an economic study indicating that the U.S. financial system has become less efficient in generating economic growth

[550] *See, e.g.,* AllianceBernstein; Rep. Bachus *et al.* (Dec. 2011); EMTA; NASP; Wellington; Japanese Bankers Ass'n.; Sen. Hagan; Prof. Duffie; Investure; Standish Mellon; IR&M; MetLife; Lord Abbett; Commissioner Barnier; Quebec; IIF; Sumitomo Trust; Liberty Global; NYSE Euronext; CIEBA; EFAMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); BDA (Feb. 2012); Putnam; Fixed Income Forum/Credit Roundtable; Western Asset Mgmt.; ACLI (Feb. 2012); IAA; CME Group; Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Australian Bankers Ass'n. (Feb. 2012); FEI; AFMA; Sen. Carper *et al.;* PUC Texas; ERCOT; IHS; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Eaton Vance; Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Union Asset; Sen. Casey; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012) (providing estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on hypothetical liquidity reduction scenarios); Thakor Study. The Agencies respond to comments regarding the potential market impact of the rule in Part VI.A.3.b.3., *infra.*

[551] *See, e.g.,* AllianceBernstein; Wellington; Investure; Standish Mellon; MetLife; Lord Abbett; Barclays; Goldman (Prop. Trading); Citigroup (Feb. 2012); BlackRock; Putnam; ACLI (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Sen. Carper *et al.;* IHS; Columbia Mgmt.; ICI (Feb. 2012) British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Thakor Study (stating that section 13 of the BHC Act will likely result in higher bid-ask spreads by causing at least some retrenchment of banks from market making, resulting in fewer market makers and less competition).

[552] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Lord Abbett; IIF; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); BDA (Feb. 2012); IHS; FTN; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; British Bankers' Ass'n.; Comm. on Capital Markets Regulation.

[553] *See, e.g.,* Prof. Duffie (arguing that, for example, ''during the financial crisis of 2007–2009, the reduced market making capacity of major dealer banks caused by their insufficient capital levels resulted in dramatic downward distortions in corporate bond prices''); IIF; Barclays; IAA; Vanguard; Wellington; FTN.

[554] *See, e.g.,* AllianceBernstein; Chamber (Dec. 2011); Members of Congress (Dec. 2011); Wellington; Sen. Hagan; Prof. Duffie; IR&M; MetLife; Lord Abbett; Liberty Global; NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); NCSHA; ASF (Feb. 2012) (stating that ''[f]ailure to permit the activities necessary for banking entities to act in [a] market-making capacity [in asset-backed securities] would have a dramatic adverse effect on the ability of securitizers to access the asset-backed securities markets and thus to obtain the debt financing necessary to ensure a vibrant U.S. economy''); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; Chamber (Feb. 2012); IHS; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; FEI; AFMA; SSgA (Feb. 2012); PNC *et al.;* ICI (Feb. 2012); British Bankers' Ass'n.; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); GE (Feb. 2012); Thakor Study (stating that when a firm's cost of capital goes up, it invests less—resulting in lower economic growth and lower employment—and citing supporting data indicating that a 1 percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in aggregate annual capital spending by U.S. nonfarm firms and job losses between 550,000 and 1.1 million per year in the nonfarm sector). One commenter further noted that a higher cost of capital can lead a firm to make riskier, short-term investments. *See* Thakor Study.

[555] *See, e.g.,* Wellington; Standish Mellon; IR&M; MetLife; Lord Abbett; NYSE Euronext; CIEBA; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Vanguard; Australian Bankers Ass'n. (Feb. 2012); FEI; Sen. Carper *et al.;* Columbia Mgmt.; SSgA (Feb. 2012); ICI (Feb. 2012); Comm. on Capital Markets Regulation; TMA Hong Kong; Sen. Casey; IHS; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); Thakor Study.

[556] *See, e.g.,* Barclays; FTN; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012).

[557] *See, e.g.,* AllianceBernstein (stating that, to the extent the rule reduces liquidity provided by market makers, open end mutual funds that are largely driven by the need to respond to both redemptions and subscriptions will be immediately impacted in terms of higher trading costs); Wellington (indicating that periods of extreme market stress are likely to exacerbate costs and challenges, which could force investors such as mutual funds and pension funds to accept distressed prices to fund redemptions or pay current benefits); Lord Abbett (stating that certain factors, such as reduced bank capital to support market-making businesses and economic uncertainty, have already reduced liquidity and caused asset managers to have an increased preference for highly liquid credits and expressing concern that, if section 13 of the BHC Act further reduces liquidity, then: (i) asset managers' increased preference for highly liquid credit could lead to unhealthy portfolio concentrations, and (ii) asset managers will maintain a larger cash cushion in portfolios that may be subject to redemption, which will likely result in investors getting poorer returns); EFAMA; BlackRock (stating that investment decisions are heavily dependent on a liquidity factor input, so as liquidity dissipates, investment strategies become more limited and returns to investors are diminished by wider spreads and higher transaction costs); CFA Inst. (noting that a mutual fund that tries to liquidate holdings to meet redemptions may have difficulty selling at acceptable prices, thus impairing the fund's NAV for both redeeming investors and for those that remain in the fund); Putnam; Fixed Income Forum/Credit Roundtable; ACLI; T. Rowe Price; Vanguard; IAA; FEI; Sen. Carper *et al.;* Columbia Mgmt.; ICI (Feb. 2012); Invesco; Union Asset; Standish Mellon; Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[558] *See, e.g.,* CIEBA (stating that for smaller issuers in particular, market makers need to have incentives to make markets, and the proposal removes important incentives); ACLI (indicating that lower liquidity will most likely result in higher costs for issuers of debt and, for lesser known or lower quality issuers, this cost may be significant and in some cases prohibitive because the cost will vary depending on the credit quality of the issuer, the amount of debt it has in the market, and the maturity of the security); PNC *et al.* (expressing concern that a regional bank's market-making activity for small and middle market customers is more likely to be inappropriately characterized as impermissible proprietary trading due to lower trading volume involving less liquid securities); Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[559] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; RBC; NYSE Euronext; Credit Suisse (Seidel).

[560] *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson.

[561] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker (stating that at some point, greater liquidity, or the perception of greater liquidity, may encourage more speculative trading).

[562] *See* Prof. Richardson.

in recent years, despite increased trading volumes.[563]

Some commenters stated that it is unlikely the proposed rule would result in the negative market impacts identified above, such as reduced market liquidity.[564] For example, a few commenters stated that other market participants, who are not subject to section 13 of the BHC Act, may enter the market or increase their trading activities to make up for any reduction in banking entities' market-making activity or other trading activity.[565] For instance, one of these commenters suggested that the revenue and profits from market making will be sufficient to attract capital and competition to that activity.[566] In addition, one commenter expressed the view that prohibiting proprietary trading may support more liquid markets by ensuring that banking entities focus on providing liquidity as market makers, rather than taking liquidity from the market in the course of ''trading to beat'' institutional buyers like pension funds, university endowments, and mutual funds.[567] Another commenter stated that, while section 13 of the BHC Act may temporarily reduce trading volume and excessive liquidity at the peak of market bubbles, it should increase the long-run stability of the financial system and render genuine liquidity and credit availability more reliable over the long term.[568]

Other commenters, however, indicated that it is uncertain or unlikely that non-banking entities will enter the market or increase their trading activities, particularly in the short term.[569] For example, one commenter noted the investment that banking entities have made in infrastructure for trading and compliance would take smaller or new firms years and billions of dollars to replicate.[570] Another commenter questioned whether other market participants, such as hedge funds, would be willing to dedicate capital to fully serving customer needs, which is required to provide ongoing liquidity.[571] One commenter stated that even if non-banking entities move in to replace lost trading activity from banking entities, the value of the current interdealer network among market makers will be reduced due to the exit of banking entities.[572] Several commenters expressed the view that migration of market making-related activities to firms outside the banking system would be inconsistent with Congressional intent and would have potentially adverse consequences for the safety and soundness of the U.S. financial system.[573]

Many commenters requested additional clarification on how the proposed market-making exemption would apply to certain asset classes and markets or to particular types of market making-related activities. In particular, commenters requested greater clarity regarding the permissibility of: (i) Interdealer trading,[574] including trading for price discovery purposes or to test market depth; [575] (ii) inventory management; [576] (iii) block positioning activity; [577] (iv) acting as an authorized participant or market maker in ETFs; [578] (v) arbitrage or other activities that promote price transparency and liquidity; [579] (vi) primary dealer activity; [580] (vii) market making in futures and options; [581] (viii) market making in new or bespoke products or customized hedging contracts; [582] and (ix) inter-affiliate transactions.[583] As discussed in more detail in Part VI.B.2.c., a number of commenters requested that the market-making exemption apply to the restrictions on acquiring or retaining an ownership

[563] *See, e.g.,* Johnson & Prof. Stiglitz (citing Thomas Phillippon, ''Has the U.S. Finance Industry Become Less Efficient?,'' NYU Working Paper, Nov. 2011); AFR *et al.* (Feb. 2012); Public Citizen; Better Markets (Feb. 2012); Prof. Johnson.

[564] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012) (stating that there is no convincing, independent evidence that the rule would increase trading costs or reduce liquidity, and the best evidence available suggests that the buy-side firms would greatly benefit from the competitive pressures that transparency can bring); Better Markets (Feb. 2012) (''Industry's claim that [section 13 of the BHC Act] will 'reduce market liquidity, capital formation, and credit availability, and thereby hamper economic growth and job creation' disregard the fact that the financial crisis did more damage to those concerns than any rule or reform possibly could.''); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012); AFR *et al.* (Feb. 2012). One commenter stated that the proposed rule would improve market liquidity, efficiency, and price transparency. *See* Alfred Brock.

[565] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012). Similarly, one commenter indicated that non-banking entity market participants could fill the current role of banking entities in the market if implementation of the rule is phased in. *See* ACLI (Feb. 2012).

[566] *See* Better Markets (Feb. 2012).

[567] *See* Prof. Johnson.

[568] *See* AFR *et al.* (Feb. 2012).

[569] *See, e.g.,* Wellington; Prof. Duffie; Investure; IIF; Liberty Global; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); FTN; Western Asset Mgmt.; IAA; PUC Texas; ICI (Feb. 2012); IIB/EBF; Invesco. In addition, some commenters recognized that other market participants are likely to fill banking entities' roles in the long term, but not in the short term. *See, e.g.,* ICFR; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012).

[570] *See* Oliver Wyman (Feb. 2012) (''Major bank-affiliated market makers have large capital bases, balance sheets, technology platforms, global operations, relationships with clients, sales forces, risk infrastructure, and management processes that would take smaller or new dealers years and billions of dollars to replicate.'').

[571] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[572] *See* Thakor Study.

[573] *See, e.g.,* Prof. Duffie; Oliver Wyman (Feb. 2012).

[574] *See, e.g.,* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[575] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading).

[576] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[577] *See infra* Part VI.A.3.c.1.b.ii. (discussing commenters' requests for greater clarity regarding the permissibility of block positioning activity).

[578] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012).

[579] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012).

[580] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); Banco de México; IIB/EBF.

[581] *See* CME Group (requesting clarification that the market-making exemption permits a banking entity to engage in market making in exchange-traded futures and options because the dealer registration requirement in § 75.4(b)(2)(iv) of the proposed rule did not refer to such instruments and stating that lack of an explicit exemption would reduce market-making activities in these instruments, which would decrease liquidity). *But see* Johnson & Prof. Stiglitz (stating that the Agencies should pay special attention to options trading and other derivatives because they are highly volatile assets that are difficult if not impossible to effectively hedge, except through a completely matched position, and suggesting that options and similar derivatives may need to be required to be sold only as riskless principal under § 75.6(b)(1)(ii) of the proposed rule or significantly limited through capital charges); Sens. Merkley & Levin (Feb. 2012) (stating that asset classes that are particularly hard to hedge, such as options, should be given special attention under the hedging exemption).

[582] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). Other commenters, however, stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or customized derivatives. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

[583] *See, e.g.,* Japanese Bankers Ass'n. (stating that transactions with affiliates and subsidiaries and related to hedging activities are a type of market making-related activity or risk-mitigating hedging activity that should be exempted by the rule); SIFMA *et al.* (Prop. Trading) (Feb. 2012). According to one of these commenters, inter-affiliate transactions should be viewed as part of a coordinated activity for purposes of determining whether a banking entity qualifies for an exemption. This commenter stated that, for example, if a market maker shifts positions held in inventory to an affiliate that is better able to manage the risk of such positions, both the market maker and its affiliate would be engaged in permitted market making-related activity. This commenter further represented that fitting the inter-affiliate swap into the exemption may be difficult (*e.g.,* one of the affiliates entering into the swap may not be holding itself out as a willing counterparty). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

interest in a covered fund.[584] Some commenters stated that no other activities should be considered permitted market making-related activity under the rule.[585] In addition, a few commenters requested clarification that high-frequency trading would not qualify for the market-making exemption.[586]

3. Final Market-Making Exemption

After carefully considering comment letters, the Agencies are adopting certain refinements to the proposed market-making exemption. The Agencies are adopting a market-making exemption that is consistent with the statutory exemption for this activity and designed to permit banking entities to continue providing intermediation and liquidity services. The Agencies note that, while all market-making activity should ultimately be related to the intermediation of trading, whether directly to individual customers through bilateral transactions or more broadly to a given marketplace, certain characteristics of a market-making business may differ among markets and asset classes.[587] The final rule is intended to account for these differences to allow banking entities to continue to engage in market making-related activities by providing customer intermediation and liquidity services across markets and asset classes, if such activities do not violate the statutory limitations on permitted activities (*e.g.,* by involving or resulting in a material conflict of interest with a client, customer, or counterparty) and are conducted in conformance with the exemption.

At the same time, the final rule requires development and implementation of trading, risk and inventory limits, risk management strategies, analyses of how the specific market making-related activities are designed not to exceed the reasonably expected near term demands of customers, compensation standards, and monitoring and review requirements that are consistent with market-making activities.[588] These requirements are designed to distinguish exempt market making-related activities from impermissible proprietary trading. In addition, these requirements are designed to ensure that a banking entity is aware of, monitors, and limits the risks of its exempt activities consistent with the prudent conduct of market making-related activities.

As described in detail below, the final market-making exemption consists of the following elements:

- A framework that recognizes the differences in market making-related activities across markets and asset classes by establishing criteria that can be applied based on the liquidity, maturity, and depth of the market for the particular type of financial instrument.
- A general focus on analyzing the overall ''financial exposure'' and ''market-maker inventory'' held by any given trading desk rather than a transaction-by-transaction analysis. The ''financial exposure'' reflects the aggregate risks of the financial instruments, and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of its market making-related activities. The ''market-maker inventory'' means all of the positions, in the financial instruments for which the trading desk stands ready to make a market that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[589]
- A definition of the term ''trading desk'' that focuses on the operational functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a single banking entity or across two or more affiliates.[590]
- Five requirements for determining whether a banking entity is engaged in permitted market making-related activities. Many of these criteria have similarities to the factors included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - The trading desk that establishes and manages a financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;[591]
  - The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute and based on certain factors and analysis;[592]
  - The banking entity has established and implements, maintains, and enforces an internal compliance program that is reasonably designed to ensure its compliance with the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:
    - The financial instruments each trading desk stands ready to purchase and sell in accordance with § 75.4(b)(2)(i) of the final rule;
    - The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with its established limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading

[584] *See, e.g.,* Cleary Gottlieb; JPMC; BoA; Credit Suisse (Williams).

[585] *See, e.g.,* Occupy; Alfred Brock.

[586] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

[587] Consistent with the FSOC study and the proposal, the final rule recognizes that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular type of financial instrument. *See* Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8356; FSOC study (stating that ''characteristics of permitted activities in one market or asset class may not be the same in another market (e.g., permitted activities in a liquid equity securities market may vary significantly from an illiquid over-the-counter derivatives market)'').

[588] Certain of these requirements, like the requirements to have risk and inventory limits, risk management strategies, and monitoring and review requirements were included in the enhanced compliance program requirement in proposed Appendix C, but were not separately included in the proposed market-making exemption. Like the statute, the proposed rule would have required that market making-related activities be designed not to exceed the reasonably expected near term demand of clients, customers, or counterparties. The Agencies are adding an explicit requirement in the final rule that a trading desk conduct analyses of customer demand for purposes of complying with this statutory requirement.

[589] *See infra* Part VI.A.3.c.1.c.ii. *See also* final rule §§ 75.4(b)(4), (5).

[590] *See infra* Part VI.A.3.c.1.c.i. The term ''trading desk'' is defined as ''the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof.'' Final rule § 75.3(e)(13).

[591] *See* final rule § 75.4(b)(2)(i); *infra* Part VI.A.3.c.1.c.iii.

[592] *See* final rule § 75.4(b)(2)(ii); *infra* Part VI.A.3.c.2.c. In addition, the Agencies are adopting a definition of the terms ''client,'' ''customer,'' and ''counterparty'' in § 75.4(b)(3) of the final rule.

desk to mitigate these risks are and continue to be effective;[593]

▪ Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, including factors used to determine the reasonably expected near term demands of clients, customers, or counterparties, on: the amount, types, and risks of its market-maker inventory; the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; the level of exposures to relevant risk factors arising from its financial exposure; and the period of time a financial instrument may be held;

▪ Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

▪ Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of the market-making exemption, and independent review of such demonstrable analysis and approval;[594]

○ To the extent that any limit identified above is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;[595]

○ The compensation arrangements of persons performing market making-related activities are designed not to reward or incentivize prohibited proprietary trading;[596] and

• The banking entity is licensed or registered to engage in market making-related activities in accordance with applicable law.[597]

• The use of quantitative measurements to highlight activities that warrant further review for compliance with the exemption.[598] As discussed further in Part VI.C.3., the Agencies have reduced some of the compliance burdens by adopting a more tailored subset of metrics than was proposed to better focus on those metrics that the Agencies believe are most germane to the evaluation of the activities that firms conduct under the market-making exemption.

In refining the proposed approach to implementing the statute's market-making exemption, the Agencies closely considered the various alternative approaches suggested by commenters.[599] However, like the proposed approach, the final market-making exemption continues to adhere to the statutory mandate that provides for an exemption to the prohibition on proprietary trading for market making-related activities. Therefore, the final rule focuses on providing a framework for assessing whether trading activities are consistent with market making. The Agencies believe this approach is consistent with the statute[600] and strikes an appropriate balance between commenters' desire for both clarity and flexibility. For example, while a bright-line or safe harbor based approach would generally provide a high degree of certainty about whether an activity qualifies for the market-making exemption, it would also provide less flexibility to recognize the differences in market-making activities across markets and asset classes.[601] In addition, any bright-line approach would be more likely to be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the market-making exemption.[602] Although a purely guidance-based approach would provide greater flexibility, it would also provide less clarity, which could make it difficult for trading personnel, internal compliance personnel, and Agency supervisors and examiners to determine whether an activity complies with the rule and would lead to an increased risk of evasion of the statutory requirements.[603]

Some commenters suggested an approach to implementing the market-making exemption that would focus on metrics or other objective factors.[604] As discussed below, a number of commenters expressed support for using the metrics as a tool to monitor trading activity and not to determine compliance with the rule.[605] While the Agencies agree that quantitative measurements are useful for purposes of monitoring a trading desk's activities and are requiring certain banking entities to calculate, record, and report quantitative measurements to the Agencies in the final rule, the Agencies do not believe that quantitative measurements should be used as a dispositive tool for determining

[593] Routine market making-related risk management activity by a trading desk is permitted under the market-making exemption and, provided the standards of the exemption are met, is not required to separately meet the requirements of the hedging exemption. The circumstances under which risk management activity relating to the trading desk's financial exposure is permitted under the market-making exemption or must separately comply with the hedging exemption are discussed in more detail in Parts VI.A.3.c.1.c.ii. and VI.A.3.c.4., *infra*.

[594] *See* final rule § 75.4(b)(2)(iii); *infra* Part VI.A.3.c.3.

[595] *See* final rule § 75.4(b)(2)(iv).

[596] *See* final rule § 75.4(b)(2)(v); *infra* Part VI.A.3.c.5.

[597] *See* final rule § 75.4(b)(2)(vi); *infra* Part VI.A.3.c.6. As discussed further below, this provision pertains to legal registration or licensing requirements that may apply to an entity engaged in market making-related activities, depending on the facts and circumstances. This provision would not require a banking entity to comply with registration requirements that are not required by law, such as discretionary registration with a national securities exchange as a market maker on that exchange.

[598] *See infra* Part VI.C.3.

[599] *See supra* Part VI.A.3.b.2.

[600] Certain approaches suggested by commenters, such as relying solely on capital requirements, requiring ring fencing, permitting all swap dealing activity, or focusing solely on how traders are compensated do not appear to be consistent with the statutory language because they do not appear to limit market making-related activity to that which is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute. *See* Prof. Duffie; STANY; ICE; Shadow Fin. Regulatory Comm.; ISDA (Feb. 2012); ISDA (Apr. 2012); G2 FinTech.

[601] While an approach establishing a number of safe harbors that are each tailored to a specific asset class would address the need to recognize differences across asset classes, such an approach may also increase the complexity of the final rule. Further, commenters did not provide sufficient information to determine the appropriate parameters of a safe harbor-based approach.

[602] As noted above, a number of commenters suggested the Agencies adopt a bright-line rule, provide a safe harbor for certain types of activities, or establish a presumption of compliance based on certain factors. *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Oct. 2012); Flynn & Fusselman; Prof. Colesanti *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading); PNC *et al.;* Oliver Wyman (Feb. 2012). Many of these commenters expressed general concern that the proposed market-making exemption may create uncertainty for individual traders engaged in market making-related activity and suggested that their proposed approach would alleviate such concern. The Agencies believe that the enhanced focus on risk and inventory limits for each trading desk (which must be tied to the near term customer demand requirement) and the clarification that the final market-making exemption does not require a trade-by-trade analysis should address concerns about individual traders having to assess whether they are complying with the market-making exemption on a trade-by-trade basis.

[603] Several commenters suggested a guidance-based approach, rather than requirements in the final rule. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could then be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[604] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[605] *See infra* Part VI.C.3. (discussing the final rule's metrics requirement). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); RBC; ICI (Feb. 2012); Occupy (stating that there are serious limits to the capabilities of the metrics and the potential for abuse and manipulation of the input data is significant); Alfred Brock.

compliance with the market-making exemption.[606]

In response to two commenters' request that the final rule focus on a banking entity's risk management structures or risk limits and not on attempting to define market-making activities,[607] the Agencies do not believe that management of risk, on its own, is sufficient to differentiate permitted market making-related activities from impermissible proprietary trading. For example, the existence of a risk management framework or risk limits, while important, would not ensure that a trading desk is acting as a market maker by engaging in customer-facing activity and providing intermediation and liquidity services.[608] The Agencies also decline to take an approach to implementing the market-making exemption that would require the development of individualized plans for each banking entity in coordination with the Agencies, as suggested by a few commenters.[609] The Agencies believe it is useful to establish a consistent framework that will apply to all banking entities to reduce the potential for unintended competitive impacts that could arise if each banking entity is subject to an individualized plan that is tailored to its specific organizational structure and trading activities and strategies.

Although the Agencies are not in the final rule modifying the basic structure of the proposed market-making exemption, certain general items suggested by commenters, such as enhanced compliance program elements and risk limits, have been incorporated in the final rule text for the market-making exemption, instead of a separate appendix.[610] Moreover, as described below, the final market-making exemption includes specific substantive changes in response to a wide variety of commenter concerns.

The Agencies understand that the economics of market making—and financial intermediation in general—require a market maker to be active in markets. In determining the appropriate scope of the market-making exemption, the Agencies have been mindful of commenters' views on market making and liquidity. Several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity, with corresponding reductions in market liquidity.[611] However, commenters disagreed about whether reduced liquidity would be beneficial or detrimental to the market, or if any such reductions would even materialize.[612] Many commenters stated that reduced liquidity could lead to other negative market impacts, such as wider spreads, higher transaction costs, greater market volatility, diminished price discovery, and increased cost of capital.

The Agencies understand that market makers play an important role in providing and maintaining liquidity throughout market cycles and that restricting market-making activity may result in reduced liquidity, with corresponding negative market impacts. For instance, absent a market maker who stands ready to buy and sell, investors may have to make large price concessions or otherwise expend resources searching for counterparties. By stepping in to intermediate trades and provide liquidity, market makers thus add value to the financial system by, for example, absorbing supply and demand imbalances. This often means taking on financial exposures, in a principal capacity, to satisfy reasonably expected near term customer demand, as well as to manage the risks associated with meeting such demand.

The Agencies recognize that, as noted by commenters, liquidity can be associated with narrower spreads, lower transaction costs, reduced volatility, greater price discovery, and lower costs of capital.[613] The Agencies agree with these commenters that liquidity provides important benefits to the financial system, as more liquid markets are characterized by competitive market makers, narrow bid-ask spreads, and frequent trading, and that a narrowly tailored market-making exemption could negatively impact the market by, as described above, forcing investors to make price concessions or unnecessarily expend resources searching for counterparties.[614] For example, while bid-ask spreads compensate market makers for providing liquidity when asset values are uncertain, under competitive forces, dealers compete with respect to spreads, thus lowering their profit margins on a per trade basis and benefitting investors.[615] Volatility is

[606] *See infra* Part VI.C.3. (discussing the final metrics requirement).

[607] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[608] However, as discussed below, the Agencies believe risk limits can be a useful tool when they must account for the nature and amount of a particular trading desk's market making-related activities, including the reasonably expected near term demands of clients, customers, or counterparties.

[609] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[610] The Agencies are not, however, adding certain additional requirements suggested by commenters, such as a new customer-facing criterion, margin requirements, or additional provisions regarding material conflicts of interest or high-risk assets or trading strategies. *See, e.g.,* Morgan Stanley; Stephen Roach; WR Hambrecht; Sens. Merkley & Levin (Feb. 2012). The Agencies believe that the final rule includes sufficient requirements to ensure that a trading desk relying on the market-making exemption is engaged in customer-facing activity (for example, the final rule requires the trading desk to stand ready to buy and sell a type of financial instrument as market maker and that the trading desk's market-maker inventory is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties). The Agencies decline to include margin requirements in the final exemption because banking entities are currently subject to a number of different margin requirements, including those applicable to, among others: SEC-registered broker-dealers; CFTC-registered swap dealers; SEC-registered security-based swap dealers: and foreign dealer entities. Further, the Agencies are not providing new requirements regarding material conflicts of interest and high-risk assets and trading strategies in the market-making exemption because the Agencies believe these issues are adequately addressed in § 75.7 of the final rule. The limitations in § 75.7 will apply to market making-related activities and all other exempted activities.

[611] *See supra* note 550 and accompanying text. The Agencies acknowledge that reduced liquidity can be costly. One commenter provided estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on certain hypothetical scenarios of reduced market liquidity. This commenter noted that its hypothetical liquidity shifts of 5, 10, and 15 percentile points were ''necessarily arbitrary'' but judged ''to be realistic potential outcomes of the proposed rule.'' Oliver Wyman (Feb. 2012). Because the Agencies have made significant modifications to the proposed rule in response to comments, the Agencies believe this commenter's concerns about the market impacts of the proposed rule have been substantially addressed.

[612] As noted above, a few commenters stated that reduced liquidity may provide certain benefits. *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson. However, a number of commenters stated that reduced liquidity would have negative market impacts. *See supra* note 550 and accompanying text.

[613] *See supra* Part VI.A.3.b.2.b.

[614] *See supra* Part VI.A.3.b.2.b. As discussed above, a few other commenters suggested that to the extent liquidity is vulnerable to destabilizing liquidity spirals, any reduced liquidity stemming from section 13 of the BHC Act and its implementing rules would not necessarily be a negative result. *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker. These commenters also suggested that the Agencies adopt stricter conditions in the market-making exemption, as discussed throughout this Part VI.A.3. However, liquidity—essentially, the ease with which assets can be converted into cash—is not destabilizing in and of itself. Rather, liquidity spirals are a function of how firms are funded. During market downturns, when margin requirements tend to increase, firms that fund their operations with leverage face higher costs of providing liquidity; firms that run up against their maximum leverage ratios may be forced to retreat from market making, contributing to the liquidity spiral. Viewed in this light, it is institutional features of financial markets—in particular, leverage—rather than liquidity itself that contributes to liquidity spirals.

[615] Wider spreads can be costly for investors. For example, one commenter estimated that a 10 basis point increase in spreads in the corporate bond market would cost investors $29 billion per year. *See* Wellington. Wider spreads can also be particularly costly for open-end mutual funds, which must trade in and out of the fund's portfolio holdings on a daily basis in order to satisfy

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driven by both uncertainty about fundamental value and the liquidity needs of investors. When markets are illiquid, participants may have to make large price concessions to find a counterparty willing to trade, increasing the importance of the liquidity channel for addressing volatility. If liquidity-based volatility is not diversifiable, investors will require a risk premium for holding liquidity risk, increasing the cost of capital.[616] Commenters additionally suggested that the effects of diminished liquidity could be concentrated in securities markets for small or midsize companies or for lesser-known issuers, where trading is already infrequent.[617] Volume in these markets can be low, increasing the inventory risk of market makers. The Agencies recognize that, if the final rule creates disincentives for banking entities to provide liquidity, these low volume markets may be impacted first.

As discussed above, the Agencies received several comments suggesting that the negative consequences associated with reduced liquidity would be unlikely to materialize under the proposed rule. For example, a few commenters stated that non-bank financial intermediaries, who are not subject to section 13 of the BHC Act, may increase their market-making activities in response to any reduction in market making by banking entities, a topic the Agencies discuss in more detail below.[618] In addition, some commenters suggested that the restrictions on proprietary trading would support liquid markets by encouraging banking entities to focus on financial intermediation activities that supply liquidity, rather than proprietary trades that demand liquidity, such as speculative trades or trades that front-run institutional investors.[619] The statute prohibits proprietary trading activity that is not exempted. As such, the termination of nonexempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants. Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

Based on the many detailed comments provided, the Agencies have made substantive refinements to the market-making exemption that the Agencies believe will reduce the likelihood that the rule, as implemented, will negatively impact the ability of banking entities to engage in the types of market making-related activities permitted under the statute and, therefore, will continue to promote the benefits to investors and other market participants described above, including greater market liquidity, narrower bid-ask spreads, reduced price concessions and price impact, lower volatility, and reduced counterparty search costs, thus reducing the cost of capital. For instance, the final market-making exemption does not require a trade-by-trade analysis, which was a significant source of concern from commenters who represented, among other things, that a trade-by-trade analysis could have a chilling effect on individual traders' willingness to engage in market-making activities.[620] Rather, the final rule has been crafted around the overall market making-related activities of individual trading desks, with various requirements that these activities be demonstrably related to satisfying reasonably expected near term customer demands and other market-making activities. The Agencies believe that applying certain requirements to the aggregate risk exposure of a trading desk, along with the requirement to establish risk and inventory limits to routinize a trading desk's compliance with the near term customer demand requirement, will reduce negative potential impacts on individual traders' decision-making process in the normal course of market making.[621] In addition, in response to a large number of comments expressing concern that the proposed market-making exemption would restrict or prohibit market making-related activities in less liquid markets, the Agencies are clarifying that the application of certain requirements in the final rule, such as the frequency of required quoting and the near term demand requirement, will account for the liquidity, maturity, and depth of the market for a given type of financial instrument. Thus, banking entities will be able to continue to engage in market making-related activities across markets and asset classes.

At the same time, the Agencies recognize that an overly broad market-making exemption may allow banking entities to mask speculative positions as liquidity provision or related hedges. The Agencies believe the requirements included in the final rule are necessary to prevent such evasion of the market-making exemption, ensure compliance with the statute, and facilitate internal banking entity and external Agency reviews of compliance with the final rule. Nevertheless, the Agencies acknowledge that these additional costs may have an impact on banking entities' willingness to engage in market making-related activities. Banking entities will incur certain compliance costs in connection with their market making-related activities under the final rule. For example, banking entities may not currently limit their trading desks' market-maker inventory to that which is designed not to exceed reasonably expected near term customer demand, as required by the statute.

As discussed above, commenters presented diverging views on whether non-banking entities are likely to enter the market or increase their market-making activities if the final rule should cause banking entities to reduce their market-making activities.[622] The

redemptions and subscriptions. *See* Wellington; AllianceBernstein.

[616] A higher cost of capital increases financing costs and translates into reduced capital investment. While one commenter estimated that a one percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in capital investments by U.S. nonfarm firms, the Agencies cannot independently verify these potential costs. Further, this commenter did not indicate what aspect of the proposed rule could cause a one percent increase in the cost of capital. *See* Thakor Study. In any event, the Agencies have made significant changes to the proposed approach to implementing the market-making exemption that should help address this commenter's concern.

[617] *See, e.g.,* CIEBA; ACLI; PNC *et al.;* Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[618] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012).

[619] *See, e.g.,* Prof. Johnson.

[620] *See supra* note 522 (discussing commenters' concerns regarding a trade-by-trade analysis).

[621] For example, by clarifying that individual trades will not be viewed in isolation and requiring strong compliance procedures, this approach will generally allow an individual trader to operate within the compliance framework established for his or her trading desk without having to assess whether each individual transaction complies with all requirements of the market-making exemption.

[622] *See supra* notes 565 and 569 and accompanying text (discussing comments on the issue of whether non-banking entities are likely to enter the market or increase their trading activities in response to reduced trading activity by banking entities). For example, one commenter stated that broker-dealers that are not affiliated with a bank would have reduced access to lender-of-last resort liquidity from the central bank, which could limit their ability to make markets during times of market stress or when capital buffers are small. *See* Prof. Duffie. However, another commenter noted that the

Agencies note that prior to the Gramm-Leach-Bliley Act of 1999, market-making services were more commonly provided by non-bank-affiliated broker-dealers than by banking entities. As discussed above, by intermediating and facilitating trading, market makers provide value to the markets and profit from providing liquidity. Should banking entities retreat from making markets, the profit opportunities available from providing liquidity will provide an incentive for non-bank-affiliated broker-dealers to enter the market and intermediate trades. The Agencies are unable to assess the likely effect with any certainty, but the Agencies recognize that a market-making operation requires certain infrastructure and capital, which will impact the ability of non-banking entities to enter the market-making business or to increase their presence. Therefore, should banking entities retreat from making markets, there could be a transition period with reduced liquidity as non-banking entities build up the needed infrastructure and obtain capital. However, because the Agencies have substantially modified this exemption in response to comments to ensure that market making related to near-term customer demand is permitted as contemplated by the statute, the Agencies do not believe the final rule should significantly impact currently-available market-making services.[623]

c. Detailed Explanation of the Market-Making Exemption

1. Requirement to Routinely Stand Ready To Purchase and Sell

a. Proposed Requirement To Hold Self Out

Section 75.4(b)(2)(ii) of the proposed rule would have required the trading desk or other organizational unit that conducts the purchase or sale in reliance on the market-making exemption to hold itself out as being willing to buy and sell, including through entering into long and short positions in, the financial instrument for its own account on a regular or continuous basis.[624] The proposal stated that a banking entity could rely on the proposed exemption only for the type of financial instrument that the entity actually made a market in.[625]

The proposal recognized that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular financial instrument.[626] To account for these variations, the Agencies proposed indicia for assessing compliance with this requirement that differed between relatively liquid markets and less liquid markets. Further, the Agencies recognized that the proposed indicia could not be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making-related activity is conducted.

In particular, the proposal stated that a trading desk or other organizational unit's market making-related activities in relatively liquid markets, such as equity securities or other exchange-traded instruments, should generally include: (i) Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis; (ii) a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; (iii) making continuous quotations that are at or near the market on both sides; and (iv) providing widely accessible and broadly disseminated quotes.[627] With respect to market making in less liquid markets, the proposal noted that the appropriate indicia of market making-related activities will vary, but should generally include: (i) Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;[628] (ii) with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market; and (iii) transaction volumes and risk proportionate to historical customer liquidity and investments needs.[629]

In discussing this proposed requirement, the Agencies stated that *bona fide* market making-related activity may include certain block positioning and anticipatory position-taking. More specifically, the proposal indicated that the *bona fide* market making-related activity described in § 75.4(b)(2)(ii) of the proposed rule would include: (i) Block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading;[630] and (ii) taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[631]

b. Comments on the Proposed Requirement To Hold Self Out

Commenters raised many issues regarding § 75.4(b)(2)(ii) of the proposed exemption, which would require a trading desk or other organizational unit to hold itself out as willing to buy and sell the financial instrument for its own account on a regular or continuous basis. As discussed below, some commenters viewed the proposed requirement as too restrictive, while other commenters stated that the requirement was too permissive. Two commenters expressed support for the proposed requirement.[632] A number of

presence and evolution of market making after the enactment of the Glass-Steagall Act mutes this particular concern. *See* Prof. Richardson.

[623] Certain non-banking entities, such as some SEC-registered broker-dealers that are not banking entities subject to the final rule, currently engage in market-making activities and, thus, should have the needed infrastructure and may attract additional capital. If the final rule has a marginal impact on banking entities' willingness to engage in market making-related activities, these non-banking entities should be able to respond by increasing their market making-related activities. The Agencies recognize, however, that firms that do not have existing infrastructure or sufficient capital are unlikely to be able to act as market makers shortly after the final rule is implemented. Nevertheless, because some non-bank-affiliated broker-dealers currently operate market-making desks, and because it was the dominant model prior to the Gramm-Leach-Bliley Act, the Agencies believe that non-bank-affiliated financial intermediaries will be able to provide market-making services longer term.

[624] *See* proposed rule § 75.4(b)(2)(ii).

[625] *See* Joint Proposal, 76 FR at 68870 (''Notably, this criterion requires that a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the [financial instrument] involved; simply because a banking entity makes a market in one type of [financial instrument] does not permit it to rely on the market-making exemption for another type of [financial instrument].''); CFTC Proposal, 77 FR at 8355–8356.

[626] *See* Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8356.

[627] *See* Joint Proposal, 76 FR at 68870–68871; CFTC Proposal, 77 FR at 8356. These proposed factors are generally consistent with the indicia used by the SEC to assess whether a broker-dealer is engaged in *bona fide* market making for purposes of Regulation SHO under the Exchange Act. *See* Joint Proposal, 76 FR at 68871 n.148; CFTC Proposal, 77 FR at 8356 n.155.

[628] The Agencies noted that, with respect to this factor, the frequency of regular quotations will vary, as moderately illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment. *See* Joint Proposal, 76 FR at 68871 n.149; CFTC Proposal, 77 FR at 8356 n.156.

[629] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356.

[630] In the preamble to the proposed rule, the Agencies stated that the SEC's definition of ''qualified block positioner'' may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in *bona fide* market making for purposes of § 75.4(b)(2)(ii) of the proposed rule. *See* Joint Proposal, 76 FR at 68871 n.151; CFTC Proposal, 77 FR at 8356 n.157.

[631] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[632] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

commenters provided views on statements in the proposal regarding indicia of *bona fide* market making in more and less liquid markets and the permissibility of block positioning and anticipatory position-taking.

Several commenters represented that the proposed requirement was too restrictive.[633] For example, a number of these commenters expressed concern that the proposed requirement may limit a banking entity's ability to act as a market maker under certain circumstances, including in less liquid markets, for instruments lacking a two-sided market, or in customer-driven, structured transactions.[634] In addition, a few commenters expressed specific concern about how this requirement would impact more limited market-making activity conducted by banks.[635]

Many commenters indicated that it was unclear whether this provision would require a trading desk or other organizational unit to regularly or continuously quote every financial instrument in which a market is made, but expressed concern that the proposed language could be interpreted in this manner.[636] These commenters noted that there are thousands of individual instruments within a given asset class, such as corporate bonds, and that it would be burdensome for a market maker to provide quotes in such a large number of instruments on a regular or continuous basis.[637] One of these commenters represented that, because customer demand may be infrequent in a particular instrument, requiring a banking entity to provide regular or continuous quotes in the instrument may not provide a benefit to its customers.[638] A few commenters requested that the Agencies provide further guidance on this issue or modify the proposed standard to state that holding oneself out in a range of similar instruments will be considered to be within the scope of permitted market making-related activities.[639]

To address concerns about the restrictiveness of this requirement, commenters suggested certain modifications. For example, some commenters suggested adding language to the requirement to account for market making in markets that do not typically involve regular or continuous, or two-sided, quoting.[640] In addition, a few commenters requested that the requirement expressly include transactions in new instruments or transactions in instruments that occur infrequently to address situations where a banking entity may not have previously had the opportunity to hold itself out as willing to buy and sell the applicable instrument.[641] Other commenters supported alternative criteria for assessing whether a banking entity is acting as a market maker, such as: (i) A willingness to respond to customer demand by providing prices upon request;[642] (ii) being in the business of providing prices upon request for that financial instrument or other financial instruments in the same or similar asset class or product class;[643] or (iii) a historical test of market-making activity, with compliance judged on the basis of actual trades.[644] Finally, two commenters stated that this requirement should be moved to Appendix B of the rule,[645] which, according to one of these commenters, would provide the Agencies greater flexibility to consider the facts and circumstances of a particular activity.[646]

Other commenters took the view that the proposed requirement was too permissive.[647] For example, one commenter stated that the proposed standard provided too much room for interpretation and would be difficult to measure and monitor. This commenter expressed particular concern that a trading desk or other organizational unit could meet this requirement by regularly or continuously making wide, out of context quotes that do not present any real risk of execution and do not contribute to market liquidity.[648] Some commenters suggested the Agencies place greater restrictions on a banking entity's ability to rely on the market-making exemption in certain illiquid

[633] *See infra* Part VI.A.3.c.1.c.iii. (addressing these concerns).

[634] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; IHS; SSgA (Feb. 2012).

[635] *See, e.g.,* PNC (stating that the proposed rule needs to account for market making by regional banks on behalf of small and middle-market customers whose securities are less liquid); ABA (stating that the rule should continue to permit banks to provide limited liquidity by buying securities that they feel are suitable for their retail and institutional customer base by stating that a bank is ''holding itself out'' when it buys and sells securities that are suitable for its customers).

[636] This issue is further discussed in Part VI.A.3.c.1.c.iii., *infra.*

[637] *See, e.g.,* Goldman (Prop. Trading) (stating that it would be burdensome for a U.S. credit market-making business to be required to produce and disseminate quotes for thousands of individual bond CUSIPs that trade infrequently and noting that a market maker in credit markets will typically disseminate indicative prices for the most liquid instruments but, for the thousands of other instruments that trade infrequently, the market maker will generally provide a price for a trade upon request from another market participant); Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* BDA (Feb. 2012); FTN (stating that in some markets, such as the markets for residential mortgage-backed securities and investment grade corporate debt, a market maker will hold itself out in a subset of instruments (*e.g.,* particular issues in the investment grade corporate debt market with heavy trading volume or that are in the midst of particular credit developments), but will trade in other instruments within the group or sector upon inquiry from customers and other dealers); Oliver Wyman (Feb. 2012) (discussing data regarding the number of U.S. corporate bonds and frequency of trading in such bonds in 2009).

[638] *See* Goldman (Prop. Trading).

[639] *See, e.g.,* RBC (recommending that the Agencies clarify that a trading desk is required to hold itself out as willing to buy and sell a particular type of ''product''); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that the Agencies use the term ''instrument,'' rather than ''covered financial position,'' to provide greater clarity); CIEBA (supporting alternative criteria that would require a banking entity to hold itself out generally as a market maker for the relevant asset class, but not for every instrument it purchases and sells); Goldman (Prop. Trading). One of these commenters recommended that the Agencies recognize and permit the following kinds of activity in related financial instruments: (i) Options market makers should be deemed to be engaged in market making in all put and call series related to a particular underlying security and should be permitted to trade the underlying security regardless of whether such trade qualifies for the hedging exemption; (ii) convertible bond traders should be permitted to trade in the associated equity security; (iii) a market maker in one issuer's bonds should be considered a market maker in similar bonds of other issuers; and (iv) a market maker in standardized interest rate swaps should be considered to be engaged in market making-related activity if it engages in a customized interest rate swap with a customer upon request. *See* RBC.

[640] *See, e.g.,* Morgan Stanley (suggesting that the Agencies add the phrase ''or, in markets where regular or continuous quotes are not typically provided, the trading unit stands ready to provide quotes upon request''); Barclays (suggesting addition of the phrase ''to the extent that two-sided markets are typically made by market makers in a given product,'' as well as changing the reference to ''purchase or sale'' to ''market making-related activity'' to avoid any inference of a trade-by-trade analysis). *See also* Fixed Income Forum/Credit Roundtable. To address concerns about the requirement's application to bespoke products, one commenter suggested that the rule clearly state that a banking entity fulfills this requirement if it markets structured transactions to its client base and stands ready to enter into such transactions with customers, even though transactions may occur on a relatively infrequent basis. *See* JPMC.

[641] *See* Wells Fargo (Prop. Trading); RBC (supporting this approach as an alternative to removing the requirement from the rule, but primarily supporting its removal). *See also* ISDA (Feb. 2012) (stating that the analysis of compliance with the proposed requirement must carefully consider the degree of presence a market maker wishes to have in a given market, which may include being a leader in certain types of instruments, having a secondary presence in others, and potentially leaving or entering other submarkets).

[642] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also suggested that such test be assessed at the ''trading unit'' level. *See id.*

[643] *See* Goldman (Prop. Trading).

[644] *See* FTN.

[645] *See* Flynn & Fusselman; JPMorgan.

[646] *See* JPMC.

[647] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; John Reed. *See infra* note 751 and accompanying text (responding to these comments).

[648] *See* Occupy.

markets, such as assets that cannot be reliably valued, products that do not have a genuine external market, or instruments for which a banking entity does not expect to have customers wishing to both buy and sell.[649] In support of these requests, commenters stated that trading in illiquid products raises certain concerns under the rule, including: A lack of reliable data for purposes of using metrics to monitor a banking entity's market making-related activity (*e.g.,* products whose valuations are determined by an internal model that can be manipulated, rather than an observable market price);[650] relation to the last financial crisis;[651] lack of important benefits to the real economy;[652] similarity to prohibited proprietary trading;[653] and inconsistency with the statute's requirements that market making-related activity must be ''designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties'' and must not result in a material exposure to high-risk assets or high-risk trading strategies.[654]

These commenters also requested that the proposed requirement be modified in certain ways. In particular, several commenters stated that the proposed exemption should only permit market making in assets that can be reliably valued through external market transactions.[655] In order to implement such a limitation, three commenters suggested that the Agencies prohibit banking entities from market making in assets classified as Level 3 under FAS 157.[656] One of these commenters explained that Level 3 assets are generally highly illiquid assets whose fair value cannot be determined using either market prices or models.[657] In addition, a few commenters suggested that banking entities be subject to additional capital charges for market making in illiquid products.[658] Another commenter stated that the Agencies should require all market making-related activity to be conducted on a multilateral organized electronic trading platform or exchange to make it possible to monitor and confirm certain trading data.[659] Two commenters emphasized that their recommended restrictions on market making in illiquid markets should not prohibit banking entities from making markets in corporate bonds.[660]

i. The Proposed Indicia

As noted above, the proposal set forth certain indicia of *bona fide* market making-related activity in liquid and less liquid markets that the Agencies proposed to apply when evaluating whether a banking entity was eligible for the proposed exemption.[661] Several commenters provided their views regarding the effectiveness of the proposed indicia.

With respect to the proposed indicia for liquid markets, a few commenters expressed support for the proposed indicia.[662] One of these commenters stated that while the proposed factors are reasonably consistent with *bona fide* market making, the Agencies should add two other factors: (i) A willingness to transact in reasonable quantities at quoted prices, and (ii) inventory turnover.[663]

Other commenters, however, stated that the proposed use of factors from the SEC's analysis of *bona fide* market making under Regulation SHO was inappropriate in this context. In particular, these commenters represented that *bona fide* market making for purposes of Regulation SHO is a purposefully narrow concept that permits a subset of market makers to qualify for an exception from the ''locate'' requirement in Rule 203 of Regulation SHO. The commenters further expressed the belief that the policy goals of section 13 of the BHC Act do not necessitate a similarly narrow interpretation of market making.[664]

A few commenters expressed particular concern about how the factor regarding patterns of purchases and sales in roughly comparable amounts would apply to market making in exchange-traded funds (''ETFs''). According to these commenters, demonstrating this factor could be difficult because ETF market making involves a pattern of purchases and sales of groups of equivalent securities (*i.e.,* the ETF shares and the basket of securities and cash that is exchanged for them), not a single security. In addition, the commenters were unsure whether this factor could be demonstrated in times of limited trading in ETF shares.[665]

The preamble to the proposed rule also provided certain proposed indicia of *bona fide* market making-related activity in less liquid markets.[666] As discussed above, commenters had differing views about whether the exemption for market making-related activity should permit banking entities to engage in market making in some or all illiquid markets. Thus, with respect to the proposed indicia for market making in less liquid markets, commenters generally stated that the indicia should be broader or narrower, depending on the commenter's overall view on the issue of market making in illiquid markets. One commenter stated

[649] *See* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

[650] *See* AFR *et al.* (Feb. 2012); Occupy.

[651] *See* Occupy.

[652] *See* John Reed.

[653] *See* Johnson & Prof. Stiglitz.

[654] *See* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity must have or reasonably expect at least two customers—one for each side of the trade—and must have a reasonable expectation of the second customer coming to take the position or risk off its books in the ''near term''); AFR *et al.* (Feb. 2012); Public Citizen.

[655] *See* AFR *et al.* (Feb. 2012) (stating that the rule should ban market making in illiquid and opaque securities with no genuine external market, but permit market making in somewhat illiquid securities, such as certain corporate bonds, as long as the securities can be reliably valued with reference to other extremely similar securities that are regularly traded in liquid markets and the financial outcome of the transaction is reasonably predictable); Johnson & Prof. Stiglitz (recommending that permitted market making be limited to assets that can be reliably valued in, at a minimum, a moderately liquid market evidenced by trading within a reasonable period, such as a week, through a real transaction and not simply with interdealer trades); Public Citizen (stating that market making should be limited to assets that can be reliably valued in a market where transactions take place on a weekly basis).

[656] *See* AFR *et al.* (Feb. 2012) (stating that such a limitation would be consistent with the proposed limitation on ''high-risk assets'' and the discussion of this limitation in proposed Appendix C); Public Citizen; Prof. Richardson.

[657] *See* Prof. Richardson.

[658] Two commenters recommended that banking entities be required to treat trading in assets that cannot be reliably valued and that trade only by appointment, such as bespoke derivatives and structured products, as providing an illiquid bespoke loan, which are subject to higher capital charges under the Federal banking agencies' capital rules. *See* Johnson & Prof. Stiglitz; John Reed. Another commenter suggested that, if not directly prohibited, trading in bespoke instruments that cannot be reliably valued should be assessed an appropriate capital charge. *See* Public Citizen.

[659] *See* Occupy. This commenter further suggested that the exemption exclude all activities that include: (i) Assets whose changes in value cannot be mitigated by effective hedges; (ii) new products with rapid growth, including those that do not have a market history; (iii) assets or strategies that include significant imbedded leverage; (iv) assets or strategies that have demonstrated significant historical volatility; (v) assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and (vi) assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties. *See id.*

[660] *See* AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz.

[661] *See supra* Part VI.A.3.c.1.a.

[662] *See* Occupy; AFR *et al.* (Feb. 2012); NYSE Euronext (expressing support for the indicia set forth in the FSOC study, which are substantially the same as the indicia in the proposal); Alfred Brock.

[663] *See* AFR *et al.* (Feb. 2012).

[664] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[665] *See* ICI (Feb. 2012); ICI Global.

[666] *See supra* Part VI.A.3.c.1.a.

that the proposed indicia are effective.[667]

The first proposed factor of market making-related activity in less liquid markets was holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis. As noted above, several commenters expressed concern about a requirement that market makers provide regular quotations in less liquid instruments, including in fixed income markets and bespoke, customized derivatives.[668] With respect to the interaction between the rule language requiring ''regular'' quoting and the proposal's language permitting trading by appointment under certain circumstances, some of these commenters expressed uncertainty about how a market maker trading only by appointment would be able to satisfy the proposed rule's regular quotation requirement.[669] In addition, another commenter stated that the proposal's recognition of trading by appointment does not alleviate concerns about applying the ''regular'' quotation requirement to market making in less liquid instruments in markets that are not, as a whole, highly illiquid, such as credit and interest rate markets.[670]

Other commenters expressed concern about only requiring a market maker to provide regular quotations or permitting trading by appointment to qualify for the market-making exemption. With respect to regular quotations, some commenters stated that such a requirement enables evasion of the prohibition on proprietary trading because a proprietary trader may post a quote at a time of little interest in a financial product or may post wide, out of context quotes on a regular basis with no real risk of execution.[671] Several commenters stated that trading only by appointment should not qualify as market making for purposes of the proposed rule.[672] Some of these commenters stated that there is no ''market'' for assets that trade only by appointment, such as customized, structured products and OTC derivatives.[673]

The second proposed criterion for market making-related activity in less liquid markets was, with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market. Two commenters expressed concern about this proposed factor.[674] In particular, one of these commenters stated that the language is fundamentally inconsistent with market making because it contemplates that only taking one side of the market is sufficient, rather than both buying and selling an instrument.[675] The other commenter expressed concern that banking entities would be allowed to accumulate a significant amount of illiquid risk because the indicia for market making-related activity in less liquid markets did not require a market maker to buy and sell in comparable amounts (as required by the indicia for liquid markets).[676]

Finally, the third proposed factor of market making in less liquid markets would consider transaction volumes and risk proportionate to historical customer liquidity and investment needs. A few commenters indicated that there may not be sufficient information available for a banking entity to conduct such an analysis.[677] For example, one commenter stated that historical information may not necessarily be available for new businesses or developing markets in which a market maker may seek to establish trading operations.[678] Another commenter expressed concern that this factor would not help differentiate market making from prohibited proprietary trading because most illiquid markets do not have a source for such historical risk and volume data.[679]

ii. Treatment of Block Positioning Activity

The proposal provided that the activity described in § 75.4(b)(2)(ii) of the proposed rule would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.[680]

A number of commenters supported the general language in the proposal permitting block positioning, but expressed concern about the reference to the definition of ''qualified block positioner'' in SEC Rule 3b–8(c).[681] With respect to using Rule 3b–8(c) as guidance under the proposed rule, these commenters represented that Rule 3b–8(c)'s requirement to resell block positions ''as rapidly as possible'' would cause negative results (*e.g.,* fire sales) or create market uncertainty (*e.g.,* when, if ever, a longer unwind would be permitted).[682] According to one of these commenters, gradually disposing of a large long position purchased from a customer may be the best means of reducing near term price volatility associated with the supply shock of trying to sell the position at once.[683] Another commenter expressed concern about the second requirement of Rule 3b–8(c), which provides that the dealer must determine in the exercise of reasonable diligence that the block cannot be sold to or purchased from others on equivalent or better terms. This commenter stated that this kind of determination would be difficult in less liquid markets because those markets do not have widely disseminated quotes that dealers can use for purposes of comparison.[684]

Beyond the reference to Rule 3b–8(c), a few commenters expressed more general concern about the proposed rule's application to block positioning activity.[685] One commenter noted that the proposal only discussed block positioning in the context of the proposed requirement to hold oneself out, which implies that block positioning activity also must meet the other requirements of the market-making exemption. This commenter requested an explicit recognition that banking entities meet the requirements of the market-making exemption when they enter into block trades for customers, including related trades entered to support the block, such as

[667] *See* Alfred Brock.

[668] *See supra* note 634 accompanying text. With respect to this factor, one commenter requested that the Agencies delete the parenthetical of ''but not necessarily continuous'' from the proposed factor as part of a broader effort to recognize the relative illiquidity of swap markets. *See* ISDA (Feb. 2012).

[669] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA. These commenters requested greater clarity or guidance on the meaning of ''regular'' in the instance of a market maker trading only by appointment. *See id.*

[670] *See* Goldman (Prop. Trading).

[671] *See* Public Citizen; Occupy. One of these commenters further noted that most markets lack a structural framework that would enable monitoring of compliance with this requirement. *See* Occupy.

[672] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; John Reed; Public Citizen.

[673] *See, e.g.,* John Reed; Public Citizen.

[674] *See* AFR *et al.* (Feb. 2012); Occupy.

[675] *See* AFR *et al.* (Feb. 2012)

[676] *See* Occupy.

[677] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy.

[678] *See* Goldman (Prop. Trading).

[679] *See* Occupy.

[680] *See* Joint Proposal, 76 FR at 68871.

[681] *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). *See also infra* note 740 (responding to these comments).

[682] *See* RBC (expressing concern about fire sales); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing concern about fire sales, particularly in less liquid markets where a block position would overwhelm the market and undercut the price a market maker can obtain); Goldman (Prop. Trading) (representing that this requirement could create uncertainty about whether a longer unwind would be permissible and, if so, under what circumstances).

[683] *See* Goldman (Prop. Trading).

[684] *See* RBC.

[685] *See* SIFMA (Asset Mgmt.) (Feb. 2012); Fidelity (requesting that the Agencies explicitly recognize that block trades qualify for the market-making exemption); Oliver Wyman (Feb. 2012).

hedging transactions.[686] Finally, one commenter expressed concern that the inventory metrics in proposed Appendix A would make dealers reluctant to execute large, principal transactions because such trades would have a transparent impact on inventory metrics in the relevant asset class.[687]

iii. Treatment of Anticipatory Market Making

In the proposal, the Agencies proposed that ''*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.'' [688] Many commenters indicated that the language in the proposal is inconsistent with the statute's language regarding near term demands of clients, customers, or counterparties. According to these commenters, the statute's ''designed'' and ''reasonably expected'' language expressly acknowledges that a market maker may need to accumulate inventory before customer demand manifests itself. Commenters further represented that the proposed standard may unduly limit a banking entity's ability to accumulate inventory in anticipation of customer demand.[689]

In addition, two commenters expressed concern that the proposal's language would effectively require a banking entity to engage in impermissible front running.[690] One of these commenters indicated that the Agencies should not restrict anticipatory trading to such a short time period.[691] To the contrary, the other commenter stated that anticipatory accumulation of inventory should be considered to be prohibited proprietary trading.[692] A few commenters noted that the standard in the proposal explicitly refers to securities and requested that the reference be changed to encompass the full scope of financial instruments covered by the rule to avoid ambiguity.[693] Several commenters recommended that the language be eliminated [694] or modified [695] to address the concerns discussed above.

iv. High-Frequency Trading

A few commenters stated that high-frequency trading should be considered prohibited proprietary trading under the rule, not permitted market making-related activity.[696] For example, one commenter stated that the Agencies should not confuse high volume trading and market making. This commenter emphasized that algorithmic traders in general—and high-frequency traders in particular—do not hold themselves out in the manner required by the proposed rule, but instead only offer to buy and sell when they think it is profitable.[697] Another commenter suggested the Agencies impose a resting period on any order placed by a banking entity in reliance on any exemption in the rule by, for example, prohibiting a banking entity from buying and subsequently selling a position within a span of two seconds.[698]

c. Final Requirement To Routinely Stand Ready To Purchase and Sell

Section 75.4(b)(2)(i) of the final rule provides that the trading desk that establishes and manages the financial exposure must routinely stand ready to purchase and sell one or more types of financial instruments related to its financial exposure and be willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments. As discussed in more detail below, the standard of ''routinely'' standing ready to purchase and sell one or more types of financial instruments will be interpreted to account for differences across markets and asset classes. In addition, this requirement provides that a trading desk must be willing and available to provide quotations and transact in the particular types of financial instruments in commercially reasonable amounts and throughout market cycles. Thus, a trading desk's activities would not meet the terms of the market-making exemption if, for example, the trading desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular, intermittent basis.

While this provision of the market-making exemption has some similarity to the requirement to hold oneself out in § 75.4(b)(2)(ii) of the proposed rule, the Agencies have made a number of refinements in response to comments. Specifically, a number of commenters expressed concern that the proposed requirement did not sufficiently account for differences between markets and asset classes and would unduly limit certain types of market making by requiring ''regular or continuous'' quoting in a particular instrument.[699]

[686] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[687] *See* Oliver Wyman (Feb. 2012). This commenter estimated that investors trading out of large block positions on their own, without a market maker directly providing liquidity, would have to pay incremental transaction costs between $1.7 and $3.4 billion per year. This commenter estimated a block trading size of $850 billion, based on a haircut of total block trading volume reported for NYSE and Nasdaq. The commenter then estimated, based on market interviews and analysis of standard market impact models provided by dealers, that the market impact of executing large block orders without direct market maker liquidity provision would be the difference between the market impact costs of executing a block trade over a 5-day period versus a 1-day period—which would be approximately 20 to 50 basis points, depending on the size of the trade. *See id.*

[688] Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[689] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (expressing concern that requiring trades to be related to clear demonstrable trading interest could curtail the market-making function by removing a market maker's discretion to develop inventory to best serve its customers and adversely restrict liquidity); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing general concern that the standard creates limitations on a market maker's inventory). These comments are addressed in Part VI.A.3.c.2., *infra.*

[690] *See* Goldman (Prop. Trading); Occupy. *See also* Public Citizen (expressing general concern that accumulating positions in anticipation of demand opens issues of front running).

[691] *See* Goldman (Prop. Trading).

[692] *See* Occupy.

[693] *See* Goldman (Prop. Trading); ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[694] *See* BoA (stating that a market maker must acquire inventory in advance of express customer demand and customers expect a market maker's inventory to include not only the financial instruments in which customers have previously traded, but also instruments that the banking entity believes they may want to trade); Occupy.

[695] *See* Morgan Stanley (suggesting a new standard providing that a purchase or sale must be ''reasonably consistent with observable customer demand patterns and, in the case of new asset classes or markets, with reasonably expected future developments on the basis of the trading unit's client relationships''); Chamber (Feb. 2012) (requesting that the final rule permit market makers to make individualized assessments of anticipated customer demand based on their expertise and experience in the markets and make trades according to those assessments); Goldman (Prop. Trading) (recommending that the Agencies instead focus on how trading activities are ''designed'' to meet the reasonably expected near term demands of clients over time, rather than whether those demands have actually manifested themselves at a given point in time); ISDA (Feb. 2012) (stating that the Agencies should clarify this language to recognize differences between liquid and illiquid markets and noting that illiquid and low volume markets necessitate that swap dealers take a longer and broader view than dealers in liquid markets).

[696] *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[697] *See* Better Markets (Feb. 2012). *See also infra* note 747 (addressing this issue).

[698] *See* Occupy.

[699] *See supra* Part VI.A.3.c.1.b. (discussing comments on this issue). The Agencies did not intend for the reference to ''covered financial

Continued

The explanation of this requirement in the proposal was intended to address many of these concerns. For example, the Agencies stated that the proposed ''indicia cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market-making activity is conducted.'' [700] Nonetheless, the Agencies believe that certain modifications are warranted to clarify the rule and to prevent a potential chilling effect on market making-related activities conducted by banking entities.

Commenters represented that the requirement that a trading desk hold itself out as being willing to buy and sell ''on a regular or continuous basis,'' as was originally proposed, was impossible to meet or impractical in the context of many markets, especially less liquid markets.[701] Accordingly, the final rule requires a trading desk that establishes and manages the financial exposure to ''routinely'' stand ready to trade one or more types of financial instruments related to its financial exposure. As discussed below, the meaning of ''routinely'' will account for the liquidity, maturity, and depth of the market for a type of financial instrument, which should address commenter concern that the proposed standard would not work in less liquid markets and would have a chilling effect on banking entities' ability to act as market makers in less liquid markets. A concept of market making that is applicable across securities, commodity futures, and derivatives markets has not previously been defined by any of the Agencies. Thus, while this standard is based generally on concepts from the securities laws and is consistent with the CFTC's and SEC's description of market making in swaps,[702] the Agencies note that it is not directly based on an existing definition of market making.[703] Instead, the approach taken in the final rule is intended to take into account and accommodate the conditions in the relevant market for the financial instrument in which the banking entity is making a market.

i. Definition of ''Trading Desk''

The Agencies are adopting a market-making exemption with requirements that generally focus on a financial exposure managed by a ''trading desk'' of a banking entity and such trading desk's market-maker inventory. The market-making exemption as originally proposed would have applied to ''a trading desk or other organizational unit'' of a banking entity. In addition, for purposes of the proposed requirement to report and record certain quantitative measurements, the proposal defined the term ''trading unit'' as each of the following units of organization of a banking entity: (i) Each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity; (ii) each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units described in paragraph (i); and (iii) all trading operations, collectively.[704]

The Agencies received few comments regarding the organizational level at which the requirements of the market-making exemption should apply, and many of the commenters that addressed this issue did not describe their suggested approach in detail.[705] One commenter suggested that the market-making exemption apply to each ''trading unit'' of a banking entity, defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity.'' [706] This suggested approach is substantially similar to the second prong of the Agencies' proposed definition of ''trading unit'' in Appendix A of the proposal. The Agencies described this prong as generally including management or reporting divisions, groups, sub-groups, or other intermediate units of organization used by the banking entity to manage one or more discrete trading units (*e.g.,* ''North American Credit Trading,'' ''Global Credit Trading,'' etc.).[707] The Agencies are concerned that this commenter's suggested approach, or any other approach applying the exemption's requirements to a higher level of organization than the trading desk, would impede monitoring of market making-related activity and detection of impermissible proprietary trading by combining a number of different trading strategies and aggregating a larger volume of trading activities.[708] Further, key requirements in the market-making exemption, such as the required limits and risk management procedures, are generally used by banking entities for risk control and applied at the trading desk level. Thus, applying them at a broader organizational level than the trading desk would create a separate system for compliance with this exemption designed to permit a banking entity to aggregate disparate trading activities and apply limits more generally. Applying the conditions of the exemption at a more aggregated level would allow banking entities more flexibility in trading and could result in a higher volume of trading that could contribute modestly to liquidity.[709]

position'' in the proposed rule to imply a single instrument, although commenters contended that the proposal may not have been sufficiently clear on this point.

[700] Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356.

[701] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; SSgA (Feb. 2012). Some commenters suggested alternative criteria, such as providing prices upon request, using a historical test of market making, or a purely guidance-based approach. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); FTN; Flynn & Fusselman; JPMC. The Agencies are not adopting a requirement that the trading desk only provide prices upon request because the Agencies believe it would be inconsistent with market making in liquid exchange-traded instruments where market makers regularly or continuously post quotes on an exchange. With respect to one commenter's suggested approach of a historical test of market making, this commenter did not provide enough information about how such a test would work for the Agencies' consideration. Finally, the final rule does not adopt a purely guidance-based approach because, as discussed further above, the Agencies believe it could lead to an increased risk of evasion.

[702] *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant,'' 77 FR 30596, 30609 (May 23, 2012) (describing market making in swaps as ''routinely standing ready to enter into swaps at the request or demand of a counterparty'').

[703] As a result, activity that is considered market making under this final rule may not necessarily be considered market making for purposes of other laws or regulations, such as the U.S. securities laws, the rules and regulations thereunder, or self-regulatory organization rules. In addition, the Agencies note that a banking entity acting as an underwriter would continue to be treated as an underwriter for purposes of the securities laws and the regulations thereunder, including any liability arising under the securities laws as a result of acting in such capacity, regardless of whether it is able to meet the terms of the market-making exemption for its activities. *See* Sens. Merkley & Levin (Feb. 2012).

[704] *See* Joint Proposal, 76 FR at 68957; CFTC Proposal, 77 FR at 8436.

[705] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[706] Morgan Stanley.

[707] *See* Joint Proposal, 76 FR at 68957 n.2.

[708] *See, e.g.,* Occupy (expressing concern that, with respect to the proposed definition of ''trading unit,'' an ''oversized'' unit could combine significantly unrelated trading desks, which would impede detection of proprietary trading activity).

[709] The Agencies recognize that the proposed rule's application to a trading desk ''or other organizational unit'' would have provided banking entities with this type of flexibility to determine the level of organization at which the market-making exemption should apply based on the entity's particular business structure and trading strategies, which would likely reduce the burdens of this aspect of the final rule. However, for the reasons noted above regarding application of this exemption to a higher organizational level than the trading

Instead of taking that approach, the Agencies have determined to permit a broader range of market making-related activities that can be effectively controlled by building on risk controls used by trading desks for business purposes. This will allow an individual trader to use instruments or strategies within limits established in the compliance program to confidently trade in the type of financial instruments in which his or her trading desk makes a market. The Agencies believe this addresses concerns that uncertainty would negatively impact liquidity. It also addresses concerns that applying the market-making exemption at a higher level of organization would reduce the effectiveness of the requirements in the final rule aimed at ensuring that the quality and character of trading is consistent with market making-related activity and would increase the risk of evasion. Moreover, several provisions of the final rule are intended to account for the liquidity, maturity, and depth of the market for a given type of financial instrument in which the trading desk makes a market. The final rule takes account of these factors to, among other things, respond to commenters' concerns about the proposed rule's potential impact on market making in less liquid markets. Applying these requirements at an organizational level above the trading desk would be more likely to result in aggregation of trading in various types of instruments with differing levels of liquidity, which would make it more difficult for these market factors to be taken into account for purposes of the exemption (for example, these factors are considered for purposes of tailoring the analysis of reasonably expected near-term demands of customers and establishing risk, inventory, and duration limits).

Thus, the Agencies continue to believe that certain requirements of the exemption should apply to a relatively granular level of organization within a banking entity (or across two or more affiliated banking entities). These requirements of the final market-making exemption have been formulated to best reflect the nature of activities at the trading desk level of granularity.

As explained below, the Agencies are applying certain requirements to a ''trading desk'' of a banking entity and adopting a definition of this term in the final rule.[710] The definition of ''trading desk'' is similar to the first prong of the proposed definition of ''trading unit.'' The Agencies are not adopting the proposed ''or other organizational unit'' language because the Agencies are concerned that approach would have provided banking entities with too much discretion to independently determine the organizational level at which the requirements should apply, including a more aggregated level of organization, which could lead to evasion of the general prohibition on proprietary trading and the other concerns noted above. The Agencies believe that adopting an approach focused on the trading desk level will allow banking entities and the Agencies to better distinguish between permitted market making-related activities and trading that is prohibited by section 13 of the BHC Act and, thus, will prevent evasion of the statutory requirements, as discussed in more detail below. Further, as discussed below, the Agencies believe that applying requirements at the trading desk level is balanced by the financial exposure-based approach, which will address commenters' concerns about the burdens of trade-by-trade analyses.

In the final rule, trading desk is defined to mean the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed.[711] The geographic location of individual traders is not dispositive for purposes of the analysis of whether the traders may comprise a single trading desk. For instance, a trading desk making markets in U.S. investment grade telecom corporate credits may use trading personnel in both New York (to trade U.S. dollar-denominated bonds issued by U.S.-incorporated telecom companies) and London (to trade Euro-denominated bonds issued by the same type of companies). This approach allows more effective management of risks of trading activity by requiring the establishment of limits, management oversight, and accountability at the level where trading activity actually occurs. It also allows banking entities to tailor the limits and procedures to the type of instruments traded and markets served by each trading desk.

In response to comments, and as discussed below in the context of the ''financial exposure'' definition, a trading desk may manage a financial exposure that includes positions in different affiliated legal entities.[712] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. Using the previous example, the U.S. investment grade telecom corporate credit trading desk may include traders working for or booking into a broker-dealer entity (for corporate bond trades), a security-based swap dealer entity (for single-name CDS trades), and/or a swap dealer entity (for index CDS or interest rate swap hedges). To clarify this issue, the definition of ''trading desk'' specifically provides that the desk can buy or sell financial instruments ''for the trading account of a banking entity or an affiliate thereof.'' Thus, a trading desk need not be constrained to a single legal entity, although it is permissible for a trading desk to only trade for a single legal entity. A trading desk booking positions in different affiliated legal entities must have records that identify all positions included in the trading desk's financial exposure and where such positions are held, as discussed below.[713]

The Agencies believe that establishing a defined organizational level at which many of the market-making exemption's requirements apply will address potential evasion concerns. Applying certain requirements of the market-making exemption at the trading desk level will strengthen their effectiveness and prevent evasion of the exemption by ensuring that the aggregate trading activities of a relatively limited group of traders on a single desk are conducted in a manner that is consistent with the exemption's standards. In particular, because many of the requirements in the market-making exemption look to the specific type(s) of financial instruments in which a market is being made, and such requirements are designed to take into account differences among markets and asset classes, the Agencies believe it is important that these requirements be applied to a discrete and identifiable unit engaged in, and operated by personnel whose responsibilities relate to, making a market in a specific set or

desk, the Agencies are not adopting the ''or other organizational unit'' language.

[710] *See* final rule § 75.3(e)(13).

[711] For example, the Agencies expect a banking entity may determine the foreign exchange options desk to be a trading desk; however, the Agencies do not expect a banking entity to consider an individual Japanese Yen options trader (*i.e.,* the trader in charge of all Yen-based options trades) as a trading desk, unless the banking entity manages its profit and loss, market making, and hedging in Japanese Yen options independently of all other financial instruments.

[712] *See infra* note 729 and accompanying text. Several commenters noted that market-making activities may be conducted across separate affiliated legal entities. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[713] *See infra* note 732 and accompanying text.

type of financial instruments. Further, applying requirements at the trading desk level should facilitate banking entity monitoring and review of compliance with the exemption by limiting the aggregate trading volume that must be reviewed, as well as allowing consideration of the particular facts and circumstances of the desk's trading activities (*e.g.,* the liquidity, maturity, and depth of the market for the relevant types of financial instruments). As discussed above, the Agencies believe that applying the requirements of the market-making exemption to a higher level of organization would reduce the ability to consider the liquidity, maturity, and depth of the market for a type of financial instrument, would impede effective monitoring and compliance reviews, and would increase the risk of evasion.

ii. Definitions of ''Financial Exposure'' and ''Market-Maker Inventory''

Certain requirements of the proposed market-making exemption referred to a ''purchase or sale of a [financial instrument].'' [714] Even though the Agencies did not intend to require a trade-by-trade review, a significant number of commenters expressed concern that this language could be read to require compliance with the proposed market-making exemption on a transaction-by-transaction basis.[715] In response to these concerns, the Agencies are modifying the exemption to clarify the manner in which compliance with certain provisions will be assessed. In particular, rather than a transaction-by-transaction focus, the market-making exemption in the final rule focuses on two related aspects of market-making activity: A trading desk's ''market-maker inventory'' and its overall ''financial exposure.''[716]

The Agencies are adopting an approach that focuses on both a trading desk's financial exposure and market-maker inventory in recognition that market making-related activity is best viewed in a holistic manner and that, during a single day, a trading desk may engage in a large number of purchases and sales of financial instruments. While all these transactions must be conducted in compliance with the market-making exemption, the Agencies recognize that they involve financial instruments for which the trading desk acts as market maker (*i.e.,* by standing ready to purchase and sell that type of financial instrument) and instruments that are acquired to manage the risks of positions in financial instruments for which the desk acts as market maker, but in which the desk is not itself a market maker.[717]

The final rule requires that activity by a trading desk under the market-making exemption be evaluated by a banking entity through monitoring and setting limits for the trading desk's market-maker inventory and financial exposure. The market-maker inventory of a trading desk includes the positions in financial instruments, including derivatives, in which the trading desk acts as market maker. The financial exposure of the trading desk includes the aggregate risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk acts as a market maker, but in which the trading desk does not itself make a market, as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker. In addition, the trading desk generally must maintain its market-maker inventory and financial exposure within its market-maker inventory limit and its financial exposure limit, respectively and, to the extent that any limit of the trading desk is exceeded, the trading desk must take action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[718] Thus, if market movements cause a trading desk's financial exposure to exceed one or more of its risk limits, the trading desk must promptly take action to reduce its financial exposure or obtain approval for an increase to its limits through the required escalation procedures, detailed below. A trading desk may not, however, enter into a trade that would cause it to exceed its limits without first receiving approval through its escalation procedures.[719]

Under the final rule, the term market-maker inventory is defined to mean all of the positions, in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section, that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[720] Those financial instruments in which a trading desk acts as market maker must be identified in the trading desk's compliance program under § 75.4(b)(2)(iii)(A) of the final rule. As used throughout this **SUPPLEMENTARY INFORMATION**, the term ''inventory'' refers to both the retention of financial instruments (*e.g.,* securities) and, in the context of derivatives trading, the risk exposures arising out of market-making related activities.[721] Consistent with the statute, the final rule requires that the market-maker inventory of a trading desk be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

The financial exposure concept is broader in scope than market-maker inventory and reflects the aggregate risks of the financial instruments (as well as any associated loans, spot commodities, or spot foreign exchange or currency) the trading desk manages as part of its market making-related activities.[722] Thus, a trading desk's financial exposure will take into account a trading desk's positions in instruments for which it does not act as a market maker, but which are

[714] *See* proposed rule § 75.4(b).

[715] Some commenters also contended that language in proposed Appendix B raised transaction-by-transaction implications. *See supra* notes 522 to 529 and accompanying text (discussing commenters' transaction-by-transaction concerns).

[716] The Agencies are not adopting a transaction-by-transaction approach because the Agencies are concerned that such an approach would be unduly burdensome or impractical and inconsistent with the manner in which *bona fide* market making-related activity is conducted. Additionally, the Agencies are concerned that the burdens of such an approach would cause banking entities to significantly reduce or cease market making-related activities, which would cause negative market impacts harmful to both investors and issuers, as well as the financial system generally.

[717] *See* Joint Proposal, 76 FR at 68870 n.146 (''The Agencies note that a market maker may often make a market in one type of [financial instrument] and hedge its activities using different [financial instruments] in which it does not make a market.''); CFTC Proposal, 77 FR at 8356 n.152.

[718] *See* final rule § 75.4(b)(2)(iv).

[719] *See* final rule § 75.4(b)(2)(iii)(E).

[720] *See* final rule § 75.4(b)(5).

[721] As noted in the proposal, certain types of market making-related activities, such as market making in derivatives, involves the retention of principal exposures rather than the retention of actual financial instruments. *See* Joint Proposal, 76 FR at 68869 n.143; CFTC Proposal, 77 FR at 8354 n.149. This type of activity would be included under the concept of ''inventory'' in the final rule.

[722] The Agencies recognize that under the statute a banking entity's positions in loans, spot commodities, and spot foreign exchange or currency are not subject to the final rule's restrictions on proprietary trading. Thus, a banking entity's trading in these instruments does not need to comply with the market-making exemption or any other exemption to the prohibition on proprietary trading. A banking entity may, however, include exposures in loans, spot commodities, and spot foreign exchange or currency that are related to the desk's market-making activities in determining the trading desk's financial exposure and in turn, the desk' s financial exposure limits under the market-making exemption. The Agencies believe this will provide a more accurate picture of the trading desk's financial exposure. For example, a market maker in foreign exchange forwards or swaps may mitigate the risks of its market-maker inventory with spot foreign exchange.

established as part of its market making-related activities, which includes risk mitigation and hedging. For instance, a trading desk that acts as a market maker in Euro-denominated corporate bonds may, in addition to Euro-denominated bonds, enter into credit default swap transactions on individual European corporate bond issuers or an index of European corporate bond issuers in order to hedge its exposure arising from its corporate bond inventory, in accordance with its documented hedging policies and procedures. Though only the corporate bonds would be considered as part of the trading desk's market-maker inventory, its overall financial exposure would also include the credit default swaps used for hedging purposes.

As noted above, the Agencies believe the extent to which a trading desk is engaged in permitted market making-related activities is best determined by evaluating both the financial exposure that results from the desk's trading activity and the amount, types, and risks of the financial instruments in the desk's market-maker inventory. Both concepts are independently valuable and will contribute to the effectiveness of the market-making exemption. Specifically, a trading desk's financial exposure will highlight the net exposure and risks of its positions and, along with an analysis of the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of that exposure consistent with its limits, the extent to which it is appropriately managing the risk of its market-maker inventory consistent with applicable limits, all of which are significant to an analysis of whether a trading desk is engaged in market making-related activities. An assessment of the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory will identify the aggregate amount of the desk's inventory in financial instruments for which it acts as market maker, the types of these financial instruments that the desk holds at a particular time, and the risks arising from such holdings. Importantly, an analysis of a trading desk's market-maker inventory will inform the extent to which this inventory is related to the reasonably expected near term demands of clients, customers, or counterparties.

Because the market-maker inventory concept is more directly related to the financial instruments that a trading desk buys and sells from customers than the financial exposure concept, the Agencies believe that requiring review and analysis of a trading desk's market-maker inventory, as well as its financial exposure, will enhance compliance with the statute's near-term customer demand requirement. While the amount, types, and risks of a trading desk's market-maker inventory are constrained by the near-term customer demand requirement, any other positions in financial instruments managed by the trading desk as part of its market making-related activities (*i.e.,* those reflected in the trading desk's financial exposure, but not included in the trading desk's market-maker inventory) are also constrained because they must be consistent with the market-maker inventory or, if taken for hedging purposes, designed to reduce the risks of the trading desk's market-maker inventory.

The Agencies note that disaggregating the trading desk's market-maker inventory from its other exposures also allows for better identification of the trading desk's hedging positions in instruments for which the trading desk does not make a market. As a result, a banking entity's systems should be able to readily identify and monitor the trading desk's hedging positions that are not in its market-maker inventory. As discussed in Part VI.A.3.c.3., a trading desk must have certain inventory and risk limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its financial exposure that are designed to facilitate the trading desk's compliance with the exemption and that are based on the nature and amount of the trading desk's market making-related activities, including analyses regarding the reasonably expected near term demands of customers.[723]

The final rule also requires these policies and procedures to contain escalation procedures if a trade would exceed the limits set for the trading desk. However, the final rule does not permit a trading desk to exceed the limits solely based on customer demand. Rather, before executing a trade that would exceed the desk's limits or changing the desk's limits, a trading desk must first follow the relevant escalation procedures, which may require additional approval within the banking entity and provide demonstrable analysis that the basis for any temporary or permanent increase in limits is consistent with the reasonably expected near term demands of customers.

Due to these considerations, the Agencies believe the final rule should result in more efficient compliance analyses on the part of both banking entities and Agency supervisors and examiners and should be less costly for banking entities to implement than a transaction-by-transaction or instrument-by-instrument approach. For example, the Agencies believe that some banking entities already compute and monitor most trading desks' financial exposures for risk management or other purposes.[724] The Agencies also believe that focusing on the financial exposure and market-maker inventory of a trading desk, as opposed to each separate individual transaction, is consistent with the statute's goal of reducing proprietary trading risk in the banking system and its exemption for market making-related activities. The Agencies recognize that banking entities may not currently disaggregate trading desks' market-maker inventory from their financial exposures and that, to the extent banking entities do not currently separately identify trading desks' market-maker inventory, requiring such disaggregation for purposes of this rule will impose certain costs. In addition, the Agencies understand that an approach focused solely on the aggregate of all the unit's trading positions, as suggested by some commenters, would present fewer burdens.[725] However, for the reasons discussed above, the Agencies believe such disaggregation is necessary to give full effect to the statute's near term customer demand requirement.

The Agencies note that whether a financial instrument or exposure stemming from a derivative is considered to be market-maker inventory is based only on whether the desk makes a market in the financial instrument, regardless of the type of counterparty or the purpose of the transaction. Thus, the Agencies believe that banking entities should be able to develop a standardized methodology for identifying a trading desk's positions and exposures in the financial instruments for which it acts as a market maker. As further discussed in this Part, a trading desk's financial exposure must reflect the aggregate risks managed by the trading desk as part of its market

[723] *See infra* Part VI.A.3.c.2.c.; final rule § 75.4(b)(2)(iii)(C).

[724] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that modern trading units generally view individual positions as a bundle of characteristics that contribute to their complete portfolio). *See also* Federal Reserve Board, Trading and Capital-Markets Activities Manual § 2000.1 (Feb. 1998) (''The risk-measurement system should also permit disaggregation of risk by type and by customer, instrument, or business unit to effectively support the management and control of risks.'').

[725] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

making-related activities,[726] and a banking entity should be able to demonstrate that the financial exposure of a trading desk is related to its market-making activities.

The final rule defines ''financial exposure'' to mean the ''aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.'' [727] In this context, the term ''aggregate'' does not imply that a long exposure in one instrument can be combined with a short exposure in a similar or related instrument to yield a total exposure of zero. Instead, such a combination may reduce a trading desk's economic exposure to certain risk factors that are common to both instruments, but it would still retain any basis risk between those financial instruments or potentially generate a new risk exposure in the case of purposeful hedging.

With respect to the frequency with which a trading desk should determine its financial exposure and the amount, types, and risks of the financial instruments in its market-maker inventory, a trading desk's financial exposure and market-maker inventory should be evaluated and monitored at a frequency that is appropriate for the trading desk's trading strategies and the characteristics of the financial instruments the desk trades, including historical intraday volatility. For example, a trading desk that repeatedly acquired and then terminated significant financial exposures throughout the day but that had little or no financial exposure at the end of the day should assess its financial exposure based on its intraday activities, not simply its end-of-day financial exposure. The frequency with which a trading desk's financial exposure and market-maker inventory will be monitored and analyzed should be specified in the trading desk's compliance program.

A trading desk's financial exposure reflects its aggregate risk exposures. The types of ''aggregate risks'' identified in the trading desk's financial exposure should reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk acts as market maker or that the desk uses for risk management purposes pursuant to this exemption, including the liquidity, maturity, and depth of the market for the relevant types of financial instruments. Thus, market factors reflected in a trading desk's financial exposure should include all significant and relevant factors associated with the products and instruments in which the desk trades as market maker or for risk management purposes, including basis risk arising from such positions.[728] Similarly, an assessment of the risks of the trading desk's market-maker inventory must reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk makes a market. Importantly, a trading desk's financial exposure and the risks of its market-maker inventory will change based on the desk's trading activity (*e.g.,* buying an instrument that it did not previously hold, increasing its position in an instrument, or decreasing its position in an instrument) as well as changing market conditions related to instruments or positions managed by the trading desk.

Because the final rule defines ''trading desk'' based on operational functionality rather than corporate formality, a trading desk's financial exposure may include positions that are booked in different affiliated legal entities.[729] The Agencies understand that positions may be booked in different legal entities for a variety of reasons, including regulatory reasons. For example, a trading desk that makes a market in corporate bonds may book its corporate bond positions in an SEC-registered broker-dealer and may book index CDS positions acquired for hedging purposes in a CFTC-registered swap dealer. A financial exposure that reflects both the corporate bond position and the index CDS position better reflects the economic reality of the trading desk's risk exposure (*i.e.,* by showing that the risk of the corporate bond position has been reduced by the index CDS position).

In addition, a trading desk engaged in market making-related activities in compliance with the final rule may direct another organizational unit of the banking entity or an affiliate to execute a risk-mitigating transaction on the trading desk's behalf.[730] The other organizational unit may rely on the market-making exemption for these purposes only if: (i) The other organizational unit acts in accordance with the trading desk's risk management policies and procedures established in accordance with § 75.4(b)(2)(iii) of the final rule; and (ii) the resulting risk-mitigating position is attributed to the trading desk's financial exposure (and not the other organizational unit's financial exposure) and is included in the trading desk's daily profit and loss calculation. If another organizational unit of the banking entity or an affiliate establishes a risk-mitigating position for the trading desk on its own accord (*i.e.,* not at the direction of the trading desk) or if the risk-mitigating position is included in the other organizational unit's financial exposure or daily profit and loss calculation, then the other organizational unit must comply with the requirements of the hedging exemption for such activity.[731] It may not rely on the market-making exemption under these circumstances. If a trading desk engages in a risk-mitigating transaction with a second trading desk of the banking entity or an affiliate that is also engaged in permissible market making-related activities, then the risk-mitigating position would be included in the first trading desk's financial exposure and the contra-risk would be included in the second trading desk's market-maker inventory and financial exposure. The Agencies believe the net effect of the final rule is to allow individual trading desks to efficiently manage their own hedging and risk mitigation activities on a holistic basis, while only allowing for external hedging directed by staff outside of the trading desk under the additional requirements of the hedging exemption.

To include in a trading desk's financial exposure either positions held at an affiliated legal entity or positions established by another organizational unit on the trading desk's behalf, a banking entity must be able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section

[726] *See* final rule § 75.4(b)(4).

[727] Final rule § 75.4(b)(4). For example, in the case of derivatives, a trading desk's financial position will be the residual risks of the trading desk's open positions. For instance, an options desk may have thousands of open trades at any given time, including hedges, but the desk will manage, among other risk factors, the trading desk's portfolio delta, gamma, rho, and volatility.

[728] As discussed in Part VI.A.3.c.3., a banking entity must establish, implement, maintain, and enforce policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell and the products, instruments, or exposures each trading desk may use for risk management purposes. *See* final rule § 75.4(b)(2)(iii).

[729] Other statutory or regulatory requirements, including those based on prudential safety and soundness concerns, may prevent or limit a banking entity from booking hedging positions in a legal entity other than the entity taking the underlying position.

[730] *See infra* Part VI.A.3.c.4.

[731] Under these circumstances, the other organizational unit would also be required to meet the hedging exemption's documentation requirement for the risk-mitigating transaction. *See* final rule § 75.5(c).

13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's financial exposure for purposes of the market-making exemption. Similarly, the supervisors and examiners of any Agency that has supervisory authority over the banking entity that holds financial instruments that are being included in another trading desk's financial exposure for purposes of the market-making exemption must have the same level of access to the records of the trading desk.[732] Banking entities should be prepared to provide all records that identify all positions included in a trading desk's financial exposure and where such positions are held.

As an example of how a trading desk's market-maker inventory and financial exposure will be analyzed under the market-making exemption, assume a trading desk makes a market in a variety of U.S. corporate bonds and hedges its aggregated positions with a combination of exposures to corporate bond indexes and specific name CDS in which the desk does not make a market. To qualify for the market-making exemption, the trading desk would have to demonstrate, among other things, that: (i) The desk routinely stands ready to purchase and sell the U.S. corporate bonds, consistent with the requirement of § 75.4(b)(2)(i) of the final rule, and these instruments (or category of instruments) are identified in the trading desk's compliance program; (ii) the trading desk's market-maker inventory in U.S. corporate bonds is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, consistent with the analysis and limits established by the banking entity for the trading desk; (iii) the trading desk's exposures to corporate bond indexes and single name CDS are designed to mitigate the risk of its financial exposure, are consistent with the products, instruments, or exposures and the techniques and strategies that the trading desk may use to manage its risk effectively (and such use continues to be effective), and do not exceed the trading desk's limits on the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; and (iv) the aggregate risks of the trading desk's exposures to U.S. corporate bonds, corporate bond indexes, and single name CDS do not exceed the trading desk's limits on the level of exposures to relevant risk factors arising from its financial exposure.

Our focus on the financial exposure of a trading desk, rather than a trade-by-trade requirement, is designed to give banking entities the flexibility to acquire not only market-maker inventory, but positions that facilitate market making, such as positions that hedge market-maker inventory.[733] As commenters pointed out, a trade-by-trade requirement would view trades in isolation and could fail to recognize that certain trades that are not customer-facing are nevertheless integral to market making and financial intermediation.[734] The Agencies understand that the risk-reducing effects of combining large diverse portfolios could, in certain instances, mask otherwise prohibited proprietary trading.[735] However, the Agencies do not believe that taking a transaction-by-transaction approach is necessary to address this concern. Rather, the Agencies believe that the broader definitions of ''financial exposure'' and ''market-maker inventory'' coupled with the tailored definition of ''trading desk'' facilitates the analysis of aggregate risk exposures and positions in a manner best suited to apply and evaluate the market-making exemption.

In short, this approach is designed to mitigate the costs of a trade-by-trade analysis identified by commenters. The Agencies recognize, however, that this approach is only effective at achieving the goals of the section 13 of the BHC Act—promoting financial intermediation and limiting speculative risks within banking entities—if there are limits on a trading desk's financial exposure. That is, a permissive market-making exemption that gives banking entities maximum discretion in acquiring positions to provide liquidity runs the risk of also allowing banking entities to engage in speculative trades. As discussed more fully in the following Parts of this **SUPPLEMENTARY INFORMATION**, the final market-making exemption provides a number of controls on a trading desk's financial exposure. These controls include, among others, a provision requiring that a trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers and that any other financial instruments managed by the trading desk be designed to mitigate the risk of such desk's market-maker inventory. In addition, the final market-making exemption requires the trading desk's compliance program to include appropriate risk and inventory limits tied to the near term demand requirement, as well as escalation procedures if a trade would exceed such limits. The compliance program, which includes internal controls and independent testing, is designed to prevent instances where transactions not related to providing financial intermediation services are part of a desk's financial exposure.

iii. Routinely Standing Ready To Buy and Sell

The requirement to routinely stand ready to buy and sell a type of financial instrument in the final rule recognizes that market making-related activities differ based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument. For example, a trading desk acting as a market maker in highly liquid markets would engage in more regular quoting activity than a market maker in less liquid markets. Moreover, the Agencies recognize that the maturity and depth of the market also play a role in determining the character of a market maker's activity.

As noted above, the standard of ''routinely'' standing ready to buy and sell will differ across markets and asset classes based on the liquidity, maturity, and depth of the market for the type of financial instrument. For instance, a trading desk that is a market maker in liquid equity securities generally should engage in very regular or continuous quoting and trading activities on both sides of the market. In less liquid markets, a trading desk should engage in regular quoting activity across the relevant type(s) of financial instruments, although such quoting may be less frequent than in liquid equity markets.[736] Consistent with the CFTC's and SEC's interpretation of market making in swaps and security-based swaps for purposes of the definitions of

[732] A banking entity must be able to provide such records when a related position is held at an affiliate, even if the affiliate and the banking entity are not subject to the same Agency's regulatory jurisdiction.

[733] The Agencies believe it is appropriate to apply the requirements of the exemption to the financial exposure of a ''trading desk,'' rather than the portfolio of a higher level of organization, for the reasons discussed above, including our concern that aggregating a large number of disparate positions and exposures across a range of trading desks could increase the risk of evasion. *See supra* Part VI.A.3.c.1.c.i. (discussing the determination to apply requirements at the trading desk level).

[734] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[735] *See, e.g.,* Occupy.

[736] Indeed, in the most specialized situations, such quotations may only be provided upon request. *See infra* note 740 and accompanying text (discussing permissible block positioning).

''swap dealer'' and ''security-based swap dealer,'' ''routinely'' in the swap market context means that the trading desk should stand ready to enter into swaps or security-based swaps at the request or demand of a counterparty more frequently than occasionally.[737] The Agencies note that a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or it may routinely stand ready to enter into derivatives on either side of the market and then enter into one or more offsetting positions in the derivatives market or another market, particularly in the case of relatively less liquid derivatives. While a trading desk may respond to requests to trade certain products, such as custom swaps, even if it does not normally quote in the particular product, the trading desk should hedge against the resulting exposure in accordance with its financial exposure and hedging limits.[738] Further, the Agencies continue to recognize that market makers in highly illiquid markets may trade only intermittently or at the request of particular customers, which is sometimes referred to as trading by appointment.[739] A trading desk's block positioning activity would also meet the terms of this requirement provided that, from time to time, the desk engages in block trades (*i.e.,* trades of a large quantity or with a high dollar value) with customers.[740]

Regardless of the liquidity, maturity, and depth of the market for a particular type of financial instrument, a trading desk should have a pattern of providing price indications on either side of the market and a pattern of trading with customers on each side of the market. In particular, in the case of relatively illiquid derivatives or structured instruments, it would not be sufficient to demonstrate that a trading desk on occasion creates a customized instrument or provides a price quote in response to a customer request. Instead, the trading desk would need to be able to demonstrate a pattern of taking these actions in response to demand from multiple customers with respect to both long and short risk exposures in identified types of instruments.

This requirement of the final rule applies to a trading desk's activity in one or more ''types'' of financial instruments.[741] The Agencies recognize that, in some markets, such as the corporate bond market, a market maker may regularly quote a subset of instruments (generally the more liquid instruments), but may not provide regular quotes in other related but less liquid instruments that the market maker is willing and available to trade. Instead, the market maker would provide a price for those instruments upon request.[742] The trading desk's activity, in the aggregate for a particular type of financial instrument, indicates whether it is engaged in activity that is consistent with § 75.4(b)(2)(i) of the final rule.

Notably, this requirement provides that the types of financial instruments for which the trading desk routinely stands ready to purchase and sell must be related to its authorized market-maker inventory and it authorized financial exposure. Thus, the types of financial instruments for which the desk routinely stands ready to buy and sell should compose a significant portion of its overall financial exposure. The only other financial instruments contributing to the trading desk's overall financial exposure should be those designed to hedge or mitigate the risk of the financial instruments for which the trading desk is making a market. It would not be consistent with the market-making exemption for a trading desk to hold only positions in, or be exposed to, financial instruments for which the trading desk is not a market maker.[743]

[737] The Agencies will consider factors similar to those identified by the CFTC and SEC in connection with this standard. *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'', 77 FR 30596, 30609 (May 23, 2012)

[738] The Agencies recognize that, as noted by commenters, preventing a banking entity from conducting customized transactions with customers may impact customers' risk exposures or transaction costs. *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies are not prohibiting this activity under the final rule, as discussed in this Part.

[739] The Agencies have considered comments on the issue of whether trading by appointment should be permitted under the final market-making exemption. The Agencies believe it is appropriate to permit trading by appointment to the extent that there is customer demand for liquidity in the relevant products.

[740] As noted in the preamble to the proposed rule, the size of a block will vary among different asset classes. The Agencies also stated in the proposal that the SEC's definition of ''qualified block positioner'' in Rule 3b–8(c) under the Exchange Act may serve as guidance for determining whether block positioning activity qualifies for the market-making exemption. In referencing that rule as guidance, the Agencies did not intend to imply that a banking entity engaged in block positioning activity would be required to meet all terms of the ''qualified block positioner'' definition at all times. Nonetheless, a number of commenters indicated that it was unclear when a banking entity would need to act as a qualified block positioner in accordance with Rule 3b–8(c) and expressed concern that uncertainty could have a chilling effect on a banking entity's willingness to facilitate customer block trades. *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). For example, a few commenters stated that certain requirements in Rule 3b–8(c) could cause fire sales or general market uncertainty. *See id.* After considering comments, the Agencies have decided that the reference to Rule 3b–8(c) is unnecessary for purposes of the final rule. In particular, the Agencies believe that the requirements in the market-making exemption provide sufficient safeguards, and the additional requirements of the ''qualified block positioner'' definition may present unnecessary burdens or redundancies with the rule, as adopted. For example, the Agencies believe that there is some overlap between § 75.4(b)(2)(ii) of the exemption, which provides that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and Rule 3b–8(c)(iii), which requires the sale of the shares comprising the block as rapidly as possible commensurate with the circumstances. In other words, the market-making exemption would require a banking entity to appropriately manage its inventory when engaged in block positioning activity, but would not speak directly to the timing element given the diversity of markets to which the exemption applies.

As noted above, one commenter analyzed the potential market impact of a complete restriction on a market maker's ability to provide direct liquidity to help a customer execute a large block trade. *See supra* note 687 and accompanying text. Because the Agencies are not restricting a banking entity's ability to engage in block positioning in the manner suggested by this commenter, the Agencies do not believe that the final rule will cause the cited market impact of incremental transaction costs between $1.7 and $3.4 billion per year. The Agencies address this commenter's concern about the impact of inventory metrics on a banking entity's willingness to engage in block trading in Part VI.C.3. (discussing the metrics requirement in the final rule and noting that metrics will not be used to determine compliance with the rule but, rather, will be monitored for patterns over time to identify activities that may warrant further review).

One commenter appeared to request that block trading activity not be subject to all requirements of the market-making exemption. *See* SIFMA (Asset Mgmt.) (Feb. 2012). Any activity conducted in reliance on the market-making exemption, including block trading activity, must meet the requirements of the market-making exemption. The Agencies believe the requirements in the final rule are workable for block positioning activity and do not believe it would be appropriate to subject block positioning to lesser requirements than general market-making activity. For example, trading in large block sizes can expose a trading desk to greater risk than market making in smaller sizes, particularly absent risk management requirements. Thus, the Agencies believe it is important for block positioning activity to be subject to the same requirements, including the requirements to establish risk limits and risk management procedures, as general market-making activity.

[741] This approach is generally consistent with commenters' requested clarification that a trading desk's quoting activity will not be assessed on an instrument-by-instrument basis, but rather across a range of similar instruments for which the trading desk acts as a market maker. *See, e.g.,* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA; Goldman (Prop. Trading).

[742] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[743] The Agencies recognize that there could be limited circumstances under which a trading desk's financial exposure does not relate to the types of financial instruments that it is standing ready to buy and sell for a short period of time. However, the Agencies would expect for such occurrences to be minimal. For example, this scenario could occur if a trading desk unwinds a hedge position after the

A trading desk's routine presence in the market for a particular type of financial instrument would not, on its own, be sufficient grounds for relying on the market-making exemption. This is because the frequency at which a trading desk is active in a particular market would not, on its own, distinguish between permitted market making-related activity and impermissible proprietary trading. In response to comments, the final rule provides that a trading desk also must be willing and available to quote, buy and sell, or otherwise enter into long and short positions in the relevant type(s) of financial instruments for its own account in commercially reasonable amounts and throughout market cycles.[744] Importantly, a trading desk would not meet the terms of this requirement if it provides wide quotations relative to prevailing market conditions and is not engaged in other activity that evidences a willingness or availability to provide intermediation services.[745] Under these circumstances, a trading desk would not be standing ready to purchase and sell because it is not genuinely quoting or trading with customers.

In the context of this requirement, ''commercially reasonable amounts'' means that the desk generally must be willing to quote and trade in sizes requested by other market participants.[746] For trading desks that engage in block trading, this would include block trades requested by customers, and this language is not meant to restrict a trading desk from acting as a block positioner. Further, a trading desk must act as a market maker on an appropriate basis throughout market cycles and not only when it is most favorable for it to do so.[747] For example, a trading desk should be facilitating customer needs in both upward and downward moving markets.

As discussed further in Part VI.A.3.c.3., the financial instruments the trading desk stands ready to buy and sell must be identified in the trading desk's compliance program.[748] Certain requirements in the final exemption apply to the amount, types, and risks of these financial instruments that a trading desk can hold in its market-maker inventory, including the near term customer demand requirement[749] and the need to have certain risk and inventory limits.[750]

In response to the proposed requirement that a trading desk or other organizational unit hold itself out, some commenters requested that the Agencies limit the availability of the market-making exemption to trading in particular asset classes or trading on particular venues (*e.g.,* organized trading platforms). The Agencies are not limiting the availability of the market-making exemption in the manner requested by these commenters.[751] Provided there is customer demand for liquidity in a type of financial instrument, the Agencies do not believe the availability of the market-making exemption should depend on the liquidity of that type of financial instrument or the ability to trade such instruments on an organized trading platform. The Agencies see no basis in the statutory text for either approach and believe that the likely harms to investors seeking to trade affected instruments (*e.g.,* reduced ability to purchase or sell a particular instrument, potentially higher transaction costs) and market quality (*e.g.,* reduced liquidity) that would arise under such an approach would not be justified,[752] particularly in light of the minimal benefits that might result from restricting or eliminating a banking entity's ability to hold less liquid assets in connection with its market making-related activities. The Agencies believe these commenters' concerns are adequately addressed by the final rule's requirements in the market-making exemption that are designed to ensure that a trading desk cannot hold risk in excess of what is appropriate to provide intermediation services designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

In response to comments on the proposed interpretation regarding anticipatory position-taking,[753] the Agencies note that the near term demand requirement in the final rule addresses when a trading desk may take positions in anticipation of reasonably expected near term customer demand.[754] The Agencies believe this approach is generally consistent with the comments the Agencies received on this issue.[755] In addition, the Agencies note that modifications to the proposed near term demand requirement in the final rule also address commenters concerns on this issue.[756]

market-making position has already been unwound or if a trading desk acquires an anticipatory hedge position prior to acquiring a market-making position. As discussed more thoroughly in Part VI.A.3.c.3., a banking entity must establish written policies and procedures, internal controls, analysis, and independent testing that establish appropriate parameters around such activities.

[744] *See, e.g.,* Occupy; Better Markets (Feb. 2012).

[745] One commenter expressed concern that a banking entity may be able to rely on the market-making exemption when it is providing only wide, out of context quotes. *See* Occupy.

[746] As discussed below, this may include providing quotes in the interdealer trading market.

[747] Algorithmic trading strategies that only trade when market factors are favorable to the strategy's objectives or that otherwise frequently exit the market would not be considered to be standing ready to purchase or sell a type of financial instrument throughout market cycles and, thus, would not qualify for the market-making exemption. The Agencies believe this addresses commenters' concerns about high-frequency trading activities that are only active in the market when it is believed to be profitable, rather than to facilitate customers. *See, e.g.,* Better Markets (Feb. 2012). The Agencies are not, however, prohibiting all high-frequency trading activities under the final rule or otherwise limiting high-frequency trading by banking entities by imposing a resting period on their orders, as requested by certain commenters. *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[748] *See* final rule § 75.4(b)(2)(iii)(A).

[749] *See* final rule § 75.4(b)(2)(ii).

[750] *See* final rule § 75.4(b)(2)(iii)(C).

[751] For example, a few commenters requested that the rule prohibit banking entities from market making in assets classified as Level 3 under FAS 157. *See supra* note 656 and accompanying text. The Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule. *See* Joint Proposal, 76 FR at 68859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR at 8344 n.107.

Further, a few commenters suggested that the exemption should only be available for trading on an organized trading facility. This type of limitation would require significant and widespread market structure changes (with associated systems and infrastructure costs) in a relatively short period of time, as market making in certain assets is primarily or wholly conducted in the OTC market, and organized trading platforms may not currently exist for these assets. The Agencies do not believe that the costs of such market structure changes would be warranted for purposes of this rule.

[752] As discussed above, a number of commenters expressed concern about the potential market impacts of the perceived restrictions on market making under the proposed rule, particularly with respect to less liquid markets, such as the corporate bond market. *See, e.g.,* Prof. Duffie; Wellington; BlackRock; ICI.

[753] Joint Proposal, 76 FR at 68871 (stating that ''*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties''); CFTC Proposal, 77 FR at 8356–8357; *see also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[754] *See* final rule § 75.4(b)(2)(ii); *infra* Part VI.A.3.c.2.c.

[755] *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[756] For example, some commenters suggested that the final rule allow market makers to make individualized assessments of anticipated customer demand, based on their expertise and experience, and account for differences between liquid and less liquid markets. *See* Chamber (Feb. 2012); ISDA (Feb. 2012). The final rule allows such assessments,

Continued

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Consistent with the statute, the proposed rule required that the trading desk or other organizational unit's market making-related activities be, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[757] This requirement is intended to prevent a trading desk from taking a speculative proprietary position that is unrelated to customer needs as part of the desk's purported market making-related activities.[758]

In the proposal, the Agencies stated that a banking entity's expectations of near term customer demand should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near term demand of those customers based on particular factors, beyond a general expectation of price appreciation. The Agencies further stated that they would not expect the activities of a trading desk or other organizational unit to qualify for the market-making exemption if the trading desk or other organizational unit is engaged wholly or principally in trading that is not in response to, or driven by, customer demands, regardless of whether those activities promote price transparency or liquidity. The proposal stated that, for example, a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule's market-making exemption.[759]

With respect to market making in a security that is executed on an exchange or other organized trading facility, the proposal provided that a market maker's activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy and the market maker is registered, if the exchange or organized trading facility registers market makers. Under the proposal, activities on an exchange or other organized trading facility that primarily take liquidity, rather than provide liquidity, would not qualify for the market-making exemption, even if conducted by a registered market maker.[760]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

As noted above, the proposed near term customer demand requirement would implement language found in the statute's market-making exemption.[761] Some commenters expressed general support for this requirement.[762] For example, these commenters emphasized that the proposed near term demand requirement is an important component that restricts disguised position-taking or market making in illiquid markets.[763] Several other commenters expressed concern that the proposed requirement is too restrictive[764] because, for example, it may impede a market maker's ability to build or retain inventory[765] or may impact a market maker's willingness to engage in block trading.[766] Comments on particular aspects of this proposed requirement are discussed below, including the proposed interpretation of this requirement in the proposal, the requirement's potential impact on market maker inventory, potential differences in this standard across asset classes, whether it is possible to predict near term customer demand, and whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined for purposes of the exemption.

i. The Proposed Guidance for Determining Compliance With the Near Term Customer Demand Requirement

As discussed in more detail above, the proposal set forth proposed guidance on how a banking entity may comply with the proposed near term customer demand requirement.[767] With respect to the language indicating that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation), one commenter stated that it is unclear how a banking entity would be able to make such determinations in markets where trades occur infrequently and customer demand is hard to predict.[768]

Several commenters expressed concern about the proposal's statement that a trading desk or other organizational unit engaged wholly or principally in trading that is not in response to, or driven by, customer demands (*e.g.,* arbitrage trading with non-customers) would not qualify for the exemption, regardless of whether the activities promote price transparency or liquidity.[769] In particular, commenters stated that it would be difficult for a market-making business to try to divide its activities that are in response to customer demand (*e.g.,* customer intermediation and hedging) from activities that promote price transparency and liquidity (*e.g.,* interdealer trading to test market depth or arbitrage trading) in order to determine their proportionality.[770] Another commenter stated that, as a matter of organizational efficiency, firms will often restrict arbitrage trading

based on historical customer demand and other relevant factors, and recognizes that near term demand may differ based on the liquidity, maturity, and depth of the market for a particular type of financial instrument. *See infra* Part VI.A.3.c.2.c.iii.

[757] *See* proposed rule § 75.4(b)(2)(iii).

[758] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8357.

[759] *See id.*

[760] *See* Joint Proposal, 76 FR at 68871–68872; CFTC Proposal, 77 FR at 8357.

[761] *See supra* Part VI.A.3.c.2.a.

[762] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Flynn & Fusselman; Better Markets (Feb. 2012).

[763] *See* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[764] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); T. Rowe Price; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation; CIEBA; Credit Suisse (Seidel); SSgA (Feb. 2012); IAA (stating that the proposed requirement is too subjective and would be difficult to administer in a range of scenarios); Barclays; Prof. Duffie.

[765] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies respond to these comments in Part VI.A.3.c.2.c., *infra.* For a discussion of comments regarding inventory management activity conducted in connection with market making, see Part VI.A.3.c.2.b.vi., *infra.*

[766] *See, e.g.,* ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation (noting that a market maker may need to hold significant inventory to accommodate potential block trade requests). Two of these commenters stated that a market maker may provide a worse price or may be unwilling to intermediate a large customer position if the market maker has to determine whether holding such position will meet the near term demand requirement, particularly if the market maker would be required to sell the block position over a short period of time. *See* ACLI (Feb. 2012); MetLife. These comments are addressed in Part VI.A.3.c.2.c.iii., *infra.*

[767] *See supra* Part VI.A.3.c.2.a.

[768] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). Another commenter suggested that the Agencies ''establish clear criteria that reflect appropriate revenue from changes in the bid-ask spread,'' noting that a legitimate market maker should be both selling and buying in a rising market (or, likewise, in a declining market). Public Citizen.

[769] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012); *see also infra* Part VI.A.3.c.2.b.viii. (discussing comments on whether arbitrage trading should be permitted under the market-making exemption under certain circumstances).

[770] *See* Goldman (Prop. Trading); RBC. One of these commenters agreed, however, that a trading desk that is ''wholly'' engaged in trading that is unrelated to customer demand should not qualify for the proposed market-making exemption. *See* Goldman (Prop. Trading).

strategies to certain specific individual traders within the market-making organization, who may sometimes be referred to as a ''desk,'' and expressed concern that this would be prohibited under the rule.[771]

In response to the proposed interpretation regarding market making on an exchange or other organized trading facility (and certain similar language in proposed Appendix B),[772] several commenters indicated that the reference to passive submission of resting orders may be too restrictive and provided examples of scenarios where market makers may need to use market or marketable limit orders.[773] For example, many of these commenters stated that market makers may need to enter market or marketable limit orders to: (i) Build or reduce inventory;[774] (ii) address order imbalances on an exchange by, for example, using market orders to lessen volatility and restore pricing equilibrium; (iii) hedge market-making positions; (iv) create markets;[775] (v) test the depth of the markets; (vi) ensure that ETFs, American depositary receipts (''ADRs''), options, and other instruments remain appropriately priced;[776] and (vii) respond to movements in prices in the markets.[777] Two commenters noted that distinctions between limit and market or marketable limit orders may not be workable in the international context, where exchanges may not use the same order types as U.S. trading facilities.[778]

A few commenters also addressed the proposed use of a market maker's exchange registration status as part of the analysis.[779] Two commenters stated that the proposed rule should not require a market maker to be registered with an exchange to qualify for the proposed market-making exemption. According to these commenters, there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices. These commenters indicated that any restrictions or burdens on such trading may decrease liquidity or make it harder to provide customers with the best price for their trade.[780] One commenter, however, stated that the exchange registration requirement is reasonable and further supported adding a requirement that traders demonstrate adherence to the same or commensurate standards in markets where registration is not possible.[781]

Some commenters recommended certain modifications to the proposed analysis. For example, a few commenters requested that the rule presume that a trading unit is engaged in permitted market making-related activity if it is registered as a market maker on a particular exchange or organized trading facility.[782] In support of this recommendation, one commenter represented that it would be warranted because registered market makers directly contribute to maintaining liquid and orderly markets and are subject to extensive regulatory requirements in that capacity.[783] Another commenter suggested that the Agencies instead use metrics to compare, in the aggregate and over time, the liquidity that a market maker makes rather than takes as part of a broader consideration of the market-making character of the relevant trading activity.[784]

ii. Potential Inventory Restrictions and Differences Across Asset Classes

A number of commenters expressed concern that the proposed requirement may unduly restrict a market maker's ability to manage its inventory.[785] Several of these commenters stated that limitations on inventory would be especially problematic for market making in less liquid markets, like the fixed-income market, where customer demand is more intermittent and positions may need to be held for a longer period of time.[786] Some commenters stated that the Agencies' proposed interpretation of this requirement would restrict a market maker's inventory in a manner that is inconsistent with the statute. These commenters indicated that the ''designed'' and ''reasonably expected'' language of the statute seem to recognize that market makers must anticipate customer requests and accumulate sufficient inventory to meet those reasonably expected demands.[787] In addition, one commenter represented that a market maker must have wide latitude and incentives for initiating trades, rather than merely reacting to customer requests for quotes, to properly risk manage its positions or to prepare for anticipated customer demand or supply.[788] Many commenters requested certain modifications to the proposed requirement to limit its impact on

[771] *See* JPMC.

[772] *See* Joint Proposal, 76 FR at 68871–68,872; CFTC Proposal, 77 FR at 8357.

[773] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); RBC. Comments on proposed Appendix B are discussed further in Part VI.A.3.c.8.b., *infra.* This issue is addressed in note 944 and its accompanying text, *infra.*

[774] Some commenters stated that market makers may need to use market or marketable limit orders to build inventory in anticipation of customer demand or in connection with positioning a block trade for a customer. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). Two of these commenters noted that these order types may be needed to dispose of positions taken into inventory as part of market making. *See* RBC; Goldman (Prop. Trading).

[775] *See* NYSE Euronext.

[776] *See* Goldman (Prop. Trading).

[777] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[778] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[779] *See* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy. *See also infra* notes 945 to 946 and accompanying text (addressing these comments).

[780] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that trading units may currently register as market makers with particular, primary exchanges on which they trade, but will serve in a market-making capacity on other trading venues from time to time); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

[781] *See* Occupy. In the alternative, this commenter would require all market making to be performed on an exchange or organized trading facility. *See id.*

[782] *See* NYSE Euronext (recognizing that registration status is not necessarily conclusive of engaging in market making-related activities); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that to the extent a trading unit is registered on a particular exchange or organized trading facility for any type of financial instrument, all of its activities on that exchange or organized trading facility should be presumed to be market making); Goldman (Prop. Trading). *See also infra* note 945 (responding to these comments). Two commenters noted that certain exchange rules may require market makers to deal for their own account under certain circumstances in order to maintain fair and orderly markets. *See* NYSE Euronext (discussing NYSE rules); Goldman (Prop. Trading) (discussing NYSE and CBOE rules). For example, according to these commenters, NYSE Rule 104(f)(ii) requires a market maker to maintain fair and orderly markets, which may involve dealing for their own account when there is a lack of price continuity, lack of depth, or if a disparity between supply and demand exists or is reasonably anticipated. *See id.*

[783] *See* Goldman (Prop. Trading). This commenter further stated that trading activities of exchange market makers may be particularly difficult to evaluate with customer-facing metrics (because ''specialist'' market makers may not have ''customers''), so conferring a positive presumption of compliance on such market makers would ensure that they can continue to contribute to liquidity, which benefits customers. This commenter noted that, for example, NYSE designated market makers (''DMMs'') are generally prohibited from dealing with customers and companies must ''wall off'' any trading units that act as DMMs. *See id.* (citing NYSE Rule 98).

[784] *See id.* (stating that spread-related metrics, such as Spread Profit and Loss, may be useful for this purpose).

[785] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). These concerns are addressed in Part VI.A.3.c.2.c., *infra.*

[786] *See, e.g.,* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012); RBC.

[787] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[788] *See* Prof. Duffie. However, another commenter stated that a legitimate market maker should respond to customer demand rather than initiate transactions, which is indicative of prohibited proprietary trading. *See* Public Citizen.

market maker inventory.[789] Commenters' views on the importance of permitting inventory management activity in connection with market making are discussed below in Part VI.A.3.c.2.b.vi.

Several commenters requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes and implement this requirement flexibly.[790] In particular, many of these commenters emphasized that the concept of ''near term demand'' should be different for less liquid markets, where transactions may occur infrequently, and for liquid markets, where transactions occur more often.[791] One commenter requested that the Agencies add the phrase ''based on the characteristics of the relevant market and asset class'' to the end of the requirement to explicitly acknowledge these differences.[792]

iii. Predicting Near Term Customer Demand

Commenters provided views on whether and, if so how, a banking entity may be able to predict near term customer demand for purposes of the proposed requirement.[793] For example, two commenters suggested ways in which a banking entity could predict near term customer demand.[794] One of these commenters indicated that banking entities should be able to utilize current risk management tools to predict near term customer demand, although these tools may need to be adapted to comply with the rule's requirements. According to this commenter, dealers commonly assess the following factors across product lines, which can relate to expected customer demand: (i) Recent volumes and customer trends; (ii) trading patterns of specific customers; (iii) analysis of whether the firm has an ability to win new customer business; (iv) comparison of the current market conditions to prior similar periods; (v) liquidity of large investors; and (vi) the schedule of maturities in customers' existing positions.[795] Another commenter stated that the reasonableness of a market maker's inventory can be measured by looking to the specifics of the particular market, the size of the customer base being served, and expected customer demand, which banking entities should be required to take into account in both their inventory practices and policies and their actual inventories. This commenter recommended that the rule permit a banking entity to assume a position under the market-making exemption if it can demonstrate a track record or reasonable expectation that it can dispose of a position in the near term.[796]

Some commenters, however, emphasized that reasonably expected near term customer demand cannot always be accurately predicted.[797] Several of these commenters requested the Agencies clarify that banking entities will not be subject to regulatory sanctions if reasonably anticipated near term customer demand does not materialize.[798] One commenter further noted that a banking entity entering a new market, or gaining or losing customers, may need greater flexibility in applying the near term demand requirement because its anticipated demand may fluctuate.[799]

iv. Potential Definitions of ''Client,'' ''Customer,'' or ''Counterparty''

Appendix B of the proposal discussed the proposed meaning of the term ''customer'' in the context of permitted market making-related activity.[800] In addition, the proposal inquired whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined in the rule for purposes of the market-making exemption.[801] Commenters expressed varying views on the proposed interpretations in the proposal and on whether these terms should be defined in the final rule.[802]

With respect to the proposed interpretations of the term ''customer'' in Appendix B, one commenter agreed with the proposed interpretations and expressed the belief that the interpretations will allow interdealer market making where brokers or other dealers act as customers. However, this commenter also requested that the Agencies expressly incorporate

[789] *See* Credit Suisse (Seidel) (suggesting that the rule allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand); Barclays (recommending the rule require that ''the market making-related activity is conducted by each trading unit such that its activities (including the maintenance of inventory) are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties consistent with the market and trading patterns of the relevant product, and consistent with the reasonable judgment of the banking entity where such demand cannot be determined with reasonable accuracy''); CIEBA. In addition, some commenters suggested an interpretation that would provide greater discretion to market makers to enter into trades based on factors such as experience and expertise dealing in the market and market exigencies. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012). Two commenters suggested that the proposed requirement should be interpreted to permit market-making activity as it currently exists. *See* MetLife; ACLI (Feb. 2012). One commenter requested that the proposed requirement be moved to Appendix B of the rule to provide greater flexibility to consider facts and circumstances of a particular activity. *See* JPMC.

[790] *See* CIEBA; Morgan Stanley; RBC; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock. The Agencies respond to these comments in Part VI.A.3.c.2.c.ii., *infra.*

[791] *See* ICI (Feb. 2012); CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); RBC.

[792] *See* Morgan Stanley.

[793] *See* Wellington; MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Chamber (Feb. 2012); FTN; RBC; Alfred Brock. These comments are addressed in Part VI.A.3.c.2.c.iii., *infra.*

[794] *See* Sens. Merkley & Levin (Feb. 2012); FTN.

[795] *See* FTN. The commenter further indicated that errors in estimating customer demand are managed through kick-out rules and oversight by risk managers and committees, with latitude in decisions being closely related to expected or empirical costs of hedging positions until they result in trading with counterparties. *See id.*

[796] *See* Sens. Merkley & Levin (Feb. 2012) (stating that banking entities should be required to collect inventory data, evaluate the data, develop policies on how to handle particular positions, and make regular adjustments to ensure a turnover of assets commensurate with near term demand of customers). This commenter also suggested that the rule specify the types of inventory metrics that should be collected and suggested that the rate of inventory turnover would be helpful. *See id.*

[797] *See* MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012); Alfred Brock. This issue is addressed in Part VI.A.3.c.2.c.iii., *infra.*

[798] *See* ICI (Feb. 2012); CIEBA; RBC; Wellington; Invesco.

[799] *See* CIEBA.

[800] *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439. More specifically, Appendix B stated: ''In the context of market making in a security that is executed on an organized trading facility or an exchange, a 'customer' is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a [financial instrument] in an OTC market, a 'customer' generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services.'' *Id.* On this last point, the proposal elaborated that in certain cases, depending on the conventions of the relevant market (*e.g.,* the OTC derivatives market), such a ''customer'' may consider itself or refer to itself more generally as a ''counterparty.'' *See* Joint Proposal, 76 FR at 68960 n.2; CFTC Proposal, 77 FR at 8439 n.2.

[801] *See* Joint Proposal, 76 FR at 68874; CFTC Proposal, 77 FR at 8359. In particular, Question 99 states: ''Should the terms 'client,' 'customer,' or 'counterparty' be defined for purposes of the market making exemption? If so, how should these terms be defined? For example, would an appropriate definition of 'customer' be: (i) A continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction; (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction; (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions; or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?'' *Id.*

[802] Comments on this issue are addressed in Part VI.A.3.c.2.c.i., *infra.*

providing liquidity to other brokers and dealers into the rule text.[803] Another commenter similarly stated that instead of focusing solely on customer demand, the rule should be clarified to reflect that demand can come from other dealers or future customers.[804]

In response to the proposal's question about whether the terms ''client,'' ''customer,'' and ''counterparty'' should be further defined, a few commenters stated that that the terms should not be defined in the rule.[805] Other commenters indicated that further definition of these terms would be appropriate.[806] Some of these commenters suggested that there should be greater limitations on who can be considered a ''customer'' under the rule.[807] These commenters generally indicated that a ''customer'' should be a person or institution with whom the banking entity has a continuing, or a direct and substantive, relationship prior to the time of the transaction.[808] In the case of a new customer, some of these commenters suggested requiring a relationship initiated by the prospective customer with a view to engaging in transactions.[809] A few commenters indicated that a party should not be considered a client, customer, or counterparty if the banking entity: (i) Originates a financial product and then finds a counterparty to take the other side of the transaction;[810] or (ii) engages in transactions driven by algorithmic trading strategies.[811] Three commenters requested more permissive definitions of these terms.[812] According to one of these commenters, because these terms are listed in the disjunctive in the statute, the broadest term—a ''counterparty''—should prevail.[813]

v. Interdealer Trading and Trading for Price Discovery or To Test Market Depth

With respect to interdealer trading, many commenters expressed concern that the proposed rule could be interpreted to restrict a market maker's ability to engage in interdealer trading.[814] As a general matter, commenters attributed these concerns to statements in proposed Appendix B[815] or to the Customer-Facing Trade Ratio metric in proposed Appendix A.[816] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity[817] and suggested ways in which this could be accomplished (*e.g.,* through a definition of ''customer'' or ''counterparty'').[818]

Commenters emphasized that interdealer trading provides certain market benefits, including increased market liquidity;[819] more efficient matching of customer order flow;[820] greater hedging options to reduce risks;[821] enhanced ability to accumulate inventory for current or near term customer demand, work down concentrated positions arising from a customer trade, or otherwise exit a position acquired from a customer;[822] and general price discovery among dealers.[823] Regarding the impact of interdealer trading on a market maker's ability to intermediate customer needs, one commenter studied the potential impact of interdealer trading limits—in combination with inventory limits—on trading in the U.S. corporate bond market. According to this commenter, if interdealer trading had been prohibited

[803] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Credit Suisse (Seidel); RBC (requesting that the Agencies recognize ''wholesale'' market making as permissible and representing that ''[i]t is irrelevant to an investor whether market liquidity is provided by a broker-dealer with whom the investor maintains a customer account, or whether that broker-dealer looks to another dealer for market liquidity'').

[804] *See* Comm. on Capital Markets Regulation.

[805] *See* FTN; ISDA (Feb. 2012); Alfred Brock.

[806] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[807] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. One of these commenters also requested that the Agencies remove the terms ''client'' and ''counterparty'' from the proposed near term demand requirement. *See* Occupy.

[808] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. These commenters stated that other banking entities should never be ''customers'' under the rule. *See id.* In addition, one of these commenters would further prevent a banking entity's employees and covered funds from being ''customers'' under the rule. *See* AFR *et al.* (Feb. 2012).

[809] *See* AFR *et al.* (Feb. 2012) (providing a similar definition for the term ''client'' as well); Public Citizen.

[810] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity's activities that involve attempting to sell clients financial instruments that it originated, rather than facilitating a secondary market for client trades in previously existing financial products, should be analyzed under the underwriting exemption, not the market-making exemption; in addition, compiling inventory of financial instruments that the bank originated should be viewed as proprietary trading).

[811] *See* AFR *et al.* (Feb. 2012).

[812] *See* Credit Suisse (Seidel) (stating that ''customer'' should be explicitly defined to include any counterparty to whom a banking entity is providing liquidity); ISDA (Feb. 2012) (recommending that, if the Agencies decide to define these terms, a ''counterparty'' should be defined as the entity on the other side of a transaction, and the terms ''client'' and ''customer'' should not be interpreted to require a relationship beyond the isolated provision of a transaction); Japanese Bankers Ass'n. (requesting that it be clearly noted that interbank participants can be customers for interbank market makers).

[813] *See* ISDA (Feb. 2012). This commenter's primary position was that further definitions are not required and could create additional and unnecessary complexity. *See id.*

[814] *See, e.g.,* JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); MetLife; Credit Suisse (Seidel); BoA; ACLI (Feb. 2012); RBC; AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012). A few commenters noted that the proposed rule would permit a certain amount of interdealer trading. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (citing statements in the proposal providing that a market maker's ''customers'' vary depending on the asset class and market in which intermediation services are provided and interpreting such statements as allowing interdealer market making where brokers or other dealers act as ''customers'' within the proposed construct); Goldman (Prop. Trading) (stating that interdealer trading related to hedging or exiting a customer position would be permitted, but expressing concern that requiring each banking entity to justify each of its interdealer trades as being related to one of its own customers would be burdensome and would reduce the effectiveness of the interdealer market). Commenters' concerns regarding interdealer trading are addressed in Part VI.A.3.c.2.c.i., *infra.*

[815] *See infra* Part VI.A.3.c.8.

[816] *See, e.g.,* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012) (recognizing that the proposed rule did not include specific limits on interdealer trading, but expressing concern that explicit or implicit limits could be established by supervisors during or after the conformance period).

[817] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[818] *See* RBC (suggesting that explicitly incorporating liquidity provision to other brokers and dealers in the market-making exemption would be consistent with the statute's reference to meeting the needs of ''counterparties,'' in addition to the needs of clients and customers); AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction); Goldman (Prop. Trading) (representing that the Agencies could evaluate and monitor the amount of interdealer trading that is consistent with a particular trading unit's market making-related or hedging activity through the customer-facing activity category of metrics); Oliver Wyman (Feb. 2012) (recommending removal or modification of any metrics or principles that would indicate that interdealer trading is not permitted).

[819] *See* Prof. Duffie; MetLife; ACLI (Feb. 2012); BDA (Feb. 2012).

[820] *See* Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); MetLife; ACLI (Feb. 2012). *See also* Thakor Study (stating that, when a market maker provides immediacy to a customer, it relies on being able to unwind its positions at opportune times by trading with other market makers, who may have knowledge about impending orders from their own customers that may induce them to trade with the market maker).

[821] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[822] *See* Goldman (Prop. Trading); Chamber (Feb. 2012). *See also* Prof. Duffie (stating that a market maker acquiring a position from a customer may wish to rebalance its inventory relatively quickly through the interdealer network, which is often more efficient than requesting immediacy from another customer or waiting for another customer who wants to take the opposite side of the trade).

[823] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

and a market maker's inventory had been limited to the average daily volume of the market as a whole, 69 percent of customer trades would have been prevented.[824] Some commenters stated that a banking entity would be less able or willing to provide market-making services to customers if it could not engage in interdealer trading.[825]

As noted above, a few commenters stated that market makers may use interdealer trading for price discovery purposes.[826] Some commenters separately discussed the importance of this activity and requested that, when conducted in connection with market-making activity, trading for price discovery be considered permitted market making-related activity under the rule.[827] Commenters indicated that price discovery-related trading results in certain market benefits, including enhancing the accuracy of prices for customers,[828] increasing price efficiency, preventing market instability,[829] improving market liquidity, and reducing overall costs for market participants.[830] As a converse, one of these commenters stated that restrictions on such activity could result in market makers setting their prices too high, exposing them to significant risk and causing a reduction of market-making activity or widening of spreads to offset the risk.[831] One commenter further requested that trading to test market depth likewise be permitted under the market-making exemption.[832] This commenter represented that the Agencies would be able to evaluate the extent to which trading for price discovery and market depth are consistent with market making-related activities for a particular market through a combination of customer-facing activity metrics, including the Inventory Risk Turnover metric, and knowledge of a banking entity's trading business developed by regulators as part of the supervisory process.[833]

vi. Inventory Management

Several commenters requested that the rule provide banking entities with greater discretion to manage their inventories in connection with market making-related activity, including acquiring or disposing of positions in anticipation of customer demand.[834] Commenters represented that market makers need to be able to build, manage, and maintain inventories to facilitate customer demand. These commenters further stated that the rule needs to provide some degree of flexibility for inventory management activities, as inventory needs may differ based on market conditions or the characteristics of a particular instrument.[835] A few commenters cited legislative history in support of allowing banking entities to hold and manage inventory in connection with market making-related activities.[836] Several commenters noted benefits that are associated with a market maker's ability to appropriately manage its inventory, including being able to meet reasonably anticipated future client, customer, or counterparty demand;[837] accommodating customer transactions more quickly and at favorable prices; reducing near term price volatility (in the case of selling a customer block position);[838] helping maintain an orderly market and provide the best price to customers (in the case of accumulating long or short positions in anticipation of a large customer sale or purchase);[839] ensuring that markets continue to have sufficient liquidity;[840] fostering a two-way market; and establishing a market-making presence.[841] Some commenters noted that market makers may need to accumulate inventory to meet customer demand for certain products or under certain trading scenarios, such as to create units of structured products (*e.g.,* ETFs and asset-backed securities)[842] and in anticipation of an index rebalance.[843]

Commenters also expressed views with respect to how much discretion a banking entity should have to manage its inventory under the exemption and how to best monitor inventory levels. For example, one commenter recommended that the rule allow market makers to build inventory in products where they believe customer

[824] *See* Oliver Wyman (Feb. 2012) (basing its finding on data from 2009). This commenter also represented that the natural level of interdealer volume in the U.S. corporate bond market made up 16 percent of total trading volume in 2010. *See id.*

[825] *See* Goldman (Prop. Trading); Morgan Stanley. *See also* BDA (Feb. 2012) (stating that if dealers in the fixed-income market are not able to trade with other dealers to ''cooperate with each other to provide adequate liquidity to the market as a whole,'' an essential source of liquidity will be eliminated from the market and existing values of fixed income securities will decline and become volatile, harming both investors who currently hold such positions and issuers, who will experience increased interest costs).

[826] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

[827] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading). One commenter provided the following example of such activity: if Security A and Security B have some price correlation but neither trades regularly, then a trader may execute a trade in Security A for price discovery purposes, using the price of Security A to make an informed bid-ask market to a customer in Security B. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[828] *See* Goldman (Prop. Trading); Chamber (Feb. 2012) (stating that this type of trading is necessary in more illiquid markets); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[829] *See* Goldman (Prop. Trading).

[830] *See* Chamber (Feb. 2012).

[831] *See id.*

[832] *See* Goldman (Prop. Trading). This commenter represented that market makers often make trades with other dealers to test the depth of the markets at particular price points and to understand where supply and demand exist (although such trading is not conducted exclusively with other dealers). This commenter stated that testing the depth of the market is necessary to provide accurate prices to customers, particularly when customers seeks to enter trades in amounts larger than the amounts offered by dealers who have sent indications to inter-dealer brokers. *See id.*

[833] *See id.*

[834] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC. Inventory management is addressed in Part VI.A.3.c.2.c., *infra.*

[835] *See, e.g.,* MFA (stating that it is critical for banking entities to continue to be able to maintain sufficient levels of inventory, which is dynamic in nature and requires some degree of flexibility in application); RBC (requesting that the Agencies explicitly acknowledge that, depending on market conditions or the characteristics of a particular security, it may be appropriate or necessary for a firm to maintain inventories over extended periods of time in the course of market making-related activities).

[836] *See, e.g.,* RBC; NYSE Euronext; Fidelity. These commenters cited a colloquy in the Congressional Record between Senator Bayh and Senator Dodd, in which Senator Bayh stated: ''With respect to [section 13 of the BHC Act], the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market-making activities, provided that activity does not exceed the reasonably expected near-term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market-making function. Without that flexibility, market makers would not be able to provide liquidity to markets.'' 156 Cong. Rec. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh).

[837] *See, e.g.,* RBC.

[838] *See* Goldman (Prop. Trading).

[839] *See id.*

[840] *See* MFA.

[841] *See* RBC.

[842] *See* Goldman (Prop. Trading); BoA.

[843] *See* Oliver Wyman (Feb. 2012). As this commenter explained, some mutual funds and ETFs track major equity indices and, when the composition of an index changes (*e.g.,* due to the addition or removal of a security or to rising or falling values of listed shares), an announcement is made and all funds tracking the index need to rebalance their portfolios. According to the commenter, banking entities may need to step in to provide liquidity for rebalances of less liquid indices because trades executed on the open market would substantially affect share prices. The commenter estimated that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year. This commenter identified the proposed inventory metrics in Appendix A as potentially limiting a banking entity's willingness or ability to facilitate index rebalance trades. *See id.* Two other commenters also discussed the index rebalancing scenario. *See* Prof. Duffie; Thakor Study. Index rebalancing is addressed in note 931, *infra.*

demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand.[844] A few commenters suggested that the Agencies provide banking entities with greater discretion to accumulate inventory, but discourage market makers from holding inventory for long periods of time by imposing increasingly higher capital requirements on aged inventory.[845] One commenter represented that a trading unit's inventory management practices could be monitored with the Inventory Risk Turnover metric, in conjunction with other metrics.[846]

vii. Acting as an Authorized Participant or Market Maker in Exchange-Traded Funds

With respect to ETF trading, commenters generally requested clarification that a banking entity can serve as an authorized participant (''AP'') to an ETF issuer or can engage in ETF market making under the proposed exemption.[847] According to commenters, APs may engage in the following types of activities with respect to ETFs: (i) Trading directly with the ETF issuer to create or redeem ETF shares, which involves trading in ETF shares and the underlying components;[848] (ii) trading to maintain price alignment between the ETF shares and the underlying components;[849] (iii) traditional market-making activity;[850] (iv) ''seeding'' a new ETF by entering into several initial creation transactions with an ETF issuer and holding the ETF shares, possibly for an extended period of time, until the ETF establishes regular trading and liquidity in the secondary markets;[851] (v) ''create to lend'' transactions, where an AP enters a creation transaction with the ETF issuer and lends the ETF shares to an investor;[852] and (vi) hedging.[853] A few commenters noted that an AP may not engage in traditional market-making activity in the relevant ETF and expressed concern that the proposed rule may limit a banking entity's ability to act in an AP capacity.[854] One commenter estimated that APs that are banking entities make up between 20 percent to 100 percent of creation and redemption activity for individual ETFs, with an average of approximately 35 percent of creation and redemption activity across all ETFs attributed to banking entities. This commenter expressed the view that, if the rule limits banking entities' ability to serve as APs, then individual investors' investments in ETFs will become more expensive due to higher premiums and discounts versus the ETF's NAV.[855]

A number of commenters stated that certain requirements of the proposed exemption may limit a banking entity's ability to serve as AP to an ETF, including the proposed near term customer demand requirement,[856] the proposed source of revenue requirement,[857] and language in the proposal regarding arbitrage trading.[858] With respect to the proposed near term customer demand requirement, a few commenters noted that this requirement could prevent an AP from building inventory to assemble creation units.[859] Two other commenters expressed the view that the ETF issuer would be the banking entity's ''counterparty'' when the banking entity trades directly with the ETF issuer, so this trading and inventory accumulation would meet the terms of the proposed requirement.[860] To permit banking entities to act as APs, two commenters suggested that trading in the capacity of an AP should be deemed permitted market making-related activity, regardless of whether the AP is acting as a traditional market maker.[861]

viii. Arbitrage or Other Activities That Promote Price Transparency and Liquidity

In response to a question in the proposal,[862] a number of commenters

[844] *See* Credit Suisse (Seidel).

[845] *See* CalPERS; Vanguard. These commenters represented that placing increasing capital requirements on aged inventory would ease the rule's impact on investor liquidity, allow banking entities to internalize the cost of continuing to hold a position at the expense of its ability to take on new positions, and potentially decrease the possibility of a firm realizing a loss on a position by decreasing the time such position is held. *See id.* One commenter noted that some banking entities already use this approach to manage risk on their market-making desks. *See* Vanguard. *See also* Capital Group (suggesting that one way to implement the statutory exemption would be to charge a trader or a trading desk for positions held on its balance sheet beyond set time periods and to increase the charge at set intervals). These comments are addressed in note 923, *infra.*

[846] *See* Goldman (Prop. Trading) (representing that the Inventory Risk Turnover metric will allow the Agencies to evaluate the length of time that a trading unit tends to hold risk positions in inventory and whether that holding time is consistent with market making-related activities in the relevant market).

[847] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (stating that an AP may trade with the ETF issuer in different capacities—in connection with traditional market-making activity, on behalf of customers, or for the AP's own account); ICI Global (discussing non-U.S. ETFs specifically); Vanguard; SSgA (Feb. 2012). One commenter represented that an AP's transactions in ETFs do not create risks associated with proprietary trading because, when an AP trades with an ETF issuer for its own account, the AP typically enters into an offsetting transaction in the underlying portfolio of securities, which cancels out investment risk and limits the AP's exposure to the difference between the market price for ETF shares and the ETF's net asset value (''NAV''). *See* Vanguard.

With respect to market-making activity in an ETF, several commenters noted that market makers play an important role in maintaining price alignment by engaging in arbitrage transactions between the ETF shares and the shares of the underlying components. *See, e.g.,* JPMC; Goldman (Prop. Trading) (making similar statement with respect to ADRs as well); SSgA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC. AP and market maker activity in ETFs are addressed in Part VI.A.3.c.2.c.i., *infra.*

[848] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; ICI (Feb. 2012) ICI Global; Vanguard; SSgA (Feb. 2012).

[849] *See* JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); ICI (Feb. 2012) ICI Global.

[850] *See* ICI Global; ICI (Feb. 2012) SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[851] *See* BoA; ICI (Feb. 2012); ICI Global.

[852] *See* BoA (stating that lending the ETF shares to an investor gives the investor a more efficient way to hedge its exposure to assets correlated with those underlying the ETF).

[853] *See* ICI Global; ICI (Feb. 2012).

[854] *See, e.g.,* Vanguard (noting that APs may not engage in market-making activity in the ETF and expressing concern that if AP activities are not separately permitted, banking entities may exit or not enter the ETF market); SSgA (Feb. 2012) (stating that APs are under no obligation to make markets in ETF shares and requiring such an obligation would discourage banking entities from acting as APs); ICI (Feb. 2012).

[855] *See* SSgA (Feb. 2012). This commenter further stated that as of 2011, an estimated 3.5 million—or 3 percent—of U.S. households owned ETFs and, as of September 2011, ETFs represented assets of approximately $951 billion. *See id.*

[856] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[857] *See* BoA. This commenter noted that the proposed source of revenue requirement could be interpreted to prevent a banking entity acting as AP from entering into creation and redemption transactions, ''seeding'' an ETF, engaging in ''create to lend'' transactions, and performing secondary market making in an ETF because all of these activities require an AP to build an inventory—either in ETF shares or the underlying components—which often result in revenue attributable to price movements. *See id.*

[858] Commenters noted that this language would restrict an AP from engaging in price arbitrage to maintain efficient markets in ETFs. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See supra* Part VI.A.3.c.2.a. (discussing the proposal's proposed interpretation regarding arbitrage trading).

[859] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[860] *See* ICI Global; ICI (Feb. 2012).

[861] *See* ICI (Feb. 2012) ICI Global. These commenters provided suggested rule text on this issue and suggested that the Agencies could require a banking entity's compliance policies and internal controls to take a comprehensive approach to the entirety of an AP's trading activity, which would facilitate easy monitoring of the activity to ensure compliance. *See id.*

[862] *See* Joint Proposal, 76 FR at 68873 (question 91) (inquiring whether the proposed exemption should be modified to permit certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency but do not

Continued

stated that certain types of arbitrage activity should be permitted under the market-making exemption.[863] For example, some commenters stated that a banking entity's arbitrage activity should be considered market making to the extent the activity is driven by creating markets for customers tied to the price differential (*e.g.,* ''box'' strategies, ''calendar spreads,'' merger arbitrage, ''Cash and Carry,'' or basis trading)[864] or to the extent that demand is predicated on specific price relationships between instruments (*e.g.,* ETFs, ADRs) that market makers must maintain.[865] Similarly, another commenter suggested that arbitrage activity that aligns prices should be permitted, such as index arbitrage, ETF arbitrage, and event arbitrage.[866] One commenter noted that many markets, such as futures and options markets, rely on arbitrage activities of market makers for liquidity purposes and to maintain convergence with underlying instruments for cash-settled options, futures, and index-based products.[867] Commenters stated that arbitrage trading provides certain market benefits, including enhanced price transparency,[868] increased market efficiency,[869] greater market liquidity,[870] and general benefits to customers.[871] A few commenters noted that certain types of hedging activity may appear to have characteristics of arbitrage trading.[872]

Commenters suggested certain methods for permitting and monitoring arbitrage trading under the exemption. For example, one commenter suggested a framework for permitting certain arbitrage within the market-making exemption, with requirements such as: (i) Common personnel with market-making activity; (ii) policies that cover the timing and appropriateness of arbitrage positions; (iii) time limits on arbitrage positions; and (iv) compensation that does not reward successful arbitrage, but instead pools any such revenues with market-making profits and losses.[873] A few commenters represented that, if permitted under the rule, the Agencies would be able to monitor arbitrage activities for patterns of impermissible proprietary trading through the use of metrics, as well as compliance and examination tools.[874]

Other commenters stated that the exemption should not permit certain types of arbitrage. One commenter stated that the rule should ensure that relative value and complex arbitrage strategies cannot be conducted.[875] Another commenter expressed the view that the market-making exemption should not permit any type of arbitrage transactions. This commenter stated that, in the event that liquidity or transparency is inhibited by a lack of arbitrage trading, a market maker should be able to find a customer who would seek to benefit from it.[876]

ix. Primary Dealer Activities

A number of commenters requested that the market-making exemption permit banking entities to meet their primary dealer obligations in foreign jurisdictions, particularly if trading in foreign sovereign debt is not separately exempted in the final rule.[877] According to commenters, a banking entity may be obligated to perform the following activities in its capacity as a primary dealer: undertaking to maintain an orderly market, preventing or correcting any price dislocations,[878] and bidding on each issuance of the relevant jurisdiction's sovereign debt.[879] Commenters expressed concern that a banking entity's trading activity as primary dealer may not comply with the proposed near term customer demand requirement[880] or the proposed source of revenue requirement.[881] To address the first issue, one commenter stated that the final rule should clarify that a banking entity acting as a primary dealer of foreign sovereign debt is engaged in primary dealer activity in response to the near term demands of the sovereign, which should be considered a client, customer, or counterparty of the banking entity.[882] Another commenter suggested that the Agencies permit primary dealer activities through commentary stating that fulfilling primary dealer obligations will not be included in determinations of whether the market-making exemption applies to a trading unit.[883]

x. New or Bespoke Products or Customized Hedging Contracts

Several commenters indicated that the proposed exemption does not adequately address market making in new or bespoke products, including structured, customer-driven transactions, and requested that the rule be modified to clearly permit such activity.[884] Many of these commenters

service client, customer, or counterparty demand); CFTC Proposal, 77 FR at 8359.

[863] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012). Arbitrage trading is further discussed in Part VI.A.3.c.2.c.i., *infra.*

[864] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[865] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[866] *See* Credit Suisse (Seidel).

[867] *See* RBC.

[868] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[869] *See* Credit Suisse (Seidel); RBC.

[870] *See* RBC.

[871] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; FTN; ISDA (Feb. 2012) (stating that arbitrage activities often yield positions that are ultimately put to use in serving customer demand and representing that the process of consistently trading makes a dealer ready and available to serve customers on a competitive basis).

[872] *See* JPMC (stating that firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and transferred by means of internal transactions to a single utility desk (which hedges all of the risks in the aggregate), and this may optically bear some characteristics of arbitrage, although the commenter requested that such activity be recognized as permitted market making-related activity under the rule); ISDA (Feb. 2012) (stating that in some swaps markets, dealers hedge through multiple instruments, which can give an impression of arbitrage in a function that is risk reducing; for example, a dealer in a broad index equity swap may simultaneously hedge in baskets of stocks, futures, and ETFs). *But see* Sens. Merkley & Levin (Feb. 2012) (''When banks use complex hedging techniques or otherwise engage in trading that is suggestive of arbitrage, regulators should require them to provide evidence and analysis demonstrating what risk is being reduced.'').

[873] *See* FTN.

[874] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). One of these commenters stated that the customer-facing activity category of metrics, as well as other metrics, would be available to evaluate whether the trading unit is engaged in a directly customer-facing business and the extent to which its activities are consistent with the market-making exemption. *See* Goldman (Prop. Trading).

[875] *See* Johnson & Prof. Stiglitz. *See also* AFR *et al.* (Feb. 2012) (noting that arbitrage, spread, or carry trades are a classic type of proprietary trade).

[876] *See* Occupy.

[877] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. *See infra* notes 905 to 906 and accompanying text (addressing these comments).

[878] *See* Goldman (Prop. Trading).

[879] *See* Banco de México.

[880] *See* JPMC; Banco de México. These commenters stated that a primary dealer is required to assume positions in foreign sovereign debt even when near term customer demand is unpredictable. *See id.*

[881] *See* Banco de México (stating that primary dealers need to be able to profit from their positions in sovereign debt, including by holding significant positions in anticipation of future price movements, so that the primary dealer business is financially attractive); IIB/EBF (stating that primary dealers may actively seek to profit from price and interest rate movements based on their debt holdings, which governments support as providing much-needed liquidity for securities that are otherwise purchased largely pursuant to buy-and-hold strategies of institutional investors and other entities seeking safe returns and liquidity buffers).

[882] *See* Goldman (Prop. Trading).

[883] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[884] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). This issue is addressed in Part VI.A.3.c.1.c.iii., *supra,* and Part VI.A.3.c.2.c.iii., *infra.*

emphasized the role such transactions play in helping customers hedge the unique risks they face.[885] Commenters stated that, as a result, limiting a banking entity's ability to conduct such transactions would subject customers to increased risks and greater transaction costs.[886] One commenter suggested that the Agencies explicitly state that a banking entity's general willingness to engage in bespoke transactions is sufficient to make it a market maker in unique products for purposes of the rule.[887]

Other commenters stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or customized derivatives.[888] For example, one commenter suggested that a banking entity be required to disaggregate such derivatives into liquid risk elements and illiquid risk elements, with liquid risk elements qualifying for the market-making exemption and illiquid risk elements having to be conducted on a riskless principal basis under § 75.6(b)(1)(ii) of the proposed rule. According to this commenter, such an approach would not impact the end user customer.[889] Another commenter stated that a banking entity making a market in bespoke instruments should be required both to hold itself out in accordance with § 75.4(b)(2)(ii) of the proposed rule and to demonstrate the purchase and the sale of such an instrument.[890]

c. Final Near Term Customer Demand Requirement

Consistent with the statute, § 75.4(b)(2)(ii) of the final rule's market-making exemption requires that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on certain market factors and analysis.[891] As discussed above in Part VI.A.3.c.1.c.ii., the trading desk's market-maker inventory consists of positions in financial instruments in which the trading desk stands ready to purchase and sell consistent with the final rule.[892] The final rule requires the financial instruments to be identified in the trading desk's compliance program. Thus, this requirement focuses on a trading desk's positions in financial instruments for which it acts as market maker. These positions of a trading desk are more directly related to the demands of customers than positions in financial instruments used for risk management purposes, but in which the trading desk does not make a market. As noted above, a position or exposure that is included in a trading desk's market-maker inventory will remain in its market-maker inventory for as long as the position or exposure is managed by the trading desk. As a result, the trading desk must continue to account for that position or exposure, together with other positions and exposures in its market-maker inventory, in determining whether the amount, types, and risks of its market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

While the near term customer demand requirement directly applies only to the trading desk's market-maker inventory, this does not mean a trading desk may establish other positions, outside its market-maker inventory, that exceed what is needed to manage the risks of the trading desk's market making-related activities and inventory. Instead, a trading desk must have limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its aggregate financial exposure that are based on the factors set forth in the near term customer demand requirement, as well as other relevant considerations regarding the nature and amount of the trading desk's market making-related activities. A banking entity must establish, implement, maintain, and enforce a limit structure, as well as other compliance program elements (*e.g.,* those specifying the instruments a trading desk trades as a market maker or may use for risk management purposes and providing for specific risk management procedures), for each trading desk that are designed to prevent the trading desk from engaging in trading activity that is unrelated to making a market in a particular type of financial instrument or managing the risks associated with making a market in that type of financial instrument.[893]

To clarify the application of this standard in response to comments,[894] the final rule provides two factors for assessing whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties. Specifically, the following must be considered under the revised standard: (i) The liquidity, maturity, and depth of the market for the relevant type of financial instrument(s),[895] and (ii) demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments in which the trading desk makes a market, including through block trades. Under the final rule, a banking entity must account for these considerations when establishing risk and inventory limits for each trading desk.[896]

For purposes of this provision, ''demonstrable analysis'' means that the analysis for determining the amount, types, and risks of financial instruments a trading desk may manage in its market-maker inventory, in accordance with the near term demand requirement, must be based on factors that can be demonstrated in a way that makes the analysis reviewable. This may include, among other things, the normal trading records of the trading desk and market information that is readily available and retrievable. If the analysis cannot be supported by the banking entity's books and records and available market data, on their own, then the other factors utilized must be identified and documented and the analysis of those factors together with the facts gathered from the trading and market records must be identified in a way that makes it possible to test the analysis.

[885] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[886] *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[887] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[888] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[889] *See* AFR *et al.* (Feb. 2012).

[890] *See* Public Citizen.

[891] The final rule includes certain refinements to the proposed standard, which would have required that the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § 75.4(b)(2)(iii).

[892] *See supra* Part VI.A.3.c.1.c.ii.; final rule § 75.4(b)(5).

[893] *See infra* Part VI.A.3.c.3. (discussing the compliance program requirements); final rule § 75.4(b)(2)(iii).

[894] *See supra* Part VI.A.3.c.2.b.i.

[895] This language has been added to the final rule to respond to commenters' concerns that the proposed near term demand requirement would be unworkable in less liquid markets or would otherwise restrict a market maker's ability to hold and manage its inventory in less liquid markets. *See supra* Part VI.A.3.c.2.b.ii. In addition, this provision is substantially similar to one commenter's suggested approach of adding the phrase ''based on the characteristics of the relevant market and asset class'' to the proposed requirement, but the Agencies have added more specificity about the relevant characteristics that should be taken into consideration. *See* Morgan Stanley.

[896] *See infra* Part VI.A.3.c.3.

Importantly, a determination of whether a trading desk's market-maker inventory is appropriate under this requirement will take into account reasonably expected near term customer demand, including historical levels of customer demand, expectations based on market factors, and current demand. For example, at any particular time, a trading desk may acquire a position in a financial instrument in response to a customer's request to sell the financial instrument or in response to reasonably expected customer buying interest for such instrument in the near term.[897] In addition, as discussed below, this requirement is not intended to impede a trading desk's ability to engage in certain market making-related activities that are consistent with and needed to facilitate permissible trading with its clients, customers, or counterparties, such as inventory management and interdealer trading. These activities must, however, be consistent with the analysis conducted under the final rule and the trading desk's limits discussed below.[898] Moreover, as explained below, the banking entity must also have in place escalation procedures to address, analyze, and document trades made in response to customer requests that would exceed one of a trading desk's limits.

The near term demand requirement is an ongoing requirement that applies to the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory. For instance, a trading desk may acquire exposures as a result of entering into market-making transactions with customers that are within the desk's market-marker inventory and financial exposure limits. Even if the trading desk is appropriately managing the risks of its market-maker inventory, its market-maker inventory still must be consistent with the analysis of the reasonably expected near term demands of clients, customers, and counterparties and the liquidity, maturity and depth of the market for the relevant instruments in the inventory. Moreover, the trading desk must take action to ensure that its financial exposure does not exceed its financial exposure limits.[899] A trading desk may not maintain an exposure in its market-maker inventory, irrespective of customer demand, simply because the exposure is hedged and the resulting financial exposure is below the desk's financial exposure limit. In addition, the amount, types, and risks of financial instruments in a trading desk's market-maker inventory would not be consistent with permitted market-making activities if, for example, the trading desk has a pattern or practice of retaining exposures in its market-maker inventory, while refusing to engage in customer transactions when there is customer demand for those exposures at commercially reasonable prices.

The following is an example of the interplay between a trading desk's market-maker inventory and financial exposure. An airline company customer may seek to hedge its long-term exposure to price fluctuations in jet fuel by asking a banking entity to create a structured ten-year, $1 billion jet fuel swap for which there is no liquid market. A trading desk that makes a market in energy swaps may service its customer's needs by executing a custom jet fuel swap with the customer and holding the swap in its market-maker inventory, if the resulting transaction does not cause the trading desk to exceed its market-maker inventory limit on the applicable class of instrument, or the trading desk has received approval to increase the limit in accordance with the authorization and escalation procedures under paragraph (b)(2)(iii)(E). In keeping with the market-making exemption as provided in the final rule, the trading desk would be required to hedge the risk from this swap, either individually or as part of a set of aggregated positions, if the trade would result in a financial exposure that exceeds the desk's financial exposure limits. The trading desk may hedge the risk of the swap, for example, by entering into one or more futures or swap positions that are identified as permissible hedging products, instruments, or exposures in the trading desk's compliance program and that analysis, including correlation analysis as appropriate, indicates would demonstrably reduce or otherwise significantly mitigate risks associated with the financial exposure from its market-making activities. Alternatively, if the trading desk also acts as a market maker in crude oil futures, then the desk's exposures arising from its market-making activities may naturally hedge the jet fuel swap (*i.e.,* it may reduce its financial exposure levels resulting from such instruments).[900] The trading desk must continue to appropriately manage risks of its financial exposure over time in accordance with its financial exposure limits.

As discussed above, several commenters expressed concern that the near-term customer demand requirement is too restrictive and that it could impede a market maker's ability to build or retain inventory, particularly in less liquid markets where demand is intermittent.[901] Because customer demand in illiquid markets can be difficult to predict with precision, market-maker inventory may not closely track customer order flow. The Agencies acknowledge that market makers will face costs associated with demonstrating that market-maker inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers, as required by the statute and the final rule because this is an analysis that banking entities may not currently undertake. However, the final rule includes certain modifications to the proposed rule that are intended to reduce the negative impacts cited by commenters, such as limitations on inventory management activity and potential restrictions on market making in less liquid instruments, which the Agencies believe should reduce the perceived burdens of the proposed near term demand requirement. For example, the final rule recognizes that liquidity, maturity, and depth of the market vary across asset classes. The Agencies expect that the express recognition of these differences in the rule should avoid unduly impeding a market maker's ability to build or retain inventory. More specifically, the Agencies recognize the relationship between market-maker inventory and customer order flow can vary across asset classes and that an inflexible standard for demonstrating that inventory does not exceed reasonably expected near term demand could provide an incentive to stop making markets in illiquid asset classes.

i. Definition of ''client,'' ''customer,'' and ''counterparty''

In response to comments requesting further definition of the terms ''client,'' ''customer,'' and ''counterparty'' for purposes of this standard,[902] the Agencies have defined these terms in the final rule. In particular, the final

[897] As discussed further below, acquiring a position in a financial instrument in response to reasonably expected customer demand would not include creating a structured product for which there is no current customer demand and, instead, soliciting customer demand during or after its creation. *See infra* note 938 and accompanying text; Sens. Merkley & Levin (Feb. 2012).

[898] The formation of structured finance products and securitizations is discussed in detail in Part VI.B.2.b. of this **SUPPLEMENTARY INFORMATION**.

[899] *See* final rule § 75.4(b)(2)(iii)(B), (C).

[900] This natural hedge with futures would introduce basis risk which, like other risks of the trading desk, must be managed within the desk's limits.

[901] *See* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012) RBC.

[902] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

rule defines ''client,'' ''customer,'' and ''counterparty'' as, on a collective or individual basis, ''market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services.'' [903] However, for purposes of the analysis supporting the market-maker inventory held to meet the reasonably expected near-term demands of clients, customer and counterparties, a client, customer, or counterparty of the trading desk does not include a trading desk or other organizational unit of another entity if that entity has $50 billion or more in total trading assets and liabilities, measured in accordance with § 75.20(d)(1),[904] unless the trading desk documents how and why such trading desk or other organizational unit should be treated as a customer or the transactions are conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.[905]

The Agencies believe this definition is generally consistent with the proposed interpretation of ''customer'' in the proposal. The proposal generally provided that, for purposes of market making on an exchange or other organized trading facility, a customer is any person on behalf of whom a buy or sell order has been submitted. In the context of the over-the-counter market, a customer was generally considered to be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship for such services.[906] The definition of client, customer, and counterparty in the final rule recognizes that, in the context of market making in a financial instrument that is executed on an exchange or other organized trading facility, a client, customer, or counterparty would be any person whose buy or sell order executes against the banking entity's quotation posted on the exchange or other organized trading facility.[907] Under these circumstances, the person would be trading with the banking entity in response to the banking entity's quotations and obtaining the banking entity's market making-related services. In the context of market making in a financial instrument in the OTC market, a client, customer, or counterparty generally would be a person that makes use of the banking entity's intermediation services, either by requesting such services (possibly via a request-for-quote on an established trading facility) or entering into a continuing relationship with the banking entity with respect to such services. For purposes of determining the reasonably expected near-term demands of customers, a client, customer, or counterparty generally would not include a trading desk or other organizational unit of another entity that has $50 billion or more in total trading assets except if the trading desk has a documented reason for treating the trading desk or other organizational unit of such entity as a customer or the trading desk's transactions are executed anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants. The Agencies believe that this exclusion balances commenters' suggested alternatives of either defining as a client, customer, or counterparty anyone who is on the other side of a market maker's trade [908] or preventing any banking entity from being a client, customer, or counterparty.[909] The Agencies believe that the first alternative is overly broad and would not meaningfully distinguish between permitted market making-related activity and impermissible proprietary trading. For example, the Agencies are concerned that such an approach would allow a trading desk to maintain an outsized inventory and to justify such inventory levels as being tangentially related to expected market-wide demand. On the other hand, preventing any banking entity from being a client, customer, or counterparty under the final rule would result in an overly narrow definition that would significantly impact banking entities' ability to provide and access market making-related services. For example, most banks look to market makers to provide liquidity in connection with their investment portfolios.

The Agencies further note that, with respect to a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of the market-making exemption as well as the underwriting exemption.[910] The Agencies believe this interpretation, together with the modifications in the rule that eliminate the requirement to distinguish between revenues from spreads and price appreciation and the recognition that the market-making exemption extends to market making-related activities appropriately captures the unique relationship between a primary dealer and the sovereign government. Thus, generally a banking entity may rely on the market-making exemption for its activities as primary dealer (or functional equivalent) to the extent those activities are outside of the underwriting exemption.[911]

[903] Final rule § 75.4(b)(3).

[904] *See* final rule § 75.4(b)(3)(i). The Agencies are using a $50 billion threshold for these purposes in recognition that firms engaged in substantial trading activity do not typically act as customers to other market makers, while smaller regional firms may seek liquidity from larger firms as part of their market making-related activities.

[905] *See* final rule § 75.4(b)(3)(i)(A), (B). In Appendix C of the proposed rule, a trading unit engaged in market making-related activities would have been required to describe how it identifies its customers for purposes of the Customer-Facing Trading Ratio, if applicable, including documentation explaining when, how, and why a broker-dealer, swap dealer, security-based swap dealer, or any other entity engaged in market making-related activities, or any affiliate thereof, is considered to be a customer of the trading unit. *See* Joint Proposal, 76 FR at 68964. While the proposed approach would not have necessarily prevented any of these entities from being considered a customer of the trading desk, it would have required enhanced documentation and justification for treating any of these entities as a customer. The final rule's exclusion from the definition of client, customer, and counterparty is similar to the proposed approach, but is more narrowly focused on firms that have $50 billion or more trading assets and liabilities because, as noted above, the Agencies believe firms engaged in such substantial trading activity are less likely to act as customers to market makers than smaller regional firms.

[906] *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439.

[907] *See, e.g.,* Goldman (Prop. Trading) (explaining generally how exchange-based market makers operate).

[908] *See* ISDA (Feb. 2012). In addition, a number of commenters suggested that the rule should not limit broker-dealers from being customers of a market maker. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC; Comm. on Capital Markets Regulation.

[909] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[910] A primary dealer is a firm that trades a sovereign government's obligations directly with the sovereign (in many cases, with the sovereign's central bank) as well as with other customers through market making. The sovereign government may impose conditions on a primary dealer or require that it engage in certain trading in the relevant government obligations (*e.g.,* participate in auctions for the government obligation or maintain a liquid secondary market in the government obligations). Further, a sovereign government may limit the number of primary dealers that are authorized to trade with the sovereign. A number of countries use a primary dealer system, including Australia, Brazil, Canada, China-Hong Kong, France, Germany, Greece, India, Indonesia, Ireland, Italy, Japan, Mexico, Netherlands, Portugal, South Africa, South Korea, Spain, Turkey, the U.K., and the U.S. *See, e.g.,* Oliver Wyman (Feb. 2012). The Agencies note that this standard would similarly apply to the relationship between a banking entity and a sovereign that does not have a formal primary dealer system, provided the sovereign's process functions like a primary dealer framework.

[911] *See* Goldman (Prop. Trading). *See also supra* Part VI.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity). Each suggestion regarding the treatment of primary dealer activity has not been incorporated into the

Continued

For exchange-traded funds (''ETFs'') (and related structures), Authorized Participants (''APs'') are generally the conduit for market participants seeking to create or redeem shares of the fund (or equivalent structure).[912] For example, an AP may buy ETF shares from market participants who would like to redeem those shares for cash or a basket of instruments upon which the ETF is based. To provide this service, the AP may in turn redeem these shares from the ETF itself. Similarly, an AP may receive cash or financial instruments from a market participant seeking to purchase ETF shares, in which case the AP may use that cash or set of financial instruments to create shares from the ETF. In either case, for the purpose of the market-making exemption, such market participants as well as the ETF itself would be considered clients, customers, or counterparties of the AP.[913] The inventory of ETF shares or underlying instruments held by the AP can therefore be evaluated under the criteria of the market-making exemption, such as how these holdings relate to reasonably expected near term customer demand.[914] These criteria can be similarly applied to other activities of the AP, such as building inventory to ''seed'' a new ETF or engaging in ETF-loan related transactions.[915] The Agencies recognize that banking entities currently conduct a substantial amount of AP creation and redemption activity in the ETF market and, thus, if the rule were to prevent or restrict a banking entity from acting as an AP for an ETF, then the rule would impact the functioning of the ETF market.[916]

Some firms, whether or not an AP in a given ETF, may also actively engage in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another. Sometimes these firms will register as market makers on an exchange for a given ETF, but other times they may not register as market maker. Regardless of whether or not the firm is registered as a market maker on any given exchange, this activity not only provides liquidity for ETFs, but also, and very importantly, helps keep the market price of an ETF in line with the NAV of the fund. The market-making exemption can be used to evaluate trading that is intended to maintain price continuity between these exchangeable instruments by considering how the firm quotes, maintains risk and exposure limits, manages its inventory and risk, and, in the case of APs, exercises its ability to create and redeem shares from the fund. Because customers take positions in ETFs with an expectation that the price relationship will be maintained, such trading can be considered to be market making-related activity.[917]

After considering comments, the Agencies continue to take the view that a trading desk would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading or other trading that is not in response to, or driven by, the demands of clients, customers, or counterparties.[918] The Agencies believe this activity, which is not in response to or driven by customer demand, is inconsistent with the Congressional intent that market making-related activity be designed not to exceed the reasonably expected near term demands

rule. Specifically, the exemption for market making as applied to a primary dealer does not extend without limitation to primary dealer activities that are not conducted under the conditions of one of the exemptions. These interpretations would be inconsistent with Congressional intent for the statute, to limit permissible market- making activity through the statute's near term demand requirement and, thus, does not permit trading without limitation. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. Rather, recognizing that market making by primary dealers is a key function, the limits and other conditions of the rule are flexible enough to permit necessary market making-related activities.

[912] ETF sponsors enter into relationships with one or more financial institutions that become APs for the ETF. Only APs are permitted to purchase and redeem shares directly from the ETF, and they can do so only in large aggregations or blocks that are commonly called ''creation units.'' In response to a question in the proposal, a number of commenters expressed concern that the proposed market-making exemption may not permit certain AP and market maker activities in ETFs and requested clarification that these activities would be permitted under the market-making exemption. *See* Joint Proposal, 76 FR at 68873 (question 91) (''Do particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed in the proposal? If so, how could the proposal better address those instruments, markets or market features?''); CFTC Proposal, 77 FR at 8359 (question 91); *supra* Part VI.A.3.c.2.b.vii. (discussing comments on this issue).

[913] This is consistent with two commenters' request that an ETF issuer be considered a ''counterparty'' of the banking entity when it trades directly with the ETF issuer as an AP. *See* ICI Global; ICI (Feb. 2012). Further, this approach is intended to address commenters' concerns that the near term demand requirement may limit a banking entity's ability to act as AP for an ETF. *See* BoA; Vanguard. The Agencies believe that one commenter's concern about the impact of the proposed source of revenue requirement on AP activity should be addressed by the replacement of this proposed requirement with a metric-based focus on when a trading desk generates revenue from its trading activity. *See* BoA; *infra* Part VI.A.3.c.7.c. (discussing the new approach to assessing a trading desk's pattern of profit and loss).

[914] This does not imply that the AP must perfectly predict future customer demand, but rather that there is a demonstrable, statistical, or historical basis for the size of the inventory held, as more fully discussed below. Consider, for example, a fixed-income ETF with $500 million in assets. If, on a typical day, an AP generates requests for $10 to $20 million of creations or redemptions, then an inventory of $10 to $20 million in bonds upon which the ETF is based (or some small multiple thereof) could be construed as consistent with reasonably expected near term customer demand. On the other hand, if under the same circumstances an AP holds $1 billion of these bonds solely in its capacity as an AP for this ETF, it would be more difficult to justify this as needed for reasonably expected near term customer demand and may be indicative of an AP engaging in prohibited proprietary trading.

[915] In ETF loan transactions (also referred to as ''create-to-lend'' transactions), an AP borrows the underlying instruments that form the creation basket of an ETF, submits the borrowed instruments to the ETF agent in exchange for a creation unit of ETF shares, and lends the resulting ETF shares to a customer that wants to borrow the ETF. At the end of the ETF loan, the borrower returns the ETF shares to the AP, and the AP redeems the ETF shares with the ETF agent in exchange for the underlying instruments that form the creation basket. The AP may return the underlying instruments to the parties from whom it borrowed them or may use them for another loan, as long as the AP is not obligated to return them at that time. For the term of the ETF loan transaction, the AP hedges against market risk arising from any rebalancing of the ETF, which would change the amount or type of underlying instruments the AP would receive in exchange for the ETF compared to the underlying instruments the AP borrowed and submitted to the ETF agent to create the ETF shares. *See* David J. Abner, ''The ETF Handbook,'' Ch. 12 (2010); Jean M. McLoughlin, Davis Polk & Wardwell LLP, to Division of Corporation Finance, U.S. Securities and Exchange Commission, dated Jan. 23, 2013, available at *http://www.sec.gov/divisions/corpfin/cf-noaction/2013/davis-polk-wardwell-llp-012813-16a.pdf.*

[916] *See* SSgA (Feb. 2012).

[917] A number of commenters expressed concern that the proposed rule would limit market making or AP activity in ETFs because market makers and APs engage in trading to maintain a price relationship between ETFs and their underlying components, which promotes ETF market efficiency. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); Credit Suisse (Prop. Trading).

[918] Some commenters suggested that a range of arbitrage trading should be permitted under the market-making exemption. *See, e.g.,* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC. Other commenters, however, stated that arbitrage trading should be prohibited under the final rule. *See* AFR *et al.* (Feb. 2012); Volcker; Occupy. In response to commenters representing that it would be difficult to comply with this standard because it requires a trading desk to determine the proportionality of its activities in response to customer demand compared to its activities that are not in response to customer demand, the Agencies believe that the statute requires a banking entity to distinguish between market making-related activities that are designed not to exceed the reasonably expected near term demands of customers and impermissible proprietary trading. *See* Goldman (Prop. Trading); RBC.

of clients, customers, or counterparties. For example, a trading desk would not be permitted to engage in general statistical arbitrage trading between instruments that have some degree of correlation but where neither instrument has the capability of being exchanged, converted, or exercised for or into the other instrument. A trading desk may, however, act as market maker to a customer engaged in a statistical arbitrage trading strategy. Furthermore as suggested by some commenters,[919] trading activity used by a market maker to maintain a price relationship that is expected and relied upon by clients, customers, and counterparties is permitted as it is related to the demands of clients, customers, or counterparties because the relevant instrument has the capability of being exchanged, converted, or exercised for or into another instrument.[920]

The Agencies recognize that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of its inventory management activities and that interdealer trading provides certain market benefits, such as more efficient matching of customer order flow, greater hedging options to reduce risk, and enhanced ability to accumulate or exit customer-related positions.[921] The final rule does not prohibit a trading desk from using the market-making exemption to engage in interdealer trading that is consistent with and related to facilitating permissible trading with the trading desk's clients, customers, or counterparties.[922] However, in determining the reasonably expected near term demands of clients, customers, or counterparties, a trading desk generally may not account for the expected trading interests of a trading desk or other organizational unit of an entity with aggregate trading assets and liabilities of $50 billion or greater (except if the trading desk documents why and how a particular trading desk or other organizational unit at such a firm should be considered a customer or the trading desk or conduct market-making activity anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants).[923]

A trading desk may engage in interdealer trading to: Establish or acquire a position to meet the reasonably expected near term demands of its clients, customers, or counterparties, including current demand; unwind or sell positions acquired from clients, customers, or counterparties; or engage in risk-mitigating or inventory management transactions.[924] The Agencies believe that allowing a trading desk to continue to engage in customer-related interdealer trading is appropriate because it can help a trading desk appropriately manage its inventory and risk levels and can effectively allow clients, customers, or counterparties to access a larger pool of liquidity. While the Agencies recognize that effective intermediation of client, customer, or counterparty trading may require a trading desk to engage in a certain amount of interdealer trading, this is an activity that will bear some scrutiny by the Agencies and should be monitored by banking entities to ensure it reflects market-making activities and not impermissible proprietary trading.

ii. Impact of the Liquidity, Maturity, and Depth of the Market on the Analysis

Several commenters expressed concern about the potential impact of the proposed near term demand requirement on market making in less liquid markets and requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes.[925] The Agencies understand that reasonably expected near term customer demand may vary based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument(s) in which the trading desk acts as market maker.[926] As a result, the final rule recognizes that these factors impact the analysis of reasonably expected near term demands of clients, customers, or counterparties and the amount, types, and risks of market-maker inventory needed to meet such demand.[927] In particular, customer demand is likely to be more frequent in more liquid markets than in less liquid or illiquid markets. As a result, market makers in more liquid cash-based markets, such as liquid equity securities, should generally have higher rates of inventory turnover and less aged inventory than market makers in less liquid or illiquid markets.[928] Market makers in less liquid cash-based markets are more likely to hold a particular position for a longer period of time due to intermittent customer demand. In the derivatives markets, market makers carry open positions and manage various risk factors, such as exposure to different points on a yield curve. These exposures are analogous to inventory in the cash-based markets. Further, it may be more difficult to reasonably predict near term customer demand in less mature markets due to,

[919] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[920] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Credit Suisse (Seidel). For example, customers have an expectation of general price alignment under these circumstances, both at the time they decide to invest in the instrument and for the remaining time they hold the instrument. To the contrary, general statistical arbitrage does not maintain a price relationship between related instruments that is expected and relied upon by customers and, thus, is not permitted under the market-making exemption. Firms engage in general statistical arbitrage to profit from differences in market prices between instruments, assets, or price or risk elements associated with instruments or assets that are thought to be statistically related, but which do not have a direct relationship of being exchangeable, convertible, or exercisable for the other.

[921] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Prof. Duffie; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[922] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity. *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012). One of these commenters analyzed the potential market impact of preventing interdealer trading, combined with inventory limits. *See* Oliver Wyman (Feb. 2012). Because the final rule does not prohibit interdealer trading or limit inventory in the manner this commenter assumed for purposes of its analysis, the Agencies do not believe the final rule will have the market impact cited by this commenter.

[923] *See* AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction).

[924] Provided it is consistent with the requirements of the market-making exemption, including the near term customer demand requirement, a trading desk may trade for purposes of determining how to price a financial instrument a customer seeks to trade with the trading desk or to determine the depth of the market for a financial instrument a customer seeks to trade with the trading desk. *See* Goldman (Prop. Trading).

[925] *See* CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); Morgan Stanley; RBC; ICI (Feb. 2012) ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock.

[926] *See supra* Part VI.A.3.c.2.b.ii. (discussing comments on this issue).

[927] *See* final rule § 75.4(b)(2)(ii)(A).

[928] The final rule does not impose additional capital requirements on aged inventory to discourage a trading desk from retaining positions in inventory, as suggested by some commenters. *See* CalPERS; Vanguard. The Agencies believe the final rule already limit a trading desk's ability to hold inventory over an extended period and do not see a need at this time to include additional capital requirements in the final rule. For example, a trading desk must have written policies and procedures relating to its inventory and must be able to demonstrate, as needed, its analysis of why the levels of its market-maker inventory are necessary to meet, or is a result of meeting, customer demand. *See* final rule § 75.4(b)(2)(ii), (iii)(C).

among other things, a lack of historical experience with client, customer, or counterparty demands for the relevant product. Under these circumstances, the Agencies encourage banking entities to consider their experience with similar products or other relevant factors.[929]

iii. Demonstrable Analysis of Certain Factors

In the proposal, the Agencies stated that permitted market making includes taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[930] A number of commenters expressed concern about this proposed interpretation's impact on market makers' inventory management activity and represented that it was inconsistent with the statute's near term demand standard, which permits market-making activity that is ''designed'' not to exceed the ''reasonably expected'' near term demands of customers.[931] In response to comments, the Agencies are permitting a trading desk to take positions in reasonable expectation of customer demand in the near term based on a demonstrable analysis that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

The proposal also stated that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation). Several commenters stated that it was unclear how such determinations should be made and expressed concern that near term customer demand cannot always be accurately predicted,[932] particularly in markets where trades occur infrequently and customer demand is hard to predict[933] or when a banking entity is entering a new market.[934] To address these comments, the Agencies are providing additional information about how a banking entity can comply with the statute's near term customer demand requirement, including a new requirement that a banking entity conduct a demonstrable assessment of reasonably expected near term customer demand and several examples of factors that may be relevant for conducting such an assessment. The Agencies believe it is important to require such demonstrable analysis to allow determinations of reasonably expected near term demand and associated inventory levels to be monitored and tested to ensure compliance with the statute and the final rule.

The final rule provides that, to help determine the appropriate amount, types, and risks of the financial instruments in the trading desk's market-maker inventory and to ensure that such inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of client, customers, or counterparties, a banking entity must conduct demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with financial instruments in which the trading desk makes a market, including through block trades. This analysis should not be static or fixed solely on current market or other factors. Instead, an appropriately conducted analysis under this provision will be both backward- and forward-looking by taking into account relevant historical trends in customer demand[935] and any events that are reasonably expected to occur in the near term that would likely impact demand.[936] Depending on the facts and circumstances, it may be proper for a banking entity to weigh these factors differently when conducting an analysis under this provision. For example, historical trends in customer demand may be less relevant when a trading desk is experiencing or expects to experience a change in the pattern of customer needs (*e.g.,* requests for block positioning), adjustments to its business model (*e.g.,* efforts to expand or contract its market shares), or changes in market conditions.[937] On the other hand, absent these types of current or anticipated events, the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory should be relatively consistent with such trading desk's historical profile of market-maker inventory.[938]

Moreover, the demonstrable analysis required under § 75.4(b)(2)(ii)(B) should account for, among other things, how the market factors discussed in § 75.4(b)(2)(ii)(A) impact the amount, types, and risks of market-maker inventory the trading desk may need to facilitate reasonably expected near term demands of clients, customers, or counterparties.[939] Other potential

[929] The Agencies agree, as suggested by one commenter, it may be appropriate for a market maker in a new asset class or market to look to reasonably expected future developments on the basis of the trading desk's customer relationships. *See* Morgan Stanley. As discussed further below, the Agencies recognize that a trading desk could encounter similar issues if it is a new entrant in an existing market.

[930] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[931] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[932] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012) Alfred Brock.

[933] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[934] *See* CIEBA.

[935] To determine an appropriate historical dataset, a banking entity should assess the relation between current or reasonably expected near term conditions and demand and those of prior market cycles.

[936] This analysis may, where appropriate, take into account prior and/or anticipated cyclicality to the demands of clients, customers, or counterparties, which may cause variations in the amounts, types, and risks of financial instruments needed to provide intermediation services at different points in a cycle. For example, the final rule recognizes that a trading desk may need to accumulate a larger-than-average amount of inventory in anticipation of an index rebalance. *See supra* note 843 (discussing a comment on this issue). The Agencies are aware that a trading desk engaged in block positioning activity may have a less consistent pattern of inventory because of the need to take on large block positions at the request of customers. *See supra* note 761 and accompanying text (discussing comments on this issue).

Because the final rule does not prevent banking entities from providing direct liquidity for rebalance trades, the Agencies do not believe that the final rule will cause the market impacts that one commenter predicted would occur were such a restriction adopted. *See* Oliver Wyman (Feb. 2012) (estimating that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year).

[937] In addition, the Agencies recognize that a new entrant to a particular market or asset class may not have knowledge of historical customer demand in that market or asset class at the outset. *See supra* note 924 and accompanying text (discussing factors that may be relevant to new market entrants for purposes of determining the reasonably expected near term demands of clients, customers, or counterparties).

[938] One commenter suggested an approach that would allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether inventory can be tied to a particular customer in the near term or to historical trends in customer demand. *See* Credit Suisse (Seidel). The Agencies believe an approach that does not provide for any consideration of historical trends could result in a heightened risk of evasion. At the same time, as discussed above, the Agencies recognize that historical trends may not always determine the amount of inventory a trading desk may need to meet reasonably expected near term demand and it may under certain circumstances be appropriate to build inventory in anticipation of a reasonably expected near term event that would likely impact customer demand. While the Agencies are not requiring that market-maker inventory be tied to a particular customer, the Agencies are requiring that a banking entity analyze and support its expectations for near term customer demand.

[939] The Agencies recognize that a trading desk could acquire either a long or short position in

factors that could be used to assess reasonably expected near term customer demand and the appropriate amount, types, and risks of financial instruments in the trading desk's market-maker inventory include, among others: (i) Recent trading volumes and customer trends; (ii) trading patterns of specific customers or other observable customer demand patterns; (iii) analysis of the banking entity's business plan and ability to win new customer business; (iv) evaluation of expected demand under current market conditions compared to prior similar periods; (v) schedule of maturities in customers' existing portfolios; and (vi) expected market events, such as an index rebalancing, and announcements. The Agencies believe that some banking entities already analyze these and other relevant factors as part of their overall risk management processes.[940]

With respect to the creation and distribution of complex structured products, a trading desk may be able to use the market-making exemption to acquire some or all of the risk exposures associated with the product if the trading desk has evidence of customer demand for each of the significant risks associated with the product.[941] To have evidence of customer demand under these circumstances, there must be prior express interest from customers in the specific risk exposures of the product. Without such express interest, a trading desk would not have sufficient information to support the required demonstrable analysis (*e.g.,* information about historical customer demand or other relevant factors).[942] The Agencies are concerned that, absent express interest in each significant risk associated with the product, a trading desk could evade the market-making exemption by structuring a deal with certain risk exposures, or amounts of risk exposures, for which there is no customer demand and that would be retained in the trading desk's inventory, potentially for speculative purposes. Thus, a trading desk would not be engaged in permitted market making-related activity if, for example, it structured a product solely to acquire a desired exposure and not to respond to customer demand.[943] When a trading desk acquires risk exposures in these circumstances, the trading desk would be expected to enter into appropriate hedging transactions or otherwise mitigate the risks of these exposures, consistent with its hedging policies and procedures and risk limits.

With regard to a trading desk that conducts its market-making activities on an exchange or other similar anonymous trading facility, the Agencies continue to believe that market-making activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy or by regularly responding to requests for quotes in markets where resting orders are not generally provided. This ensures that the trading desk has a pattern of providing, rather than taking, liquidity. However, this does not mean that a trading desk acting as a market maker on an exchange or other similar anonymous trading facility is only permitted to use these types of orders in connection with its market making-related activities. The Agencies recognize that it may be appropriate for a trading desk to enter market or marketable limit orders on an exchange or other similar anonymous trading facility, or to request quotes from other market participants, in connection with its market making-related activities for a variety of purposes including, among others, inventory management, addressing order imbalances on an exchange, and hedging.[944] In response to comments, the Agencies are not requiring a banking entity to be registered as a market maker on an exchange or other similar anonymous trading facility, if the exchange or other similar anonymous trading facility registers market makers, for purposes of the final rule.[945] The Agencies recognize, as noted by commenters, that there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices and that requiring registration with each exchange or other trading facility may unnecessarily restrict or impose burdens on exchange market-making activities.[946]

A banking entity is not required to conduct the demonstrable analysis under § 75.4(b)(2)(B) of the final rule on an instrument-by-instrument basis. The Agencies recognize that, in certain cases, customer demand may be for a particular type of exposure, and a customer may be willing to trade any one of a number of instruments that would provide the demanded exposure. Thus, an assessment of the amount, types, and risks of financial instruments that the trading desk may hold in market-maker inventory and that would be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties does not need to be made for each financial instrument in which the trading desk acts as market maker. Instead, the amount and types of financial instruments in the trading desk's market-maker inventory should be

reasonable anticipation of near term demands of clients, customers, or counterparties. In particular, if it is expected that customers will want to buy an instrument in the near term, it may be appropriate for the desk to acquire a long position in such instrument. If it is expected that customers will want to sell the instrument, acquiring a short position may be appropriate under certain circumstances.

[940] *See supra* Part VI.A.3.c.2.b.iii. *See* FTN; Morgan Stanley (suggesting a standard that would require a position to be ''reasonably consistent with observable customer demand patterns'').

[941] Complex structured products can contain a combination of several different types of risks, including, among others, market risk, credit risk, volatility risk, and prepayment risk.

[942] In contrast, a trading desk may respond to requests for customized transactions, such as custom swaps, provided that the trading desk is a market maker in the risk exposures underlying the swap or can hedge the underlying risk exposures, consistent with its financial exposure and hedging limits, and otherwise meets the requirements of the market-making exemption. For example, a trading desk may routinely make markets in underlying exposures and, thus, would meet the requirements for engaging in transactions in derivatives that reflect the same exposures. Alternatively, a trading desk might meet the requirements by routinely trading in the derivative and hedging in the underlying exposures. *See supra* Part VI.A.3.c.1.c.iii.

[943] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012).

[944] The Agencies are clarifying this point in response to commenters who expressed concern that the proposal would prevent an exchange market maker from using market or marketable limit orders under these circumstances. *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); RBC.

[945] *See supra* notes 774 to 779 and accompanying text (discussing commenters' response to statements in the proposal requiring exchange registration as a market maker under certain circumstances). Similarly, the final rule does not establish a presumption of compliance with the market-making exemption based on registration as a market maker with an exchange, as requested by a few commenters. *See supra* note 777 and accompanying text. As noted above, activity that is considered market making for purposes of this rule may not be considered market making for purposes of other rules, including self-regulatory organization rules, and vice versa. In addition, exchange requirements for registered market makers are subject to change without consideration of the impact on this rule. Although a banking entity is not required to be an exchange-registered market maker under the final rule, a banking entity must be licensed or registered to engage in market making-related activities in accordance with applicable law. For example, a banking entity would be required to be an SEC-registered broker-dealer to engage in market making-related activities in securities in the U.S. unless the banking entity is exempt from registration or excluded from regulation as a dealer under the Exchange Act. *See infra* Part VI.A.3.c.6.; final rule § 75.4(b)(2)(vi).

[946] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

consistent with the types of financial instruments in which the desk makes a market and the amount and types of such instruments that the desk's customers are reasonably expected to be interested in trading.

In response to commenters' concern that banking entities may be subject to regulatory sanctions if reasonably expected customer demand does not materialize,[947] the Agencies recognize that predicting the reasonably expected near term demands of clients, customers, or counterparties is inherently subject to changes based on market and other factors that are difficult to predict with certainty. Thus, there may at times be differences between predicted demand and actual demand from clients, customers, or counterparties. However, assessments of expected near term demand may not be reasonable if, in the aggregate and over longer periods of time, a trading desk exhibits a repeated pattern or practice of significant variation in the amount, types, and risks of financial instruments in its market-maker inventory in excess of what is needed to facilitate near term customer demand.

iv. Relationship to Required Limits

As discussed further below, a banking entity must establish limits for each trading desk on the amount, types, and risks of its market-maker inventory, level of exposures to relevant risk factors arising from its financial exposure, and period of time a financial instrument may be held by a trading desk. These limits must be reasonably designed to ensure compliance with the market-making exemption, including the near term customer demand requirement, and must take into account the nature and amount of the trading desk's market making-related activities. Thus, the limits should account for and generally be consistent with the historical near term demands of the desk's clients, customers, or counterparties and the amount, types, and risks of financial instruments that the trading desk has historically held in market-maker inventory to meet such demands. In addition to the limits that a trading desk selects in managing its positions to ensure compliance with the market-making exemption set out in § 75.4(b), the Agencies are requiring, for banking entities that must report metrics in Appendix A, such limits include, at a minimum, ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics as limits, except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.[948] The Agencies believe that these metrics can be useful for measuring and managing many types of positions and trading activities and therefore can be useful in establishing a minimum set of metrics for which limits should be applied.[949]

As this requirement applies on an ongoing basis, a trade in excess of one or more limits set for a trading desk should not be permitted simply because it responds to customer demand. Rather, a banking entity's compliance program must include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the requirements of this near term demand requirement and with the prudent management of risk by the banking entity, and independent review of such demonstrable analysis and approval.[950] The Agencies expect that a trading desk's escalation procedures will generally explain the circumstances under which a trading desk's limits can be increased, either temporarily or permanently, and that such increases must be consistent with reasonably expected near term demands of the desk's clients, customers, or counterparties and the amount and type of risks to which the trading desk is authorized to be exposed.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

To ensure that a banking entity relying on the market-making exemption had an appropriate framework in place to support its compliance with the exemption, § 75.4(b)(2)(i) of the proposed rule required a banking entity to establish an internal compliance program, as required by subpart D of the proposal, designed to ensure compliance with the requirements of the market-making exemption.[951]

b. Comments on the Proposed Compliance Program Requirement

A few commenters supported the proposed requirement that a banking entity establish a compliance program under § 75.20 of the proposed rule as effective.[952] For example, one commenter stated that the requirement ''keeps a strong focus on the bank's own workings and allows banks to self-monitor.'' [953] One commenter indicated that a comprehensive compliance program is a ''cornerstone of effective corporate governance,'' but cautioned against placing ''undue reliance'' on compliance programs.[954] As discussed further below in Parts VI.C.1. and VI.C.3., many commenters expressed concern about the potential burdens of the proposed rule's compliance program requirement, as well as the proposed requirement regarding quantitative measurements. According to one commenter, the compliance burdens associated with these requirements may dissuade a banking entity from attempting to comply with the market-making exemption.[955]

c. Final Compliance Program Requirement

Similar to the proposed exemption, the market-making exemption adopted in the final rule requires that a banking entity establish and implement, maintain, and enforce an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing.[956] This provision further requires that the compliance program include particular written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

- The financial instruments each trading desk stands ready to purchase and sell as a market maker;
- The actions the trading desk will take to demonstrably reduce or

[947] *See* RBC; CIEBA; Wellington; ICI (Feb. 2012) Invesco.

[948] *See* Appendix A.

[949] The Agencies recognize that for some types of positions or trading strategies, the use of ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics may be ineffective and accordingly limits do not need to be set for those metrics if such ineffectiveness is demonstrated by the banking entity.

[950] *See* final rule § 75.4(b)(2)(iii); *infra* Part VI.A.3.c.3.c. (discussing the meaning of ''independent'' review for purposes of this requirement).

[951] *See* proposed rule § 75.4(b)(2)(i); Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8355.

[952] *See* Flynn & Fusselman; Morgan Stanley.

[953] *See* Flynn & Fusselman.

[954] *See* Occupy.

[955] *See* ICI (Feb. 2012).

[956] The independent testing standard is discussed in more detail in Part VI.C., which discusses the compliance program requirement in § 75.20 of the final rule.

otherwise significantly mitigate promptly the risks of its financial exposure consistent with the required limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

- Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by the near term customer demand requirement of the final rule, on:
  - The amount, types, and risks of its market-maker inventory;
  - The amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes;
  - Level of exposures to relevant risk factors arising from its financial exposure; and
  - Period of time a financial instrument may be held;
- Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its required limits; and
- Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of § 75.4(b)(2)(ii) of the final rule, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[957]

The compliance program requirement in the proposed market-making exemption did not include specific references to all the compliance program elements now listed in the final rule. Instead, these elements were generally included in the compliance requirements of Appendix C of the proposed rule. The Agencies are moving certain of these requirements into the market-making exemption to ensure that critical components are made part of the compliance program for market making-related activities. Further, placing these requirements within the market-making exemption emphasizes the important role they play in overall compliance with the exemption.[958] Banking entities should note that these compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in market making-related activities under the final rule. Each of the requirements in paragraphs (b)(2)(iii)(A) through (E) must be appropriately tailored to the individual trading activities and strategies of each trading desk on an ongoing basis.

As a threshold issue, the compliance program must identify the products, instruments, and exposures the trading desk may trade as market maker or for risk management purposes.[959] Identifying the relevant instruments in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the exemption by preventing an individual trader on a market-making desk from establishing positions in instruments that are unrelated to the desk's market-making function. Further, this identification of instruments helps form the basis for the specific types of inventory and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, depth, and maturity of the market for the relevant type of financial instrument. The Agencies note that a banking entity should be able to demonstrate the relationship between the instruments in which a trading desk may act as market maker and the instruments the desk may use to manage the risk of its market making-related activities and inventory and why the instruments the desk may use to manage its risk appropriately and effectively mitigate the risk of its market making-related activities without generating an entirely new set of risks that outweigh the risks that are being hedged.

The final rule provides that a banking entity must establish an appropriate risk management framework for each of its trading desks that rely on the market-making exemption.[960] This includes not only the techniques and strategies that a trading desk may use to manage its risk exposures, but also the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposures consistent with its required limits, which are discussed in more detail below. While the Agencies do not expect a trading desk to hedge all of the risks that arise from its market

[957] *See* final rule § 75.4(b)(2)(iii).

[958] The Agencies note that a number of commenters requested that the Agencies place a greater emphasis on inventory limits and risk limits in the final exemption. *See, e.g.,* Citigroup (suggesting that the market-making exemption utilize risk limits that would be set for each trading unit based on expected levels of customer trading—estimated by looking to historical results, target product and customer lists, and target market share—and an appropriate amount of required inventory to support that level of customer trading); Prof. Colesanti *et al.* (suggesting that the exemption include, among other things, a bright-line threshold of the amount of risk that can be retained (which cannot be in excess of the size and type required for market making), positions limits, and limits on holding periods); Sens. Merkley & Levin (Feb. 2012) (suggesting the use of specific parameters for inventory levels, along with a number of other criteria, to establish a safe harbor); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (recommending the use of risk limits in combination with a guidance-based approach); Japanese Bankers Ass'n. (suggesting that the rule set risk allowances for market making-related activities based on required capital for such activities). The Agencies are not establishing specific limits in the final rule, as some commenters appeared to recommend, in recognition of the fact that appropriate limits will differ based on a number of factors, including the size of the market-making operation and the liquidity, depth, and maturity of the market for the particular type(s) of financial instruments in which the trading desk is permitted to trade. *See* Sens. Merkley & Levin (Feb. 2012); Prof. Colesanti *et al.* However, banking entities relying on the market-making exemption must set limits and demonstrate how the specific limits and limit methodologies they have chosen are reasonably designed to limit the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory consistent with the reasonably expected near term demands of the banking entity's clients, customers, and counterparties, subject to the market and conditions discussed above, and to commensurately control the desk's overall financial exposure.

[959] *See* final rule § 75.4(b)(2)(iii)(A) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell in accordance with § 75.4(b)(2)(i) of the final rule); final rule § 75.4(b)(2)(iii)(B) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the products, instruments, or exposures each trading desk may use for risk management purposes).

[960] This standard addresses issues raised by commenters concerning: certain language in proposed Appendix B regarding market making-related risk management; the market making-related hedging provision in § 75.4(b)(3) of the proposed rule; and, to some extent, the proposed source of revenue requirement in § 75.4(b)(2)(v) of the proposed rule. *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439–8440; proposed rule § 75.4(b)(3); Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358; Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco; Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); FTN; RBC; NYSE Euronext; MFA. As discussed in more detail above, a number of commenters emphasized that market making-related activities necessarily involve a certain amount of risk-taking to provide ''immediacy'' to customers. *See, e.g.,* Prof. Duffie; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Commenters also represented that the amount of risk a market maker needs to retain may differ across asset classes and markets. *See, e.g.,* Morgan Stanley; Credit Suisse (Seidel). The Agencies believe that the requirement we are adopting better recognizes that appropriate risk management will tailor acceptable position, risk and inventory limits based on the type(s) of financial instruments in which the trading desk is permitted to trade and the liquidity, maturity, and depth of the market for the relevant type of financial instrument.

making-related activities, the Agencies do expect each trading desk to take appropriate steps consistent with market-making activities to contain and limit risk exposures (such as by unwinding unneeded positions) and to follow reasonable procedures to monitor the trading desk's risk exposures (*i.e.,* its financial exposure) and hedge risks of its financial exposure to remain within its relevant risk limits.[961]

As discussed in Part VI.A.3.c.4.c., managing the risks associated with maintaining a market-maker inventory that is appropriate to meet the reasonably expected near-term demands of customers is an important part of market making.[962] The Agencies understand that, in the context of market-making activities, inventory management includes adjustment of the amount and types of market-maker inventory to meet the reasonably expected near term demands of customers.[963] Adjustments of the size and types of a financial exposure are also made to reduce or mitigate the risks associated with financial instruments held as part of a trading desk's market-maker inventory. A common strategy in market making is to establish market-maker inventory in anticipation of reasonably expected customer needs and then to reduce that market-maker inventory over time as customer demand materializes.[964] If customer demand does not materialize, the market maker addresses the risks associated with its market-maker inventory by adjusting the amount or types of financial instruments in its inventory as well as taking steps otherwise to mitigate the risk associated with its inventory.

The Agencies recognize that, to provide effective intermediation services, a trading desk engaged in permitted market making-related activities retains a certain amount of risk arising from the positions it holds in inventory and may hedge certain aspects of that risk. The requirements in the final rule establish controls around a trading desk's risk management activities, yet still recognize that a trading desk engaged in market making-related activities may retain a certain amount of risk in meeting the reasonably expected near term demands of clients, customers, or counterparties. As the Agencies noted in the proposal, where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act.[965] The Agencies emphasize that the only risk management activities that qualify for the market-making exemption—and that are not subject to the hedging exemption—are risk management activities conducted or directed by the trading desk in connection with its market making-related activities and in conformance with the trading desk's risk management policies and procedures.[966] A trading desk engaged in market making-related activities would be required to comply with the hedging exemption or another available exemption for any risk management or other activity that is not in conformance with the trading desk's required market-making risk management policies and procedures.

A banking entity's written policies and procedures, internal controls, analysis, and independent testing identifying and addressing the products, instruments, or exposures and the techniques and strategies that may be used by each trading desk to manage the risks of its market making-related activities and inventory must cover both how the trading desk may establish hedges and how such hedges are removed once the risk they were mitigating is unwound. With respect to establishing positions that hedge or otherwise mitigate the risk(s) of market making-related positions held by the trading desk, the written policies and procedures may consider the natural hedging and diversification that occurs in an aggregation of long and short positions in financial instruments for which the trading desk is a market maker,[967] as it documents its specific risk-mitigating strategies that use instruments for which the desk is a market maker or instruments for which the desk is not a market maker. Further, the written policies and procedures identifying and addressing permissible hedging techniques and strategies must address the circumstances under which the trading desk may be permitted to engage in anticipatory hedging. Like the proposed rule's hedging exemption, a trading desk may establish an anticipatory hedge position before it becomes exposed to a risk that it is highly likely to become exposed to, provided there is a sound risk management rationale for establishing such an anticipatory hedge position.[968] For example, a trading desk may hedge against specific positions promised to customers, such as volume-weighted average price (''VWAP'') orders or large block trades, to facilitate the customer trade.[969] The amount of time that an anticipatory hedge may precede the establishment of the position to be hedged will depend on market factors,

[961] It may be more efficient for a banking entity to manage some risks at a higher organizational level than the trading desk level. As a result, a banking entity's written policies and procedures may delegate the responsibility to mitigate specific risks of the trading desk's financial exposure to an entity other than the trading desk, including another organizational unit of the banking entity or of an affiliate, provided that such organizational unit of the banking entity or of an affiliate is identified in the banking entity's written policies and procedures. Under these circumstances, the other organizational unit of the banking entity or of an affiliate must conduct such hedging activity in accordance with the requirements of the hedging exemption in § 75.5 of the final rule, including the documentation requirement in § 75.5(c). As recognized in Part VI.A.4.d.4., hedging activity conducted by a different organizational unit than the unit responsible for the positions being hedged presents a greater risk of evasion. Further, the risks being managed by a higher organizational level than the trading desk may be generated by trading desks engaged in market making-related activity or by trading desks engaged in other permitted activities. Thus, it would be inappropriate for such hedging activity to be conducted in reliance on the market-making exemption.

[962] *See supra* Part VI.A.3.c.2.c. (discussing the final near term demand requirement).

[963] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[964] *See, e.g.,* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[965] *See* Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[966] As discussed above, if a trading desk operating under the market-making exemption directs a different organizational unit of the banking entity or an affiliate to establish a hedge position on the desk's behalf, then the other organizational unit may rely on the market-making exemption to establish the hedge position as long as: (i) The other organizational unit's hedging activity is consistent with the trading desk's risk management policies and procedures (*e.g.,* the hedge instrument, technique, and strategy are consistent with those identified in the trading desk's policies and procedures); and (ii) the hedge position is attributed to the financial exposure of the trading desk and is included in the trading desk's daily profit and loss. If a different organizational unit of the banking entity or of an affiliate establishes a hedge for the trading desk's financial exposure based on its own determination, or if such position was not established in accordance with the trading desk's required procedures or was included in that other organizational unit's financial exposure and/or daily profit and loss, then that hedge position must be established in compliance with the hedging exemption in § 75.5 of the rule, including the documentation requirement in § 75.5(c). *See supra* Part VI.A.3.c.1.c.ii.

[967] For example, this may occur if a U.S. corporate bond trading desk acquires a $100 million long position in the corporate bonds of one issuer from clients, customers, or counterparties and separately acquires a $50 million short position in another issuer in the same market sector in reasonable expectation of near term demand of clients, customers, or counterparties. Although both positions were acquired to facilitate customer demand, the positions may also naturally hedge each other, to some extent.

[968] *See* Joint Proposal, 76 FR at 68875; CFTC Proposal, 77 FR at 8361.

[969] Two commenters recommended that banking entities be permitted to establish hedges prior to acquiring the underlying risk exposure under these circumstances. *See* Credit Suisse (Seidel); BoA.

such as the liquidity of the hedging position.

Written policies and procedures, internal controls, analysis, and independent testing established pursuant to the final rule identifying and addressing permissible hedging techniques and strategies should be designed to prevent a trading desk from over-hedging its market-maker inventory or financial exposure. Over-hedging would occur if, for example, a trading desk established a position in a financial instrument for the purported purpose of reducing a risk associated with one or more market-making positions when, in fact, that risk had already been mitigated to the full extent possible. Over-hedging results in a new risk exposure that is unrelated to market-making activities and, thus, is not permitted under the market-making exemption.

A trading desk's financial exposure generally would not be considered to be consistent with market making-related activities to the extent the trading desk is engaged in hedging activities that are inconsistent with the management of identifiable risks in its market-maker inventory or maintains significant hedge positions after the underlying risk(s) of the market-maker inventory have been unwound. A banking entity's written policies and procedures, internal controls, analysis, and independent testing regarding the trading desk's permissible hedging techniques and strategies must be designed to prevent a trading desk from engaging in over-hedging or maintaining hedge positions after they are no longer needed.[970] Further, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities are and continue to be effective, which would include monitoring for and addressing any scenarios where a trading desk may be engaged in over-hedging or maintaining unnecessary hedge positions or new significant risks have been introduced by the hedging activity.

As a result of these limitations, the size and risks of the trading desk's hedging positions are naturally constrained by the size and risks of its market-maker inventory, which must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as well as by the risk limits and controls established under the final rule. This ultimately constrains a trading desk's overall financial exposure since such position can only contain positions, risks, and exposures related to the market-maker inventory that are designed to meet current or near term customer demand and positions, risks and exposures designed to mitigate the risks in accordance with the limits previously established for the trading desk.

The written policies and procedures identifying and addressing a trading desk's hedging techniques and strategies also must describe how and under what timeframe a trading desk must remove hedge positions once the underlying risk exposure is unwound. Similarly, the compliance program established by the banking entity to specify and control the trading desk's hedging activities in accordance with the final rule must be designed to prevent a trading desk from purposefully or inadvertently transforming its positions taken to manage the risk of its market-maker inventory under the exemption into what would otherwise be considered prohibited proprietary trading.

Moreover, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities and inventory—including the instruments, techniques, and strategies used for risk management purposes—are and continue to be effective. This includes ensuring that hedges taken in the context of market making-related activities continue to be effective and that positions taken to manage the risks of the trading desk's market-maker inventory are not purposefully or inadvertently transformed into what would otherwise be considered prohibited proprietary trading. If a banking entity's monitoring procedures find that a trading desk's risk management procedures are not effective, such deficiencies must be promptly escalated and remedied in accordance with the banking entity's escalation procedures. A banking entity's written policies and procedures must set forth the process for determining the circumstances under which a trading desk's risk management strategies may be modified. In addition, risk management techniques and strategies developed and used by a trading desk must be independently tested or verified by management separate from the trading desk.

To control and limit the amount and types of financial instruments and risks that a trading desk may hold in connection with its market making-related activities, a banking entity must establish, implement, maintain, and enforce reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing specific limits on a trading desk's market-maker inventory, risk management positions, and financial exposure. In particular, the compliance program must establish limits for each trading desk, based on the nature and amount of its market making-related activities (including the factors prescribed by the near term customer demand requirement), on the amount, types, and risks of its market-maker inventory, the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes, the level of exposures to relevant risk factors arising from its financial exposure, and the period of time a financial instrument may be held.[971] The limits would be set, as appropriate, and supported by an analysis for specific types of financial instruments, levels of risk, and duration of holdings, which would also be required by the compliance appendix. This approach will build on existing risk management infrastructure for market-making activities that subject traders to a variety of internal, predefined limits.[972] Each of these limits is independent of the others, and a trading desk must maintain its aggregated market-making position within each of these limits, including by taking action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[973] For example, if changing market conditions cause an increase in one or more risks within the trading desk's financial exposure and that increased risk causes the desk to exceed one or more of its limits, the trading desk must take prompt action to reduce its risk exposure (either by hedging the risk or unwinding its existing positions) or receive approval of a temporary or permanent increase to its limit through the required escalation procedures.

The Agencies recognize that trading desks' limits will differ across asset classes and acknowledge that trading desks engaged in market making-related activities in less liquid asset classes, such as corporate bonds, certain derivatives, and securitized products, may require different inventory, risk exposure, and holding period limits than trading desks engaged in market

[970] *See* final rule § 75.4(b)(2)(iii)(B).

[971] *See* final rule § 75.4(b)(2)(iii)(C).

[972] *See, e.g.,* Citigroup (Feb. 2012) (noting that its suggested approach to implementing the market-making exemption, which would focus on risk limits and risk architecture, would build on existing risk limits and risk management systems already present in institutions).

[973] *See* final rule § 75.4(b)(2)(iv).

making-related activities in more liquid financial instruments, such as certain listed equity securities. Moreover, the types of risk factors for which limits are established should not be limited solely to market risk factors. Instead, such limits should also account for all risk factors that arise from the types of financial instruments in which the trading desk is permitted to trade. In addition, these limits should be sufficiently granular and focused on the particular types of financial instruments in which the desk may trade. For example, a trading desk that makes a market in derivatives would have exposures to counterparty risk, among others, and would need to have appropriate limits on such risk. Other types of limits that may be relevant for a trading desk include, among others, position limits, sector limits, and geographic limits.

A banking entity must have a reasonable basis for the limits it establishes for a trading desk and must have a robust procedure for analyzing, establishing, and monitoring limits, as well as appropriate escalation procedures.[974] Among other things, the banking entity's compliance program must provide for: (i) Written policies and procedures and internal controls establishing and monitoring specific limits for each trading desk; and (ii) analysis regarding how and why these limits are determined to be appropriate and consistent with the nature and amount of the desk's market making-related activities, including considerations related to the near term customer demand requirement. In making these determinations, a banking entity should take into account and be consistent with the type(s) of financial instruments the desk is permitted to trade, the desk's trading and risk management activities and strategies, the history and experience of the desk, and the historical profile of the desk's near term customer demand and market and other factors that may impact the reasonably expected near term demands of customers.

The limits established by a banking entity should generally reflect the amount and types of inventory and risk that a trading desk holds to meet the reasonably expected near term demands of clients, customers, or counterparties. As discussed above, while the trading desk's market-maker inventory is directly limited by the reasonably expected near term demands of customers, the positions managed by the trading desk outside of its market-maker inventory are similarly constrained by the near term demand requirement because they must be designed to manage the risks of the market-maker inventory in accordance with the desk's risk management procedures. As a result, the trading desk's risk management positions and aggregate financial exposure are also limited by the current and reasonably expected near term demands of customers. A trading desk's market-maker inventory, risk management positions, or financial exposure would not, however, be permissible under the market-making exemption merely because the market-maker inventory, risk management positions, or financial exposure happens to be within the desk's prescribed limits.[975]

In addition, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits and patterns regarding the portions of the trading desk's limits that are accounted for by the trading desk's activity.[976] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes or modifications to the trading desk's strategy).[977] This process must cover potential scenarios when a trading desk's limits should be raised, as well as potential scenarios when a trading desk's limits should be lowered. For example, if a trading desk experiences reduced customer demand over a period of time, that trading desk's limits should be decreased to address the factors prescribed by the near term demand requirement.

A banking entity's compliance program must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval of any increase to one or more of a trading desk's limits.[978] Thus, in order to increase a limit of a trading desk—on either a temporary or permanent basis—there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, including the factors identified in § 75.4(b)(2)(ii) of the final rule, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § 75.20(b)(6).

As already discussed, commenters have represented that the compliance costs associated with the proposed rule, including the compliance program and metrics requirements, may be significant and ''may dissuade a banking entity from attempting to comply with the market making-related activities exemption.'' [979] The Agencies believe that a robust compliance program is necessary to ensure adherence to the rule and to prevent evasion, although, as discussed in Part VI.C.3., the Agencies are adopting a more tailored set of quantitative measurements to better focus on those that are most germane to evaluating market making-related activity. The Agencies acknowledge that the compliance program requirements for the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing, represent a new regulatory requirement for banking entities and the Agencies have thus been mindful that it may impose significant costs and may cause a banking entity to reconsider whether to conduct market making-related activities. Despite the potential costs of the compliance program, the Agencies believe they are warranted to ensure that the goals of the rule and statute will be met, such as promoting

[974] *See* final rule § 75.4(b)(2)(iii)(C).

[975] For example, if a U.S. corporate bond trading desk has a prescribed limit of $200 million net exposure to any single sector of related issuers, the desk's limits may permit it to acquire a net economic exposure of $400 million long to issuer ABC and a net economic exposure of $300 million short to issuer XYZ, where ABC and XYZ are in the same sector. This is because the trading desk's net exposure to the sector would only be $100 million, which is within its limits. Even though the net exposure to this sector is within the trading desk's prescribed limits, the desk would still need to be able to demonstrate how its net exposure of $400 million long to issuer ABC and $300 million short to issuer XYZ is related to customer demand.

[976] *See* final rule § 75.4(b)(2)(iii)(D).

[977] For example, a banking entity may determine to permit temporary, short-term increases to a trading desk's risk limits due to an increase in short-term credit spreads or in response to volatility in instruments in which the trading desk makes a market, provided the increased limit is consistent with the reasonably expected near term demands of clients, customers, or counterparties. As noted above, other potential circumstances that could warrant changes to a trading desk's limits include: A change in the pattern of customer needs, adjustments to the market maker's business model (*e.g.,* new entrants or existing market makers trying to expand or contract their market share), or changes in market conditions. *See supra* note 937 and accompanying text.

[978] *See* final rule § 75.4(b)(2)(iii)(E).

[979] *See* ICI (Feb. 2012).

the safety and soundness of banking entities and the financial stability of the United States.

4. Market Making-Related Hedging

a. Proposed Treatment of Market Making-Related Hedging

In the proposal, certain hedging transactions related to market making were considered to be made in connection with a banking entity's market making-related activity for purposes of the market-making exemption. The Agencies explained that where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act.[980] To qualify for the market-making exemption, a hedging transaction would have been required to meet certain requirements under § 75.4(b)(3) of the proposed rule. This provision required that the purchase or sale of a financial instrument: (i) Be conducted to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption; and (ii) meet the criteria specified in § 75.5(b) of the proposed hedging exemption and, where applicable, § 75.5(c) of the proposal.[981] In the proposal, the Agencies noted that a market maker may often make a market in one type of financial instrument and hedge its activities using different financial instruments in which it does not make a market. The Agencies stated that this type of hedging transaction would meet the terms of the market-making exemption if the hedging transaction met the requirements of § 75.4(b)(3) of the proposed rule.[982]

b. Comments on the Proposed Treatment of Market Making-Related Hedging

Several commenters recommended that the proposed market-making exemption be modified to establish a more permissive standard for market maker hedging.[983] A few of these commenters stated that, rather than applying the standards of the risk-mitigating hedging exemption to market maker hedging, a market maker's hedge position should be permitted as long as it is designed to mitigate the risk associated with positions acquired through permitted market making-related activities.[984] Other commenters emphasized the need for flexibility to permit a market maker to choose the most effective hedge.[985] In general, these commenters expressed concern that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers.[986] For example, one commenter stated that ''[t]he ability of market makers to freely offset or hedge positions is what, in most cases, makes them willing to buy and sell [financial instruments] to and from customers, clients or counterparties,'' so ''[a]ny impediment to hedging market making-related positions will decrease the willingness of banking entities to make markets and, accordingly, reduce liquidity in the marketplace.'' [987]

In addition, some commenters expressed concern that certain requirements in the proposed hedging exemption may result in a reduction in market-making activities under certain circumstances.[988] For example, one commenter expressed concern that the proposed hedging exemption would require a banking entity to identify and tag hedging transactions when hedges in a particular asset class take place alongside a trading desk's customer flow trading and inventory management in that same asset class.[989] Further, a few commenters represented that the proposed reasonable correlation requirement in the hedging exemption could impact market making by discouraging market makers from entering into customer transactions that do not have a direct hedge [990] or making it more difficult for market makers to cost-effectively hedge the fixed income securities they hold in inventory, including hedging such inventory positions on a portfolio basis.[991]

One commenter, however, stated that the proposed approach is effective.[992] Another commenter indicated that it is confusing to include hedging within the market-making exemption and suggested that a market maker be required to rely on the hedging exemption under § 75.5 of the proposed rule for its hedging activity.[993]

As noted above in the discussion of comments on the proposed source of revenue requirement, a number of commenters expressed concern that the proposed rule assumed that there are effective, or perfect, hedges for all market making-related positions.[994] Another commenter stated that market makers should be required to hedge whenever an inventory imbalance arises, and the absence of a hedge in such circumstances may evidence prohibited proprietary trading.[995]

c. Treatment of Market Making-Related Hedging in the Final Rule

Unlike the proposed rule, the final rule does not require that market making-related hedging activities separately comply with the requirements found in the risk-mitigating hedging exemption if conducted or directed by the same trading desk conducting the market-making activity. Instead, the Agencies are including requirements for market making-related hedging activities within the market-making exemption in response to comments.[996] As discussed above, a trading desk's compliance program must include written policies and procedures, internal controls, independent testing and analysis identifying and addressing the products, instruments, exposures, techniques, and strategies a trading desk may use to manage the risks of its market making-related activities, as well as the actions the trading desk will take to demonstrably reduce or otherwise significant mitigate the risks of its financial exposure consistent with its required limits.[997] The Agencies believe this approach addresses commenters' concerns that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers because it allows banking entities to determine

[980] *See* Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[981] *See* proposed rule § 75.4(b)(3); Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[982] *See* Joint Proposal, 76 FR at 68870 n.146; CFTC Proposal, 77 FR at 8356 n.152.

[983] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA. These comments are addressed in Part VI.A.3.c.4.c., *infra.*

[984] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* FTN (stating that the principal requirement for such hedges should be that they reduce the risk of market making).

[985] *See* NYSE Euronext (stating that the best hedge sometimes involves a variety of complex and dynamic transactions over the time in which an asset is held, which may fall outside the parameters of the exemption); MFA; JPMC.

[986] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[987] RBC.

[988] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012).

[989] *See* Goldman (Prop. Trading).

[990] *See* BoA.

[991] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[992] *See* Alfred Brock.

[993] *See* Occupy.

[994] *See infra* notes 1073 to 1075 and accompanying text.

[995] *See* Public Citizen.

[996] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA.

[997] *See* final rule § 75.4(b)(2)(iii)(B); *supra* Part VI.A.3.c.3.c.

how best to manage the risks of trading desks' market making-related activities through reasonable policies and procedures, internal controls, independent testing, and analysis, rather than requiring compliance with the specific requirements of the hedging exemption.[998] Further, this approach addresses commenters' concerns about the impact of certain requirements of the hedging exemption on market making-related activities.[999]

The Agencies believe it is consistent with the statute's reference to ''market making-related'' activities to permit market making-related hedging activities under this exemption. In addition, the Agencies believe it is appropriate to require a trading desk to appropriately manage its risks, consistent with its risk management procedures and limits, because management of risk is a key factor that distinguishes permitted market making-related activity from impermissible proprietary trading. As noted in the proposal, while ''a market maker attempts to eliminate some [of the risks arising from] its retained principal positions and risks by hedging or otherwise managing those risks [ ], a proprietary trader seeks to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains.'' [1000]

The Agencies recognize that some banking entities may manage the risks associated with market making at a different level than the individual trading desk.[1001] While this risk management activity is not permitted under the market-making exemption, it may be permitted under the hedging exemption, provided the requirements of that exemption are met. Thus, the Agencies believe banking entities will continue to have options available that allow them to efficiently hedge the risks arising from their market-making operations. Nevertheless, the Agencies understand that this rule will result in additional documentation or other potential burdens for market making-related hedging activity that is not conducted by the trading desk responsible for the market-making positions being hedged.[1002] As discussed in Part VI.A.4.d.4., hedging conducted by a different organizational unit than the trading desk that is responsible for the underlying positions presents an increased risk of evasion, so the Agencies believe it is appropriate for such hedging activity to be required to comply with the hedging exemption, including the associated documentation requirement.

5. Compensation Requirement

a. Proposed Compensation Requirement

Section 75.4(b)(2)(vii) of the proposed market-making exemption would have required that the compensation arrangements of persons performing market making-related activities at the banking entity be designed not to reward proprietary risk-taking.[1003] In the proposal, the Agencies noted that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a financial instrument position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, would be inconsistent with the proposed market-making exemption.

The Agencies stated that under the proposed rule, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking. However, the Agencies noted that a banking entity relying on the proposed market-making exemption would be able to appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained.[1004]

b. Comments Regarding the Proposed Compensation Requirement

Several commenters recommended certain revisions to the proposed compensation requirement.[1005] Two commenters stated that the proposed requirement is effective,[1006] while one commenter stated that it should be removed from the rule.[1007] Moreover, in addressing this proposed requirement, commenters provided views on: identifiable characteristics of compensation arrangements that incentivize prohibited proprietary trading,[1008] methods of monitoring compliance with this requirement,[1009] and potential negative incentives or outcomes this requirement could cause.[1010]

With respect to suggested modifications to this requirement, a few commenters suggested that a market maker's compensation should be subject to additional limitations.[1011] For example, two commenters stated that compensation should be restricted to particular sources, such as fees, commissions, and spreads.[1012] One commenter suggested that compensation should not be symmetrical between gains and losses and, further, that trading gains reflecting an unusually high variance in position values should either not be reflected in compensation and bonuses or should be less reflected than other gains and losses.[1013] Another commenter recommended that the Agencies remove ''designed'' from the rule text and provide greater clarity about how a banking entity's compensation regime must be structured.[1014] Moreover, a number of commenters stated that compensation should be vested for a period of time, such as until the trader's market making positions have been fully unwound and are no longer in the banking entity's inventory.[1015] As one commenter explained, such a requirement would discourage traders from carrying inventory and encourage them to get out of positions as soon as possible.[1016] Some commenters also recommended that compensation be risk adjusted.[1017]

[998] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[999] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading).

[1000] *See* Joint Proposal, 76 FR at 68961.

[1001] *See, e.g.,* letter from JPMC (stating that, to minimize risk management costs, firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and passed by means of internal transactions to a single utility desk and suggesting this be recognized as permitted market making-related behavior).

[1002] *See* final rule § 75.5(c).

[1003] *See* proposed rule § 75.4(b)(2)(vii).

[1004] *See* Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8358.

[1005] *See* Prof. Duffie; SIFMA *et al.* (Prop. Trading) (Feb. 2012); John Reed; Credit Suisse (Seidel); JPMC; Morgan Stanley; Better Markets (Feb. 2012); Johnson & Prof. Stiglitz; Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[1006] *See* FTN; Alfred Brock.

[1007] *See* Japanese Bankers Ass'n.

[1008] *See* Occupy.

[1009] *See* Occupy; Goldman (Prop. Trading).

[1010] *See* AllianceBernstein; Prof. Duffie; Investure; STANY; Chamber (Dec. 2011).

[1011] *See* Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Occupy; John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012). These comments are addressed in note 1032, *infra.*

[1012] *See* Better Markets (Feb. 2012); Public Citizen.

[1013] *See* AFR *et al.* (Feb. 2012)

[1014] *See* Occupy.

[1015] *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie (''A trader's incentives for risk taking can be held in check by vesting incentive-based compensation over a substantial period of time. Pending compensation can thus be forfeited if a trader's negligence causes substantial losses or if his or her employer fails.''); Sens. Merkley & Levin (Feb. 2012).

[1016] *See* John Reed.

[1017] *See* Johnson & Prof. Stiglitz; John Reed; Sens. Merkley & Levin (Feb. 2012).

A few commenters indicated that the proposed approach may be too restrictive.[1018] Two of these commenters stated that the compensation requirement should instead be set forth as guidance in Appendix B.[1019] In addition, two commenters requested that the Agencies clarify that compensation arrangements must be designed not to reward prohibited proprietary risk-taking. These commenters were concerned the proposed approach may restrict a banking entity's ability to provide compensation for permitted activities, which also involve proprietary trading.[1020]

Two commenters discussed identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading.[1021] For example, one commenter stated that rewarding pure profit and loss, without consideration for the risk that was assumed to capture it, is an identifiable characteristic of an arrangement that incentivizes proprietary risk-taking.[1022] For purposes of monitoring and ensuring compliance with this requirement, one commenter noted that existing Board regulations for systemically important banking entities require comprehensive firm-wide policies that determine compensation. This commenter stated that those regulations, along with appropriately calibrated metrics, should ensure that compensation arrangements are not designed to reward prohibited proprietary risk-taking.[1023] For similar purposes, another commenter suggested that compensation incentives should be based on a metric that meaningfully accounts for the risk underlying profitability.[1024]

Certain commenters expressed concern that the proposed compensation requirement could incentivize market makers to act in a way that would not be beneficial to customers or market liquidity.[1025] For example, two commenters expressed concern that the requirement could cause market makers to widen their spreads or charge higher fees because their personal compensation depends on these factors.[1026] One commenter stated that the proposed requirement could dampen traders' incentives and discretion and may make market makers less likely to accept trades involving significant increases in risk or profit.[1027] Another commenter expressed the view that profitability-based compensation arrangements encourage traders to exercise due care because such arrangements create incentives to avoid losses.[1028] Finally, one commenter stated that compliance with the proposed requirement may be difficult or impossible if the Agencies do not take into account the incentive-based compensation rulemaking.[1029]

c. Final Compensation Requirement

Similar to the proposed rule, the market-making exemption requires that the compensation arrangements of persons performing the banking entity's market making-related activities, as described in the exemption, are designed not to reward or incentivize prohibited proprietary trading.[1030] The language of the final compensation requirement has been modified in response to comments expressing concern about the proposed language regarding ''proprietary risk-taking.''[1031] The Agencies note that the Agencies do not intend to preclude an employee of a market-making desk from being compensated for successful market making, which involves some risk-taking.

The Agencies continue to hold the view that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a position held in inventory, rather than use of that inventory to successfully provide effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed retained principal risk, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not prohibited proprietary trading.[1032] For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the market-making exemption.

6. Registration Requirement

a. Proposed Registration Requirement

Under § 75.4(b)(2)(iv) of the proposed rule, a banking entity relying on the market-making exemption with respect to trading in securities or certain derivatives would be required to be appropriately registered as a securities dealer, swap dealer, or security-based swap dealer, or exempt from registration or excluded from regulation as such type of dealer, under applicable securities or commodities laws. Further, if the banking entity was engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States in a manner for which no U.S. registration is required, the banking entity would be required to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.[1033]

b. Comments on the Proposed Registration Requirement

A few commenters stated that the proposed dealer registration requirement is effective.[1034] However, a number of commenters opposed the proposed dealer registration requirement in whole or in part.[1035]

[1018] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Morgan Stanley.

[1019] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1020] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies respond to these comments in note 1026 and its accompanying text, *infra.*

[1021] *See* Occupy; Alfred Brock.

[1022] *See* Occupy. The Agencies respond to this comment in Part VI.A.3.c.5.c., *infra.*

[1023] *See* Goldman (Prop. Trading).

[1024] *See* Occupy.

[1025] *See* AllianceBernstein; Investure; Prof. Duffie; STANY. This issue is addressed in note 1032, *infra.*

[1026] *See* AllianceBernstein; Investure.

[1027] *See* Prof. Duffie.

[1028] *See* STANY.

[1029] *See* Chamber (Dec. 2011).

[1030] *See* final rule § 75.4(b)(2)(v).

[1031] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1032] Because the Agencies are not limiting a market maker's compensation to specific sources, such as fees, commissions, and bid-ask spreads, as recommended by a few commenters, the Agencies do not believe the compensation requirement in the final rule will incentivize market makers to widen their quoted spreads or charge higher fees and commissions, as suggested by certain other commenters. *See* Better Markets (Feb. 2012); Public Citizen; AllianceBernstein; Investure. In addition, the Agencies note that an approach requiring revenue from fees, commissions, and bid-ask spreads to be fully distinguished from revenue from price appreciation can raise certain practical difficulties, as discussed in Part VI.A.3.c.7. The Agencies also are not requiring compensation to be vested for a period of time, as recommended by some commenters to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement. *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012).

[1033] *See* proposed rule § 75.4(b)(2)(iv); Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8357–8358.

[1034] *See* Occupy; Alfred Brock.

[1035] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that if the requirement is not removed from

Continued

Commenters' primary concern with the requirement appeared to be its application to market making-related activities outside of the United States for which no U.S. registration is required.[1036] For example, several commenters stated that many non-U.S. markets do not provide substantive regulation of dealers for all asset classes.[1037] In addition, two commenters stated that booking entities may be able to rely on intra-group exemptions under local law rather than carrying dealer registrations, or a banking entity may execute customer trades through an international dealer but book the position in a non-dealer entity for capital adequacy and risk management purposes.[1038] Several of these commenters requested, at a minimum, that the dealer registration requirement not apply to dealers in non-U.S. jurisdictions.[1039]

In addition, with respect to the provisions that would generally require a banking entity to be a form of SEC- or CFTC-registered dealer for market-making activities in securities or derivatives in the United States, a few commenters stated that these provisions should be removed from the rule.[1040] These commenters represented that removing these provisions would be appropriate for several reasons. For example, one commenter stated that dealer registration does not help distinguish between market making and speculative trading.[1041] Another commenter indicated that effective market making often requires a banking entity to trade on several exchange and platforms in a variety of markets, including through legal entities other than SEC- or CFTC-registered dealer entities.[1042] One commenter expressed general concern that the proposed requirement may result in the market-making exemption being unavailable for market making in exchange-traded futures and options because those markets do not have a corollary to dealer registration requirements in securities, swaps, and security-based swaps markets.[1043]

Some commenters expressed particular concern about the provisions that would generally require registration as a swap dealer or a security-based swap dealer.[1044] For example, one commenter expressed concern that these provisions may require banking regulators to redundantly enforce CFTC and SEC registration requirements. Moreover, according to this commenter, the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' do not focus on the market making core of the swap dealing business.[1045] Another commenter stated that incorporating the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' is contrary to the Administrative Procedure Act.[1046]

c. Final Registration Requirement

The final requirement of the market-making exemption provides that the banking entity must be licensed or registered to engage in market making-related activity in accordance with applicable law.[1047] The Agencies have considered comments regarding the dealer registration requirement in the proposed rule.[1048] In response to comments, the Agencies have narrowed the scope of the proposed requirement's application to banking entities engaged in market making-related activity in foreign jurisdictions.[1049] Rather than requiring these banking entities to be subject to substantive regulation of their dealing business in the relevant foreign jurisdiction, the final rule only require a banking entity to be a registered dealer in a foreign jurisdiction to the extent required by applicable foreign law. The Agencies have also simplified the language of the proposed requirement, although the Agencies have not modified the scope of the requirement with respect to U.S. dealer registration requirements.

This provision is not intended to expand the scope of licensing or registration requirements under relevant U.S. or foreign law that are applicable to a banking entity engaged in market-making activities. Instead, this provision recognizes that compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.[1050] For example, a U.S. banking entity would be expected to be an SEC-registered dealer to rely on the market-making exemption for trading in securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances, or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[1051] Similarly, a U.S. banking entity is expected to be a CFTC-registered swap dealer or SEC-registered security-based swap dealer to rely on the market-making exemption for trading in swaps or security-based swaps, respectively,[1052] unless the

the rule, then it should only be an indicative factor of market making); Morgan Stanley; Goldman (Prop. Trading); ISDA (Feb. 2012).

[1036] *See* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012); JPMC. This issue is addressed in note 1044 and its accompanying text, *infra.*

[1037] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1038] *See* JPMC; Goldman (Prop. Trading).

[1039] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Morgan Stanley (requesting the addition of the phrase ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions).

[1040] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). Rather than remove the requirement entirely, one commenter recommended that the Agencies move the dealer registration requirement to proposed Appendix B, which would allow the Agencies to take into account the facts and circumstances of a particular trading activity. *See* JPMC.

[1041] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1042] *See* Goldman (Prop. Trading).

[1043] *See* CME Group.

[1044] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1045] *See* ISDA (Feb. 2012).

[1046] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1047] *See* final rule § 75.4(b)(2)(vi).

[1048] *See supra* Part VI.A.3.c.5.b. One commenter expressed concern that the instruments listed in § 75.4(b)(2)(iv) of the proposed rule could be interpreted as limiting the availability of the market-making exemption to other instruments, such as exchange-traded futures and options. In response to this comment, the Agencies note that the reference to particular instruments in § 75.4(b)(2)(iv) was intended to reflect that trading in certain types of instruments gives rise to dealer registration requirements. This provision was not intended to limit the availability of the market-making exemption to certain types of financial instruments. *See* CME Group.

[1049] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley.

[1050] In response to commenters who stated that the dealer registration requirement should be removed from the rule because, among other things, registration as a dealer does not distinguish between permitted market making and impermissible proprietary trading, the Agencies recognize that acting as a registered dealer does not ensure that a banking entity is engaged in permitted market making-related activity. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). However, this requirement recognizes that registration as a dealer is an indicator of market making-related activities in the circumstances in which a person is legally obligated to be a registered dealer to act as a market maker.

[1051] A banking entity relying on the market-making exemption for transactions in security-based swaps would generally be required to be a registered security-based swap dealer and would not be required to be a registered securities dealer. However, a banking entity may be required to be a registered securities dealer if it engages in market-making transactions involving security-based swaps with persons that are not eligible contract participants. The definition of ''dealer'' in section 3(a)(5) of the Exchange Act generally includes ''any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants), for such person's own account.'' 15 U.S.C. 78c(a)(5).

To the extent, if any, that a banking entity relies on the market-making exemption for its trading in municipal securities or government securities, rather than the exemption in § 75.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer.

[1052] As noted above, under certain circumstances, a banking entity acting as market maker in security-

banking entity is exempt from registration or excluded from regulation as a swap dealer or security-based swap dealer.[1053] In response to comments on whether this provision should generally require registration as a swap dealer or security-based swap dealer to make a market in swaps or security-based swaps,[1054] the Agencies continue to believe that this requirement is appropriate. In general, a person that is engaged in making a market in swaps or security-based swaps or other activity causing oneself to be commonly known in the trade as a market maker in swaps or security-based swaps is required to be a registered swap dealer or registered security-based swap dealer, unless exempt from registration or excluded from regulation as such.[1055] As noted above, compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.

As noted above, the Agencies have determined that, rather than require a banking entity engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States to be subject to substantive regulation of its dealing business in the foreign jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration requirements under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). As a result, this requirement will not impact a banking entity's ability to engage in permitted market making-related activities in a foreign jurisdiction that does not provide for substantive regulation of dealers.[1056]

7. Source of Revenue Analysis

a. Proposed Source of Revenue Requirement

To qualify for the market-making exemption, the proposed rule required that the market making-related activities of the trading desk or other organizational unit be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of financial instrument positions it holds in trading accounts or the hedging of such positions.[1057] This proposed requirement was intended to ensure that activities conducted in reliance on the market-making exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the intermediation and liquidity services a market maker provides to its customers, rather than changes in the market value of the positions or risks held in inventory.[1058]

b. Comments Regarding the Proposed Source of Revenue Requirement

As discussed in more detail below, many commenters expressed concern about the proposed source of revenue requirement. These commenters raised a number of concerns including, among others, the proposed requirement's potential impact on a market maker's inventory or on costs to customers, the difficulty of differentiating revenues from spreads and revenues from price appreciation in certain markets, and the need for market makers to be compensated for providing intermediation services.[1059] Several of these commenters requested that the proposed source of revenue requirement be removed from the rule or modified in certain ways. Some commenters, however, expressed support for the proposed requirement or requested that the Agencies place greater restrictions on a banking entity's permissible sources of revenue under the market-making exemption.[1060]

i. Potential Restrictions on Inventory, Increased Costs for Customers, and Other Changes to Market-Making Services

Many commenters stated that the proposed source of revenue requirement may limit a market maker's ability to hold sufficient inventory to facilitate customer demand.[1061] Several of these commenters expressed particular concern about applying this requirement to less liquid markets or to facilitating large customer positions, where a market maker is more likely to hold inventory for a longer period of time and has increased risk of potential price appreciation (or depreciation).[1062] Further, another commenter questioned how the proposed requirement would apply when unforeseen market pressure or disappearance of customer demand results in a market maker holding a particular position in inventory for longer than expected.[1063] In response to this proposed requirement, a few commenters stated that it is important for market makers to be able to hold a certain amount of inventory to: provide liquidity (particularly in the face of order imbalances and market volatility),[1064] facilitate large trades, and hedge positions acquired in the course of market making.[1065]

Several commenters expressed concern that the proposed source of revenue requirement may incentivize a market maker to widen its quoted spreads or otherwise impose higher fees to the detriment of its customers.[1066] For example, some commenters stated that the proposed requirement could result in a market maker having to sell a position in its inventory within an artificially prescribed period of time and, as a result, the market maker would pay less to initially acquire the position from a customer.[1067] Other commenters represented that the proposed source of revenue requirement would compel market makers to hedge their exposure

based swaps may be required to be a registered securities dealer. *See supra* note 1051.

[1053] For example, a banking entity meeting the conditions of the *de minimis* exception in SEC Rule 3a71–2 under the Exchange Act would not need to be a registered security-based swap dealer to act as a market maker in security-based swaps. *See* 17 CFR 240.3a71–2.

[1054] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1055] *See* 7 U.S.C. 1a(49)(A); 15 U.S.C. 78c(a)(71)(A).

[1056] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley. This is consistent with one commenter's suggestion that the Agencies add ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions. *See* Morgan Stanley.

[1057] *See* proposed rule § 75.4(b)(2)(v).

[1058] *See* Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8358.

[1059] These concerns are addressed in Part VI.A.3.c.7.c., *infra.*

[1060] *See infra* note 1103 (responding to these comments).

[1061] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); T. Rowe Price; PUC Texas; SSgA (Feb. 2012); ICI (Feb. 2012) Invesco; MetLife; MFA.

[1062] *See, e.g.,* Morgan Stanley; BoA; BlackRock; T. Rowe Price; Goldman (Prop. Trading); NYSE Euronext (suggesting that principal trading by market makers in large sizes is essential in some securities, such as an AP's trading in ETFs); Prof. Duffie; SSgA (Feb. 2012); CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); MFA. To explain its concern, one commenter stated that bid-ask spreads are useful to capture the concept of market-making revenues when a market maker is intermediating on a close to real-time basis between balanced customer buying and selling interest for the same instrument, but such close-in-time intermediation does not occur in many large or illiquid assets, where demand gaps may be present for days, weeks, or months. *See* Morgan Stanley.

[1063] *See* Capital Group.

[1064] *See* NYSE Euronext; CIEBA (stating that if the rule discourages market makers from holding inventory, there will be reduced liquidity for investors and issuers).

[1065] *See* NYSE Euronext. For a more in-depth discussion of comments regarding the benefits of permitting market makers to hold and manage inventory, see Part VI.A.3.c.2.b.vi., *infra.*

[1066] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA.

[1067] *See* MetLife; ACLI (Feb. 2012); ICI (Feb. 2012) SSgA (Feb. 2012).

to price movements, which would likely increase the cost of intermediation.[1068]

Some commenters stated that the proposed source of revenue requirement may make a banking entity less willing to make markets in instruments that it may not be able to resell immediately or in the short term.[1069] One commenter indicated that this concern may be heightened in times of market stress.[1070] Further, a few commenters expressed the view that the proposed requirement would cause banking entities to exit the market-making business due to restrictions on their ability to make a profit from market-making activities.[1071] Moreover, in one commenter's opinion, the proposed requirement would effectively compel market makers to trade on an agency basis.[1072]

ii. Certain Price Appreciation-Related Profits Are an Inevitable or Important Component of Market Making

A number of commenters indicated that market makers will inevitably make some profit from price appreciation of certain inventory positions because changes in market values cannot be precisely predicted or hedged.[1073] In particular, several commenters emphasized that matched or perfect hedges are generally unavailable for most types of positions.[1074] According to one commenter, a provision that effectively requires a market-making business to hedge all of its principal positions would discourage essential market-making activity. The commenter explained that effective hedges may be unavailable in less liquid markets and hedging can be costly, especially in relation to the relative risk of a trade and hedge effectiveness.[1075] A few commenters further indicated that making some profit from price appreciation is a natural part of market making or is necessary to compensate a market maker for its willingness to take a position, and its associated risk (*e.g.,* the risk of market changes or decreased value), from a customer.[1076]

iii. Concerns Regarding the Workability of the Proposed Standard in Certain Markets or Asset Classes

Some commenters represented that it would be difficult or burdensome to identify revenue attributable to the bid-ask spread versus revenue arising from price appreciation, either as a general matter or for specific markets.[1077] For example, one commenter expressed the opinion that the difference between the bid-ask spread and price appreciation is ''metaphysical'' in some sense,[1078] while another stated that it is almost impossible to objectively identify a bid-ask spread or to capture profit and loss solely from a bid-ask spread in most markets.[1079] Other commenters represented that it is particularly difficult to make this distinction when trades occur infrequently or where prices are not transparent, such as in the fixed-income market where no spread is published.[1080]

Many commenters expressed particular concern about the proposed requirement's application to specific markets, including: The fixed-income markets;[1081] the markets for commodities, derivatives, securitized products, and emerging market securities;[1082] equity and physical commodity derivatives markets;[1083] and customized swaps used by customers of banking entities for hedging purposes.[1084] Another commenter expressed general concern about extremely volatile markets, where market makers often see large upward or downward price swings over time.[1085]

Two commenters emphasized that the revenues a market maker generates from hedging the positions it holds in inventory are equivalent to spreads in many markets. These commenters explained that, under these circumstances, a market maker generates revenue from the difference between the customer price for the position and the banking entity's price for the hedge. The commenters noted that proposed Appendix B expressly recognizes this in the case of derivatives and recommended that Appendix B's

[1068] *See* SSgA (Feb. 2012); PUC Texas.

[1069] *See* ICI (Feb. 2012) SSgA (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); BoA.

[1070] *See* CIEBA (arguing that banking entities may be reluctant to provide liquidity when markets are declining and there are more sellers than buyers because it would be necessary to hold positions in inventory to avoid losses).

[1071] *See* Credit Suisse (Seidel) (arguing that banking entities are likely to cease being market makers if they are: (i) Unable to take into account the likely direction of a financial instrument, or (ii) forced to take losses if a financial instrument moves against them, but cannot take gains if the instrument's price moves in their favor); STANY (contending that banking entities cannot afford to maintain unprofitable or marginally profitable operations in highly competitive markets, so this requirement would cause banking entities to eliminate a majority of their market-making functions).

[1072] *See* IR&M (arguing that domestic corporate and securitized credit markets are too large and heterogeneous to be served appropriately by a primarily agency-based trading model).

[1073] *See* Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas (contending that it is impossible to predict the behavior of even the most highly correlated hedge in comparison to the underlying position); CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco.

[1074] *See* Morgan Stanley; Credit Suisse (Seidel); SSgA (Feb. 2012); PUC Texas; Wellington; AllianceBernstein; Investure.

[1075] *See* Wellington. Moreover, one commenter stated that, as a general matter, market makers need to be compensated for bearing risk related to providing immediacy to a customer. This commenter stated that ''[t]he greater the inventory risk faced by the market maker, the higher the expected return (compensation) that the market maker needs,'' to compensate the market maker for bearing the risk and reward its specialization skills in that market (*e.g.,* its knowledge about market conditions and early indicators that may imply future price movements in a particular direction). This commenter did not, however, discuss the source of revenue requirement in the proposed rule. *See* Thakor Study.

[1076] *See* Capital Group; Prof. Duffie; Investure; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); RBC; PNC.

[1077] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group.

[1078] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1079] *See* Citigroup (Feb. 2012). *See also* Barclays (arguing that a bid-ask spread cannot be defined on a consistent basis with respect to many instruments).

[1080] *See* Goldman (Prop. Trading); BoA; Morgan Stanley (''Observable, actionable, bid/ask spreads exist in only a small subset of institutional products and markets. Indicative bid/ask spreads may be observable for certain products, but this pricing would typically be specific to small size standard lot trades and would not represent a spread applicable to larger and/or more illiquid trades. End-of-day valuations for assets are calculated, but they are not an effective proxy for real-time bid/ask spreads because of intra-day price movements.''); RBC; Capital Group (arguing that bid-ask spreads in fixed-income markets are not always quantifiable or well defined and can fluctuate widely within a trading day because of small or odd lot trades, price discovery activity, a lack of availability to cover shorts, or external factors not directly related to the security being traded).

[1081] *See* Capital Group; CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012). These commenters stated that the requirement may be problematic for the fixed-income markets because, for example, market makers must hold inventory in these markets for a longer period of time than in more liquid markets. *See id.*

[1082] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that these markets are characterized by even less liquidity and less frequent trading than the U.S. corporate bond market). This commenter also stated that in markets where trades are large and less frequent, such as the market for customized securitized products, appreciation in price of one position may be a predominate contributor to the overall profit and loss of the trading unit. *See id.*

[1083] *See* BoA. According to this commenter, the distinction between capturing a spread and price appreciation is fundamentally flawed in some markets, like equity derivatives, because the market does not trade based on movements of a particular security or underlying instrument. This commenter indicated that expected returns are instead based on the bid-ask spread the market maker charges for implied volatility as reflected in options premiums and hedging of the positions. *See id.*

[1084] *See* CIEBA (stating that because it would be difficult for a market maker to enter promptly into an offsetting swap, the market maker would not be able to generate income from the spread).

[1085] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter questioned whether proposed Appendix B's reference to ''unexpected market disruptions'' as an explanatory fact and circumstance was intended to permit such market making. *See id.*

guidance on this point apply equally to certain non-derivative positions.[1086]

A few commenters questioned how this requirement would work in the context of block trading or otherwise facilitating large trades, where a market maker may charge a premium or discount for taking on a large position to provide ''immediacy'' to its customer.[1087] One commenter further explained that explicitly quoted bid-ask spreads are only valid for indicated trade sizes that are modest enough to have negligible market impact, and such spreads cannot be used for purposes of a significantly larger trade.[1088]

iv. Suggested Modifications to the Proposed Requirement

To address some or all of the concerns discussed above, many commenters recommended that the source of revenue requirement be modified [1089] or removed from the rule entirely.[1090] With respect to suggested changes, some commenters stated that the Agencies should modify the rule text,[1091] use a metrics-based approach to focus on customer revenues,[1092] or replace the proposed requirement with guidance.[1093] Some commenters requested that the Agencies modify the focus of the requirement so that, for example, dealers' market-making activities in illiquid securities can function as close to normal as possible [1094] or market makers can take short-term positions that may ultimately result in a profit or loss.[1095] As discussed below, some commenters stated that the Agencies should modify the proposed requirement to place greater restrictions on market maker revenue.

v. General Support for the Proposed Requirement or for Placing Greater Restrictions on a Market Maker's Sources of Revenue

Some commenters expressed support for the proposed source of revenue requirement or stated that the requirement should be more restrictive.[1096] For example, one of these commenters stated that a real market maker's trading book should be fully hedged, so it should not generate profits in excess of fees and commissions except in times of rare and extraordinary market conditions.[1097] According to another commenter, the final rule should make it clear that banking entities seeking to rely on the market-making exemption may not generally seek to profit from price movements in their inventories, although their activities may give rise to modest and relatively stable profits arising from their limited inventory.[1098] One commenter recommended that the proposed requirement be interpreted to limit market making in illiquid positions because a banking entity cannot have the required revenue motivation when it enters into a position for which there is no readily discernible exit price.[1099]

Further, some commenters suggested that the Agencies remove the word ''primarily'' from the provision to limit banking entities to specified sources of revenue.[1100] In addition, one of these commenters requested that the Agencies restrict a market maker's revenue to fees and commissions and remove the allowance for revenue from bid-ask spreads because generating bid-ask revenues relies exclusively on changes in market values of positions held in inventory.[1101] For enforcement purposes, a few commenters suggested that the Agencies require banking entities to disgorge any profit obtained from price appreciation.[1102]

c. Final Rule's Approach To Assessing Revenues

Unlike the proposed rule, the final rule does not include a requirement that a trading desk's market making-related activity be designed to generate revenue primarily from fees, commissions, bid-ask spreads, or other income not attributable to appreciation in the value of a financial instrument or hedging.[1103] The revenue requirement was one of the most commented upon aspects of the market-making exemption in the proposal.[1104]

The Agencies believe that an analysis of patterns of revenue generation and profitability can help inform a judgment regarding whether trading activity is consistent with the intermediation and liquidity services that a market maker provides to its customers in the context of the liquidity, maturity, and depth of the relevant market, as opposed to prohibited proprietary trading activities. To facilitate this type of analysis, the Agencies have included a metrics data reporting requirement that is refined from the proposed metric regarding profits and losses. The Comprehensive Profit and Loss Attribution metric collects information regarding the daily fluctuation in the value of a trading desk's positions to various sources, along with its volatility, including: (i)

[1086] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). In its discussion of ''customer revenues,'' Appendix B states: ''In the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract.'' Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8440. *See also* RBC (requesting clarification on how the proposed standard would apply if a market maker took an offsetting position in a different instrument (*e.g.,* a different bond) and inquiring whether, if the trader took the offsetting position, its revenue gain is attributable to price appreciation of the two offsetting positions or from the bid-ask spread in the respective bonds).

[1087] *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading). *See also* Thakor Study (discussing market makers' role of providing ''immediacy'' in general).

[1088] *See* CIEBA.

[1089] *See, e.g.,* JPMC; Barclays; Goldman (Prop. Trading); BoA; CFA Inst.; ICI (Feb. 2012) Flynn & Fusselman.

[1090] *See, e.g.,* CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); Capital Group; RBC. In addition to the concerns discussed above, one commenter stated that the proposed requirement may set limits on the values of certain metrics, and it would be inappropriate to prejudge the appropriate results of such metrics at this time. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1091] *See, e.g.,* Barclays. This commenter provided alternative rule text stating that ''market making-related activity is conducted by each trading unit such that its activities are reasonably designed to generate revenues primarily from fees, commissions, bid-ask spreads, or other income attributable to satisfying reasonably expected customer demand.'' *See id.*

[1092] *See* Goldman (Prop. Trading) (suggesting that the Agencies use a metrics-based approach to focus on customer revenues, as measured by Spread Profit and Loss (when it is feasible to calculate) or other metrics, especially because a proprietary trading desk would not be expected to earn any revenues this way). This commenter also indicated that the ''primarily'' standard in the proposed rule is problematic and can be read to mean ''more than 50%,'' which is different from Appendix B's acknowledgment that the proportion of customer revenues relative to total revenues will vary by asset class. *See id.*

[1093] *See* BoA (recommending that the guidance state that the Agencies would consider the design and mix of such revenues as an indicator of potentially prohibited proprietary trading, but only for those markets for which revenues are quantifiable based on publicly available data, such as segments of certain highly liquid equity markets).

[1094] *See* CFA Inst.

[1095] *See* ICI (Feb. 2012).

[1096] *See* Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); FTN; Public Citizen; Occupy; Alfred Brock.

[1097] *See* Better Markets (Feb. 2012). *See also* Public Citizen (arguing that the imperfection of a hedge should signal potential disqualification of the underlying position from the market-making exemption).

[1098] *See* Sens. Merkley & Levin (Feb. 2012). This commenter further suggested that the rule identify certain red flags and metrics that could be used to monitor this requirement, such as: (i) Failure to obtain relatively low ratios of revenue-to-risk, low volatility, and relatively high turnover; (ii) significant revenues from price appreciation relative to the value of securities being traded; (iii) volatile revenues from price appreciation; or (iv) revenue from price appreciation growing out of proportion to the risk undertaken with the security. *See id.*

[1099] *See* AFR *et al.* (Feb. 2012).

[1100] *See* Occupy; Better Markets (Feb. 2012). *See supra* note 1108 (addressing these comments).

[1101] *See* Occupy.

[1102] *See* Occupy; Public Citizen.

[1103] *See* proposed rule § 75.4(b)(2)(v).

[1104] *See infra* Part VI.A.3.c.7.b.

Profit and loss attributable to current positions that were also held by the banking entity as of the end of the prior day (''existing positions); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions.[1105]

This quantitative measurement has certain conceptual similarities to the proposed source of revenue requirement in § 75.4(b)(2)(v) of the proposed rule and certain of the proposed quantitative measurements.[1106] However, in response to comments on those provisions, the Agencies have determined to modify the focus from particular revenue sources (*e.g.,* fees, commissions, bid-ask spreads, and price appreciation) to when the trading desk generates revenue from its positions. The Agencies recognize that when the trading desk is engaged in market making-related activities, the day one profit and loss component of the Comprehensive Profit and Loss Attribution metric may reflect customer-generated revenues, like fees, commissions, and spreads (including embedded premiums or discounts), as well as that day's changes in market value. Thereafter, profit and loss associated with the position carried in the trading desk's book may reflect changes in market price until the position is sold or unwound. The Agencies also recognize that the metric contains a residual component for profit and loss that cannot be specifically attributed to existing positions or new positions.

The Agencies believe that evaluation of the Comprehensive Profit and Loss Attribution metric could provide valuable information regarding patterns of revenue generation by market-making trading desks involved in market-making activities that may warrant further review of the desk's activities, while eliminating the requirement from the proposal that the trading desk demonstrate that its primary source of revenue, under all circumstances, is fees, commissions and bid/ask spreads. This modified focus will reduce the burden associated with the proposed source of revenue requirement and better account for the varying depth and liquidity of markets.[1107] In addition, the Agencies believe these modifications appropriately address commenters' concerns about the proposed source of revenue requirement and reduce the potential for negative market impacts of the proposed requirement cited by commenters, such as incentives to widen spreads or disincentives to engage in market making in less liquid markets.[1108]

The Agencies recognize that this analysis is only informative over time, and should not be determinative of an analysis of whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. The Agencies believe this quantitative measurement provides appropriate flexibility to obtain information on market-maker revenues, which is designed to address commenters' concerns about the proposal's source of revenue requirement (*e.g.,* the burdens associated with differentiating spread revenue from price appreciation revenue) while also helping assess patterns of revenue generation that may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation.

8. Appendix B of the Proposed Rule

a. Proposed Appendix B Requirement

The proposed market-making exemption would have required that the market making-related activities of the trading desk or other organizational unit of the banking entity be consistent with the commentary in proposed Appendix B.[1109] In this proposed Appendix, the Agencies provided overviews of permitted market making-related activity and prohibited proprietary trading activity.[1110]

The proposed Appendix also set forth various factors that the Agencies proposed to use to help distinguish prohibited proprietary trading from permitted market making-related activity. More specifically, proposed Appendix B set forth six factors that, absent explanatory facts and circumstances, would cause particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity. The proposed factors focused on: (i) Retaining risk in excess of the size and type required to provide intermediation services to customers (''risk management factor''); (ii) primarily generating revenues from price movements of retained principal positions and risks, rather than customer revenues (''source of revenues factor''); (iii) generating only very small

[1105] *See* Appendix A of the final rule (describing the Comprehensive Profit and Loss Attribution metric). This approach is generally consistent with one commenter's suggested metrics-based approach to focus on customer-related revenues. *See* Goldman (Prop. Trading); *see also* Sens. Merkley & Levin (Feb. 2012) (suggesting the use of metrics to monitor a firm's source of revenue); proposed Appendix A.

[1106] *See supra* Part VI.A.3.c.7. and *infra* Part VI.C.3.

[1107] The Agencies understand that some commenters interpreted the proposed requirement as requiring that both the bid-ask spread for a financial instrument and the revenue a market maker acquired from such bid-ask spread through a customer trade be identifiable on a close-to-real-time basis and readily distinguishable from any additional revenue gained from price appreciation (both on the day of the transaction and for the rest of the holding period). *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group. We recognize that such a requirement would be unduly burdensome. In fact, the proposal noted that bid-ask spreads or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable in certain asset classes for purposes of the proposed Spread Profit and Loss metric in Appendix A of the proposal. *See* Joint Proposal, 76 FR at 68958–68959; CFTC Proposal, 77 FR at 8438. Moreover, the burden associated with the proposed requirement should be further reduced because we are not adopting a stand-alone requirement regarding a trading desk's source of revenue. Instead, when and how a trading desk generates profit and loss from its trading activities is a factor that must be considered for purposes of the near term customer demand requirement. It is not a dispositive factor for determining compliance with the exemption.

Further, some commenters expressed concern that the proposed requirement suggested market makers were not permitted to profit from price appreciation, but rather only from observable spreads or explicit fees or commissions. *See, e.g.,* Wellington, Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco. The Agencies confirm that the intent of the market-making exemption is not to preclude a trading desk from generating any revenue from price appreciation. Because this approach clarifies that a trading desk's source of revenue is not limited to its quoted spread, the Agencies believe this quantitative measurement will address commenters concerns that the proposed source of revenue requirement could create incentives for market makers to widen their spreads, result in higher transaction costs, require market makers to hedge any exposure to price movements, or discourage a trading desk from making a market in instruments that it may not be able to sell immediately. *See* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA; SIFMA (Asset Mgmt.) (Feb. 2012). The modifications to this provision are designed to better reflect when, on average and across many transactions, profits are gained rather than how they are gained, similar to the way some firms measure their profit and loss today. *See, e.g.,* Goldman (Prop. Trading).

[1108] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA. The Agencies are not adopting an approach that limits a market maker to specified revenue sources (*e.g.,* fees, commissions, and spreads), as suggested by some commenters, due to the considerations discussed above. *See* Occupy; Better Markets (Feb. 2012). In response to the proposed source of revenue requirement, some commenters noted that a market maker may charge a premium or discount for taking on a large position from a customer. *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading).

[1109] *See* proposed rule § 75.4(b)(2)(vi).

[1110] *See* Joint Proposal, 76 FR at 68873, 68960–68961; CFTC Proposal, 77 FR at 8358, 8439–8440.

or very large amounts of revenue per unit of risk, not demonstrating consistent profitability, or demonstrating high earnings volatility (''revenues relative to risk factor''); (iv) not trading through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making desk to provide liquidity services, or retaining principal positions in excess of reasonably expected near term customer demands (''customer-facing activity factor''); (v) routinely paying rather than earning fees, commissions, or spreads (''payment of fees, commissions, and spreads factor''); and (vi) providing compensation incentives to employees that primarily reward proprietary risk-taking (''compensation incentives factor'').[1111]

b. Comments on Proposed Appendix B

Commenters expressed differing views about the accuracy of the commentary in proposed Appendix B and the appropriateness of including such commentary in the rule. For example, some commenters stated that the description of market making-related activity in the proposed appendix is accurate [1112] or appropriately accounts for differences among asset classes.[1113] Other commenters indicated that the appendix is too strict or narrow.[1114] Some commenters recommended that the Agencies revise proposed Appendix B's approach by, for example, placing greater focus on what market making is rather than what it is not,[1115] providing presumptions of activity that will be treated as permitted market making-related activity,[1116] re-formulating the appendix as nonbinding guidance,[1117] or moving certain requirements of the proposed exemption to the appendix.[1118] One commenter suggested the Agencies remove Appendix B from the rule and instead use the conformance period to analyze and develop a body of supervisory guidance that appropriately characterizes the nature of market making-related activity.[1119]

A few commenters expressed concern about the appendix's facts-and-circumstances-based approach to distinguishing between prohibited proprietary trading and permitted market making-related activity and stated that such an approach will make it more difficult or burdensome for banking entities to comply with the proposed rule [1120] or will generate regulatory uncertainty.[1121] As discussed below, other commenters opposed proposed Appendix B because of its level of granularity [1122] or due to perceived restrictions on interdealer trading or generating revenue from retained principal positions or risks in the proposed appendix.[1123] A number of commenters expressed concern about the complexity or prescriptiveness of the six proposed factors for distinguishing permitted market making-related activity from prohibited proprietary trading.[1124]

With respect to the level of granularity of proposed Appendix B, a number of commenters expressed concern that the reference to a ''single significant transaction'' indicated that the Agencies will review compliance with the proposed market-making exemption on a trade-by-trade basis and stated that assessing compliance at the level of individual transactions would be unworkable.[1125] One of these commenters further stated that assessing compliance at this level of granularity would reduce a market maker's willingness to execute a customer sell order as principal due to concern that the market maker may not be able to immediately resell such position. The commenter noted that this chilling effect would be heightened in declining markets.[1126]

A few commenters interpreted certain statements in proposed Appendix B as limiting interdealer trading and expressed concerns regarding potential limitations on this activity.[1127] These commenters emphasized that market makers may need to trade with non-customers to: (i) Provide liquidity to other dealers and, indirectly, their customers, or to otherwise allow customers to access a larger pool of liquidity; [1128] (ii) conduct price discovery to inform the prices a market maker can offer to customers; [1129] (iii) unwind or sell positions acquired from

[1111] *See* Joint Proposal, 76 FR at 68873, 68961–68963; CFTC Proposal, 77 FR at 8358, 8440–8442.

[1112] *See* MetLife; ACLI (Feb. 2012).

[1113] *See* Alfred Brock. *But see, e.g.,* Occupy (stating that the proposed commentary only accounts for the most liquid and transparent markets and fails to accurately describe market making in most illiquid or OTC markets).

[1114] *See* Morgan Stanley; IIF; Sumitomo Trust; ISDA (Apr. 2012); BDA (Feb. 2012) (Oct. 2012) (stating that proposed Appendix B places too great of a focus on derivatives trading and does not reflect how principal trading operations in equity and fixed income markets are structured). One of these commenters requested that the appendix be modified to account for certain activities conducted in connection with market making in swaps. This commenter indicated that a swap dealer may not regularly enjoy a dominant flow of customer revenues and may consistently need to make revenue from its book management. In addition, the commenter stated that the appendix should recognize that making a two-way market may be a dominant theme, but there are certain to be frequent occasions when, as a matter of market or internal circumstances, a market maker is unavailable to trade. *See* ISDA (Apr. 2012).

[1115] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1116] *See* Sens. Merkley & Levin (Feb. 2012). This commenter stated that, for example, Appendix B could deem market making involving widely-traded stocks and bonds issued by well-established corporations, government securities, or highly liquid asset-backed securities as the type of plain vanilla, low risk capital activities that are presumptively permitted, provided the activity is within certain, specified parameters for inventory levels, revenue-to-risk metrics, volatility, and hedging. *See id.*

[1117] *See* Morgan Stanley; Flynn & Fusselman.

[1118] *See* JPMC. In support of such an approach, the commenter argued that sometimes proposed § 75.4(b) and Appendix B addressed the same topic and, when this occurs, it is unclear whether compliance with Appendix B constitutes compliance with § 75.4(b) or if additional compliance steps are required. *See id.*

[1119] *See* Morgan Stanley.

[1120] *See* NYSE Euronext; Morgan Stanley.

[1121] *See* IAA.

[1122] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[1123] *See* Morgan Stanley; Chamber (Feb. 2012); Goldman (Prop. Trading).

[1124] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Chamber (Feb. 2012); ICFR; Morgan Stanley; Goldman (Prop. Trading); Occupy; Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011); Public Citizen; NYSE Euronext. *But see* Alfred Brock (stating that the proposed factors are effective).

[1125] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). In particular, proposed Appendix B provided that ''The particular types of trading activity described in this appendix may involve the aggregate trading activities of a single trading unit, a significant number or series of transactions occurring at one or more trading units, or a single significant transaction, among other potential scenarios.'' Joint Proposal, 76 FR at 68961; CFTC Proposal, 77 FR at 8441. The Agencies address commenters' trade-by-trade concerns in Part VI.A.3.c.1.c.ii., *infra.*

[1126] *See* Goldman (Prop. Trading).

[1127] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012). Specifically, commenters cited statements in proposed Appendix B indicating that market makers ''typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions.'' On this issue, the appendix further stated that ''a market maker generally only transacts with non-customers to the extent necessary to hedge or otherwise manage the risks of its market making-related activities, including managing its risk with respect to movements of the price of retained principal positions and risks, to acquire positions in amounts consistent with reasonably expected near term demand of its customers, or to sell positions acquired from its customers.'' The appendix recognized, however, that the ''appropriate proportion of a market maker's transactions that are with customers versus non-customers varies depending on the type of positions involved and the extent to which the positions are typically hedged in non-customer transactions.'' Joint Proposal, 76 FR at 68961; CFTC Proposal, 77 FR at 8440. Commenters' concerns regarding interdealer trading are addressed in Part VI.A.3.c.2.c.i., *infra.*

[1128] *See* Morgan Stanley; Goldman (Prop. Trading).

[1129] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012).

customers;[1130] (iv) establish or acquire positions to meet reasonably expected near term customer demand;[1131] (v) hedge;[1132] and (vi) sell a financial instrument when there are more buyers than sellers for the instrument at that time.[1133] Further, one of these commenters expressed the view that the proposed appendix's statements are inconsistent with the statutory market-making exemption's reference to ''counterparties.''[1134]

In addition, a few commenters expressed concern about statements in proposed Appendix B about a market maker's source of revenue.[1135] According to one commenter, the statement that profit and loss generated by inventory appreciation or depreciation must be ''incidental'' to customer revenues is inconsistent with market making-related activity in less liquid assets and larger transactions because market makers often must retain principal positions for longer periods of time in such circumstances and are unable to perfectly hedge these positions.[1136] As discussed above with respect to the source of revenue requirement in § 75.4(b)(v) of the proposed rule, a few commenters requested that Appendix B's discussion of ''customer revenues'' be modified to state that revenues from hedging will be considered to be customer revenues in certain contexts beyond derivatives contracts.[1137]

A number of commenters discussed the six proposed factors in Appendix B that, absent explanatory facts and circumstances, would have caused a particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity.[1138] With respect to the proposed factors, one commenter indicated that they are appropriate,[1139] while another commenter stated that they are complex and their effectiveness is uncertain.[1140] Another commenter expressed the view that ''[w]hile each of the selected factors provides evidence of 'proprietary trading,' warrants regulatory attention, and justifies a shift in the burden of proof, some require subjective judgments, are subject to gaming or data manipulation, and invite excessive reliance on circumstantial evidence and lawyers' opinions.''[1141]

In response to the proposed risk management factor,[1142] one commenter expressed concern that it could prevent a market maker from warehousing positions in anticipation of predictable but unrealized customer demands and, further, could penalize a market maker that misestimated expected demand. This commenter expressed the view that such an outcome would be contrary to the statute and would harm market liquidity.[1143] Another commenter requested that this presumption be removed because in less liquid markets, such as markets for corporate bonds, equity derivatives, securitized products, emerging markets, foreign exchange forwards, and fund-linked products, a market maker needs to act as principal to facilitate client requests and, as a result, will be exposed to risk.[1144]

Two commenters expressed concern about the proposed source of revenue factor.[1145] One commenter stated that this factor does not accurately reflect how market making occurs in a majority of markets and asset classes.[1146] The other commenter expressed concern that this factor shifted the emphasis of § 75.4(b)(v) of the proposed rule, which required that market making-related activities be ''designed'' to generate revenue primarily from certain sources, to the actual outcome of activities.[1147]

With respect to the proposed revenues relative to risk factor, one commenter supported this aspect of the proposal.[1148] Some commenters, however, expressed concern about using these factors to differentiate permitted market making-related activity from prohibited proprietary trading.[1149] These commenters stated that volatile risk-taking and revenue can be a natural result of principal market-making activity.[1150] One commenter noted that customer flows are often ''lumpy'' due to, for example, a market maker's facilitation of large trades.[1151]

A few commenters indicated that the analysis in the proposed customer-facing activity factor may not accurately reflect how market making occurs in certain markets and asset classes due to potential limitations on interdealer trading.[1152] According to another commenter, however, a banking entity's non-customer facing trades should be required to be matched with existing customer counterparties.[1153] With respect to the near term customer demand component of this factor, one commenter expressed concern that it goes farther than the statute's activity-based ''design'' test by analyzing whether a trading unit's inventory has exceeded reasonably expected near term customer demand at any particular point in time.[1154]

Some commenters expressed concern about the payment of fees, commissions,

[1130] *See* Morgan Stanley; Chamber (Feb. 2012) (stating that market makers in the corporate bond, interest rate derivative, and natural gas derivative markets frequently trade with other dealers to work down a concentrated position originating with a customer trade).

[1131] *See* Morgan Stanley; Chamber (Feb. 2012).

[1132] *See* Goldman (Prop. Trading).

[1133] *See* Chamber (Feb. 2012).

[1134] *See* Goldman (Prop. Trading).

[1135] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). On this issue, Appendix B stated that certain types of ''customer revenues'' provide the primary source of a market maker's profitability and, while a market maker also incurs losses or generates profits as price movements occur in its retained principal positions and risks, ''such losses or profits are incidental to customer revenues and significantly limited by the banking entity's hedging activities.'' Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8440. The Agencies address commenters' concerns about proposed requirements regarding a market maker's source of revenue in Part VI.A.3.c.7.c., *infra.*

[1136] *See* Morgan Stanley.

[1137] *See supra* note 1086 and accompanying text.

[1138] *See supra* note 1111 and accompanying text.

[1139] *See* Alfred Brock.

[1140] *See* Japanese Bankers Ass'n.

[1141] Sens. Merkley & Levin (Feb. 2012).

[1142] The proposed appendix stated that the Agencies would use certain quantitative measurements required in proposed Appendix A to help assess the extent to which a trading unit's risks are potentially being retained in excess amounts, including VaR, Stress VaR, VaR Exceedance, and Risk Factor Sensitivities. *See* Joint Proposal, 76 FR at 68961–68962; CFTC Proposal, 77 FR at 8441. One commenter questioned whether, assuming such metrics are effective and the activity does not exceed the banking entity's expressed risk appetite, it is necessary to place greater restrictions on risk-taking, based on the Agencies' judgment of the level of risk necessary for *bona fide* market making. *See* ICFR.

[1143] *See* Chamber (Feb. 2012).

[1144] *See* Credit Suisse (Seidel).

[1145] *See* Goldman (Prop. Trading); Morgan Stanley.

[1146] *See* Morgan Stanley.

[1147] *See* Goldman (Prop. Trading). This commenter suggested that the Agencies remove any negative presumptions based on revenues and instead use revenue metrics, such as Spread Profit and Loss (when it is feasible to calculate) or other metrics for purposes of monitoring a banking entity's trading activity. *See id.*

[1148] *See* Occupy (stating that these factors are important and will provide invaluable information about the nature of the banking entity's trading activity).

[1149] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1150] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011). For example, one commenter stated that because markets and trading volumes are volatile, consistent profitability and low earnings volatility are outside a market maker's control. In support of this statement, the commenter indicated that: (i) Customer trading activity varies significantly with market conditions, which results in volatility in a market maker's earnings and profitability; and (ii) a market maker will experience volatility associated with changes in the value of its inventory positions, and principal risk is a necessary feature of market making. *See* Morgan Stanley.

[1151] *See* Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1152] *See* Morgan Stanley; Goldman (Prop. Trading).

[1153] *See* Public Citizen.

[1154] *See* Oliver Wyman (Feb. 2012).

and spreads factor.[1155] One commenter appeared to support this proposed factor.[1156] According to one commenter, this factor fails to recognize that market makers routinely pay a variety of fees in connection with their market making-related activity, including, for example, fees to access liquidity on another market to satisfy customer demand, transaction fees as a matter of course, and fees in connection with hedging transactions. This commenter also indicated that, because spreads in current, rapidly-moving markets are volatile, short-term measurements of profit compared to spread revenue is problematic, particularly for less liquid stocks.[1157] Another commenter stated that this factor reflects a bias toward agency trading and principal market making in highly liquid, exchange-traded markets and does not reflect the nature of principal market making in most markets.[1158] One commenter recommended that the rule require that a trader who pays a fee be prepared to document the chain of custody to show that the instrument is shortly re-sold to an interested customer.[1159]

Regarding the proposed compensation incentives factor, one commenter requested that the Agencies make clear that explanatory facts and circumstances cannot justify a trading unit providing compensation incentives that primarily reward proprietary risk-taking to employees engaged in market making. In addition, the commenter recommended that the Agencies delete the word ''primarily'' from this factor.[1160]

c. Determination to Not Adopt Proposed Appendix B

To improve clarity, the final rule establishes particular criteria for the exemption and does not incorporate the commentary in proposed Appendix B regarding the identification of permitted market making-related activities. This **SUPPLEMENTARY INFORMATION** provides guidance on the standards for compliance with the market-making exemption.

9. Use of Quantitative Measurements

Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review.[1161] The Agencies will not use quantitative measurements as a dispositive tool for differentiating between permitted market making-related activities and prohibited proprietary trading. Like the framework the Agencies have developed for the market-making exemption, the Agencies recognize that there may be differences in the quantitative measurements across markets and asset classes.

4. Section 75.5: Permitted Risk-Mitigating Hedging Activities

Section 75.5 of the proposed rule implemented section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on proprietary trading for certain risk-mitigating hedging activities.[1162] Section 13(d)(1)(C) provides an exemption for risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings (the ''hedging exemption''). Section 75.5 of the final rule implements the hedging exemption with a number of modifications from the proposed rule to respond to commenters' concerns as described more fully below.

a. Summary of Proposal's Approach To Implementing the Hedging Exemption

The proposed rule would have required seven criteria to be met in order for a banking entity's activity to qualify for the hedging exemption. First, §§ 75.5(b)(1) and 75.5(b)(2)(i) of the proposed rule generally required that the banking entity establish an internal compliance program that is designed to ensure the banking entity's compliance with the requirements of the hedging limitations, including reasonably designed written policies and procedures, internal controls, and independent testing, and that a transaction for which the banking entity is relying on the hedging exemption be made in accordance with the compliance program established under § 75.5(b)(1). Next, § 75.5(b)(2)(ii) of the proposed rule required that the transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity. Moreover, § 75.5(b)(2)(iii) of the proposed rule required that the transaction be reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate. Furthermore, § 75.5(b)(2)(iv) of the proposed rule required that the hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction. Section 75.5(b)(2)(v) of the proposed rule required that any hedge position established in reliance on the hedging exemption be subject to continuing review, monitoring and management. Finally, § 75.5(b)(2)(vi) of the proposed rule required that the compensation arrangements of persons performing the risk-mitigating hedging activities be designed not to reward proprietary risk-taking. Additionally, § 75.5(c) of the proposed rule required the banking entity to document certain hedging transactions at the time the hedge is established.

b. Manner of Evaluating Compliance With the Hedging Exemption

A number of commenters expressed concern that the final rule required application of the hedging exemption on a trade-by-trade basis.[1163] One commenter argued that the text of the proposed rule seemed to require a trade-by-trade analysis because each ''purchase or sale'' or ''hedge'' was subject to the requirements.[1164] The final rule modifies the proposal by generally replacing references to a ''purchase or sale'' in the § 75.5(b) requirements with ''risk-mitigating hedging activity.'' The Agencies believe this approach is consistent with the statute, which refers to ''risk-mitigating hedging activity.''[1165]

[1155] *See* NYSE Euronext; Morgan Stanley.

[1156] *See* Public Citizen.

[1157] *See* NYSE Euronext.

[1158] *See* Morgan Stanley.

[1159] *See* Public Citizen.

[1160] *See* Occupy. This commenter also stated that the commentary in Appendix B stating that a banking entity may give some consideration of profitable hedging activities in determining compensation would provide inappropriate incentives. *See id.*

[1161] *See infra* Part VI.C.3.; final rule Appendix A.

[1162] *See* 12 U.S.C. 1851(d)(1)(C); proposed rule § 75.5.

[1163] *See* Ass'n. of Institutional Investors (Feb. 2012); *see also* Barclays; ICI (Feb. 2012); Investure; MetLife; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley; Fixed Income Forum/Credit Roundtable; Fidelity; FTN.

[1164] *See* Barclays.

[1165] *See* 12 U.S.C. 1851(d)(1)(C) (stating that ''risk-mitigating hedging activities'' are permitted under certain circumstances).

Section 13(d)(1)(C) of the BHC Act specifically authorizes risk-mitigating hedging activities in connection with and related to ''individual or aggregated positions, contracts or other holdings.'' [1166] Thus, the statute does not require that exempt hedging be conducted on a trade-by-trade basis, and permits hedging of aggregated positions. The Agencies recognized this in the proposed rule, and the final rule continues to permit hedging activities in connection with and related to individual or aggregated positions.

The statute also requires that, to be exempt under section 13(d)(1)(C), hedging activities be risk-mitigating. The final rule incorporates this statutory requirement. As explained in more detail below, the final rule requires that, in order to qualify for the exemption for risk-mitigating hedging activities: The banking entity implement, maintain, and enforce an internal compliance program, including policies and procedures that govern and control these hedging activities; the hedging activity be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates specific, identifiable risks; the hedging activity not give rise to significant new risks that are left unhedged; the hedging activity be subject to continuing review, monitoring and management to address risk that might develop over time; and the compensation arrangements for persons performing risk-mitigating hedging activities be designed not to reward or incentivize prohibited proprietary trading. These requirements are designed to focus the exemption on hedging activities that are designed to reduce risk and that also demonstrably reduce risk, in accordance with the requirement under section 13(d)(1)(C) that hedging activities be risk-mitigating to be exempt. Additionally, the final rule imposes a documentation requirement on certain types of hedges.

Consistent with the other exemptions from the ban on proprietary trading for market-making and underwriting, the Agencies intend to evaluate whether an activity complies with the hedging exemption under the final rule based on the totality of circumstances involving the products, techniques, and strategies used by a banking entity as part of its hedging activity.[1167]

c. Comments on the Proposed Rule and Approach To Implementing the Hedging Exemption

Commenters expressed a variety of views on the proposal's hedging exemption. A few commenters offered specific suggestions described more fully below regarding how, in their view, the hedging exemption should be strengthened to ensure proper oversight of hedging activities.[1168] These commenters expressed concern that the proposal's exemption was too broad and argued that all proprietary trading could be designated as a hedge under the proposal and thereby evade the prohibition of section 13.[1169]

By contrast, a number of other commenters argued that the proposal imposed burdensome requirements that were not required by statute, would limit the ability of banking entities to hedge in a prudent and cost-effective manner, and would reduce market liquidity.[1170] These commenters argued that implementation of the requirements of the proposal would decrease safety and soundness of banking entities and the financial system by reducing cost-effective risk management options. Some commenters emphasized that the ability of banking entities to hedge their positions and manage risks taken in connection with their permissible activities is a critical element of liquid and efficient markets, and that the cumulative impact of the proposal would inhibit this risk-mitigation by raising transaction costs and suppressing essential and beneficial hedging activities.[1171]

A number of commenters expressed concern that the proposal's hedging exemption did not permit the full breadth of transactions in which banking entities engage to hedge or mitigate risks, such as portfolio hedging,[1172] dynamic hedging,[1173] anticipatory hedging,[1174] or scenario hedging.[1175] Some commenters stated that restrictions on a banking entity's ability to hedge may have a chilling effect on its willingness to engage in other permitted activities, such as market making.[1176] In addition, many of these commenters stated that, if a banking entity is limited in its ability to hedge its market-making inventory, it may be less willing or able to assume risk on behalf of customers or provide financial products to customers that are used for hedging purposes. As a result, according to these commenters, it will be more difficult for customers to hedge their risks and customers may be forced to retain risk.[1177]

Another commenter contended that the proposal represented an inappropriate ''one-size-fits-all'' approach to hedging that did not properly take into account the way banking entities and especially market intermediaries operate, particularly in less-liquid markets.[1178] Two commenters requested that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of the proposed exemption and, in particular, that a banking entity is not obligated to choose the ''best hedge'' and may use the cheapest instrument available.[1179] One commenter suggested uncertainty about the permissibility of a situation where gains on a hedge position exceed losses on the underlying position. The commenter suggested that uncertainty may lead banking entities to not use the most cost-effective hedge, which would make hedging less efficient and raise costs for banking entities and customers.[1180] However, another commenter expressed concern about banking entities relying on the cheapest satisfactory hedge. The commenter explained that such hedges lead to more complicated risk profiles and require banking entities to engage in additional transactions to hedge the

[1166] *See* 12 U.S.C. 1851(d)(1)(C).

[1167] *See* Part VI.A.4.b., *infra.*

[1168] *See, e.g.,* AFR *et al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1169] *See, e.g.,* Occupy.

[1170] *See, e.g.,* Australian Bankers' Ass'n (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1171] *See* Credit Suisse (Seidel); ICI (Feb. 2012); Wells Fargo (Prop. Trading); *see also* Banco de México; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA.

[1172] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA; HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1173] *See* Goldman (Prop. Trading); BoA.

[1174] *See* Barclays; State Street (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1175] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Markets Regulation. Each of these types of activities is discussed further below. *See infra* Part VI.A.4.d.2.

[1176] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1177] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Credit Suisse (Seidel).

[1178] *See* Barclays.

[1179] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel).

[1180] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

exposures resulting from the imperfect, cheapest hedge.[1181]

A few commenters suggested the hedging exemption be modified in favor of a simpler requirement that banking entities adopt risk limits and policies and procedures commensurate with qualitative guidance issued by the Agencies.[1182] Many of these commenters also expressed concerns that the proposed rule's hedging exemption would not allow so-called asset-liability management (''ALM'') activities.[1183] Some commenters proposed that the risk-mitigating hedging exemption reference a set of relevant descriptive factors rather than specific prescriptive requirements.[1184] Other alternative frameworks suggested by commenters include: (i) Reformulating the proposed requirements as supervisory guidance; [1185] (ii) establishing a safe harbor,[1186] presumption of compliance,[1187] or bright line test; [1188] or (iii) a principles-based approach that would require a banking entity to document its risk-mitigating hedging strategies for submission to its regulator.[1189]

d. Final Rule

The final rule provides a multi-faceted approach to implementing the hedging exemption that seeks to ensure that hedging activity is designed to be risk-reducing in nature and not designed to mask prohibited proprietary trading.[1190] The final rule includes a number of modifications in response to comments.

This multi-faceted approach is intended to permit hedging activities that are risk-mitigating and to limit potential abuse of the hedging exemption while not unduly constraining the important risk-management function that is served by a banking entity's hedging activities. This approach is also intended to ensure that any banking entity relying on the hedging exemption has in place appropriate internal control processes to support its compliance with the terms of the exemption. While commenters proposed a number of alternative frameworks for the hedging exemption, the Agencies believe the final rule's multi-faceted approach most effectively balances commenter concerns with statutory purpose. In response to commenter requests to reformulate the proposed rule as supervisory guidance,[1191] including the suggestion that the Agencies simply require banking entities to adopt risk limits and policies and procedures commensurate with qualitative Agency guidance,[1192] the Agencies believe that such an approach would provide less clarity than the adopted approach. Although a purely guidance-based approach could provide greater flexibility, it would also provide less specificity, which could make it difficult for banking entity personnel and the Agencies to determine whether an activity complies with the rule and could lead to an increased risk of evasion of the statutory requirements. Further, while a bright-line or safe harbor approach to the hedging exemption would generally provide a high degree of certainty about whether an activity qualifies for the exemption, it would also provide less flexibility to recognize the differences in hedging activity across markets and asset classes.[1193] In addition, the use of any bright-line approach would more likely be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the hedging exemption. Similarly, the Agencies decline to establish a presumption of compliance because, in light of the constant innovation of trading activities and the differences in hedging activity across markets and asset classes, establishing appropriate parameters for a presumption of compliance with the hedging exemption would potentially be less capable of recognizing these legitimate differences than our current approach.[1194] Moreover, the Agencies decline to follow a principles-based approach requiring a banking entity to document its hedging strategies for submission to its regulator.[1195] The Agencies believe that evaluating each banking entity's trading activity based on an individualized set of documented hedging strategies could be unnecessarily burdensome and result in unintended competitive impacts since banking entities would not be subject to one uniform rule. The Agencies believe the multi-faceted approach adopted in the final rule establishes a consistent framework applicable to all banking entities that will reduce the potential for such adverse impacts.

Further, the Agencies believe the scope of the final hedging exemption is appropriate because it permits risk-mitigating hedging activities, as mandated by section 13 of the BHC Act,[1196] while requiring a robust compliance program and other internal controls to help ensure that only genuine risk-mitigating hedges can be used in reliance on the exemption.[1197] In response to concerns that the proposed hedging exemption would reduce legitimate hedging activity and thus impact market liquidity and the banking entity's willingness to engage in permissible customer-related activity,[1198] the Agencies note that the requirements of the final hedging exemption are designed to permit banking entities to properly mitigate specific risk exposures, consistent with the statute. In addition, hedging related to market-making activity conducted by a market-making desk is subject to the requirements of the market-making exemption, which are designed to permit banking entities to continue providing valuable intermediation and liquidity services, including related risk-management activity.[1199] Thus, the final hedging exemption will not negatively impact the safety and soundness of banking entities or the

[1181] *See* Occupy.

[1182] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1183] A detailed discussion of ALM activities is provided in Part VI.A.1.d.2 of this **SUPPLEMENTARY INFORMATION** relating to the definition of trading account. As explained in that part, the final rule does not allow use of the hedging exemption for ALM activities that are outside of the hedging activities specifically permitted by the final rule.

[1184] *See* BoA; JPMC; Morgan Stanley.

[1185] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI.

[1186] *See* Prof. Richardson; ABA (Keating).

[1187] *See* Barclays; BoA; ISDA (Feb. 2012).

[1188] *See* Johnson & Prof. Stiglitz.

[1189] *See* HSBC.

[1190] *See* final rule § 75.5.

[1191] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI (Feb. 2012); BoA; Morgan Stanley.

[1192] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1193] Some commenters requested that the Agencies establish a safe harbor. *See* Prof. Richardson; ABA (Keating). One commenter requested that the Agencies adopt a bright-line test. *See* Johnson & Prof. Stiglitz.

[1194] A few commenters requested that the Agencies establish a presumption of compliance. *See* Barclays; BoA; ISDA (Feb. 2012).

[1195] One commenter suggested this principles-based approach. *See* HSBC.

[1196] Section 13(d)(1)(C) of the BHC Act permits ''risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.'' 12 U.S.C. 1851(d)(1)(C).

[1197] Some commenters were concerned that the proposed hedging exemption was too broad and that all proprietary trading could be designated as a hedge. *See, e.g.,* Occupy.

[1198] *See, e.g.,* Australian Bankers Ass'n. (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1199] *See supra* Part VI.A.3.c.4.

financial system or have a chilling effect on a banking entity's willingness to engage in other permitted activities, such as market making.[1200]

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

1. Compliance Program Requirement

The first criterion of the proposed hedging exemption required a banking entity to establish an internal compliance program designed to ensure the banking entity's compliance with the requirements of the hedging exemption and conduct its hedging activities in compliance with that program. While the compliance program under the proposal was expected to be appropriate for the size, scope, and complexity of each banking entity's activities and structure, the proposal would have required each banking entity with significant trading activities to implement robust, detailed hedging policies and procedures and related internal controls and independent testing designed to prevent prohibited proprietary trading in the context of permitted hedging activity.[1201] These enhanced programs for banking entities with large trading activity were expected to include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader designed to ensure that hedging strategies mitigated risk and were not for the purpose of engaging in prohibited proprietary trading.

Commenters, including industry groups, generally expressed support for requiring policies and procedures to monitor the safety and soundness, as well as appropriateness, of hedging activity.[1202] Some of these commenters advocated that the final rule presume that a banking entity is in compliance with the hedging exemption if the banking entity's hedging activity is done in accordance with the written policies and procedures required under its compliance program.[1203] One commenter represented that the proposed compliance framework was burdensome and complex.[1204]

Other commenters expressed concerns that the hedging exemption would be too limiting and burdensome for community and regional banks.[1205] Some commenters argued that foreign banking entities should not be subject to the requirements of the hedging exemption for transactions that do not introduce risk into the U.S. financial system.[1206] Other commenters stated that coordinated hedging through and by affiliates should qualify as permitted risk-mitigating hedging activity.[1207]

Some commenters urged the Agencies to adopt detailed limitations on hedging activities. For example, one commenter urged that all hedging trades be labeled as such at the inception of the trade and detailed information regarding the trader, manager, and supervisor authorizing the trade be kept and reviewed.[1208] Another commenter suggested that the hedging exemption contain a requirement that the banking entity employee who approves a hedge affirmatively certify that the hedge conforms to the requirements of the rule and has not been put in place for the direct or indirect purpose or effect of generating speculative profits.[1209] A few commenters requested limitations on instruments that can be used for hedging purposes.[1210]

The final rule retains the proposal's requirement that a banking entity establish an internal compliance program that is designed to ensure the banking entity limits its hedging activities to hedging that is risk-mitigating.[1211] The final rule largely retains the proposal's approach to the compliance program requirement, except to the extent that, as requested by some commenters,[1212] the final rule modifies the proposal to provide additional detail regarding the elements that must be included in a compliance program. Similar to the proposal, the final rule contemplates that the scope and detail of a compliance program will reflect the size, activities, and complexity of banking entities in order to ensure that banking entities engaged in more active trading have enhanced compliance programs without imposing undue burden on smaller organizations and entities that engage in little or no trading activity.[1213] The final rule also requires, like the proposal, that the banking entity implement, maintain, and enforce the program.[1214]

In response to commenter concerns about ensuring the appropriate level of senior management involvement in establishing these policies,[1215] the final rule requires that the written policies and procedures be developed and implemented by a banking entity at the appropriate level of organization and expressly address the banking entity's requirements for escalation procedures, supervision, and governance related to hedging activities.[1216]

[1200] Some commenters believed that restrictions on hedging would have a chilling effect on banking entities' willingness to engage in market making, and may result in customers experiencing difficulty in hedging their risks or force customers to retain risk. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA; IHS.

[1201] These aspects of the compliance program requirement are described in further detail in Part VI.C. of this **SUPPLEMENTARY INFORMATION.**

[1202] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1203] *See* BoA; Barclays; HSBC; JPMC; Morgan Stanley; *see also* Goldman (Prop. Trading); RBC; Barclays; ICI (Feb. 2012); ISDA (Apr. 2012); PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). See the discussion of why the Agencies decline to take a presumption of compliance approach above.

[1204] *See* Barclays.

[1205] *See* ICBA; M&T Bank.

[1206] *See, e.g.,* Bank of Canada; Allen & Overy (on behalf of Canadian Banks). Additionally, foreign banking entities engaged in hedging activity may be able to rely on the exemption for trading activity conducted by foreign banking entities in lieu of the hedging exemption, provided they meet the requirements of the exemption for trading by foreign banking entities under § 75.6(e) of the final rule. *See infra* Part VI.A.8.

[1207] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1208] *See* Sens. Merkley & Levin (Feb. 2012).

[1209] *See* Better Markets (Feb. 2012).

[1210] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras.

[1211] *See* final rule § 75.5(b)(1). The final rule retains the proposal's requirement that the compliance program include, among other things, written hedging policies.

[1212] *See, e.g.,* BoA; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1213] *See* final rule § 75.20(a) (stating that ''[t]he terms, scope and detail of [the] compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity''). The Agencies believe this helps address some commenters' concern that the hedging exemption would be too limiting and burdensome for community and regional banks. *See* ICBA; M&T Bank.

[1214] Many of these policies and procedures were contained as part of the proposed rule's compliance program requirements under Appendix C. They have been moved, and in some cases modified, in order to more clearly demonstrate how they are incorporated into the requirements of the hedging exemption.

[1215] *See* Better Markets (Feb. 2012). The final rule does not require affirmative certification of each hedge, as suggested by this commenter, because the Agencies believe it would unnecessarily slow legitimate transactions. The Agencies believe the final rule's required management framework and escalation procedures achieve the same objective as the commenter's suggested approach, while imposing fewer burdens on legitimate risk-mitigating hedging activity.

[1216] *See* final rule §§ 75.20(b), 75.5(b). This approach builds on the proposal's requirement that senior management and intermediate managers be accountable for the effective implementation of the compliance program.

Like the proposal, the final rule specifies that a banking entity's compliance regime must include reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a trading desk may use in its risk-mitigating hedging activities.[1217] The focus on policies and procedures governing risk identification and mitigation, analysis and testing of position limits and hedging strategies, and internal controls and ongoing monitoring is expected to limit use of the hedging exception to risk-mitigating hedging. The final rule adds to the proposed compliance program approach by requiring that the banking entity's written policies and procedures include position and aging limits with respect to such positions, contracts, or other holdings.[1218] The final rule, similar to the proposed rule, also requires that the compliance program contain internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures.[1219] Further, the final rule retains the proposed requirement that the compliance program provide for the conduct of analysis and independent testing designed to ensure that the positions, techniques, and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged.[1220]

The final rule also adds that correlation analysis be undertaken as part of the analysis of the hedging positions, techniques, and strategies that may be used. This provision effectively changes the requirement in the proposed rule that the hedge must maintain correlation into a requirement that correlation be analyzed as part of the compliance program before a hedging activity is undertaken. This provision incorporates the concept in the proposed rule that a hedge should be correlated (negatively, when sign is considered) to the risk being hedged. However, the Agencies recognize that some effective hedging activities, such as deep out-of-the-money puts and calls, may not be exhibit a strong linear correlation to the risks being hedged and also that correlation over a period of time between two financial positions does not necessarily mean one position will in fact reduce or mitigate a risk of the other. Rather, the Agencies expect the banking entity to undertake a correlation analysis that will, in many but not all instances, provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce. It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods. Rather, the nature and extent of the correlation analysis undertaken would be dependent on the facts and circumstances of the hedge and the underlying risks targeted. If correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation.

Moreover, the final rule requires hedging activity conducted in reliance on the hedging exemption be subject to continuing review, monitoring, and management that is consistent with the banking entity's written hedging policies and procedures and is designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, the specific, identifiable risks that develop over time from hedging activity and underlying positions.[1221] This ongoing review should consider market developments, changes in positions or the configuration of aggregated positions, changes in counterparty risk, and other facts and circumstances related to the risks associated with the underlying and hedging positions, contracts, or other holdings.

The Agencies believe that requiring banking entities to develop and follow detailed compliance policies and procedures related to risk-mitigating hedging activity will help both banking entities and examiners understand the risks to which banking entities are exposed and how these risks are managed in a safe and sound manner. With this increased understanding, banking entities and examiners will be better able to evaluate whether banking entities are engaged in legitimate, risk-reducing hedging activity, rather than impermissible proprietary trading. While the Agencies recognize there are certain costs associated with this compliance program requirement,[1222] we believe this provision is necessary to ensure compliance with the statute and the final rule. As discussed in Part VI.C.1., the Agencies have modified the proposed compliance program structure to reduce burdens on small banking entities.[1223]

The Agencies note that hedging may occur across affiliates under the hedging exemption.[1224] To ensure that hedging across trading desks or hedging done at a level of the organization outside of the trading desk does not result in prohibited proprietary trading, the final rule imposes enhanced documentation requirements on these activities, which are discussed more fully below. The Agencies also note that nothing in the final rule limits or restricts the ability of the appropriate supervisory agency of a banking entity to place limits on interaffiliate hedging in a manner consistent with their safety and soundness authority to the extent the

[1217] This approach is generally consistent with some commenters' suggested approach of limiting the instruments that can be used for hedging purposes; although the final rules provide banking entities with discretion to determine the types of positions, contracts, or other holdings that will mitigate specific risks of individual or aggregated holdings and thus may be used for risk-mitigating hedging activity. *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras. In response to one commenter's request that the final rule require all hedges to be labeled at inception and certain detailed information be documented for each hedge, the Agencies note that the final rules continue to require detailed documentation for hedging activity that presents a heightened risk of evasion. *See* Sens. Merkley & Levin (Feb. 2012); final rule § 75.5(c); *infra* Part VI.A.4.d.4. The Agencies believe a documentation requirement targeted at these scenarios balances the need to prevent evasion of the general prohibition on proprietary trading with the concern that documentation requirements can slow or impede legitimate risk-mitigating activity in the normal course.

[1218] *See* final rule § 75.5(b)(1)(i). Some commenters expressed support for the use of risk limits in determining whether trading activity qualifies for the hedging exemption. *See, e.g.,* Barclays; Credit Suisse (Seidel); ICI (Feb. 2012); Morgan Stanley.

[1219] *See* final rule § 75.5(b)(1)(ii).

[1220] *See* final rule § 75.5(b)(1)(iii). The final rule's requirement to demonstrably reduce or otherwise significantly mitigate is discussed in greater detail below.

[1221] The proposal also contained a continuing review, monitoring, and management requirement. *See* proposed rule § 75.5(b)(2)(v). The final rule modifies the proposed requirement, however, by removing the ''reasonable correlation'' requirement and instead requiring that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks. Correlation analysis is, however, a necessary component of the analysis element in the compliance program requirement of the hedging exemption in the final rule. *See* final rule § 75.5(b). This change is discussed below.

[1222] *See* Barclays.

[1223] *See infra* Part VI.C.1. Some commenters expressed concern that the compliance program requirement would place undue burden on regional or community banks. *See* ICBA; M&T Bank.

[1224] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

agency has such authority.[1225] Additionally, nothing in the final rule limits or modifies the applicability of CFTC regulations with respect to the clearing of interaffiliate swaps.[1226]

2. Hedging of Specific Risks and Demonstrable Reduction of Risk

Section 75.5(b)(2)(ii) of the proposed rule required that a qualifying transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity.[1227] This criterion implemented the essential element of the hedging exemption that the transaction be risk-mitigating.

Some commenters expressed support for this provision, particularly the requirement that a banking entity be able to tie a hedge to a specific risk.[1228] One of these commenters stated that a demonstrated reduction in risk should be a key indicator of whether a hedge is in fact permitted.[1229] However, some commenters argued that the list of risks eligible to be hedged under the proposed rule, which included risks arising from aggregated positions, could justify transactions that should be viewed as prohibited proprietary trading.[1230] Another commenter contended that the term ''basis risk'' was undefined and could heighten the potential that this exemption would be used to evade the prohibition on proprietary trading.[1231]

Other commenters argued that requiring a banking entity to specify the particular risk being hedged discourages effective hedging and increases the risk at banking entities. These commenters contended that hedging activities must address constantly changing positions and market conditions.[1232] Another commenter argued that this requirement could render a banking entity's hedges impermissible if those hedges do not succeed in fully hedging or mitigating an identified risk as determined by a post hoc analysis and could prevent banking entities from entering into hedging transactions in anticipation of risks that the banking entity expects will arise (or increase).[1233] Certain commenters requested that the hedging exemption provide a safe harbor for positions that satisfy FASB ASC Topic 815 (formerly FAS 133) hedging accounting standards, which provides that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts, as assets or liabilities in the statement of financial position and measure them at fair value.[1234] Another commenter suggested that scenario hedges could be identifiable and subject to review by the Agencies using VaR, Stress VaR, and VaR Exceedance, as well as revenue metrics.[1235]

The Agencies have considered these comments carefully in light of the statute. Section 13(d)(1)(C) of the BHC Act provides an exemption from the prohibition on proprietary trading only for hedging activity that is ''designed to reduce the specific risks to the banking entity in connection with and related to'' individual or aggregated positions, contracts, or other holdings of the banking entity.[1236] Thus, while the statute permits hedging of individual or aggregated positions (as discussed more fully below), the statute requires that, to be exempt from the prohibition on proprietary trading, hedging transactions be designed to reduce specific risks.[1237] Moreover, it requires that these specific risks be in connection with or related to the individual or aggregated positions, contracts, or other holdings of the banking entity.

The final rule implements these requirements. To ensure that exempt hedging activities are designed to reduce specific risks, the final rule requires that the hedging activity at inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified individual or aggregated positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1238] Hedging activities and limits should be based on analysis conducted by the banking entity of the appropriateness of hedging instruments, strategies, techniques, and limits. As discussed above, this analysis must include analysis of correlation between the hedge and the specific identifiable risk or risks that the hedge is designed to reduce or significantly mitigate.[1239]

This language retains the focus of the statute and the proposed rule on reducing or mitigating specific and identified risks.[1240] As discussed more fully above, banking entities are required to describe in their compliance policies and procedures the types of strategies, techniques, and positions that may be used for hedging.

The final rule does not prescribe the hedging strategy that a banking entity must employ. While one commenter urged that the final rule require each banking entity to adopt the ''best hedge'' for every transaction,[1241] the Agencies believe that the complexity of positions, market conditions at the time of a transaction, availability of hedging

[1225] In addition, section 608 of the Dodd-Frank Act added credit exposure arising from securities borrowing and lending or a derivative transaction with an affiliate to the list of covered transactions subject to the restrictions of section 23A of the FR Act, in each case to the extent that such transaction causes a bank to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7) and (8). As a consequence, interaffiliate hedging activity within a banking entity may be subject to limitation or restriction under section 23A of the FR Act.

[1226] *See* 17 CFR 50.52.

[1227] *See* proposed rule § 75.5(b)(2)(ii); *see also* Joint Proposal, 76 FR at 68875.

[1228] *See* AFR (June 2013); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1229] *See* Sens. Merkley & Levin (Feb. 2012).

[1230] *See* Public Citizen; *see also* Occupy.

[1231] *See* Occupy.

[1232] *See, e.g.,* Japanese Bankers Ass'n.

[1233] *See* Barclays.

[1234] *See* ABA (Keating); Wells Fargo (Prop. Trading). Although certain accounting standards, such as FASB ASC Topic 815 hedge accounting standards, address circumstances in which a transaction may be considered a hedge of another transaction, the final rule does not refer to or expressly rely on these accounting standards because such standards: (i) are designed for financial statement purposes, not to identify proprietary trading; and (ii) change often and are likely to change in the future without consideration of the potential impact on section 13 of the BHC Act.

[1235] *See* JPMC.

[1236] 12 U.S.C. 1851(d)(1)(C).

[1237] Some commenters expressed support for the requirement that a banking entity tie a hedge to a specific risk. *See* AFR (June 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1238] *See* final rule § 75.5(b)(2)(ii).

[1239] *See* final rule § 75.5(b)(1)(iii).

[1240] Some commenters represented that the proposed list of risks eligible to be hedged could justify transactions that should be considered proprietary trading. *See* Public Citizen; Occupy. One commenter was concerned about the proposed inclusion of ''basis risk'' in this list. *See* Occupy. As noted in the proposal, the Agencies believe the inclusion of a list of eligible risks, including basis risk, helps implement the essential element of the statutory hedging exemption—*i.e.,* that the transaction is risk-reducing in connection with a specific risk. *See* Joint Proposal, 76 FR at 68875. *See also* 12 U.S.C. 1851(d)(1)(C). Further, the Agencies believe the other requirements of the final hedging exemption, including requirements regarding internal controls and a compliance program, help to ensure that only legitimate hedging activity qualifies for the exemption.

[1241] *See, e.g.,* Occupy.

transactions, costs of hedging, and other circumstances at the time of the transaction make a requirement that a banking entity always adopt the ''best hedge'' impractical, unworkable, and subjective.

Nonetheless, the statute requires that, to be exempt under section 13(d)(1)(C), hedging activity must be risk-mitigating. To ensure that only risk-mitigating hedging is permitted under this exemption, the final rule requires that in its written policies and procedures the banking entity identify the instruments and positions that may be used in hedging, the techniques and strategies the banking entity deems appropriate for its hedging activities, as well as position limits and aging limits on hedging positions. These written policies and procedures also must specify the escalation and approval procedures that apply if a trader seeks to conduct hedging activities beyond the limits, position types, strategies, or techniques authorized for the trader's activities.[1242]

As noted above, commenters were concerned that risks associated with permitted activities and holdings change over time, making a determination regarding the effectiveness of hedging activities in reducing risk dependent on the time when risk is measured. To address this, the final rule requires that the exempt hedging activity be designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, risk at the inception of the hedge. As explained more fully below, because risks and the effectiveness of a hedging strategy may change over time, the final rule also requires the banking entity to implement a program to review, monitor, and manage its hedging activity over the period of time the hedging activity occurs in a manner designed to reduce or significantly mitigate and demonstrably reduce or otherwise significantly mitigate new or changing risks that may develop over time from both the banking entity's hedging activities and the underlying positions. Many commenters expressed concern that the proposed ongoing review, monitoring, and management requirement would limit a banking entity's ability to engage in aggregated position hedging.[1243] One commenter stated that because aggregated position hedging may result in modification of hedging exposures across a variety of underlying risks, even as the overall risk profile of a banking entity is reduced, it would become impossible to subsequently review, monitor, and manage individual hedging transactions for compliance.[1244] The Agencies note that the final rule, like the statute, requires that the hedging activity relate to individual or aggregated positions, contracts or other holdings being hedged, and accordingly, the review, monitoring and management requirement would not limit the extent of permitted hedging provided for in section 13(d)(1)(C) as implied by some commenters. Further, the final rule recognizes that the determination of whether hedging activity demonstrably reduces or otherwise significantly mitigates risks that may develop over time should be ''based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof.'' [1245]

A number of other commenters argued that a legitimate risk-reducing hedge may introduce new risks at inception.[1246] A few commenters contended that a requirement that no new risks be associated with a hedge would be inconsistent with prudent risk management and greatly reduce the ability of banking entities to reduce overall risk through hedging.[1247] A few commenters stated that the proposed requirement does not recognize that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner.[1248] With respect to the timing of the initial hedge and any additional transactions necessary to reduce significant exposures arising from it, one of these commenters represented that requiring contemporaneous hedges is impracticable, would raise transaction costs, and would make hedging uneconomic.[1249] Another commenter stated that this requirement could have a chilling effect on risk managers' willingness to engage in otherwise permitted hedging activity.[1250]

Other commenters stated that a position that does not fully offset the risk of an underlying position is not in fact a hedge.[1251] These commenters believed that the introduction of new risks at inception of a transaction indicated that the transaction was impermissible proprietary trading and not a hedge.[1252]

The Agencies recognize that prudent risk-reducing hedging activities by banking entities are important to the efficiency of the financial system.[1253] The Agencies further recognize that hedges are generally imperfect; consequently, hedging activities can introduce new and sometimes significant risks, such as credit risk, basis risk, or new market risk, especially when hedging illiquid positions.[1254] However, the Agencies also recognize that hedging activities present an opportunity to engage in impermissible proprietary trading designed to profit from exposure to these types of risks.

To address these competing concerns, the final rule substantially retains the proposed requirement that, at the inception of the hedging activity, the risk-reducing hedging activity does not give rise to significant new or additional risk that is not itself contemporaneously hedged. This approach is designed to allow banking entities to continue to engage in prudent risk-mitigating activities while ensuring that the hedging exemption is not used to engage in prohibited proprietary trading by taking on prohibited short-term exposures under the guise of hedging.[1255] As noted in the proposal,

[1242] A banking entity must satisfy the enhanced documentation requirements of § 75.5(c) if it engages in hedging activity utilizing positions, contracts, or holdings that were not identified in its written policies and procedures.

[1243] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1244] *See* Barclays.

[1245] Final rule § 75.5(b)(2)(iv)(B). The Agencies believe this provision addresses some commenters' concern that the ongoing review, monitoring, and management requirement would limit hedging of aggregated positions, and that such ongoing review of individual hedge transactions with a variety of underlying risks would be impossible. *See* SIFMA (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1246] *See* ABA (Keating); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* AFR *et al.* (Feb. 2012).

[1247] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1248] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays.

[1249] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1250] *See* BoA.

[1251] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; AFR (Nov. 2012).

[1252] *See* Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012).

[1253] *See* FSOC study (stating that ''[p]rudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability'').

[1254] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1255] Some commenters stated that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner, and requiring contemporaneous hedges would raise transaction costs and the potential for hedges to become uneconomical. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays. As noted in the proposal, the Agencies believe that requiring a contemporaneous hedge of any significant new risk that arises at the inception of a hedge is appropriate because a transaction that creates significant new risk exposure that is not itself hedged at the same time would appear to be indicative of prohibited proprietary trading. *See* Joint Proposal, 76 FR at 68876. Thus, the Agencies believe this requirement is necessary to prevent evasion of the general prohibition on proprietary trading. In response to

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however, the Agencies recognize that exposure to new risks may result from legitimate hedging transactions;[1256] this provision only prohibits the introduction of additional significant exposures through the hedging transaction unless those additional exposures are contemporaneously hedged.

As noted above, the final rule recognizes that whether hedging activity will demonstrably reduce risk must be based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1257] The Agencies believe this approach balances commenters' request that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of the proposed exemption[1258] with concerns that allowing banking entities to rely on the cheapest satisfactory hedge will lead to additional hedging transactions.[1259] The Agencies expect that hedging strategies and techniques, as well as assessments of risk, will vary across positions, markets, activities and banking entities, and that a ''one-size-fits-all'' approach would not accommodate all types of appropriate hedging activity.[1260]

By its terms, section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .''[1261] The preamble to the proposed rule made clear that, consistent with the statutory reference to mitigating risks of individual or aggregated positions, this criterion permits hedging of risks associated with aggregated positions.[1262] This approach is consistent with prudent risk-management and safe and sound banking practice.[1263]

The proposed rule explained that, to be exempt under this provision, hedging activities must reduce risk with respect to ''positions, contracts, or other holdings of the banking entity.'' The proposal also required that a banking entity relying on the exemption be prepared to identify the specific position or risks associated with aggregated positions being hedged and demonstrate that the hedging transaction was risk-reducing in the aggregate, as measured by appropriate risk management tools.

Some commenters were of the view that the hedging exemption applied to aggregated positions or portfolio hedging and was consistent with prudent risk-management practices. These commenters argued that permitting a banking entity to hedge aggregate positions and risks arising from a portfolio of assets would be more efficient from both a procedural and business standpoint.[1264]

By contrast, other commenters argued that portfolio-based hedging could be used to mask prohibited proprietary trading.[1265] One commenter contended that the statute provides no basis for portfolio hedging, and another commenter similarly suggested that portfolio hedging should be prohibited.[1266] Another commenter suggested adopting limits that would prevent the use of the hedging exemption to conduct proprietary activity at one desk as a theoretical ''hedge for proprietary trading at another desk.''[1267] Among the limits suggested by these commenters were a requirement that a banking entity have a well-defined compliance program, the formation of central ''risk management'' groups to perform and monitor hedges of aggregated positions, and a requirement that the banking entity demonstrate the capacity to measure aggregate risk across the institution with precision using proven models.[1268] A few commenters suggested that the presence of portfolio hedging should be viewed as an indicator of imperfections in hedging at the desk level and be a flag used by examiners to identify and review the integrity of specific hedges.[1269]

The final rule, like the proposed rule, implements the statutory language providing for risk-mitigating hedging activities related to individual or aggregated positions. For example, activity permitted under the hedging exemption would include the hedging of one or more specific risks arising from identified positions, contracts, or other holdings, such as the hedging of the aggregate risk of identified positions of one or more trading desks. Further, the final rule requires that these hedging activities be risk-reducing with respect to the identified positions, contracts, or other holdings being hedged and that the risk reduction be demonstrable. Specifically, the final rule requires, among other things: That the banking entity has a robust compliance program reasonably designed to ensure compliance with the exemption; that each hedge is subject to continuing review, monitoring and management designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time related to the hedging activity and the underlying positions, contracts, or other holdings of the banking entity; and that the banking entity meet a documentation requirement for hedges not established by the trading desk responsible for the underlying position or for hedges effected through a financial instrument, technique or strategy that is not specifically identified in the trading desk's written policies and procedures. The Agencies believe this approach addresses concerns that a banking entity could use the hedging exemption to conduct proprietary activity at one desk as a theoretical hedge for proprietary trading at another desk in a manner consistent with the statute.[1270] Further, the Agencies believe the adopted exemption allows banking entities to engage in hedging of aggregated positions[1271] while helping to ensure that such hedging activities are truly risk-mitigating.[1272]

commenters' concerns about transaction costs and uneconomical hedging, the Agencies note that this provision only requires additional hedging of ''significant'' new or additional risk and does not apply to any risk exposure arising from a hedge.

[1256] *See* Joint Proposal, 76 FR at 68876.

[1257] *See* final rule § 75.5(b)(2)(ii).

[1258] *See* SIFMA (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1259] *See* Occupy.

[1260] *See* Barclays.

[1261] 12 U.S.C. 1851(d)(1)(C).

[1262] *See* Joint Proposal, 76 FR at 68875.

[1263] *See, e.g.,* Australian Bankers' Ass'n. (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1264] *See, e.g.* ABA (Keating); Ass'n. of Institutional Investors (Sept. 2012); BoA; *see also* Barclays (expressing concern that the proposed rule could result in regulatory review of individual hedging trades for compliance on a *post hoc* basis); HSBC; ISDA (Apr. 2012); ICI (Feb. 2012); PNC; MetLife; RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1265] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen; Johnson & Prof. Stiglitz.

[1266] *See* Sens. Merkley & Levin (Feb. 2012) (commenting that the use of the term ''aggregate'' positions was intended to note that firms do not have to hedge on a trade-by-trade basis but could not hedge on a portfolio basis); Johnson & Prof. Stiglitz.

[1267] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1268] *See, e.g.,* Occupy; Public Citizen.

[1269] *See* Public Citizen; Occupy; AFR *et al.* (Feb. 2012).

[1270] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1271] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1272] The Agencies believe certain limits suggested by commenters, such as the formation of central

As noted above, several commenters questioned whether the hedging exemption should apply to ''portfolio'' hedging and whether portfolio hedging may create the potential for abuse of the hedging exemption. The term ''portfolio hedging'' is not used in the statute. The language of section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .'' [1273] After consideration of the comments regarding portfolio hedging, and in light of the statutory language, the Agencies are of the view that the statutory language is clear on its face that a banking entity may engage in risk-mitigating hedging in connection with aggregated positions of the banking entity. The permitted hedging activity, when involving more than one position, contract, or other holding, must be in connection with or related to aggregated positions of the banking entity.

Moreover, hedging of aggregated positions under this exemption must be related to identifiable risks related to specific positions, contracts, or other holdings of the banking entity. Hedging activity must mitigate one or more specific risks arising from an identified position or aggregation of positions. The risks in this context are not intended to be more generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modeling or other considerations. For example, the hedging activity cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.[1274] Rather, the hedging exemption permits the banking entity to engage in trading activity designed to reduce or otherwise mitigate specific identifiable risks related to identified individual or aggregated positions that the banking entity is otherwise lawfully permitted to have.

When undertaking a hedge to mitigate the risk of an aggregation of positions, the banking entity must be able to specifically identify the risk factors arising from this set of positions. In identifying the aggregate set of positions that is being hedged for purposes of § 75.5(b)(2)(ii) and, where applicable, § 75.5(c)(2)(i), the banking entity needs to identify the positions being hedged with sufficient specificity so that at any point in time, the specific financial instrument positions or components of financial instrument positions held by the banking entity that comprise the set of positions being hedged can be clearly identified.

The proposal would have permitted a series of hedging transactions designed to rebalance hedging position(s) based on changes resulting from permissible activities or from a change in the price or other characteristic of the individual or aggregated positions, contracts, or other holdings being hedged.[1275] The Agencies recognized that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.[1276]

Some commenters questioned the risk-mitigating nature of a hedge if, at inception, that hedge contained component risks that must be dynamically managed throughout the life of the hedge. These commenters stated that hedges that do not continuously match the risk of underlying positions are not in fact risk-mitigating hedges in the first place.[1277]

On the other hand, other commenters argued that banking entities must be permitted to engage in dynamic hedging activity, such as in response to market conditions which are unforeseeable or out of the control of the banking entity,[1278] and expressed concern that the limitations of the proposed rule, especially the requirement that hedging transactions ''maintain a reasonable level of correlation,'' might impede truly risk-reducing hedging activity.[1279]

A number of commenters asserted that there could be confusion over the meaning of ''reasonable correlation,'' which was used in the proposal as part of explaining what type of activity would qualify for the hedging exemption. Some commenters urged requiring that there be a ''high'' or ''strong'' correlation between the hedge and the risk of the underlying asset.[1280]

Other commenters indicated that uncertainty about the meaning of reasonable correlation could limit valid risk-mitigating hedging activities because the level of correlation between a hedge and the risk of the position or aggregated positions being hedged changes over time as a result of changes in market factors and conditions.[1281] Some commenters represented that the proposed provision would cause certain administrative burdens [1282] or may result in a reduction in market-making activities in certain asset classes.[1283] A few commenters expressed concern that the reasonable correlation requirement could render a banking entity's hedges impermissible if they do not succeed in being reasonably correlated to the relevant risk or risks based on an after-the-fact analysis that incorporates market developments that could not have been foreseen at the time the hedge was placed. These commenters tended to favor a different approach or a type of safe harbor based on an initial determination of correlation.[1284] Some commenters argued the focus of the hedging exemption should be on risk reduction and not on reasonable

''risk management'' groups to monitor hedges of aggregated positions, are unnecessary given the aforementioned limits in the final rule. *See* Occupy; Public Citizen.

[1273] *See* 12 U.S.C. 1851(d)(1)(C).

[1274] The Agencies believe that it would be inconsistent with Congressional intent to permit some or all of these activities under the hedging exemption, regardless of whether certain metrics could be useful for monitoring such activity. *See* JPMC.

[1275] *See* proposed rule § 75.5(b)(2)(ii) (requiring that the hedging transaction ''hedges or otherwise mitigates one or more specific risks . . . arising in connection with and related to individual or aggregated positions, contracts, or other holdings of [the] banking entity''). The proposal noted that this requirement would include, for example, dynamic hedging. *See* Joint Proposal, 76 FR at 68875.

[1276] The proposal noted that this corresponding modification to the hedge should also be reasonably correlated to the material changes in risk that are intended to be hedged or otherwise mitigated, as required by § 75.5(b)(2)(iii) of the proposed rule.

[1277] *See* AFR *et al.* (Feb. 2012); Public Citizen; *see also* Better Markets (Feb. 2012), Sens. Merkley & Levin (Feb. 2012).

[1278] *See* Japanese Bankers Ass'n.

[1279] *See, e.g.,* BoA; Barclays; ISDA (Apr. 2012); PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1280] *See, e.g.,* Occupy; Public Citizen; AFR *et. al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1281] *See* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; *see also* Chamber (Feb. 2012).

[1282] *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1283] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012). As discussed above, market-maker hedging at the trading desk level is no longer subject to the hedging exemption and is instead subject to the requirements of the market-making exemption, which is designed to permit banking entities to continue providing legitimate market-making services, including managing the risk of market-making activity. *See also supra* Part VI.A.3.c.4. of this **SUPPLEMENTARY INFORMATION.**

[1284] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* FTN; BoA.

correlation.[1285] One commenter suggested that risk management metrics such as VaR and risk factor sensitivities could be the focus for permitted hedging instead of requirements like reasonable correlation under the proposal.[1286]

In consideration of commenter concerns about the proposed reasonable correlation requirement, the final rule modifies the proposal in the following key respects. First, the final rule modifies the requirement of ''reasonable correlation'' by providing that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks.[1287] This change is designed to reinforce that hedging activity should be demonstrably risk reducing or mitigating rather than simply correlated to risk. This change acknowledges that hedges need not simply be correlated to underlying positions, and that hedging activities should be consciously designed to reduce or mitigate identifiable risks, not simply the result of pairing correlated positions, as some commenters suggested.[1288] As discussed above, the Agencies do, however, recognize that correlation is often a critical element of demonstrating that a hedging activity reduces the risks it is designed to address. Accordingly, the final rule requires that banking entities conduct correlation analysis as part of the required compliance program in order to utilize the hedging exemption.[1289] The Agencies believe this change better allows consideration of the facts and circumstances of the particular hedging activity as part of the correlation analysis and therefore addresses commenters' concerns that the proposed reasonable correlation requirement could cause administrative burdens, impede legitimate hedging activity,[1290] and require an after-the-fact analysis.[1291]

Second, the final rule provides that the determination of whether an activity or strategy is risk-reducing or mitigating must, in the first instance, be made at the inception of the hedging activity. A trade that is not risk-reducing at its inception is not viewed as a hedge for purposes of the exemption in § 75.5.[1292]

Third, the final rule requires that the banking entity conduct analysis and independent testing designed to ensure that the positions, techniques, and strategies used for hedging are reasonably designed to reduce or otherwise mitigate the risk being hedged. As noted above, such analysis and testing must include correlation analysis. Evidence of negative correlation may be a strong indicator that a given hedging position or strategy is risk-reducing. Moreover, positive correlation, in some instances, may be an indicator that a hedging position or strategy is not designed to be risk-mitigating. The type of analysis and factors considered in the analysis should take account of the facts and circumstances, including type of position being hedged, market conditions, depth and liquidity of the market for the underlying and hedging position, and type of risk being hedged.

The Agencies recognize that markets and risks are dynamic and that the risks from a permissible position or aggregated positions may change over time, new risks may emerge in the positions underlying the hedge and in the hedging position, new risks may emerge from the hedging strategy over time, and hedges may become less effective over time in addressing the related risk.[1293] The final rule, like the proposal, continues to allow dynamic hedging. Additionally, the final rule requires the banking entity to engage in ongoing review, monitoring, and management of its positions and related hedging activity to reduce or otherwise significantly mitigate the risks that develop over time. This ongoing hedging activity must be designed to reduce or otherwise significantly mitigate, and must demonstrably reduce or otherwise significantly mitigate, the material changes in risk that develop over time from the positions, contracts, or other holdings intended to be hedged or otherwise mitigated in the same way, as required for the initial hedging activity. Moreover, the banking entity is required under the final rule to support its decisions regarding appropriate hedging positions, strategies and techniques for its ongoing hedging activity in the same manner as for its initial hedging activities. In this manner, the final rule permits a banking entity to engage in effective management of its risks throughout changing market conditions[1294] while also seeking to prohibit the banking entity from taking large proprietary positions through action or inaction related to an otherwise permissible hedge.[1295]

As explained above, the final rule requires a banking entity relying on the hedging exemption to be able to demonstrate that the banking entity is exposed to the specific risks being hedged at the inception of the hedge and any adjustments thereto. However, in the proposal, the Agencies requested comment on whether the hedging exemption should be available in certain cases where hedging activity begins before the banking entity becomes exposed to the underlying risk. The Agencies proposed that the hedging exemption would be available in certain cases where the hedge is established ''slightly'' before the banking entity becomes exposed to the underlying risk if such anticipatory hedging activity: (i) Was consistent with appropriate risk management practices; (ii) otherwise met the terms of the hedging exemption; and (iii) did not involve the potential for speculative profit. For example, a banking entity that was contractually obligated or otherwise highly likely to

[1285] *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *see also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1286] *See* Goldman (Prop. Trading). Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review. *See infra* Part VI.C.3.; final rule Appendix A. The Agencies do not intend to use quantitative measurements as a dispositive tool for differentiating between permitted hedging activities and prohibited proprietary trading.

[1287] Some commenters stated that the hedging exemption should focus on risk reduction, not reasonable correlation. *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy. One of these commenters noted that demonstrated risk reduction should be a key requirement. *See* Sens. Merkley & Levin (Feb. 2012).

[1288] *See* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *see also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1289] *See* final rule § 75.5(b)(1)(iii).

[1290] Some commenters expressed concern that the proposed ''reasonable correlation'' requirement might impede truly risk-reducing activity. *See, e.g.,* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); ISDA (Apr. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY. Some of these commenters stated that the proposed requirement would cause administrative burdens. *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1291] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012; *see also* FTN.

[1292] By contrast, the proposed requirement did not specify that the hedging activity reduce risk ''at the inception of the hedge.'' *See* proposed rule § 75.5(b)(2)(ii).

[1293] Some commenters noted that hedging activities must address constantly changing positions and market conditions and expressed concern about requiring a banking entity to identify the particular risk being hedged. *See* Japanese Bankers Ass'n.; Barclays.

[1294] A few commenters expressed concern that the proposed ''reasonable correlation'' requirement would render hedges impermissible if not reasonably correlated to the relevant risk(s) based on a *post hoc* analysis. *See, e.g.,* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1295] Some commenters questioned the risk-mitigating nature of a hedge if, at inception, it contained risks that must be dynamically managed throughout the life of the hedge. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

become exposed to a particular risk could engage in hedging that risk in advance of actual exposure.[1296]

A number of commenters argued that anticipatory hedging is a necessary and prudent activity and that the final rule should permit anticipatory hedging more broadly than did the proposed rule.[1297] In particular, commenters were concerned that permitting hedging activity only if it occurs ''slightly'' before a risk is taken could limit hedging activities that are crucial to risk management.[1298] Commenters expressed concern that the proposed approach would, among other things, make it difficult for banking entities to accommodate customer requests for transactions with specific price or size executions [1299] and limit dynamic hedging activities that are important to sound risk management.[1300] In addition, a number of commenters requested that the rule permit banking entities to engage in scenario hedging, a form of anticipatory hedging that addresses potential exposures to ''tail risks.'' [1301]

Some commenters expressed concern about the proposed criterion that the hedging activity not involve the potential for speculative profit.[1302] These commenters argued that the proper focus of the hedging exemption should be on the purpose of the transaction, and whether the hedge is correlated to the underlying risks being hedged (in other words, whether the hedge is effective in mitigating risk).[1303] By contrast, another commenter urged the Agencies to adopt a specific metric to track realized profits on hedging activities as an indicator of prohibited arbitrage trading.[1304]

Like the proposal, the final rule does not prohibit anticipatory hedging. However, in response to commenter concerns that the proposal would limit a banking entity's ability to respond to customer requests and engage in prudent risk management, the final rule does not retain the proposed requirement discussed above that an anticipatory hedge be established ''slightly'' before the banking entity becomes exposed to the underlying risk and meet certain conditions. To address commenter concerns with the statutory mandate, several parts of the final rule are designed to ensure that all hedging activities, including anticipatory hedging activities, are designed to be risk reducing and not impermissible proprietary trading activities. For example, the final rule retains the proposed requirement that a banking entity have reasonably designed policies and procedures indicating the positions, techniques and strategies that each trading desk may use for hedging. These policies and procedures should specifically address when anticipatory hedging is appropriate and what policies and procedures apply to anticipatory hedging.

The final rule also requires that a banking entity relying on the hedging exemption be able to demonstrate that the hedging activity is designed to reduce or significantly mitigate, and does demonstrably reduce or otherwise significantly mitigate, specific, identifiable risks in connection with individual or aggregated positions of the banking entity.[1305] Importantly, to use the hedging exemption, the final rule requires that the banking entity subject its hedging activity to continuing review, monitoring, and management that is designed to reduce or significantly mitigate specific, identifiable risks, and that demonstrably reduces or otherwise significantly mitigates identifiable risks, in connection with individual or aggregated positions of the banking entity.[1306] The final rule also requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in § 75.5(b)(2) and is not prohibited proprietary trading. If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, under these provisions, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce the risk associated with that position as soon as reasonably practicable after it is determined that the anticipated risk will not materialize. This requirement focuses on the purpose of the hedge as a trade designed to reduce anticipated risk and not for other purposes. The Agencies will (and expect that banking entities also will) monitor the activities of banking entities to identify prohibited trading activity that is disguised as anticipatory hedging.

As noted above, one commenter suggested the Agencies adopt a metric to monitor the profitability of a banking entity's hedging activity.[1307] We are not adopting such a metric because we do not believe it would be useful to monitor the profit and loss associated with hedging activity in isolation without considering the profit and loss associated with the individual or aggregated positions being hedged. For example, the commenter's suggested metric would not appear to provide information about whether the gains arising from hedging positions offset or mitigate losses from individual or aggregated positions being hedged.

3. Compensation

The proposed rule required that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward proprietary risk-taking.[1308] In the proposal, the Agencies stated that hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing

[1296] *See* Joint Proposal, 76 FR at 68875.

[1297] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1298] *See* BoA; Credit Suisse (Seidel); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1299] *See* Credit Suisse (Seidel); BoA.

[1300] *See* PNC *et al.*

[1301] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Market Regulation. As discussed above, hedging activity relying on this exemption cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.

[1302] *See* ABA (Keating); CH/ABASA; *see also* Credit Suisse (Seidel); PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012). One commenter argued that anticipatory hedging should not be permitted because it represents illegal front running. *See* Occupy. The Agencies note that not all anticipatory hedging would constitute illegal front running. Any activity that is illegal under another provision of law, such as front running under section 10(b) of the Exchange Act, remains illegal; and section 13 of the BHC Act and any implementing rules thereunder do not represent a grant of authority to engage in any such activity. *See* 15 U.S.C. 78j.

[1303] As discussed above, the final hedging exemption replaces the ''reasonable correlation'' concept with the requirement that hedging activity ''demonstrably reduce or otherwise significantly mitigate'' specific, identifiable risks.

[1304] *See* AFR *et al.* (Feb. 2012); *see also* Part VI.C.3.d., *infra.*

[1305] This requirement modifies proposed rule § 75.5(b)(2)(ii) and (iii). As discussed above, the addition of ''demonstrably reduces or significantly mitigates'' language replaces the proposed ''reasonable correlation'' requirement.

[1306] The proposed rule contained a similar provision, except that the proposed provision also required that the continuing review maintain a reasonable level of correlation between the hedge transaction and the risk being hedged. *See* proposed rule § 75.5(b)(2)(v). As discussed above, the proposed ''reasonable correlation'' requirement was removed from that provision and instead a requirement has been added to the compliance program provision that correlation analysis be undertaken when analyzing hedging positions, techniques, and strategies before they are implemented.

[1307] *See* AFR *et al.* (Feb. 2012).

[1308] *See* proposed rule § 75.5(b)(2)(vi).

risk, are inconsistent with permitted risk-mitigating hedging activities.[1309]

Commenters generally supported this requirement and indicated that its inclusion was very important and valuable.[1310] Some commenters argued that the final rule should limit compensation based on profits derived from hedging transactions, even if those hedging transactions were in fact risk-mitigating hedges, and urged that employees be compensated instead based on success in risk mitigation at the end of the life of the hedge.[1311] In contrast, other commenters argued that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking.[1312]

After considering comments received on the compensation requirements of the proposed hedging exemption, the final rule substantially retains the proposed requirement that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward prohibited proprietary trading. The final rule is also modified to make clear that rewarding or incentivizing profit making from prohibited proprietary trading is not permitted.[1313]

The Agencies recognize that compensation, especially incentive compensation, may be both an important motivator for employees as well as a useful indicator of the type of activity that an employee or trading desk is engaged in. For instance, an incentive compensation plan that rewards an employee engaged in activities under the hedging exemption based primarily on whether that employee's positions appreciate in value instead of whether such positions reduce or mitigate risk would appear to be designed to reward prohibited proprietary trading rather than risk-reducing hedging activities.[1314] Similarly, a compensation arrangement that is designed to incentivize an employee to exceed the potential losses associated with the risks of the underlying position rather than reduce risks of underlying positions would appear to reward prohibited proprietary trading rather than risk-mitigating hedging activities. The banking entity should review its compensation arrangements in light of the guidance and rules imposed by the appropriate Federal supervisor for the entity regarding compensation.[1315]

4. Documentation Requirement

Section 75.5(c) of the proposed rule would have imposed a documentation requirement on certain types of hedging transactions. Specifically, for any transaction that a banking entity conducts in reliance on the hedging exemption that involved a hedge established at a level of organization different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the hedging transaction is designed to reduce, the banking entity was required, at a minimum, to document: The risk-mitigating purpose of the transaction; the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce; and the level of organization that is establishing the hedge.[1316] Such documentation was required to be established at the time the hedging transaction is effected. The Agencies expressed concern in the proposal that hedging transactions established at a different level of organization than the positions being hedged may present or reflect heightened potential for prohibited proprietary trading, either at the trading desk level or at the level instituting the hedging transaction. In other words, the further removed hedging activities are from the specific positions, contracts, or other holdings the banking entity intends to hedge, the greater the danger that such activity is not limited to hedging specific risks of individual or aggregated positions, contracts, or other holdings of the banking entity, as required by the rule.

Some commenters argued that the final rule should require comprehensive documentation for all activity conducted pursuant to the hedging exemption, regardless of where it occurs in an organization.[1317] One of these commenters stated that such documentation can be easily and quickly produced by traders and noted that traders already record execution details of every trade.[1318] Several commenters argued that the rule should impose a requirement that banks label all hedges at their inception and provide information regarding the specific risk being offset, the expected duration of the hedge, how it will be monitored, how it will be wound down, and the names of the trader, manager, and supervisor approving the hedge.[1319]

Some commenters requested that the documentation requirement be applied at a higher level of organization,[1320] and some commenters noted that policies and procedures alone would be sufficient to address hedging activity, wherever conducted within the organization.[1321] Two commenters indicated that making the documentation requirement narrower is necessary to avoid impacts or delays in daily trading operations that could lead to a banking entity being exposed to greater risks.[1322] A number of commenters stated that any enhanced documentation requirement would be burdensome and costly, and would impede rapid and effective risk mitigation, whether done at a trading desk or elsewhere in the banking entity.[1323]

At least one commenter also argued that a banking entity should be permitted to consolidate some or all of its hedging activity into a trading desk that is not responsible for the underlying positions without triggering a requirement that all hedges undertaken by a trading desk be documented solely because the hedges are not undertaken by the trading desk that originated the underlying position.[1324]

The final rule substantially retains the proposed requirement for enhanced documentation for hedging activity

[1309] *See* Joint Proposal, 76 FR at 68868.

[1310] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen.

[1311] *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1312] *See* Morgan Stanley.

[1313] One commenter stated that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking, rather than apply to hedging activities. *See* Morgan Stanley.

[1314] Thus, the Agencies agree with one commenter who stated that compensation for hedging should not be based purely on profits derived from hedging. However, the final rule does not require compensation vesting, as suggested by this commenter, because the Agencies believe the final hedging exemption includes sufficient requirements to ensure that only risk-mitigating hedging is permitted under the exemption without a compensation vesting provision. *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1315] *See* 12 U.S.C. 5641.

[1316] For example, as explained under the proposal, a hedge would be established at a different level of organization of the banking entity if multiple market-making desks were exposed to similar risks and, to hedge such risks, a hedge was established at the direction of a supervisor or risk manager responsible for more than one desk rather than at each of the market-making desks that established the initial positions, contracts, or other holdings. *See* Joint Proposal, 76 FR at 68876 n.161.

[1317] *See* AFR (June 2013); Occupy.

[1318] *See* Occupy.

[1319] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR (June 2013).

[1320] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; *see also* Japanese Bankers Ass'n.

[1321] *See* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1322] *See* JPMC; Barclays.

[1323] *See* Barclays; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Japanese Bankers Ass'n.

[1324] *See* JPMC.

conducted under the hedging exemption if the hedging is not conducted by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings, the risks of which the hedging activity is designed to reduce. The final rule clarifies that a banking entity must prepare enhanced documentation if a trading desk establishes a hedging position and is not the trading desk that established the underlying positions, contracts, or other holdings. The final rule also requires enhanced documentation for hedges established to hedge aggregated positions across two or more desks. This change in the final rule clarifies that the level of the organization at which the trading desk exists is important for determining whether the trading desk established or is responsible for the underlying positions, contracts, or other holdings. The final rule recognizes that a trading desk may be responsible for hedging aggregated positions of that desk and other desks, business units, or affiliates. In that case, the trading desk putting on the hedge is at least one step removed from some of the positions being hedged. Accordingly, the final rule provides that the documentation requirements in § 75.5 apply if a trading desk is hedging aggregated positions that include positions from more than one trading desk.

The final rule adds to the proposal by requiring enhanced documentation for hedges established by the specific trading desk establishing or directly responsible for the underlying positions, contracts, or other holdings, the risks of which the purchases or sales are designed to reduce, if the hedge is effected through a financial instrument, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures as a product, instrument, exposure, technique, or strategy that the trading desk may use for hedging.[1325] The Agencies note that this documentation requirement does not apply to hedging activity conducted by a trading desk in connection with the market making-related activities of that desk or by a trading desk that conducts hedging activities related to the other permissible trading activities of that desk so long as the hedging activity is conducted in accordance with the compliance program for that trading desk.

The Agencies continue to believe that, for the reasons stated in the proposal, it is appropriate to retain documentation of hedging transactions conducted by those other than the traders responsible for the underlying position in order to permit evaluation of the activity. In order to reduce the burden of the documentation requirement while still giving effect to the rule's purpose, the final rule requires limited documentation for hedging activity that is subject to a documentation requirement, consisting of: (1) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings that the purchase or sale is designed to reduce; (2) the specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and (3) the trading desk or other business unit that is establishing and responsible for the hedge transaction. As in the proposal, this documentation must be established contemporaneously with the hedging transaction. Documentation would be contemporaneous if it is completed reasonably promptly after a trade is executed. The banking entity is required to retain records for no less than 5 years (or such longer period as may be required under other law) in a form that allows the banking entity to promptly produce such records to the Agency on request.[1326] While the Agencies recognize this documentation requirement may result in certain costs, the Agencies believe this requirement is necessary to prevent evasion of the statute and final rule.

5. Section 75.6(a)–(b): Permitted Trading in Certain Government and Municipal Obligations

Section 75.6 of the proposed rule permitted a banking entity to engage in trading activities that were authorized by section 13(d)(1) of the BHC Act,[1327] including trading in certain government obligations, trading on behalf of customers, trading by insurance companies, and trading outside of the United States by certain foreign banking entities.[1328] Section 75.6 of the final rule generally incorporates these same statutory exemptions. However, the final rule has been modified in some ways in response to comments received on the proposal.

a. Permitted Trading in U.S. Government Obligations

Section 13(d)(1)(A) permits trading in various U.S. government, U.S. agency and municipal securities.[1329] Section 75.6(a) of the proposed rule, which implemented section 13(d)(1)(A) of the BHC Act, permitted the purchase or sale of a financial instrument that is an obligation of the United States or any agency thereof or an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*).[1330] The proposal did not contain an exemption for trading in derivatives referencing exempt U.S. government and agency securities, but requested comment on whether the final rule should contain an exemption for proprietary trading in options or other derivatives referencing an exempt government obligation.[1331]

Commenters were generally supportive of the manner in which the proposal implemented the exemption for permitted trading in U.S. government and U.S. agency obligations.[1332] Many commenters argued that the exemption for permissible proprietary trading in government obligations should be expanded, however, to include trading in derivatives on government obligations.[1333] These commenters asserted that failure to provide an exemption would adversely impact liquidity in the underlying government obligations themselves and increase

[1325] One commenter suggested that the rule require documentation when a banking entity needs to engage in new types of hedging transactions that are not covered by its hedging policies, although this commenter's suggested approach would only apply when a hedge is conducted two levels above the level at which the risk arose. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies agree that documentation is needed when a trading desk is acting outside of its hedging policies and procedures. However, the final rule does not limit this documentation requirement to circumstances when the hedge is conducted two organizational levels above the trading desk. Such an approach would be less effective than the adopted approach at addressing evasion concerns.

[1326] *See* final rule § 75.5(c)(3).

[1327] *See* proposed rule § 75.6.

[1328] *See* 12 U.S.C. 1851(d)(1)(A), (C), (F), and (H).

[1329] 12 U.S.C. 1851(d)(1)(A).

[1330] The Agencies proposed that United States ''agencies'' for this purpose would include those agencies described in section 201.108(b) of the Board's Regulation A. *See* 12 CFR 201.108(b). The Agencies also noted that the terms of the exemption would encompass the purchase or sale of enumerated government obligations on a forward basis (*e.g.,* in a to-be-announced market). In addition, this would include pass-through or participation certificates that are issued and guaranteed by a government-sponsored entity (*e.g.,* the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with its securitization activities.

[1331] *See* Joint Proposal, 76 FR at 68878.

[1332] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1333] *See* BoA; CalPERS; Credit Suisse (Seidel); CME Group; Fixed Income Forum/Credit Roundtable; FIA; JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

borrowing costs to governments.[1334] Several commenters asserted that U.S. government and agency obligations and derivatives on those instruments are substitutes and pose the same investment risks and opportunities.[1335] According to some commenters, the significant connections between these markets and the interchangeable nature of these instruments significantly contribute to price discovery, in particular, in the cash market for U.S. Treasury obligations.[1336] Commenters also argued that trading in Treasury futures and options improves liquidity in Treasury securities markets by providing an outlet to relieve any supply and demand imbalances in spot obligations. Many commenters argued that the authority to engage in trading in derivatives on U.S. government, agency, and municipal obligations is inherent in the statutory exceptions granted by section 13(d)(1)(A) to trade in the underlying obligation.[1337] To the extent there is any doubt about the scope of those exemptions, commenters urged the Agencies to use the exemptive authority under section 13(d)(1)(J) if necessary to permit proprietary trading in derivatives on government obligations.[1338] Two commenters opposed providing an exemption for proprietary trading in derivatives on exempt government obligations.[1339]

The final rule has not been modified to permit a banking entity to engage in proprietary trading of derivatives on U.S. government and agency obligations.

The Agencies note that the cash market for exempt government obligations is already one of the most liquid markets in the world, and the final rule will permit banking entities to participate fully in these cash markets. In addition, the final rule permits banking entities to make a market in U.S. government securities and in derivatives on those securities. Moreover, the final rule allows banking entities to continue to use U.S. government obligations and derivatives on those obligations in risk-mitigating hedging activities permitted by the rule. Further, proprietary trading in derivatives on such obligations will continue by entities other than banking entities.

Proprietary trading of derivatives on U.S. government obligations is not necessary to promote and protect the safety and soundness of a banking entity or the financial stability of the United States. Commenters offered no compelling reasons why derivatives on exempt government obligations pose little or no risk to the financial system as compared to derivatives on other financial products for which proprietary trading is generally prohibited and did not indicate how proprietary trading in derivatives of U.S. government and agency obligations by banking entities would promote the safety and soundness of those entities or the financial stability of the United States. For these reasons, the Agencies have not determined to provide an exemption for proprietary trading in derivatives on exempt government obligations.

The Agencies believe banking entities will continue to provide significant support and liquidity to the U.S. government and agency security markets through permitted trading in the cash exempt government obligations markets, making markets in government obligation derivatives and through derivatives trading for hedging purposes. The final rule adopts the same approach as the proposed rule for the exemption for permitted trading in U.S. government and U.S. agency obligations. In response to commenters, the Agencies are clarifying how banking entities would be permitted to use Treasury derivatives on Treasury securities when relying on the exemptions for market-making related activities and risk-mitigating hedging activities. The Agencies agree with commenters that some Treasury derivatives are close economic substitutes for Treasury securities and provide many of the same economic exposures.[1340] The Agencies also understand that the markets for Treasury securities and Treasury futures are fully integrated, and that trading in these derivative instruments is essential to ensuring the continued smooth functioning of market-making related activities in Treasury securities. Treasury derivatives are frequently used by market makers to hedge their market-making related positions across many different types of fixed-income securities. Under the final rule, market makers will generally be able to continue their practice of using Treasury futures to hedge their activities as block positioners off exchanges. Additionally, when engaging in permitted market-making related or risk-mitigating hedging activities in accordance with the requirements in §§ 75.4(b) or 75.(5), the final rule permits banking entities to acquire a short or long position in Treasury futures through manual trading or automated processes. For example, a banking entity would be permitted to use Treasury futures to hedge the duration risk (*i.e.,* the measure of a bond's price sensitivity to interest rates movements) associated with the banking entity's market-making in Treasury securities or other fixed-income products, provided that the banking entity complies with the market-making requirements in § 75.4(b). In their market making, banking entities also frequently trade Treasury futures (and acquire a corresponding long or short position) in reasonable anticipation of the near-term demands of their clients, customers, and counterparties. For example, banking entities may acquire a long or short position in Treasury futures to hedge anticipated market risk when they reasonably expect clients, customers, or counterparties will seek to establish long or short positions in on- or off-the-run Treasury securities. Similarly, banking entities could acquire a long or short position in the ''Treasury basis'' to hedge the anticipated basis risk associated with making markets for clients, customers, or counterparties that are reasonably expected to engage in basis trading of the price spread between Treasury futures and Treasury securities. A banking entity can also use Treasury futures (or other derivatives on exempt government obligations) to hedge other risks such as the aggregated interest rate risk for specifically identified loans as well as other financial instruments such as asset-backed securities, corporate bonds, and interest rate swaps. Therefore, depending on the relevant facts and circumstances, banking entities would be permitted to acquire a very large long or short position in Treasury derivatives provided that they comply with the requirements in §§ 75.4(b) or 75.(5). The Agencies also understand that banking entities that have been designated as ''primary dealers'' by the Federal Reserve Bank of New York are required to underwrite issuances of Treasury securities. This necessitates the banking entities to frequently establish very large short positions in Treasury futures to order to hedge the duration risk associated with potentially owning a large volume of Treasury securities. As described below,[1341] the Agencies note that, with

[1334] *See* BoA; FIA; HSBC; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading).

[1335] *See* Barclays; Credit Suisse (Seidel); Fixed Income Forum/Credit Roundtable; FIA.

[1336] *See* Barclays; CME Group; Fixed Income Forum/Credit Roundtable; *see also* UBS.

[1337] *See* CME Group; *see also* Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1338] *See* Barclays; CME Group; JPMC.

[1339] *See* Occupy; Alfred Brock.

[1340] *See supra* note 1335.

[1341] *See infra* Part VI.A.3.c.2.c.i.

respect to a banking entity that acts as a primary dealer for Treasury securities, the U.S. government will be considered a client, customer, or counterparty of the banking entity for purposes of the market-making exemption.[1342] We believe this interpretation appropriately captures the unique relationship between a primary dealer and the government. Moreover, this interpretation clarifies that a banking entity may rely on the market-making exemption for its activities as primary dealer to the extent those activities are outside the scope of the underwriting exemption.[1343]

The final rule also includes an exemption for obligations of or guaranteed by the United States or an agency of the United States. An obligation guaranteed by the U.S. or an agency of the U.S. is, in effect, an obligation of the U.S. or that agency.

The final rule also includes an exemption for an obligation of the FDIC, or any entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act (''FDI Act'') or Title II of the Dodd-Frank Act.[1344] These FDIC receivership and conservatorship operations are authorized under the FDI Act and Title II of the Dodd-Frank Act and are designed to lower the FDIC's resolution costs. The Agencies believe that an exemption for these types of obligations would promote and protect the safety and soundness of banking entities and the financial stability of the United States because they facilitate the FDIC's ability to conduct receivership and conservatorship operations in an orderly manner, thereby limiting risks to the financial system generally that might otherwise occur if the FDIC was restricted in its ability to conduct these operations.

b. Permitted Trading in Foreign Government Obligations

The proposed rule did not contain an exemption for trading in obligations of foreign sovereign entities. As part of the proposal, however, the Agencies specifically requested comment on whether proprietary trading in the obligations of foreign governments would promote and protect the safety and soundness of banking entities and the financial stability of the United States under section 13(d)(1)(J) of the BHC Act.[1345]

The treatment of proprietary trading in foreign sovereign obligations prompted a significant number of comments. Many commenters, including foreign governments, foreign and domestic banking entities, and various trade groups, argued that the final rule should permit trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments.[1346] Representatives from foreign governments such as Canada, Germany, Luxembourg, Japan, Australia, and Mexico specifically requested an exemption for trading in obligations of their governments and argued that an exemption was necessary and appropriate to maintain and promote financial stability in their markets.[1347] Some commenters also requested an exemption for trading in obligations of multinational central banks, such as Eurobonds issued or guaranteed by the European Central Bank.[1348]

Many commenters argued that the same rationale for the statutory exemption for proprietary trading in U.S. government obligations supported exempting proprietary trading in foreign sovereign debt and related obligations.[1349] Commenters contended that lack of an express exemption for trading in foreign sovereign obligations could critically impact the functioning of money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations.[1350] These commenters also contended that an exemption for proprietary trading in foreign sovereign debt would promote and protect the safety and soundness and the financial stability of the United States by avoiding the possible negative effects of a contraction of government bond market liquidity.[1351]

Commenters also contended that in some foreign markets, local regulations or market practice require U.S. banking entities operating in those jurisdictions to hold, trade or support government issuance of local sovereign securities. They also indicated that these instruments are traded in the United States or on U.S. markets.[1352] In addition, a number of commenters contended that U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the United States by U.S. primary dealers and alleged that restricting these trading activities would have a significant negative impact on the ability of foreign governments to implement their monetary policy and on liquidity for such securities in many foreign markets.[1353] A few commenters further argued that banking entities use foreign sovereign debt, particularly debt of their home country and of the country in which they are operating, to manage their risk by posting sovereign securities as collateral in foreign jurisdictions, to manage international rate and foreign exchange risk (particularly in local operations), and for liquidity and asset-liability management purposes in different

[1342] *See supra* note 910 (explaining the functions of primary dealers).

[1343] *See supra* Part VI.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity, as well as one commenter's request for such an interpretation).

[1344] *See* final rule § 75.6(a)(4).

[1345] *See* Joint Proposal, 76 FR at 68878.

[1346] *See, e.g.,* Allen & Overy (Gov't Obligations); Allen & Overy (Canadian Banks); BoA; Australian Bankers Ass'n. (Feb. 2012); AFMA; Banco de México; Bank of Canada; Ass'n of German Banks; BAROC; Barclays; BEC (citing the National Institute of Banking and Finance); British Bankers' Ass'n.; BaFin/Deutsche Bundesbank; Chamber (Feb. 2012); Mexican Banking Comm'n.; French Treasury *et al.;* EFAMA; ECOFIN; EBF; French Banking Fed'n.; FSA (Apr. 2012); FIA; Goldman (Prop. Trading); HSBC; Hong Kong Inv. Funds Association; IIB/EBF; ICFR; ICSA; IRSG; Japanese Bankers Ass'n.; Ass'n. of Banks in Malaysia; OSFI; British Columbia; Québec; Sumitomo Trust; TMA Hong Kong; UBS; Union Asset.

[1347] *See, e.g.,* Allen & Overy (Gov't Obligations); Bank of Canada; British Columbia; Ontario; IIAC; Quebec; IRSG; IIB/EBF; Mitsubishi; Gov't of Japan/ Bank of Japan; Australian Bankers Ass'n (Feb. 2012); AFMA; Banco de México; Ass'n. of German Banks; ALFI; Embassy of Switzerland.

[1348] *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't Obligations).

[1349] *See* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; BaFIN/Deutsche Bundesbank; EFAMA; Union Asset; TMA Hong Kong; ICI (Feb. 2012) (arguing that such an exemption would be consistent with Congressional intent to limit the extra-territorial application of U.S. law).

[1350] *See* Banco de México; Barclays; BoA; Gov't of Japan/Bank of Japan; IIAC; OSFI.

[1351] *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Banco de México; Ass'n. of German Banks; Barclays; Mexican Banking Comm'n.; EFAMA; EBF; French Banking Fed'n.; Goldman (Prop. Trading); HSBC; IIB/EBF; HSBC; ICSA; T. Rowe Price; UBS; Union Asset; IRSG; EBF; Mitsubishi (citing Japanese Bankers Ass'n. and IIB); Wells Fargo (Prop. Trading); ICI Global.

[1352] *See* Allen & Overy (Gov't. Obligations) (contending that ''even if not primary dealers, banking entities or their branches or agencies acting in certain foreign jurisdictions, such as Singapore and India, are still required to hold or transact in local sovereign debt under local law''); BoA; Barclays; Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1353] *See* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup; Goldman (Prop. Trading); IIB/EBF; *see also* JPMC (suggesting that, at a minimum, the Agencies should make clear that all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities are protected by the market-making-related permitted activity); SIFMA *et al.* (Prop. Trading) (Feb. 2012). As discussed in Parts VI.A.2.c.2.c. and VI.A.2.c.2.b.ix of this **SUPPLEMENTARY INFORMATION**, the Agencies believe primary dealing activities would generally qualify under the scope of the market-making or underwriting exemption.

countries.[1354] Similarly, commenters expressed concern that the lack of an exemption for trading in foreign government obligations could adversely interact with other banking regulations, such as liquidity requirements under the Basel III capital rules that encourage financial institutions to hold large concentrations of sovereign bonds to match foreign currency denominated obligations.[1355] Commenters also expressed particular concern that the limitations and obligations of section 13 of the BHC Act would likely be problematic and unduly burdensome if banking entities were able to trade in foreign sovereign obligations only under the market making or other proposed exemptions from the proprietary trading prohibition.[1356] One commenter expressed the view that lack of an exemption for proprietary trading in foreign government obligations together with the proposed exemption for trading that occurs solely outside the U.S. may cause foreign banks to close their U.S. branches to avoid being subject to section 13 of the BHC Act and any final rule thereunder.[1357]

According to some commenters, providing an exemption only for proprietary trading in U.S. government obligations, without a similar exemption for foreign government obligations, would be discriminatory and inconsistent with longstanding principles of national treatment and with U.S. treaty obligations, such as obligations under the World Trade Organization framework or bilateral trade agreements.[1358] In addition, several commenters argued that not exempting proprietary trading of foreign sovereign debt may encourage foreign regulators to enact similar regulations to the detriment of U.S. financial institutions operating abroad.[1359] However, another commenter disagreed that the failure to exempt trading in foreign government obligations would violate trade agreements or that the proposal discriminated in any way against foreign banking entities' ability to compete with U.S. banking entities in the U.S.[1360]

Based on these concerns, some commenters suggested that the Agencies exempt proprietary trading by foreign banking entities in obligations of their home or host country.[1361] Other commenters suggested allowing trading in foreign government obligations that meet some condition on quality (*e.g.,* OECD-member country obligations, government bonds eligible as collateral for Federal Reserve advances, sovereign bonds issued by G–20 countries, or other highly liquid or rated instruments).[1362] One commenter indicated that in their view, provided appropriate risk-management procedures are followed, investing in non-U.S. government securities is as low risk as investing in U.S. government securities despite current price volatility in certain types of sovereign debt.[1363] Some commenters also suggested the final rule give deference to home country regulation and permit foreign banking entities to engage in proprietary trading in any government obligation to the extent that such trading is permitted by the entity's primary regulator.[1364]

By contrast, other commenters argued that proprietary trading in foreign sovereign obligations represents a risky activity and that there is no effective way to draw the line between safe and unsafe foreign debt.[1365] Two of these commenters pointed to several publicly reported instances where proprietary trading in foreign sovereign obligations resulted in significant losses to certain firms. These commenters argued that restricting proprietary trading in foreign sovereign debt would not cause reduced liquidity in government bond markets since banking entities would still be permitted to make a market in and underwrite foreign government obligations.[1366] A few commenters suggested that, if the final rule exempted proprietary trading in foreign sovereign debt, foreign governments should commit to pay for any damage to the U.S. financial system related to proprietary trading in their obligations pursuant to such exemption.[1367]

The Agencies carefully considered all the comments related to proprietary trading in foreign sovereign debt in light of the language, purpose and standards for exempting activity contained in section 13 of the BHC Act. Under section 13(d)(1)(J), the Agencies may grant an exemption from the prohibitions of the section for any activity that the Agencies determine would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The Agencies note as an initial matter that section 13 permits banking entities—both inside the United States and outside the United States—to make markets in and to underwrite all types of securities, including all types of foreign sovereign debt. The final rule implements the statutory market-making and underwriting exemptions, and thus, the key role of banking entities in facilitating trading and liquidity in foreign government debt through market-making and underwriting is maintained. This includes underwriting and marketmaking as a primary dealer in foreign sovereign obligations. Banking entities may also hold foreign sovereign debt in their long-term investment book. In addition, the final rule does not prevent foreign banking entities from engaging in proprietary trading outside of the United States in any type of sovereign debt.[1368] Moreover, the Agencies continue to believe that positions, including positions in foreign government obligations, acquired or taken for the *bona fide* purpose of liquidity management and in accordance with a documented liquidity management plan that is consistent with the relevant Agency's supervisory requirements, guidance and expectations regarding liquidity management are not covered by the prohibitions in section 13.[1369] The final rule continues to incorporate this view.[1370]

The issue raised by commenters, therefore, is the extent to which proprietary trading in foreign sovereign obligations by U.S. banking entities anywhere in the world and by foreign banking entities in the United States is consistent with promoting and protecting the safety and soundness of the banking entity and the financial stability of the United States. Taking

[1354] *See* Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1355] *See* Allen & Overy (Gov't. Obligations); BoA.

[1356] *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1357] *See* Comm. on Capital Markets Regulation.

[1358] *See* Allen & Overy (Gov't. Obligations); Banco de México; IIB/EBF; Ass'n. of Banks in Malaysia.

[1359] *See* Sumitomo Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Govt. Obligations); BoA; ICI Global; RBC; ICFR; ICI (Feb. 2012); Bank of Canada; Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); Chamber (Feb. 2012); BAROC. *See also* IIB/EBF.

[1360] *See* Sens. Merkley & Levin (Feb. 2012).

[1361] *See* Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS; *see also* BAROC.

[1362] *See* BoA; Cadwalader (on behalf of Singapore Banks); IIB/EBF; Norinchukin; OSFI; Cadwalader (on behalf of Thai Banks); Ass'n. of Banks in Malaysia; UBS; *see also* BAROC; ICFR; Japanese Bankers Ass'n.; JPMC; Québec.

[1363] *See, e.g.,* Allen & Overy (Gov't Obligations).

[1364] *See* Allen & Overy (Gov't. Obligations); HSBC.

[1365] *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1366] *See* Prof. Johnson; Better Markets (Feb. 2012).

[1367] *See* Better Markets (Feb. 2012); *see also* Prof. Johnson.

[1368] *See* final rule § 75.6(e).

[1369] *See* Joint Proposal, 76 FR at 68862.

[1370] *See* final rule § 75.3(d)(3).

into account the information provided by commenters, the Agencies' understanding of market operations, and the purpose and language of section 13, the Agencies have determined to grant a limited exemption to the prohibition on proprietary trading for trading in foreign sovereign obligations under certain circumstances.

This exemption, which is contained in § 75.6(b) of the final rule, permits the U.S. operations of foreign banking entities to engage in proprietary trading in the United States in the foreign sovereign debt of the foreign sovereign under whose laws the banking entity—or the banking entity that controls it—is organized (hereinafter, the ''home country''), and any multinational central bank of which the foreign sovereign is a member so long as the purchase or sale as principal is not made by an insured depository institution.[1371] Similar to the exemption for proprietary trading in U.S. government obligations, the permitted trading activity in the U.S. by the eligible U.S. operations of a foreign banking entity would extend to obligations of political subdivisions of the foreign banking entity's home country.[1372]

Permitting the eligible U.S. operations of a foreign banking entity to engage in proprietary trading in the United States in the foreign sovereign obligations of the foreign entity's home country allows these U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations.[1373] At the same time, the risk of these trading activities is largely determined by the foreign sovereign that charters the foreign bank. By not permitting proprietary trading in foreign sovereign debt in insured depository institutions (other than in accordance with the limitations in other exemptions), the exemption limits the direct risks of these activities to insured depository institutions in keeping with the statute.[1374] Thus, the Agencies have determined that this limited exemption for proprietary trading in foreign sovereign obligations promotes and protects the safety and soundness of banking entities and also promotes and protects the financial stability of the United States.

The Agencies have also determined to permit a foreign bank or foreign broker-dealer regulated as a securities dealer and controlled by a U.S. banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized (hereinafter, the ''home country''), including obligations of an agency or political subdivision of that foreign sovereign.[1375] This limited exemption is necessary to allow U.S. banking organizations to continue to own and acquire foreign banking organizations and broker-dealers without requiring those foreign banking organizations and broker-dealers to discontinue proprietary trading in the sovereign debt of the foreign banking entity's home country.[1376] The Agencies have determined that this limited exemption will promote the safety and soundness of banking entities and the financial stability of the United States by allowing U.S. banking entities to continue to be affiliated with and operate foreign banking entities and benefit from international diversification and participation in global financial markets.[1377] However, the Agencies intend to monitor activity of banking entities under this exemption to ensure that U.S. banking entities are not seeking to evade the restrictions of section 13 by using an affiliated foreign bank or broker-dealer to engage in proprietary trading in foreign sovereign debt on behalf of or for the benefit of other parts of the U.S. banking entity.

Apart from this limited exemption, the Agencies have not extended this exemption to proprietary trading in foreign sovereign debt by U.S. banking entities for several reasons. First, section 13 was primarily concerned with the risks posed to the U.S. financial system by proprietary trading activities. This risk is most directly transmitted by U.S. banking entities, and while commenters alleged that prohibiting U.S. banking entities from engaging in proprietary trading in debt of foreign sovereigns would harm liquidity in those markets, the evidence provided by commenters did not sufficiently indicate that permitting U.S. banking entities to engage in proprietary trading (as opposed to market-making or underwriting) in debt of foreign sovereigns contributed in any significant degree to the liquidity of markets in foreign sovereign instruments.[1378] Thus, expanding the exemption to permit U.S. banking entities to engage in proprietary trading in debt of foreign sovereigns would likely increase the risks to these entities and the U.S. financial system without a significant concomitant and offsetting benefit. As explained above, these U.S.

[1371] *See* final rule § 75.6(b). Some commenters requested an exemption for trading in obligations of multinational central banks. *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't. Obligations). In the case of a foreign banking entity that is owned or controlled by a second foreign banking entity domiciled in a country other than the home country of the first foreign banking entity, the final rule would permit the eligible U.S. operations of the first foreign banking entity to engage in proprietary trading only in the sovereign debt of the first foreign banking entity's home country, and would permit the U.S. operations of the second foreign banking entity to engage in proprietary trading only in the sovereign debt of the home country of the second foreign banking entity. As noted earlier, other provisions of the final rule make clear that the rule does not restrict the proprietary trading outside of the United States of either foreign banking organization in debt of any foreign sovereign.

[1372] *See* Part VI.A.5.c., *infra*. Many commenters requested an exemption for trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Bank of Canada; Ass'n. of German Banks; BAROC; Barclays.

[1373] As part of this exemption, for example, the U.S. operations of a European bank would be able to trade in obligations issued by the European Central Bank. Many commenters represented that the same rationale for exempting trading in U.S. government obligations supports exempting trading in foreign sovereign debt. *See, e.g.,* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; EFAMA; ICI (Feb. 2012).

[1374] The Agencies believe this approach appropriately balances commenter concerns that proprietary trading in foreign sovereign obligations represents a risky activity and the interest in preserving the ability of U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations. *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1375] *See* final rule § 75.6(c). Many commenters requested an exemption for trading in foreign sovereign debt, and some commenters suggested exempting proprietary trading by foreign banking entities in obligations of their home country. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; FSA (Apr. 2012); Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS.

[1376] Commenters argued that in some foreign markets, U.S. banks operating in those jurisdictions are required by local regulation or market practice to trade in local sovereign securities. *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Ass'n. of German Banks; Barclays; EBF; Goldman (Prop. Trading); UBS.

[1377] Some commenters represented that the limitations and obligations of section 13 would be problematic and unduly burdensome on banking entities because they would only be able to trade in foreign sovereign obligations under existing exemptions, such as the market-making exemption. *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1378] *See, e.g.,* BoA; Citigroup; Goldman (Prop. Trading); IIB/EBF; Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012).; Banco de México; Barclays. The Agencies recognize some commenters' representation that restricting trading in foreign sovereign debt would not necessarily cause reduced liquidity in government bond markets because banking entities would still be able to make a market in and underwrite foreign government obligations. *See* Prof. Johnson; Better Markets (Feb. 2012).

entities are permitted by the final rule to continue to engage fully in market-making in and underwriting of debt of foreign sovereigns anywhere in the world. The only restriction placed on these entities is on the otherwise impermissible proprietary trading in these instruments for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements.

The Agencies recognize that, depending on the extent to which banking entities subject to the rule have contributed to the liquidity of trading markets for foreign sovereign debt, the lack of an exemption for proprietary trading in foreign sovereign debt could result in certain negative impacts on the markets for such debt. In general, the Agencies believe these concerns should be mitigated somewhat by the refined exemptions for market making, underwriting and permitted trading activity of foreign banking entities; however, those exemptions do not address certain of the collateral, capital, and other operational issues identified by commenters.[1379] Foreign sovereign debt of home and host countries generally serves these purposes. Due to the relationships among global financial markets, permitting trading that supports these essential functions promotes the financial stability and the safety and soundness of banking entities.[1380] In contrast, a broad exemption for proprietary trading in all foreign sovereign debt without the limitations contained in the underwriting, market making and hedging exemptions could lead to more complicated risk profiles and significant unhedged risk exposures that section 13 of the BHC Act is designed to address. Thus, the Agencies believe use of section 13(d)(1)(J) exemptive authority to permit proprietary trading in foreign government obligations in certain limited circumstances is appropriate.

The Agencies decline to follow commenters' suggested alternative of allowing trading in foreign government obligations if the obligations meet a particular condition on quality, such as obligations of OECD member countries.[1381] The Agencies do not believe such an approach responds to the statutory purpose of limiting risks posed to the U.S. financial system by proprietary trading activities as directly as our current approach, which is structured to limit the exposure of banking entities, including insured depository institutions, to the risks of foreign sovereign debt. Additionally, the Agencies decline to permit proprietary trading in any obligation permitted under the laws of the foreign banking entity's home country,[1382] because such an approach could result in unintended competitive impacts since banking entities would not be subject to one uniform standard inside the United States. Further, unlike some commenters, the Agencies do not believe it is appropriate to require foreign governments to commit to paying for any damage to the U.S. financial system resulting from the foreign sovereign debt exemption.[1383]

The proposal also did not contain an exemption for trading in derivatives on foreign government obligations. Many commenters who recommended providing an exemption for proprietary trading in foreign government obligations also requested that the exemption be extended to derivatives on foreign government obligations.[1384] Two of these commenters urged that trading in derivatives on foreign sovereign obligations should be exempt for the same reason that trading in derivatives on U.S. government obligations is exempt because such trading supports liquidity and price stability in the market for the underlying government obligations.[1385] One commenter recommended that the Agencies use the authority in section 13(d)(1)(J) to grant an exemption for proprietary trading in derivatives on foreign government obligations.[1386]

The final rule has not been modified in § 75.6(b) to permit a banking entity to engage in proprietary trading in derivatives on foreign government obligations. As noted above, the Agencies have determined not to permit proprietary trading in derivatives on U.S. exempt government obligations under section 13(d) and, for the same reasons, have determined not to extend the permitted activities to include proprietary trading in derivatives on foreign government obligations.

c. *Permitted Trading in Municipal Securities*

Section 75.6(a) of the proposed rule implemented an exemption to the prohibition against proprietary trading under section 13(d)(1)(A) of the BHC Act, which permits trading in certain governmental obligations. This exemption permits the purchase or sale of obligations issued by any State or any political subdivision thereof (the ''municipal securities trading exemption''). The proposed rule included both general obligation bonds and limited obligation bonds, such as revenue bonds, within the scope of this municipal securities trading exemption. The proposed rule, however, did not extend to obligations of ''agencies'' of States or political subdivisions thereof.[1387]

Many commenters, including industry participants, trade groups, and Federal and state governmental representatives, argued that the municipal securities trading exemption should be interpreted to permit banking entities to engage in proprietary trading in a broader range of municipal securities, including the

[1379] Representatives from foreign governments stated that an exemption allowing trading in obligations of their governments is necessary to maintain financial stability in their markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Bank of Canada; IRSG; IIB/EBF; Gov't of Japan/Bank of Japan; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Ass'n. of German Banks; ALFI. Commenters argued that exempting trading in foreign sovereign debt would avoid the possible negative impacts of a contraction of government bond market liquidity. *See, e.g.,* BoA; Citigroup; Goldman (Feb. 2012); IIB/EBF. Additionally, commenters suggested that failing to provide an exemption for this activity would impact money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations. *See, e.g.,* Barclays; BoA; Gov't of Japan/Bank of Japan; OSFI. A number of commenters also argued that, since U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the U.S. by U.S. primary dealers, the lack of an exemption would have a significant, negative impact on the ability of foreign governments to implement monetary policy and on liquidity in many foreign markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); IIB/EBF. Some commenters argued that banking entities and their customers use foreign sovereign debt to manage their risk by posting collateral in foreign jurisdictions and to manage international rate and foreign exchange risk. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1380] The Agencies generally concur with commenters' concerns that because the lack of an exemption could result in negative consequences—such as harming liquidity in foreign sovereign debt markets, making it more difficult and more costly for foreign governments to fund themselves, or subjecting banking entities to increased concentration risk—systemic risk could increase or there could be spillover effects that would harm global markets, including U.S. markets. *See* IIF; EBF; ICI Global; HSBC; Barclays; ICI (Feb. 2012); IIB/EBF; Union Asset. Additionally, in consideration of one commenter's statements, the Agencies believe that failing to provide this exemption may cause foreign banks to close their U.S. branches, which could harm U.S. markets. *See* Comm. on Capital Markets Regulation.

[1381] *See, e.g.,* BoA; Cadwalader (on behalf of Singapore Banks); IIB/EBF; OSFI; UBS; BAROC; Japanese Bankers Ass'n.; JPMC.

[1382] Some commenters suggested permitting non-U.S. banking entities to trade in any government obligation to the extent that such trading is permitted by the entity's primary regulator. *See* Allen & Overy (Gov't. Obligations); HSBC.

[1383] *See* Better Markets (Feb. 2012); *see also* Prof. Johnson.

[1384] *See* Barclays; Credit Suisse (Seidel); IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; RBC; Sumitomo Trust; UBS.

[1385] *See* Barclays; FIA.

[1386] *See* Barclays.

[1387] *See* Joint Proposal, 76 FR at 68878 n.165.

following: Obligations issued directly by States and political subdivisions thereof; obligations issued by agencies, constituted authorities, and similar governmental entities acting as instrumentalities on behalf of States and political subdivisions thereof; and obligations issued by such governmental entities that are treated as political subdivisions under various more expansive definitions of political subdivisions under Federal and state laws.[1388] These commenters argued that States and municipalities often issue obligations through agencies and instrumentalities and that these obligations generally have the same level of risk as direct obligations of States and political subdivisions.[1389] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the terms and purposes of section 13 and would not adversely affect the safety and soundness of banking entities involved in these transactions or create additional risk to the financial stability of the United States.[1390]

Commenters expressed concerns that the proposed rule would result in a bifurcation of the municipal securities market that would achieve no meaningful benefits to the safety and soundness of banking entities, create administrative burdens for determining whether or not a municipal security qualifies for the exemption, result in inconsistent applications across different States, increase costs, and decrease liquidity in the diverse municipal securities market.[1391] Commenters also argued that the market for securities issued by agencies and instrumentalities of States and political subdivisions thereof would be especially disrupted, and would affect about 40 percent of the municipal securities market.[1392]

Commenters recommended that the final rule provide a broad exemption to the prohibition on proprietary trading for municipal securities, based on the definition of ''municipal securities'' used in section 3(a)(29) of the Exchange Act,[1393] which is understood by market participants and by Congress, and has a well-settled meaning and an established body of law. [1394] Other commenters contended that adopting the same definition of municipal securities as used in the Federal securities laws would reduce regulatory burden, remove uncertainty, and lead to consistent treatment of these securities under the banking and securities laws.[1395] According to some commenters, the terms ''agency'' and ''political subdivision'' are used differently under some State laws, and some State laws identify certain agencies as political subdivisions or define political subdivision to include agencies.[1396] Commenters also noted that a number of Federal statutes and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1397] Commenters suggested that the Agencies interpret the term ''political subdivision'' in section 13 more broadly than in the proposal to include a wider range of State and municipal governmental obligations issued by agencies and instrumentalities or, alternatively, that the Agencies use the exemptive authority in section 13(d)(1)(J) if necessary to permit proprietary trading of a broader array of State and municipal obligations.[1398]

On the other hand, one commenter contended that bonds issued by agencies and instrumentalities of States or municipalities pose risks to the banking system because the commenter believed the market for these bonds has not been properly regulated or controlled.[1399] A few commenters also recommended tightening the proposed municipal securities trading exemption to exclude conduit obligations that benefit private businesses and private organizations.[1400] One commenter suggested that the proposed municipal securities trading exemption should not apply to tax-exempt municipal bonds that benefit private businesses (referred to as ''private activity bonds'' in the Internal Revenue Code [1401]) and that allow private businesses to finance private projects at lower interest rates as

[1388] *See, e.g.,* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); BoA; BDA (Feb. 2012); Capital Group; Chamber (Feb. 2012); Citigroup (Jan. 2012); CHFA; Eaton Vance; Fidelity; Fixed Income Forum/Credit Roundtable; HSBC; MEFA; Nuveen Asset Mgmt.; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* MSRB; Fidelity; State of New York; STANY; SIFMA (Municipal Securities) (Feb. 2012); State Street (Feb. 2012); North Carolina; T. Rowe Price; Sumitomo Trust; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1389] *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* North Carolina; Washington State Treasurer; *see also* NABL; Ashurst; BDA (Feb. 2012); Chamber (Feb. 2012); Eaton Vance; Fidelity; MEFA; MSRB; Am. Pub. Power *et al.;* Nuveen Asset Mgmt.; PNC; SIFMA (Municipal Securities) (Feb. 2012); UBS.

[1390] *See* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; Wells Fargo (Prop. Trading); *see also* Capital Group (arguing that municipal securities are not generally used as a profit making strategy and thus, including all municipal securities in the exemption by itself should not adversely affect the safety and soundness of banking entities); PNC (arguing that the safe and sound nature of trading in State and municipal agency obligations was ''a fact recognized by Congress in 1999 when it authorized well capitalized national banks to underwrite and deal in, without limit, general obligation, limited obligation and revenue bonds issued by or on behalf of any State, or any public agency or authority of any State or political subdivision of a State''); Sens. Merkley & Levin (Feb. 2012).

[1391] *See, e.g.,* MSRB; City of New York; Am. Pub. Power *et al.;* Wells Fargo; State of New York; Washington State Treasurer; ABA (Keating); Capital Group; North Carolina; Eaton Vance; Port Authority; Connecticut; Citigroup (Jan. 2012); Ashurst; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 2012).

[1392] *See, e.g.,* MSRB (stating that, based on data from Thomson Reuters, 41.4 percent of the municipal securities issued in FY 2011 were issued by agencies and authorities).

[1393] *See* 15 U.S.C. 78c(a)(29).

[1394] *See* ABA (Keating); Ashurst; BoA; Capital Group; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); Eaton Vance; Fidelity; MEFA; MTA–NY; MSRB; Am. Pub. Power *et al.;* NABL; NCSL; State of New York; Nuveen Asset Mgmt.; Port Authority; PNC; SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1395] *See* Ashurst; Citigroup (Jan. 2012) (noting that the National Bank Act explicitly lists State agencies and authorities as examples of political subdivisions); MSRB.

[1396] *See, e.g.,* Citigroup (Jan. 2012).

[1397] *See, e.g.,* MSRB; Citigroup (Jan. 2012). In addition to the Federal securities laws, the National Bank Act explicitly includes agencies and authorities as examples of political subdivisions. *See* 12 U.S.C. 24(seventh) (permitting investments in securities ''issued by or on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or any public agency or authority of any State or political subdivision of a State . . . .''). In addition, a number of banking regulations also include agencies as examples of political subdivisions or define political subdivision to include municipal agencies, authorities, districts, municipal corporations and similar entities. *See, e.g.,* 12 CFR 1.2; 12 CFR 160.30; 12 CFR 161.38; 12 CFR 330.15. Further, for purposes of the tax-exempt bond provisions in the Internal Revenue Code, Treasury regulations treat obligations issued by or ''on behalf of'' States or political subdivisions by ''constituted authorities'' as obligations of such States or political subdivisions, and the Treasury regulations define the term ''political subdivision'' to mean ''any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. . . .'' *See* 26 CFR 1.103–1(b).

[1398] *See* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation; Sens. Merkley & Levin (Feb. 2012); MSRB; Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1399] *See* Occupy.

[1400] *See* AFR *et al.* (Feb. 2012); Occupy.

[1401] *See* 26 U.S.C. 141. In general, the rules applicable to the issuance of tax-exempt private activity bonds under the Internal Revenue Code of 1986, as amended (the ''Code'') are more restrictive than those applicable to traditional governmental bonds issued by States or political subdivisions thereof. Section 146 of the Code imposes an annual State bond volume cap on most tax-exempt private activity bonds that is tied to measures of State populations. Sections 141–150 of the Code impose other additional restrictions on tax-exempt private activity bonds, including, among others, eligible project and use restrictions, bond maturity restrictions, land and existing property financing restrictions, an advance refunding prohibition, and a public approval requirement.

a result of the exemption from Federal income taxation for the interest received by investors.[1402]

The final rule includes the statutory exemption for proprietary trading of obligations of any State or political subdivision thereof.[1403] In response to the public comments and for the reasons discussed below, this exemption uses the definition of the term ''municipal security'' modeled after the definition of ''municipal securities'' under section 3(a)(29) of the Exchange Act,[1404] but with simplifications.[1405] The final rule defines the term ''municipal security'' to mean ''a security which is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.''

The final rule modifies the proposal to permit proprietary trading in obligations issued by agencies and instrumentalities acting on behalf of States and municipalities (*e.g.,* port authority bonds and bonds issued by municipal agencies or corporations).[1406] As noted by commenters, many States and municipalities rely on securities issued by agencies and instrumentalities to fund essential activities, including utility systems, infrastructure projects, affordable housing, hospitals, universities, and other nonprofit institutions.[1407] Both obligations issued directly by States and political subdivisions thereof and obligations issued by an agency or instrumentality of such a State or local governmental entity are ultimately obligations of the State or local governmental entity on whose behalf they act. Moreover, exempting obligations issued by State and municipal agencies and instrumentalities in the same manner as the direct obligations of States and municipalities lessens potential inconsistent treatment of government obligations across States and municipalities that use different funding methods for government projects.[1408]

The Agencies believe that interpreting the language of section 13(d)(1)(A) of the BHC Act to provide an exemption to the prohibition on proprietary trading for obligations issued by States and municipal agencies and instrumentalities as described above is consistent with the terms and purposes of section 13 of the BHC Act.[1409] The Agencies recognize that state and political subdivision agency obligations generally present the same level of risk as direct obligations of States and political subdivisions.[1410] Moreover, the Agencies recognize that other Federal laws and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1411] The Agencies decline to exclude from this exemption conduit obligations that benefit private entities, as suggested by some commenters.[1412]

The proposal did not exempt proprietary trading of derivatives on obligations of States and political subdivisions. The proposal solicited comment on whether exempting proprietary trading in options or other derivatives referencing an obligation of a State or political subdivision thereof was consistent with the terms and purpose of the statute.[1413] The Agencies did not receive persuasive information on this topic and, for the same reasons discussed above related to derivatives on U.S. government securities, the Agencies have determined not to provide an exemption for proprietary trading in municipal securities, beyond the underwriting, market-making, hedging and other exemptions provided generally in the rule. The Agencies note that banking entities may trade derivatives on municipal securities under any other available exemption to the prohibition on proprietary trading,

[1402] *See* AFR *et al.* (Feb. 2012).

[1403] *See* final rule § 75.6(a)(3).

[1404] Many commenters requested that the final rule use the definition of ''municipal securities'' used in the Federal securities laws because, among other reasons, the industry is familiar with that definition and such an approach would promote consistent treatment of these securities under banking and securities laws. *See, e.g.,* ABA (Keating); Ashurst; BoA; Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); NCSL; Port Authority; SIFMA (Municipal Securities) (Feb. 2012); MSRB. Section 3(a)(29) of the Exchange Act defines the term ''municipal securities'' to mean ''securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.'' *See* 15 U.S.C. 78c(a)(29).

[1405] The definition of municipal securities in section 3(a)(29) of the Exchange Act has outdated tax references to the prior law under the former Internal Revenue Code of 1954, including particularly references to certain provisions involving the concept of ''industrial development bonds.'' The successor current Internal Revenue Code of 1986, as amended, replaces the prior definition of ''industrial development bonds'' with a revised, more restrictive successor definition of ''private activity bonds'' and related definitions of ''exempt facility bonds'' and ''small issue bonds.'' In recognition of the numerous tax law changes since the last statutory revision of section 3(a)(29) of the Exchange Act in 1970 and the potential attendant confusion, the Agencies determined to use a simpler, streamlined, independent definition of municipal securities for purposes of the municipal securities trading exception. This revised definition is intended to encompass, among others, any securities that are covered by the definition of the term ''municipal securities'' under section 3(a)(29) of the Exchange Act.

[1406] Many commenters requested that the municipal securities trading exemption be interpreted to include a broader range of State and municipal obligations issued by agencies and instrumentalities. *See, e.g.,* ABA (Keating); Ashurst; BoA; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; Sens. Merkley & Levin (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation.

[1407] *See, e.g.,* Citigroup (Jan. 2012); Ashurst; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Chamber (Dec. 2011); BlackRock; Fixed Income Forum/Credit Roundtable.

[1408] Commenters represented that the proposed rule would result in inconsistent applications of the exemption across States and political subdivisions. The Agencies also recognize, as noted by commenters, that the proposed rule would likely have resulted in a bifurcation of the municipal securities market and associated administrative burdens and disruptions. *See, e.g.,* MSRB; Am. Pub. Power *et al.;* Port Authority; Citigroup (Jan. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012).

[1409] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the terms and purposes of section 13. *See, e.g.,* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012).

[1410] Commenters argued that obligations issued by agencies and instrumentalities generally have the same level of risk as direct obligations of States and political subdivisions. *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* North Carolina. In response to one commenter's concern that the markets for bonds issued by agencies and instrumentalities are not properly regulated, the Agencies note that all types of municipal securities, as defined under the securities laws to include, among others, State direct obligation bonds and agency or instrumentality bonds, are generally subject to the same regulations under the securities laws. Thus, the Agencies do not believe that obligations of agencies and instrumentalities are subject to less effective regulation than obligations of States and political subdivisions. *See* Occupy.

[1411] Commenters noted that a number of Federal statutes and regulations define ''political subdivision'' to include municipal agencies and instrumentalities. *See, e.g.,* MSRB; Citigroup (Jan. 2012).

[1412] *See* AFR *et al.* (Feb. 2012); Occupy. The Agencies do not believe it is appropriate to exclude conduit obligations, which are tax-exempt municipal bonds, from this exemption because such obligations are used to finance important projects related to, for example, multi-family housing, healthcare (hospitals and nursing homes), colleges and universities, power and energy companies and resource recovery facilities. *See* U.S. Securities & Exchange Comm'n., Report on the Municipal Securities Market 7 (2012), *available at http://www.sec.gov/news/studies/2012/munireport073112.pdf.*

[1413] *See* Joint Proposal, 76 FR at 68878.

providing the requirements of the relevant exemption are met.

d. Determination to Not Exempt Proprietary Trading in Multilateral Development Bank Obligations

The proposal did not exempt proprietary trading in obligations of multilateral banks or derivatives on multilateral development bank obligations but requested comment on this issue.[1414] A number of commenters argued that the final rule should include an exemption for obligations of multilateral development banks.[1415]

The Agencies have not included an exemption to permit banking entities to engage in proprietary trading in obligations of multilateral development banks at this time. The Agencies do not believe that providing an exemption for trading obligations of multilateral development banks will help enhance the markets for these obligations and therefore promote and protect the safety and soundness of banking entities and U.S. financial stability.

6. Section 75.6(c): Permitted Trading on Behalf of Customers

Section 13(d)(1)(D) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of financial instruments on behalf of customers.[1416] The statute does not define when a transaction or activity is conducted ''on behalf of customers.''

a. Proposed Exemption for Trading on Behalf of Customers

Section 75.6(b) of the proposed rule implemented the exemption for trading on behalf of customers by exempting three types of trading activity. Section 75.6(b)(i) of the proposed rule provided that a purchase or sale of a financial instrument occurred on behalf of customers if the transaction (i) was conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of that customer, and (ii) involved solely financial instruments for which the banking entity's customer, and not the banking entity or any affiliate of the banking entity, was the beneficial owner. This exemption was intended to permit trading activity that a banking entity conducts in the context of providing investment advisory, trust, or fiduciary services to customers provided that the banking entity structures the activity so that the customer, and not the banking entity, benefits from any gains and suffers any losses on the traded positions.

Section 75.6(b)(ii) of the proposed rule exempted the purchase or sale of a covered financial position if the banking entity was acting as riskless principal.[1417] Under the proposed rule, a banking entity qualified as a riskless principal if the banking entity, after having received an order to purchase or sell a covered financial position from a customer, purchased or sold the covered financial position for its own account to offset a contemporaneous sale to or purchase from the customer.[1418]

Section 75.6(b)(iii) of the proposed rule permitted trading by a banking entity that was an insurance company for the separate account of insurance policyholders. Under the proposed rule, only a banking entity that is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator was eligible for this prong of the exemption for trading on behalf of customers. Additionally, the purchase or sale of the covered financial position was exempt only if it was solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company under which all profits and losses arising from the purchase or sale of the financial instrument were allocated to the separate account and inured to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity. These types of transactions are customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets even though the banking entity is treated as the owner of those assets for certain purposes.

b. Comments on the Proposed Rule

Several commenters contended that the Agencies construed the statutory exemption too narrowly by limiting permissible proprietary trading on behalf of customers to only three categories of transactions.[1419] Some of these commenters argued the exemption in the proposal was not consistent with the statutory language or Congressional intent to permit all transactions that are ''on behalf of customers.''[1420] One of these commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to permit only customer-driven transactions involving securities and not other financial instruments such as foreign exchange forwards and other derivatives.[1421]

Several commenters urged the Agencies to expand the exemption for trading on behalf of customers to permit other categories of customer-driven transactions in which the banking entity may be acting as principal but that serve legitimate customer needs including capital formation. For example, one commenter urged the Agencies to permit customer-driven transactions in which the banking entity has no ready counterparty but that are undertaken at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions.[1422] Other commenters urged the Agencies to exempt transactions where the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction.[1423] Commenters argued that these kinds of transactions are similar in purpose and level of risk to riskless principal transactions.[1424] Commenters also argued that these transactions could be viewed as market-making related activities, but indicated that the potential uncertainty and costs of making that determination would discourage banking entities from taking principal risks to accommodate customer needs.[1425] Commenters also requested that the Agencies expressly

[1414] *See id.*

[1415] Commenters argued that including obligations of multilateral developments banks in a foreign sovereign debt exemption is necessary to avoid endangering international cooperation in financial regulation and potential retaliatory prohibitions against U.S. government obligations. *See* Ass'n. of German Banks; Sumitomo; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Additionally, some commenters represented that an exemption for obligations of international and multilateral development banks is appropriate for many of the same reasons provided for exempting U.S. government obligations and foreign sovereign debt generally. *See* Ass'n. of German Banks; Barclays; Goldman (Prop. Trading); IIB/EBF; ICFR; ICI Global; FIA; Sumitomo Trust; Allen & Overy (Gov't. Obligations); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1416] 12 U.S.C. 1851(d)(1)(D).

[1417] *See* Joint Proposal, 76 FR at 68879.

[1418] This language generally mirrors that used in the Board's Regulation Y, OCC interpretive letters, and the SEC's Rule 3a5–1 under the Exchange Act. *See* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993).

[1419] *See, e.g.,* Am. Express; BoA; ISDA (Apr. 2012); RBC; SIMFA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1420] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1421] *See* Am. Express.

[1422] *See* RBC. The Agencies note that acting as a block positioner is expressly contemplated and included as part of the exemption for market making-related activities under the final rule.

[1423] *See* BoA; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1424] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1425] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

permit transactions on behalf of customers to create structured products, as well as for client funding needs, customer clearing, and prime brokerage, if these transactions are included within the trading account.[1426]

In contrast, some commenters supported the proposed approach for implementing the exemption for trading on behalf of customers or urged narrowing the exemption.[1427] One commenter expressed general support for the requirement that all profits (or losses) from the transaction flow to the customer and not the banking entity providing the service for a transaction to be exempt.[1428] One commenter contended that the statute did not permit transactions on behalf of customers to be performed by an investment adviser.[1429] Another commenter argued that the final rule should permit a banking entity to engage in a riskless principal transaction only where the banking entity has already arranged for another customer to be on the other side of the transaction.[1430] Other commenters urged the Agencies to ensure that both parties to the transaction agree beforehand to the time and price of any relevant trade to ensure that the banking entity solely stands in the middle of the transaction and in fact passes on all gains (or losses) from the transaction to the customers.[1431] Commenters also urged the Agencies to define other key terms used in the exemption. For instance, some commenters requested that the final rule define which entities may qualify as a ''customer'' for purposes of the exemption.[1432]

Some commenters urged the Agencies to provide uniform guidance on how the Agencies will interpret the riskless principal exemption.[1433] One commenter urged the Agencies to clarify how the riskless principal exemption would be implemented with respect to transactions in derivatives, including a hedged derivative transaction executed at the request of a customer.[1434]

Several commenters generally expressed support for the exemption for trading for the separate account of insurance policyholders under the proposed rule.[1435] One commenter requested that the final rule more clearly articulate who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure.[1436]

Several commenters argued that certain types of separate account activities, including the allocation of seed money by an insurance company to a separate account or the offering of certain non-variable separate account contracts by the insurance company, would not appear to be permitted under the proposal.[1437] Commenters also expressed concern that these separate account activities might not satisfy the proposed requirement that all profits and losses arising from the purchase or sale of the financial position inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company.[1438] In addition, commenters argued that under the proposed rule, these activities would appear to fall outside of the exemption for activities in the general account of an insurance company because the proposed rule defined a general account as excluding a separate account.[1439] Commenters urged the Agencies to more closely align the exemptions for trading by an insurance company for the general account and separate account.[1440] According to these commenters, this change would permit insurance companies to continue to engage in the business of insurance by offering the full suite of insurance products to their customers.[1441]

c. Final Exemption for Trading on Behalf of Customers

The Agencies have carefully considered the comments and are adopting the exemption for trading on behalf of customers with several modifications. The Agencies believe that the final rule implements the exemption in section 13(d)(1)(D) in a manner consistent with the legislative intent to allow banking entities to use their own funds to purchase or sell financial instruments when acting on behalf of their customers.[1442] At the same time, the limited activities permitted under the final rule limit the potential for abuse.[1443]

The final rule slightly modifies the proposed rule by providing that a banking entity is not prohibited from trading on behalf of customers when that activity is conducted by the banking entity as trustee or in a similar fiduciary capacity for a customer and so long as the transaction is conducted for the account of, or on behalf of the customer and the banking entity does not have or retain a beneficial ownership of the financial instruments. The final rule removes the proposal's express exemption for investment advisers. After further consideration, the Agencies do not believe an express reference to investment advisers is necessary because investment advisers generally act in a fiduciary capacity on behalf of clients in a manner that is separately covered by other exclusions and exemptions in the final rule. Additionally, the final rule deletes the proposal's express exemption for commodity trading advisors because the legal relationship between a commodity trading advisor and its client depends on the facts and circumstances of each relationship. Therefore, the Agencies determined that it was appropriate to limit the discussion to fiduciary obligations generally and to omit any specific discussion of commodity trading advisors. In order to ensure that a banking entity utilizes this exemption to engage only in transactions for customers and not to conduct its own trading activity, the final rule (consistent with the proposed rule) requires that the purchase or sale of financial instruments be conducted for the account of the customer and that it involve solely financial instruments of which the customer, and not the banking entity, is beneficial owner.[1444] The final rule, like the proposed rule, permits transactions in any financial instrument, including derivatives such as foreign exchange forwards, so long as

[1426] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1427] *See, e.g.,* Alfred Brock; ICBA; Occupy.

[1428] *See* ICBA.

[1429] *See* Occupy.

[1430] *See* Public Citizen.

[1431] *See* Occupy; Alfred Brock.

[1432] *See* Occupy; Public Citizen. Conversely, other commenters supported the approach taken in the proposed rule without requesting such a definition. *See* Alfred Brock.

[1433] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1434] *See* Am. Express.

[1435] *See* ACLI; Chris Barnard; NAMIC; Fin. Services Roundtable (Feb. 3, 2012).

[1436] *See* Chris Barnard.

[1437] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1438] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1439] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1440] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1441] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1442] *See* 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''this permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves.'').

[1443] Some commenters urged narrowing the exemption. *See, e.g.,* Alfred Brock; ICBA; Occupy. The Agencies believe the final rule is appropriately narrow to limit potential abuse.

[1444] *See* final rule § 75.6(c)(1)(ii)–(iii). *See also* proposed rule § 75.6(b)(2)(i)(B)–(C).

those transactions are on behalf of customers.[1445]

While some commenters requested that the final rule define ''customer'' for purposes of this exemption,[1446] the Agencies believe the requirements of this exemption address commenters' underlying concerns about what constitutes a ''customer.'' Specifically, the Agencies believe that requiring a transaction relying on this exemption to be conducted in a fiduciary capacity for a customer, to be conducted for the account of the customer, and to involve solely financial instruments of which the customer is beneficial owner address the underlying concerns that a transaction could qualify for this exemption if done on behalf of an indirect customer or on behalf of a customer not served by the banking entity.

The final rule also provides that a banking entity may act as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset the contemporaneous sale of the financial instrument to (purchase from) the customer.[1447] Any transaction conducted pursuant to the exemption for riskless principal activity must be customer-driven and may not expose the banking entity to gains (or losses) on the value of the traded instruments as principal.[1448] Importantly, the final rule does not permit a banking entity to purchase (or sell) a financial instrument without first having a customer order to buy (sell) the instrument. While some commenters requested that the Agencies modify the final rule to permit activity without a customer order,[1449] the Agencies are concerned that broadening the exemption in this manner would enable banking entities to evade the requirements of section 13 and engage in prohibited proprietary trading under the guise of trading on behalf of customers.

Several commenters requested that the final rule explain how a banking entity may determine when it is acting as riskless principal.[1450] The Agencies note that riskless principal transactions typically are undertaken as an alternative method of executing orders by customers to buy or sell financial instruments on an agency basis. Acting as riskless principal does not include acting as underwriter or market maker in the particular financial instrument and is generally understood to be equivalent to agency or brokerage transactions in which all of the risks associated with ownership of financial instruments are borne by customers. The Agencies have generally equivalent standards for determining when a banking entity acts as riskless principal and require that the banking entity, after receiving an order to buy (or sell) a financial instrument from a customer, buys (or sells) the instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.[1451] The Agencies intend to determine whether a banking entity acts as riskless principal in accordance with and subject to the requirements of these standards.

Some commenters requested that the final rule permit a greater variety of transactions to be conducted on behalf of customers. Many of these transactions, such as transactions that facilitate customer liquidity needs or block positioning transactions [1452] or transactions in which the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction,[1453] may be permissible under the market-making exemption. To the extent these transactions are conducted by a market maker, the Agencies believe that the restrictions and limits required in connection with market making-related activities are important for limiting the risks to the banking entity from these transactions.[1454] While some commenters requested that clearing and settlement activities and prime brokerage activities be viewed as permitted proprietary trading on behalf of customers,[1455] these transactions are not considered proprietary trading as an initial matter under the final rule.[1456]

Finally, the Agencies have decided to move the exemption for trading activity conducted by an insurance company for a separate account into the provision exempting trading activity in an insurance company's general account in order to better align the two exemptions.[1457] As discussed below in Part VI.A.7., the final rule provides exemptions for trading activity conducted by an insurance company that is a banking entity either in the general account or in a separate account of customers in § 75.6(d). As explained below, the statute specifically exempts trading activity that is conducted by a regulated insurance company engaged in the business of insurance for the general account of the company if conducted in accordance with applicable state law and if not prohibited by the appropriate Federal banking agencies.[1458] Unlike activity for the general account of an insurance company, investments made by regulated insurance companies in separate accounts in accordance with applicable state law are made on behalf of and for the benefit of customers of the insurance company.[1459] Also unlike

[1445] Some commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to not permit transactions in foreign exchange forwards and other derivatives. *See* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1446] *See* Occupy; Public Citizen.

[1447] *See* final rule § 75.6(c)(2).

[1448] Some commenters urged the Agencies to ensure that the banking entity passes on all gains (or losses) from the transaction to the customers. *See* Occupy; Public Citizen.

[1449] *See* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1450] *See, e.g.,* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1451] *See, e.g.,* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993). One commenter stated that a banking entity should only be allowed to engage in a riskless principal transaction where the banking entity has already arranged for another customer to be on the other side of the transaction. *See* Public Citizen. The Agencies believe that the contemporaneous requirement in the final rule addresses this comment.

[1452] One commenter requested an exemption for transactions at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions. *See* RBC.

[1453] Some commenters requested an exemption for these types of transactions. *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1454] Some commenters stated that the potential uncertainty and costs of determining whether an activity qualifies for the market-making exemption would discourage banking entities from taking principal risks to accommodate customer needs. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies believe that adjustments made to the market-making exemption in the final rule help address this concern. Specifically, the final market-making exemption better accounts for the varying characteristics of market-making across markets and assets classes.

[1455] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1456] *See* final rule § 75.3(d)(4)–(6). *See also infra* Part VI.A.1.d.3–4.

[1457] Some commenters requested that the Agencies more closely align the exemptions for trading by an insurance company for the general account and separate account. *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1458] *See* 12 U.S.C. 1851(d)(1)(F).

[1459] One commenter requested clarification on who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure. *See* Chris Barnard. The Agencies note that the proposed requirement that all profits and losses arising from the purchase or sale of a financial instrument inure to the benefit or detriment of the ''owners of the insurance policies supported by the separate account'' has been removed. *See* proposed rule § 75.6(b)(2)(iii)(C). Instead, the final rule requires that the income, gains, and losses from assets allocated to a separate account be credited to

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general accounts (which are supported by all of the assets of the insurance company), a separate account is supported only by the assets in that account and does not have call on the other assets of the company. The customer benefits (or loses) based solely on the performance of the assets in the separate account. These arrangements are the equivalent for insurance companies of fiduciary accounts at banks. For these reasons, the final rule recognizes that separate accounts at regulated insurance companies maintained in accordance with applicable state insurance laws are exempt from the prohibitions in section 13 as acquisitions on behalf of customers.

7. Section 75.6(d): Permitted Trading by a Regulated Insurance Company

Section 13(d)(1)(F) permits a banking entity that is a regulated insurance company acting for its general account, or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions (the ''general account exemption'').[1460] Section 13(d)(1)(D) permits a banking entity to purchase or sell a financial instrument on behalf of customers.[1461] In the proposed rule, the Agencies viewed Section 13(d)(1)(D) as permitting an insurance company to purchase or sell a financial instrument for certain separate accounts (the ''separate account exemption''). The proposal implemented both these exemptions with respect to activities of insurance companies, in each case subject to the restrictions discussed below.[1462]

Section 75.6(c) of the proposed rule implemented the general account exemption by generally restating the statutory requirements of the exemption that:

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

The proposed rule defined the term ''general account'' to include all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law.[1463]

As noted above in Part VI.A.6.a., § 75.6(b)(iii) of the proposed rule provided an exemption for a banking entity that is an insurance company when it acted through a separate account for the benefit of insurance policyholders. The proposed rule defined a ''separate account'' as an account established or maintained by a regulated insurance company subject to regulation by a State insurance regulator or foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[1464]

To limit the potential for abuse of the separate account exemption, the proposed rule included requirements designed to ensure that the separate account trading activity is subject to appropriate regulation and supervision under insurance laws and not structured so as to allow gains or losses from trading activity to inure to the benefit or detriment of the banking entity.[1465] In particular, the proposed rule provided that a purchase or sale of a financial instrument qualified for the separate account exemption only if:

- The banking entity is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;[1466]
- The banking entity purchases or sells the financial instrument solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- All profits and losses arising from the purchase or sale of the financial instrument are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity; and
- The purchase or sale is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

The proposal explained that the proposed separate account exception represented transactions on behalf of customers because the insurance-related transactions are generally customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets, even though the banking entity may be treated as the owner of those assets for certain purposes.

Commenters generally supported the general account exemption and the separate account exemption for regulated insurance companies as consistent with both the statute and Congressional intent to accommodate the business of insurance.[1467] For instance, commenters argued that the statute was designed to appropriately accommodate the business of insurance, subject to regulation in accordance with relevant insurance company investment laws, in recognition that insurance company investment activities are already subject to comprehensive regulation and oversight.[1468]

A few commenters expressed concerns about the definition of ''general account'' and ''separate

or charged against the account without regard to other income, gains or losses of the insurance company. *See* final rule § 75.2(z) (definition of ''separate account''). Thus, the final rule no longer references ''owners of the insurance policies supported by the separate account.'' The Agencies note, however, that the final rule requires exempted separate account transactions to be ''conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.'' *See* final rule § 75.6(d)(3).

[1460] *See* 12 U.S.C. 1851(d)(1)(F).

[1461] *See* 12 U.S.C. 1851(d)(1)(D).

[1462] *See* proposed rule §§ 75.6(b)(2)(iii), 75.6(c).

[1463] *See* proposed rule § 75.3(c)(6).

[1464] *See* proposed rule § 75.2(z).

[1465] The Agencies noted in the proposal they would not consider profits to inure to the benefit of the banking entity if the banking entity were solely to receive payment, out of separate account profits, of fees unrelated to the investment performance of the separate account.

[1466] The proposed rule provided definitions of the terms ''State insurance regulator'' and ''foreign insurance regulator.'' *See* proposed rule § 75.3(c)(4), (13).

[1467] *See, e.g.,* Alfred Brock; Chris Barnard; Fin. Services Roundtable (Feb. 3, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); TIAA–CREF; NAMIC.

[1468] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Country Fin. *et al.*; Sutherland (on behalf of Comm. of Annuity Insurers).

account.'' [1469] One commenter argued the definition of general account was unclear.[1470] A few commenters expressed concern that the proposed definition of separate account inappropriately excluded some separate accounts, such as certain insurance company investment activities such as guaranteed investment contracts, which would also not fall within the proposed definition of general account.[1471] Several commenters argued that the final rule should be modified so that all insurance company investment activity permitted under applicable insurance laws would qualify for either the general account exemption or the separate account exemption.[1472]

Some commenters argued that the prohibition in the proposed definition of separate account against any profits or losses from activity in the account inuring to the benefit (or detriment) of the insurance company would exclude some activity permitted by insurance regulation in separate accounts.[1473] For example, commenters contended that an insurer may allocate its own funds to a separate account as ''seed money'' and the profits and losses on those funds inure to the benefit or detriment of the insurance company.[1474]

Some commenters expressed specific concerns about the scope or requirements of the proposal. For instance, one commenter argued that the final rule should provide that a trade is exempt if the trade is made by an affiliate of the insurance company in accordance with state insurance law.[1475] Another commenter urged that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign insurance company was inconsistent with the safety and soundness or financial stability.[1476]

One commenter suggested that insurance company affiliates of banking entities should expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[1477] By contrast, other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities.[1478] These commenters argued that insurance companies are already subject to comprehensive regulation of the kinds and amounts of investments they can make under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits.

After considering the comments received and the language and purpose of the statute, the final rule has been modified to better account for the language of the statute and more appropriately accommodate the business of insurance.

As explained in the proposal, section 13(d)(1)(F) of the BHC Act specifically and broadly exempts the purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company engaged in the business of insurance for the general account of the company (and by an affiliate solely for the general account of the regulated insurance company). Section 13(d)(1)(D) of the statute also specifically exempts the same activity when done on behalf of customers. As explained in the proposal, separate accounts managed and maintained by insurance companies as part of the business of insurance are generally customer-driven and do not expose the banking entity to gains or losses on the value of assets held in the separate account, even though the banking entity may be treated as the owner of the assets for certain purposes. Unlike the general account of the insurance company, separate accounts are managed on behalf of specific customers, much as a bank would manage a trust or fiduciary account.

For these reasons, the final rule retains both the general account exemption and the separate account exemption. The final rule removes any gap between the definition of general account and the definition of separate account by defining the general account to be all of the assets of an insurance company except those allocated to one or more separate accounts.[1479]

The final rule also combines the general account exemption and the separate account exemption into a single section. This makes clear that both exemptions are available only:

- If the insurance company or its affiliate purchases or sells the financial instruments solely for the general account of the insurance company or a separate account of the insurance company;
- The purchases or sales of financial instruments are conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance regarding insurance is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[1480]

Like section 13(d)(1)(F) of the BHC Act, the final rule permits an affiliate of an insurance company to purchase and sell financial instruments in reliance on the general account exemption, so long as that activity is for the general account of the insurance company. Similarly, the final rule implements section 13(d)(1)(D) and permits an affiliate of an insurance company to purchase and sell financial instruments for a separate account of the insurance company, so long as the separate account is

[1469] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); Sutherland (on behalf of Comm. of Annuity Insurers).

[1470] *See* Sutherland (on behalf of Comm. of Annuity Insurers).

[1471] *See* ACLI (Jan. 2012); NAMIC.

[1472] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; *see also* Nationwide.

[1473] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* Nationwide.

[1474] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012).

[1475] *See* USAA.

[1476] *See* HSBC Life.

[1477] *See* Sens. Merkley & Levin (Feb. 2012).

[1478] *See* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Mutual of Omaha; NAMIC.

[1479] *See* final rule § 75.2(p), (bb). Some commenters expressed concerns about the proposed definitions of ''general account'' and ''separate account,'' including that the proposed definition of ''separate account'' excluded some legitimate separate account activities that do not fall within the proposed general account definition. *See, e.g.,* ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers). *See also* proposed rule §§ 75.2(z), 75.3(c)(5).

[1480] The Federal banking agencies have not at this time determined, as part of the final rule, that the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. The Federal banking agencies expect to monitor, in conjunction with the FSOC, the insurance company investment laws, regulations, and written guidance of States or jurisdictions to which exempt transactions are subject and make such determinations in the future, where appropriate. The Agencies believe the final approach addresses one commenter's request that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign company was inconsistent with the safety and soundness or financial stability. *See* HSBC Life.

established and maintained at the insurance company.

Importantly, the final rule applies only to covered trading activity in a general or separate account of a licensed insurance company engaged in the business of insurance under the supervision of a State or foreign insurance regulator. As in the statute, an affiliate of an insurance company may not rely on this exemption for activity in any account of the affiliate (unless it, too, meets the definition of an insurance company). An affiliate may rely on the exemption to the limited extent that the affiliate is acting solely for the account of the insurance company.[1481]

As noted above, one commenter requested that the final rule impose special data and reporting obligations on insurance companies. Other commenters argued that insurance companies are already subject to comprehensive regulation under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits. In accordance with the statute,[1482] the Agencies expect insurance companies to have appropriate compliance programs in place for any activity subject to section 13 of the BHC Act.

The final rule contains a number of other related definitions that are intended to help make clear the limitations of the insurance company exemption, including definitions of foreign insurance regulator and State insurance regulator.

8. Section 75.6(e): Permitted Trading Activities of a Foreign Banking Entity

Section 13(d)(1)(H) of the BHC Act[1483] permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States (the ''foreign trading exemption'').[1484] The statute does not define when a foreign banking entity's trading occurs solely outside of the United States.

The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and activity that constitutes trading solely outside of the United States. The proposed rule effectively precluded a foreign banking entity from engaging in proprietary trading through a transaction that had any connection with the United States, including: Trading with any party located in the United States; allowing U.S. personnel of the foreign banking entity to be involved in the purchase or sale; or executing any transaction in the United States (on an exchange or otherwise).[1485]

In general, commenters emphasized the importance of and supported an exemption for foreign trading activities of foreign banking entities. However, a number of commenters expressed concerns that the proposed foreign trading exemption was too narrow and would not be effective in permitting foreign banking entities to engage in foreign trading activities.[1486] For instance, many commenters stated that the proposal's prohibition on trading activities that have any connection to the U.S. was not consistent with the purpose of section 13 of the BHC Act where the risk of the trading activity is taken or held outside of the United States and does not implicate the U.S. safety net.[1487] These commenters argued that, since one of the principal purposes of section 13 of the BHC Act is to limit the risk posed by prohibited proprietary trading to the Federal safety net, the safety and soundness of U.S. banking entities, and the financial stability of the United States, the exemption for foreign trading activity should similarly focus on whether the trading activity involves principal risk being taken or held by the foreign banking entity inside the United States.[1488]

Many commenters argued that the proposal's transaction-based approach to implementing the foreign trading exemption would harm U.S. markets and U.S. market participants. For example, some commenters argued that the proposed exemption would cause foreign banks to exit U.S. markets or shrink their U.S.-based operations, thereby resulting in less liquidity and greater fragmentation in markets without producing any significant offsetting benefit.[1489] Commenters also asserted that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities and would lead to foreign firms refusing to trade with U.S. counterparties, including the foreign operations of U.S. entities, to avoid compliance costs associated with relying on another exemption under the proposed rule.[1490] Additionally, commenters argued that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[1491]

a. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(H) provides that, in order to be eligible for the foreign trading exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. The proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

Commenters generally supported this aspect of the proposal.[1492] However, some commenters requested that the final rule be modified to allow U.S. banking entities' affiliates or branches that are physically located outside of the United States (''foreign operations of U.S. banking entities'') to engage in proprietary trading outside of the United States pursuant to this

[1481] Although one commenter requested that the final rule exempt a trade as long as the trade is made by an affiliate of the insurance company in accordance with state insurance law, the Agencies believe the final approach properly implements the statute. *See* USAA.

[1482] *See* 12 U.S.C. 1851(e)(1) (requiring that the Agencies issue regulations regarding ''internal controls and recordkeeping, in order to insure compliance with this section'').

[1483] Section 13(d)(1)(H) of the BHC Act provides an exemption to the prohibition on proprietary trading for trading conducted by a foreign banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act, if the trading occurs solely outside of the United States, and the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(H).

[1484] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the rule's implementation of section 13(d)(1)(H) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[1485] *See* proposed rule § 75.6(d).

[1486] *See, e.g.,* IIB/EBF; ICI Global; ICI (Feb. 2012); Wells Fargo (Prop. Trading); BoA.

[1487] *See* IIB/EBF; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Seidel); Cadwalader (on behalf of Thai Banks).

[1488] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1489] *See* ICE; ICI Global; BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; IIB/EBF.

[1490] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA; Citigroup (Feb. 2012). As discussed below in Part VI.C. of this **SUPPLEMENTARY INFORMATION,** other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[1491] *See* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Commissioner Barnier; Ass'n. of German Banks; Société Générale; Chamber (Dec. 2012).

[1492] *See* Sens. Merkley & Levin (Feb. 2012) (arguing that the final rule's foreign trading exemption should not exempt foreign affiliates of U.S. banking entities when they engage in trading activity abroad); *see also* Occupy; Alfred Brock.

exemption.[1493] These commenters argued that, unless foreign operations of U.S. banking entities are provided similar authority to engage in proprietary trading outside of the United States, foreign operations of U.S. banking entities would be at a competitive disadvantage abroad with respect to foreign banking entities. One commenter also asserted that, unless foreign operations of U.S. banking entities were able to effectively access foreign markets, they could be shut out of those markets and would be unable to effectively manage their risks in a safe and sound manner.[1494]

As noted above, section 13(d)(1)(H) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[1495] Because of this express statutory threshold requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its trading activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act.[1496] The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[1497]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[1498] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[1499] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[1500] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[1501] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the exemption for proprietary trading activity of a foreign banking entity.[1502]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not currently subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of this exemption[1503] if the entity, on a fully-consolidated basis, meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[1504] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and section 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States.[1505] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the prohibition on proprietary trading.

b. Permitted Trading Activities of a Foreign Banking Entity

As noted above, the proposed rule laid out a transaction-based approach to

[1493] *See* Citigroup (Feb. 2012); Sen. Carper; IIF; ABA (Keating); Wells Fargo (Prop. Trading); Abbot Labs. *et* al. (Feb. 14, 2012).

[1494] *See* Citigroup (Feb. 2012).

[1495] *See* 12 U.S.C. 1851(d)(1)(H).

[1496] *See* final rule § 75.6(e)(1)(ii).

[1497] Section 75.6(e)(2) addresses only when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(H) of the BHC Act, are unable to rely on the foreign trading exemption.

[1498] *See* 12 U.S.C. 1843(c)(9).

[1499] *See* 12 CFR 211.20 *et seq.*

[1500] Commenters noted that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign trading exemption. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. Accordingly, the final rule does not retain the proposal's requirement that the activity be conducted in compliance with subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the exemption in section 13(d)(1)(H) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[1501] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule referenced only the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[1502] This modification to the definition of foreign banking organization is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State a commonwealth, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, or the United States Virgin Islands.

[1503] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[1504] *See* final rule § 75.6(e)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § 75.6(e)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

[1505] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § 75.6(e)(2)(ii)(B).

implementing the foreign trading exemption and provided that a transaction would be considered to qualify for the exemption only if (i) the transaction was conducted by a banking entity not organized under the laws of the United States or of one or more States; (ii) no party to the transaction was a resident of the United States; (iii) no personnel of the banking entity that was directly involved in the transaction was physically located in the United States; and (iv) the transaction was executed wholly outside the United States.[1506]

Many commenters objected to the proposed exemption, arguing that it was unworkable and would have unintended consequences. For example, commenters argued that prohibiting a foreign banking entity from conducting a proprietary trade with a resident of the United States, including a subsidiary or branch of a U.S. banking entity, wherever located, would likely cause foreign banking entities to be unwilling to enter into permitted trading transactions with foreign subsidiaries or branches of U.S. firms.[1507] In addition, some commenters represented that it would be difficult to determine and track whether a party is a resident of the United States or that this requirement would require non-U.S. banking entities to inefficiently bifurcate their activities into U.S.-facing and non-U.S.-facing trading desks.[1508] For example, one commenter noted that trading on many exchanges and platforms is anonymous (*i.e.,* each party to the trade is unaware of the identity of the other party to the trade), so a foreign banking entity would likely have to avoid U.S. trading platforms and exchanges entirely to avoid transactions with any resident of the United States.[1509] Further, commenters stated that the proposed rule could deter foreign banking entities from conducting business with U.S. parties outside of the United States, which could also incentivize foreign market centers to limit participation by U.S. parties on their markets.[1510]

Commenters also expressed concern about the requirement that transactions be executed wholly outside of the United States in order to qualify for the proposed foreign trading exemption. Commenters represented that foreign banking entities currently use U.S. trading platforms to trade in certain products (such as U.S.-listed securities or a variety of derivatives contracts), to take advantage of robust U.S. infrastructure, and for time zone reasons.[1511] Commenters indicated that the proposed requirement could harm the competitiveness of U.S. trading platforms and the liquidity available on such facilities.[1512] Some commenters stated that this requirement would effectively result in most foreign banking entities moving their trading operations and personnel outside of the United States and executing transactions on exchanges outside of the United States.[1513] These commenters stated that the relocation of these activities would reduce trading activity in the United States that supports the financial stability and efficiency of U.S. markets. Moreover, these commenters argued that, if foreign banking entities relocate their personnel from the United States to overseas, this would diminish U.S. jobs with no concomitant benefit. They also contended that the proposal was at cross purposes with other parts of the Dodd-Frank Act and would hinder growth of market infrastructure being developed under the requirements of Title VII of that Act, including use of swap execution facilities and security-based swap execution facilities to enhance transparency in the swaps markets and use of central clearinghouses to reduce counterparty risk for the parties to a swap transaction.[1514] For example, one commenter represented that the proposed exemption could make it difficult for non-U.S. swap entities to comply with potential mandatory execution requirements under Title VII of the Dodd-Frank Act and could cause market fragmentation across borders through the creation of parallel execution facilities outside of the United States, which would result in less transparency and greater systemic risk.[1515] In addition, another commenter stated that the proposed requirement would force issuers to dually list their securities to permit trading on non-U.S. exchanges and, further, clearing and settlement systems would have to be set up outside of the United States, which would create inefficiencies, operational risks, and potentially systemic risk by adding needless complexity to the financial system.[1516]

Instead of the proposal's transaction-based approach to implementing the foreign trading exemption, many commenters suggested the final rule adopt a risk-based approach.[1517] These commenters noted that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign trading activity of foreign banking entities.[1518] Commenters also noted that foreign trading activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[1519]

The Agencies have carefully considered these comments and have determined to modify the approach in the final rule. The Agencies believe that the revisions mitigate the potential adverse impacts of the proposed approach while still remaining faithful to the overall purpose of section 13(d)(1)(H). Also, the Agencies believe that section 13(d)(1)(J) of the BHC Act, which authorizes the Agencies to provide an exemption from the prohibition on proprietary trading for any activity the Agencies determine by rule ''would promote and protect the safety and soundness of the banking entity and the financial stability of the United States,'' [1520] supports allowing foreign banking entities to use U.S. infrastructure and trade with certain U.S. counterparties in certain circumstances, which will promote and protect the safety and soundness of banking entities and U.S. financial stability.

Overall, the comments illustrated that both the mechanical steps of the specified transactions to purchase or sell various instruments (*e.g.,* execution, clearing), and the identity of the entity for whose trading account the specified trading is conducted are important.[1521] Consistent with the comments described above, the Agencies believe that the

[1506] *See* proposed rule § 75.6(d).

[1507] *See* BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; Credit Suisse (Seidel); George Osbourne; IIB/EBF.

[1508] *See* Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); IIF; ICE; Banco de México; ICFR; Australian Bankers Ass'n. (Feb. 2012); BAROC.

[1509] *See* ICE.

[1510] *See, e.g.,* RBC.

[1511] *See, e.g.,* IIF; ICE; Société Générale; Mexican Banking Comm'n.; Australian Bankers Ass'n. (Feb. 2012); Banco de México; OSFI. In addition, a few commenters argued that Canadian and Mexican financial firms frequently use U.S. infrastructure to conduct their trading activities in Canada or Mexico. *See, e.g.,* OSFI; Banco de México; Mexican Banking Comm'n.

[1512] *See, e.g.,* ICE; Société Générale (arguing that the requirement would impair capital raising efforts of many U.S. companies); Australian Bankers Ass'n. (Feb. 2012); Canadian Minister of Fin.; Ass'n. of German Banks.

[1513] *See* IIB/EBF.

[1514] *See* Bank of Canada; Banco de México; Allen & Overy (on behalf of Canadian Banks).

[1515] *See* Allen & Overy (on behalf of Candian Banks).

[1516] *See* IIF.

[1517] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1518] *See* IIB/EBF.

[1519] *See* IIB/EBF.

[1520] *See* 12 U.S.C. 1851(d)(1)(J).

application of section 13(d)(1)(H) and their exemptive authority under section 13(d)(1)(J) should focus on both how the transaction occurs and which entity will bear the risk of those transactions. Although the statute does not define expressly what it means to act ''as a principal'' (acting as principal ordinarily means acting for one's own account), the combination of references to engaging as principal and to a trading account focuses on an entity's incurring risks of profit and loss through taking ownership of securities and other instruments. Thus, the final rule provides an exemption for trading activities of foreign banking entities that addresses both the location of the facilities that effect the acquisition, holding, and disposition of such positions, and the location of the banking entity that incurs such risks through acquisition, holding, and disposition of such positions.

The Agencies believe this approach is consistent with one of the principal purposes of section 13, which is to limit risks that proprietary trading poses to the U.S. financial system.[1522] Further, the purpose of section 13(d)(1)(H) is to limit the extraterritorial application of section 13 as it applies to foreign banking entities.[1523]

In addition, prohibiting foreign banking entities from using U.S. infrastructure or trading with all U.S. counterparties could cause certain trading activities to move offshore, with corresponding negative impacts on U.S. market participants, including U.S. banking entities. For example, movement of trading activities offshore, particularly in U.S. financial instruments, could result in bifurcated markets for these instruments that are less efficient and less liquid and could reduce transparency for oversight of trading in these instruments. In addition, reducing access to foreign counterparties for U.S. instruments could concentrate risks in the United States and to its financial system. Moreover, the statute provides separate exemptions for U.S. banking entities to engage in underwriting and market making-related activities, subject to certain requirements, and there is no evidence that limiting the range of potential customers for these entities would further the purposes of the statute. In fact, it is possible that limiting the customer bases of U.S. banking entities, as well as other U.S. firms that are not banking entities, could reduce their ability to effectively manage their inventories and risks and could also result in concentration risk.

These potential effects of the approach taken in the proposal appear to be inconsistent with the statute's goals, including the promotion and protection of the safety and soundness of banking entities and U.S. financial stability. To the contrary, the exemptive approach taken in the final rule appears to be more consistent with the goals of the statute and would promote and protect the safety and soundness of banking entities and U.S. financial stability by limiting the risks of foreign banking entities' proprietary trading activities to the U.S. financial system, while also allowing U.S. markets to continue to operate efficiently in conjunction with foreign markets (rather than creating incentives to establish barriers between U.S. and foreign markets).[1524]

Thus, in response to commenter concerns, the final rule has been modified to better reflect the text and achieve the overall purposes of the statute (by ensuring that the principal risks of proprietary trading by foreign banking entities allowed under the foreign trading exemption remain solely outside of the United States) while mitigating potentially adverse effects on competition.[1525] In order to ensure these risks remain largely outside of the United States, and to limit potential risk that could flow to the U.S. financial system through trades by foreign banking entities with or through U.S. entities, the final rule includes several conditions on the availability of the exemption. Specifically, in addition to limiting the exemption to foreign banking entities, the final rule provides that the exemption for the proprietary trading activity of a foreign banking entity is available only if:

- The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;[1526]
- The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;
- The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;
- No financing for the banking entity's purchase or sale is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;[1527]
- The purchase or sale is not conducted with or through any U.S. entity,[1528] other than:
  - A purchase or sale with the foreign operations of a U.S. entity, if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale.

The Agencies believe it is appropriate to exercise their exemptive authority under section 13(d)(1)(J) to also allow, under clause (vi) of the final rule, the following types of purchases or sales conducted with a U.S. entity:

- A purchase or sale with an unaffiliated market intermediary acting as principal,[1529] provided the purchase

[1522] *See, e.g.,* 12 U.S.C. 1851(b)(1) (directing the FSOC to study and make recommendations on implementing section 13 so as to, among other things, protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities).

[1523] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the foreign trading exemption ''recognize[s] rules of international comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law.'').

[1524] 12 U.S.C. 1851(d)(1)(J).

[1525] The proposed rule also contained a definition of ''resident of the United States'' that was designed to capture the scope of U.S. counterparties that, if involved in the transaction, would preclude that transaction from being considered to have occurred solely outside the United States. The final rule addresses this point by including a definition, for purposes of § 75.6(e) only, of the term ''U.S. entity.''

[1526] Personnel that arrange, negotiate, or execute a purchase or sale conducted under the exemption for trading activity of a foreign banking entity must be located outside of the United States. Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. Personnel in the United States also cannot serve as decision makers in transactions conducted under this exemption. Personnel that engage in back-office functions, such as clearing and settlement of trades, would not be considered to arrange, negotiate, or execute a purchase or sale for purposes of this provision.

[1527] This provision is not intended to restrict the ability of a U.S. branch or affiliate of a foreign banking entity to provide funds collected in the United States to its foreign parent for general purposes.

[1528] ''U.S. entity'' is defined for purposes of this provision as any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State. *See* final rule § 75.6(e)(4).

[1529] This provision would generally allow market intermediaries to engage in market-making, underwriting or similar market intermediation functions.

or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

○ A purchase or sale through an unaffiliated market intermediary, provided the purchase or sale is conducted anonymously (i.e. each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale) on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

The requirements are designed to ensure that any foreign banking entity engaging in trading activity under this exemption does so in a manner that ensures the risk, decision-making, arrangement, negotiation, execution and financing of the activity resides solely outside the United States and limits the risk to the U.S. financial system from trades by foreign banking entities with or through U.S. entities.

The final rule specifically recognizes that, for purposes of the exemption for trading activity of a foreign banking entity, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[1530] This provision helps give effect to the statutory language limiting the foreign trading exemption to activities of foreign banking entities that occur solely outside of the United States by clarifying that the U.S. operations of foreign banking entities may not conduct proprietary trading based on this exemption.

The Agencies have considered whether the concerns raised by commenters that the foreign operations of U.S. banking entities would be disadvantaged in competing outside the United States warrant an exemption under section 13(d)(1)(J) of the BHC Act that extends to foreign operations of U.S. banking entities. The competitiveness of U.S. banking entities outside the United States often improves the potential for the operations of U.S. firms outside the United States to succeed and be profitable, and thereby, often improves the safety and soundness of the entity and financial stability in the United States.

However, Congress has determined to generally prohibit U.S. banking entities (including foreign branches and subsidiaries thereof) from engaging in proprietary trading because of the perceived risks of those activities to banking entities and the U.S. economy.[1531] Allowing U.S. banking entities to conduct, through branches or subsidiaries that are physically located outside the United States, the same proprietary trading activities those U.S. firms are expressly prohibited from conducting directly through their operations located within the United States would subject U.S. banking entities and the U.S. economy to the very risks section 13 is designed to avoid. The risks of proprietary trading would continue to be borne by the U.S. banking entity whether the activity is conducted by the U.S. banking entity through units physically located inside or outside of the United States. Moreover, the robust trading markets that exist overseas could allow U.S. banking entities to shift their prohibited proprietary trading activities to branches or subsidiaries that are physically located outside the United States under such an exemption, without achieving a meaningful elimination of risk. Accordingly, the Agencies have not exercised their authority under section 13(d)(1)(J) at this time to allow U.S. banking entities to conduct otherwise prohibited proprietary trading activities through operations located outside the United States. As a consequence, and consistent with the statutory language and purpose of section 13(d)(1)(H) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under, or directly or indirectly controlled by a banking entity that is organized under, the laws of the United States or of one or more States.[1532]

As discussed above, many commenters requested that the final rule permit a foreign banking entity to engage in proprietary trading transactions with a greater variety of counterparties, including counterparties that are located in or organized and incorporated under the laws of the United States or of one or more States.[1533] These commenters also requested that the final rule not require that any purchase or sale under the exemption be executed wholly outside of the United States.

As described above and in response to commenters' concerns, the final rule provides that a foreign banking entity generally may engage in trading activity under the exemption with U.S. entities, provided the transaction is with the foreign operations of an unaffiliated U.S. firm (whether or not the U.S. firm is a banking entity subject to section 13 of the BHC Act) and does not involve any personnel of the U.S. entity that are in the United States and involved in the arrangement, negotiation, or execution of the transaction. The Agencies have also exercised their exemptive authority under section 13(d)(1)(J) to allow foreign banking entities to engage in a transaction that is either through an unaffiliated market intermediary and executed anonymously on an exchange or similar trading facility (regardless of whether the ultimate counterparty is a U.S. entity or not) or is executed with a U.S. entity that is an unaffiliated market intermediary acting as principal, provided in either case that the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

For purposes of the final rule, market intermediary is defined as an unaffiliated entity, acting as an intermediary, that is: (i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such; (ii) a swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such; (iii) a security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or (iv) a futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.[1534]

These provisions of the final rule, viewed as a whole, prevent the

[1530] *See* final rule § 75.6(e)(5).

[1531] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (''However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly.'').

[1532] *See* final rule § 75.6(e)(1)(i).

[1533] A number of commenters also requested that the foreign trading exemption permit proprietary trading of foreign sovereign debt or similar obligations of foreign governments. As discussed in Part VI.A.5.b. of this **SUPPLEMENTARY INFORMATION**, the final rule addresses banking entities' ability to engage in transaction in these types of instruments in § 75.6(b).

[1534] *See* final rule § 75.6(e)(5). For example, under this definition, a bank that is exempt from registration as a swap dealer under the de minimis exception to swap dealer registration requirements could be a market intermediary for transactions in swaps. *See* 17 CFR 1.3(ggg)(4).

exemption for trading of foreign banking entities from weakening U.S. trading markets and U.S. firms that are either not subject to the provisions of section 13 or that conduct activities in compliance with other parts of section 13. For instance, the final rule permits a foreign banking entity to trade under the exemption with the foreign operations of a U.S. firm, so long as the purchase or sale does not involve any personnel of the U.S. firm who are located in the United States and involved in arranging, negotiating or executing the trade.[1535] Transactions that occur outside of the United States between foreign operations of U.S. entities and foreign banking entities improve access to and functioning of liquid markets without raising the concerns for increased risk to banking entities in the U.S. that motivated enactment of section 13 of the BHC Act. The final rule permits a foreign banking entity to engage in transactions with the foreign operations of both U.S. non-banking and U.S. banking entities. Among other things, this approach will ensure that the foreign operations of U.S. banking entities continue to be able to access foreign markets.[1536] The language of the exemption expressly requires that trading with the foreign operations of a U.S. entity may not involve the use of personnel of the U.S. entity who are located in the United States for purposes of arranging, negotiating, or executing transactions.

Under the final rule, the exemption in no way exempts the U.S. or foreign operations of the U.S. banking entities from having to comply with the restrictions and limitations of section 13. Thus, the U.S. and foreign operations of a U.S. banking entity that is engaged in permissible market making-related activities or other permitted activities may engage in those transactions with a foreign banking entity that is engaged in proprietary trading in accordance with the exemption under § 75.6(e) of the final rule. Importantly, the final rule does not impose a duty on the foreign banking entity or the U.S. banking entity to ensure that its counterparty is conducting its activity in conformance with section 13 of the BHC Act and the final rule. Rather, that burden is at all times on each party subject to section 13 to ensure that it is conducting its activities in accordance with section 13 and this implementing rule.

The final rule also permits, pursuant to section 13(d)(1)(J), a foreign banking entity to trade through an unaffiliated market intermediary if the trade is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization.[1537] Allowing foreign banking entities to generally conduct anonymous proprietary trades on U.S. exchanges and similar anonymous trading facilities allows these exchanges and facilities—which are generally not subject to section 13 and do not take the risks section 13 is designed to address—to serve the widest possible range of counterparties. This prevents the potential adverse impacts from possible reductions in competitiveness of or liquidity available on these regulated exchanges and facilities, which could also harm other U.S. market participants who trade on these exchanges and facilities. In addition, the Agencies recognize that anonymous trading on exchanges and similar anonymous trading facilities promotes transparency and that prohibiting foreign banking entities from trading on U.S. exchanges and similar anonymous trading facilities under this exemption would likely reduce transparency for trading in U.S. financial instruments. All of these considerations support the Agencies' exercise of their exemptive authority under section 13(d)(1)(J) to allow such trading by foreign banking entities.

The final rule requires that foreign banking entities trade through an unaffiliated market intermediary to access a U.S. exchange or trading facility in recognition that existing laws and regulations generally require this structure.[1538] For purposes of this exemption, an exchange would include, unless the context otherwise requires, any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, and any exchange or security-based swap execution facility, as such terms are defined under the Exchange Act.[1539]

This provision of the final rule requires that foreign banking entities trade anonymously and that the trade be centrally cleared and settled. The Agencies understand that in these circumstances, the foreign banking entity would not have any prior information regarding its counterparty to the trade. Requiring that the trade be executed anonymously preserves the benefits of allowing U.S. entities to participate in such trades, while reducing the potential for evasion of section 13 that could occur if foreign banking entities directly arranged purchases and sales with U.S. entities.[1540] The final rule specifies that a trade is anonymous if each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. That is, it is lack of knowledge of the identity of the counterparty(ies) to the trade that is relevant. The final rule does not prohibit foreign banking entities from accessing a trading facility through an unaffiliated U.S. market intermediary (which the foreign banking entity would necessarily know), so long as the foreign banking entity is not aware of the identity of the counterparty to the transaction.

Similarly, also pursuant to section 13(d)(1)(J), the final rule allows a foreign banking entity to trade with an unaffiliated market intermediary acting in a principal capacity and effecting a market intermediation function, in a transaction that is not conducted on an exchange or similar anonymous trading facility, as long as the trade is promptly cleared and settled through a clearing agency or derivatives clearing organization. This provision recognizes that not all financial instruments are traded on an exchange or similar anonymous trading facility and, thus, allows foreign banking entities to trade and contribute to market liquidity in all types of U.S. financial instruments without requiring separate market infrastructure to be developed outside the U.S. for such trading activity, which could result in inefficiencies and reduce U.S. market liquidity. Market intermediaries can serve the same general purpose as exchanges or similar trading facilities in intermediating between buyers and sellers, particularly in asset classes that do not generally trade on these exchanges or facilities, although this intermediation function

[1535] *See* final rule § 75.6(e)(3)(v)(A).

[1536] The Agencies believe that this provision should address commenters' concerns that the proposed rule could cause foreign banking entities to avoid conducting business with U.S. firms outside the United States or could incentivize foreign market places to restrict access to U.S. firms. *See, e.g.,* RBC.

[1537] Under the final rule, ''anonymous'' means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. *See* final rule § 75.3(e)(1).

[1538] *See, e.g.,* 15 U.S.C. 78f(c)(1) (providing that a national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer).

[1539] *See* final rule § 75.3(e)(6) (defining the term ''exchange''). The rule refers to an ''exchange or similar trading facility.'' A similar trading facility for these purposes may include, for example, an alternative trading system.

[1540] In addition, allowing a foreign banking entity to trade directly with a U.S. end user customer under the foreign trading exemption could give the foreign banking entity a competitive advantage over U.S. banking entities with respect to trading in the United States.

may not be as immediate in the case of market intermediaries.

In either case (*i.e.,* for either an anonymous trade or a trade with an unaffiliated market intermediary), if the U.S. counterparty to the transaction is a banking entity subject to section 13 and these rules, it must comply with an exemption to the prohibition on proprietary trading, such as the market-making exemption or the exemption for riskless principal transactions. Allowing foreign banking entities to trade with unaffiliated U.S. market intermediaries, including banking entities engaged in permitted market making-related activities, expands the range of potential buyers and sellers for which the U.S. entities can trade and may result in more efficient and timely matching of trades, reducing inventory risks to the U.S. market intermediary. At the same time, this exemption does not permit a U.S. market intermediary that is subject to section 13 of the BHC Act to conduct trading activities other than in compliance with the provisions of section 13. Thus, the Agencies believe it is appropriate to allow foreign banking entities to conduct such trading under the exemption in section 13(d)(1)(J).

To reduce risks to U.S. entities and the potential for evasion, the provisions allowing trading with U.S. entities include two additional protections. First, the final rule does not allow a foreign banking entity to trade through an affiliated U.S. entity under the exemption out of concern that it could increase the risk of evasion.[1541] Second, a foreign banking entity's trades conducted through an unaffiliated market intermediary on an exchange or conducted directly with an unaffiliated market intermediary must be promptly cleared and settled through a clearing agency or derivatives clearing organization acting as central counterparty. Consistent with the goals of section 13 to reduce risk to banking entities and the U.S. financial system, this requirement is designed to reduce risk to U.S. entities arising from foreign banking entities' proprietary trading activity, particularly counterparty risk, and preclude foreign banking entities from relying on the exemption for trading that creates exposure of U.S. counterparties pursuant to bilateral, uncleared transactions, which poses heightened counterparty credit risks.[1542] This condition is also consistent with the systemic risk benefits of central clearing and may incentivize the use of central clearing for trading by foreign banking entities and foreign affiliates of U.S. banking entities. The Agencies believe this approach is consistent with and reinforces the goals of the central clearing framework of Title VIII of the Dodd-Frank Act.

The final rule does not allow a foreign banking entity to trade with a broader range of U.S. entities under the exemption because the Agencies are concerned such an approach may result in adverse competitive impacts between U.S. banking entities and foreign banking entities with respect to their trading in the United States, which could harm the safety and soundness of banking entities and U.S. financial stability. For example, such an approach could allow foreign banking entities to act as market makers for U.S. customers under the exemption in § 75.6(e) of the final rule so long as the foreign banking entity held the risk of its market-making trades outside the United States. In turn, this could give foreign banking entities a competitive advantage over U.S. banking entities with respect to U.S. market-making activities because foreign banking entities could trade directly with U.S. non-banking entities without incurring the additional costs, or being subject to the limitations, associated with the market-making or other exemptions under the rule. This competitive disparity in turn could create a significant potential for regulatory arbitrage. The Agencies do not believe this result was intended by the statute. Instead, the final rule seeks to alleviate the concern that an overly broad approach to the exemption (*e.g.,* permitting trading with all U.S. counterparties) may result in competitive impacts and increased risks to the U.S. financial system, while mitigating the concern that an overly narrow approach to the exemption (*e.g.,* prohibiting trading with any U.S. counterparty) may cause market bifurcations, reduce the efficiency and liquidity of markets, and harm U.S. market participants.

9. Section 75.7: Limitations on Permitted Trading Activities

Section 75.8 of the proposed rule implemented section 13(d)(2) of the BHC Act,[1543] which provides that a banking entity may not engage in certain exempt activities (*e.g.,* permitted market making-related activities, risk-mitigating hedging, etc.) if the activity would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[1544] The Agencies sought comment on proposed definitions of the terms ''material conflict of interest,'' ''high-risk asset,'' and ''high-risk trading strategy'' for these purposes.

With respect to general comments regarding the proposed rule, commenters generally agreed on the need to limit banking entities' proprietary trading activities so as to avoid material conflicts of interest and material exposures to high-risk trading strategies and high-risk assets.[1545] One commenter expressed support for the Agencies' proposed approach, stating that the proposed rule was clear and structured in such a manner so that it should remain effective even as financial markets evolve and change.[1546] As discussed in greater detail below, most commenters suggested amendments, clarification, or alternative approaches. For example, some commenters expressed concern regarding the application of the prudential backstops to the activities of foreign banking entities.[1547] The Agencies did not receive any comments on the prohibition against transactions or activities that pose a threat to the safety or soundness of the banking entity or the financial stability of the United States.

As explained in detail below, the Agencies have carefully reviewed

[1541] In addition, allowing a foreign banking entity to trade through or with a U.S. affiliate under the exemption for trading activity of a foreign banking entity could give the foreign banking entity a competitive advantage over U.S. banking entities that are subject to limitations on their trading activities. Thus, the Agencies are not permitting a foreign banking entity to trade through a U.S. affiliate as agent, as requested by some commenters. *See, e.g.,* IIB/EBF. However, the Agencies recognize that, with respect to trading anonymously, there is no way to know the identity of the counterparty to the trade. Thus, a foreign banking entity would not be in violation of this rule if it traded through an unaffiliated market intermediary on an exchange, in accordance with the exemption for trading activity of a foreign banking entity, and the counterparty to its trade happened to be an affiliated entity.

[1542] As discussed above, centralized clearing redistributes counterparty risk among members of a clearing agency or derivatives clearing organization through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. *See supra* note 271 and accompanying text.

[1543] Section 75.8 of the proposed rule regarding limitations on permitted trading activities is consistent with § 75.17 of the proposed rule regarding other limitations on permitted covered funds activities. Accordingly, the discussion regarding proposed rule § 75.8 and final rule § 75.7 in this part also pertain to § 75.17 of the proposed rule and § 75.16 of the final rule. *See also* Part VI.B.6., *infra.*

[1544] *See* 12 U.S.C. 1851(d)(2).

[1545] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Paul Volcker.

[1546] *See* Alfred Brock.

[1547] *See* IIB/EBF; Ass'n. of German Banks.

comments on the proposed rule's implementation of the prudential backstops under section 13(d)(2) of the BHC Act, including commenters' suggestions for expanding, contracting, or revising the proposed rule. After carefully considering these comments, the Agencies continue to believe the expansive scope of section 13 of the BHC Act supports a similarly inclusive approach focusing on the facts and circumstances of each potential conflict or high-risk activity. Therefore, and in consideration of all issues discussed below, the Agencies are adopting the final rule substantially as proposed.[1548] The Agencies intend to develop additional guidance regarding best practices for addressing potential material conflicts of interest, high-risk assets and trading strategies and practices that pose significant risks to safety and soundness and to the U.S. financial system as the Agencies and banking entities gain experience with implementation of the requirements and limitations in section 13 of the BHC Act and this rule, which are all generally designed to limit risky behavior in trading and investment activities.

a. Scope of ''Material Conflict of Interest''

1. Proposed Rule

Section 75.8(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with a permitted trading activity, were prohibited under the proposal.[1549] As noted in the proposal, conflicts of interest may arise in a variety of circumstances related to permitted trading activities. For example, a banking entity may acquire substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its lending, underwriting, investment advisory or other activities which, if improperly transmitted to and used in trading operations, would permit the banking entity to use such information to its customers', clients' or counterparties' disadvantage. Similarly, a banking entity may conduct a transaction that places the banking entity's own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer involved in that transaction. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1550] In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances.[1551]

To address these types of material conflicts of interest, § 75.8(b) of the proposed rule specified that a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest, and subject to specific requirements provided in the proposal, through either (i) timely and effective disclosure, or (ii) information barriers.[1552] Unless the conflict of interest is addressed and mitigated in one of the two ways specified in the proposal, the related transaction, class of transactions or activity would be prohibited under the proposed rule, notwithstanding the fact that it may be otherwise permitted under §§ 75.4 through 75.6 of the proposed rule.[1553]

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

Section 75.8(b)(1) of the proposed rule described the two requirements that must be met in cases where a banking entity addresses and mitigates a material conflict of interest through timely and effective disclosure. First, § 75.8(b)(1)(A)(i) of the proposed rule required that the banking entity, prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, make clear, timely and effective disclosure of the conflict or potential conflict of interest, together with any other necessary information. This would also require such disclosure to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1554] Disclosure that is only general or generic, rather than specific to the individual, class, or type of transaction or activity, or that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, would not meet this standard. Second, § 75.8(b)(1)(ii) of the proposed rule required that the disclosure be made explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty that was created or would be created by the conflict or potential conflict.[1555]

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

[1548] The Agencies note that proposed Appendix C, which required banking entities to describe how they comply with these provisions, will be adopted as Appendix B with similar requirements regarding compliance with the limitations on permitted activities.

[1549] Section 75.17(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with permitted covered fund activities, are prohibited.

[1550] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), available at *http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.*

[1551] *See* Joint Proposal, 76 FR at 68893.

[1552] *See* proposed rule § 75.8(b)(1).

[1553] *See* Joint Proposal, 76 FR at 68893.

[1554] *See id.*

[1555] *See* proposed rule § 75.8(b)(1)(B).

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

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

Section 75.8(b)(2) of the proposed rule described the requirements that must be met in cases where a banking entity uses information barriers that are reasonably designed to prevent a material conflict of interest from having a materially adverse effect on a client, customer or counterparty. Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among units of the entity. Examples of information barriers include, but are not limited to, restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees. Such information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.[1556]

In order to address and mitigate a conflict of interest through the use of the information barriers pursuant to § 75.8(b)(2) of the proposed rule, a banking entity would be required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. Importantly, the proposed rule also provided that, notwithstanding a banking entity's establishment of such information barriers if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of proposed § 75.8(b)(1).[1557] This aspect of the proposal was intended to make clear that, in specific cases in which a banking entity has established an information barrier but knows or should reasonably know that it has failed or will fail to prevent a conflict of interest arising from a specific transactions or activity that disadvantages a client, customer, or counterparty, the information barrier is insufficient to address that conflict and the transaction would be prohibited, unless the banking entity is otherwise able to address and mitigate the conflict through timely and effective disclosure under the proposal.[1558]

The proposed definition of material conflict of interest did not address instances in which a banking entity has made a material misrepresentation to its client, customer, or counterparty in connection with a transaction, class of transactions, or activity, as such transactions or activity appears to involve fraud rather than a conflict of interest. This is because such misrepresentations are generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws).[1559] In addition, the Agencies noted that any activity involving a material misrepresentation to, or other fraudulent conduct with respect to, a client, customer, or counterparty would not be permitted under the proposed rule in the first instance.

2. Comments on the Proposed Limitation on Material Conflicts of Interest

Commenters expressed a variety of views regarding the treatment of material conflicts of interest under the proposal, including the manner in which conflicts may be mitigated or eliminated. One commenter believed that the proposed material conflict of interest provisions would be effective.[1560] Another commenter stated that conflicts of interest were unavoidable but that the final rule should ensure that institutional investors have confidence that the banking entities they are dealing with

[1556] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)–(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks). 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1557] *See* proposed rule § 75.8(b)(2).

[1558] *See* Joint Proposal, 76 FR at 68894.

[1559] *See* 12 U.S.C. 1851(g)(3).

[1560] *See* Alfred Brock.

are not operating at a conflict with investors' goals.[1561]

Other commenters expressed differing views on whether the proposed rule's provisions for addressing conflicts of interest through disclosure or information barriers were appropriate. A few commenters stated there is no statutory basis for allowing conflicts of interest in connection with exempted activities even if banking entities provide disclosure or establish information barriers, and the rule should prohibit banking entities from engaging in permitted activities if material conflicts of interest exist.[1562] One commenter believed the definition did not appear to address issues of customer favoritism, in which a bank is financially incentivized to treat one customer more favorably than another (typically less sophisticated) customer.[1563] Some commenters believed that the proposed definition of material conflict of interest was too vague or narrow and suggested it should be strengthened by either expanding the types of transactions that may result in a material conflict of interest or by imposing additional limitations or restrictions on transactions.[1564] For instance, one commenter suggested the final rule consider depositors of a banking entity to be ''customers'' for the purpose of this provision, impose a fiduciary duty on any banking entity conducting an exempt activity pursuant to section 13(d)(1) of the BHC Act, and impose size restrictions on any banking entity engaging in proprietary trading under an exemption. This commenter also stated that a banking entity inherently has a material conflict of interest with its customer when it takes the opposite side of a transaction and, therefore, that the final rule should require a banking entity to disgorge all principal gains from transactions conducted pursuant to any exemption under section 13(d)(1) of the BHC Act, including market-making, trading in U.S. government obligations, insurance company activities and other exempt activities.[1565] In addition, a few commenters stated that, if disclosure or information barriers were permitted to mitigates conflicts under the final rule, clients of the banking entity must be required to acknowledge in writing that they understand the potential conflicts of interest present in order for any disclosure to be effective in mitigating a conflict of interest.[1566]

Some commenters believed that the Agencies should consider issuing additional guidance regarding the definition of material conflicts of interest, high-risk assets, and high-risk trading strategies.[1567] One commenter stated that the final rule should limit the extraterritorial impact of section 13 by only applying the restrictions of section 13(d)(2) of the BHC Act to the U.S. operations or activities of foreign banking entities and that the regulation of safety and soundness of the foreign operations and activities of foreign banking entities should be left to the home country regulator or supervisor of a foreign banking entity.[1568]

Some commenters provided general suggestions on enhancing compliance with the prohibition on material conflicts of interest. A common suggestion among industry participants was to implement the prohibition on material conflicts of interest under these rules in a manner consistent with the implementation of section 621 of Dodd-Frank.[1569] One commenter suggested that trading in government obligations should not be subject to the material conflict of interest provision because government obligations are broadly traded and do not present the types of conflicts addressed by the proposed rule.[1570] In contrast, one commenter stated banking entities should be required to receive pre-trade clearance from the Federal Reserve for trading in certain government obligations like municipal bonds and mortgage-backed securities, due to their role in the 2008 financial crisis.[1571]

a. Disclosure

Some commenters expressed concern about potential difficulties associated with the proposed disclosure provision and provided suggestions to address these difficulties. For example, a few commenters noted the difficulty in determining what constitutes effective disclosure,[1572] especially in relation to the volume of disclosure or the impact of information asymmetry in illiquid markets.[1573] One commenter stated that unless the rule requires full disclosure of a banking entity's trading strategy and the rationale behind it, allowing disclosure will permit the banking entity to protect itself without adequately mitigating the harm of the conflict. This commenter also noted the practical difficulties associated with disclosing anticipated future conflicts and conflicts in the context of block trading.[1574] Another commenter stated market participants understand inherent conflicts of interest and believed disclosure in such situations would be burdensome and unnecessary.[1575] One commenter stated that the rule should require a banking entity to negate, not just permit the client, customer, or counterparty to substantially mitigate, the materially adverse effect of the conflict.[1576]

A few commenters disagreed with the disclosure provision, noting that Congress specifically considered and rejected disclosure as a mitigation method for purposes of section 621 of the Dodd-Frank Act and that this indicates the Agencies should not permit a material conflict of interest to be mitigated through disclosure for purposes of section 13 of the BHC Act.[1577]

Commenters were in disagreement as to the extent and timing of disclosure that should be required under the rule. Some commenters stated the disclosure provisions would slow trading, and suggested the rule require only one-time disclosure at the inception of the business relationship [1578] or periodic disclosures to address ongoing conflicts.[1579] One of these commenters noted that extensive trade-by-trade disclosure requirements create the risk of unintended breaches of confidentiality.[1580] Other commenters requested the Agencies provide additional guidance, such as when transaction-specific disclosure is necessary,[1581] whether disclosure should be written,[1582] and what constitutes ''reasonable detail.'' [1583]

[1561] *See* Paul Volcker.

[1562] *See* Public Citizen; Sens. Merkley & Levin; Occupy; AFR *et al.* (Feb. 2012).

[1563] *See* Public Citizen.

[1564] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1565] *See* Occupy.

[1566] *See, e.g.,* Lynda Aiman-Smith; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1567] *See* Rep. Blumenauer *et al.;* Sens. Merkley & Levin (Feb. 2012).

[1568] *See* IIB/EBF; EBF.

[1569] *See* ASF (Conflicts) (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); LSTA (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1570] *See* BDA (Feb. 2012).

[1571] *See* Occupy.

[1572] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR.

[1573] *See* Occupy.

[1574] *See* Public Citizen; *see also* AFR *et al.* (Feb. 2012).

[1575] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012)

[1576] *See* Occupy.

[1577] *See, e.g.,* Occupy.

[1578] *See* ISDA (Apr. 2012); Arnold & Porter.

[1579] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Apr. 2012).

[1580] *See* ISDA (Apr. 2012).

[1581] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012);

[1582] *See* Sens. Merkley & Levin (Feb. 2012); ICFR (questioning the effectiveness of enforcement mechanisms if oral disclosure permitted under the rule); Occupy.

[1583] *See* ICFR.

In addition, some commenters provided suggestions on whether parties should be required to acknowledge receipt of disclosures [1584] or affirmatively consent to the conflict.[1585] One commenter proposed allowing a majority of a committee of independent board members to approve consent to waivers of conflicts of interest.[1586] One commenter believed disclosure and consent by a sophisticated investor ought to be sufficient to serve as a waiver to most types of conflict of interest.[1587] In contrast, another commenter asserted general disclosure or waivers of conflicts should never be allowed, and the Agencies should not provide *any* additional guidance as to the extent, timing, frequency, or scope of disclosure appropriate in any given situation.[1588] Similarly, one commenter asserted the Agencies should not provide guidance on what issues can be addressed by disclosure, as such guidance would be ''dangerously prescriptive and would introduce moral hazards.'' [1589]

b. Information Barriers

A few commenters addressed the information barriers provision of the proposed rule. One commenter expressed support for the proposed approach,[1590] while three commenters stated this provision was ineffective.[1591] A few commenters opposed the information barriers provision because they believed information barriers would make conflict mitigation more difficult [1592] or would effectively mandate that no single officer be aware of a banking entity's collective operations.[1593]

A few commenters also requested the Agencies provide guidance regarding the use of information barriers. One commenter requested the Agencies specify the type and nature of information barriers and where they are practical to implement.[1594] Another commenter believed that the Agencies should view information barriers favorably. This commenter stated that information barriers should be permitted for addressing conflicts of interest unless the banking entity knows, or should reasonably know, that the information barrier would not be effective in restricting the spread of information that could lead to the conflict.[1595] To provide greater clarity, another commenter recommended the Agencies provide guidance on certain elements that may be used to determine the reasonableness of information barriers, such as memorialization of procedures and documentation of actions taken pursuant to such procedures.[1596]

3. Final Rule

After considering carefully comments received on the proposal as well as the purpose and language of section 13 of the BHC Act, the Agencies have adopted the final rule largely as proposed. Under the final rule, a banking entity that engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to the transaction, class of transactions, or activity, must address and mitigate the conflict of interest, where possible, through either timely and effective disclosure or informational barriers.[1597] This requirement is in addition to, and does not supplant, any limitations or prohibitions contained in other laws. For example, a material misrepresentation by a banking entity to its client, customer, or counterparty in connection with market-making activities may involve fraud and is generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws) [1598] as well as being prohibited under section 13 of the BHC Act.

The Agencies believe that certain of commenters' suggested modifications to the proposed rule are outside the scope of the Agencies' statutory authority. For example, the Agencies do not believe section 13 of the BHC Act provides statutory authority to directly impose limits on the size of banking entities [1599] or to implement specific fiduciary standards on banking entities.[1600] In addition, the Agencies do not believe it is appropriate to expand the definition of ''customer'' to include individuals and entities that solely make use of the bank's traditional banking services because section 13 is focused on the trading activities and investment in which banking entities may be involved.[1601]

The final rule recognizes that a banking entity may address or substantially mitigate a potential conflict of interest by making adequate disclosures or creating and enforcing informational barriers. Some commenters argued that the legislative history of the Dodd-Frank Act suggests that disclosure or informational barriers are not adequate to address a material conflict of interest.[1602] However, section 13 of the BHC Act directs the Agencies to define ''material conflict of interest'' and gives the Agencies discretion to determine how to define this term for purposes of the rule. Under the final rule, a material conflict of interest exists when the banking entity engages in transactions or activities that cause its interests to be materially adverse to the interests of its client, customer, or counterparty. At the same time, the final rule provides banking entities the opportunity to take certain actions to address the conflict, such that the conflict does not have a materially adverse effect on that client, customer, or counterparty. Under the final rule, a banking entity may address a conflict by establishing, maintaining, and enforcing information barriers reasonably designed to avoid a conflict's materially adverse effect, or by disclosing the conflict in a manner that allows the client, customer, or counterparty to substantially mitigate or negate any materially adverse effect created by the conflict of interest. The Agencies believe that, to the extent the materially adverse effect of a conflict has been substantially mitigated, negated, or avoided, it is appropriate to allow the

[1584] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

[1585] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012).

[1586] *See* Arnold & Porter.

[1587] *See* Arnold & Porter.

[1588] *See* Alfred Brock (stating there is no such thing as a ''sophisticated party'').

[1589] *See* ICFR.

[1590] *See* Alfred Brock.

[1591] *See* Better Markets (Feb. 2012); Occupy; Public Citizen.

[1592] *See* Occupy.

[1593] *See* Public Citizen (contending that this would undermine the Dodd-Frank Act's requirement to promote sound management, ensure financial stability, and reduce systemic risk).

[1594] *See* AFR *et al.* (Feb. 2012).

[1595] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1596] *See* ISDA (Apr. 2012) (arguing that its suggested guidance was derived from prior SEC and self-regulatory organization guidance on information barriers).

[1597] The Agencies note that the definition of material conflict of interest and the disclosure provisions related to that definition apply solely for purposes of the rule's definition of material conflict of interest, and does not affect the scope of that term in other contexts or a banking entity's obligation to comply with additional or different requirements with respect to a conflict under applicable securities, banking, or other laws (*e.g.,* section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities).

[1598] *See* 12 U.S.C. 1851(g)(3).

[1599] *See* Occupy.

[1600] *See* Occupy.

[1601] *See* Occupy.

[1602] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

transaction, class of transaction, or activity under the final rule. Continuing to view the conflict as a material conflict of interest under these circumstances would not appear to benefit the banking entity's client, customer, or counterparty. The disclosure standard under the final rule requires clear and meaningful information be provided to the client, customer, or counterparty in a manner that provides such party the opportunity to negate or substantially mitigate, any materially adverse effects on such party created by the conflict.

Some commenters suggested that obtaining consent to or waiver of disclosed conflicts should be sufficient to comply with the rule.[1603] The Agencies do not believe that consent or waivers alone are sufficient to address material conflicts of interest, and continue to believe that any banking entity using disclosure to address a conflict of interest should be required to provide any client, customer, or counterparty with whom the banking entity has a conflict with the opportunity to negate or substantially mitigate the materially adverse effect of the conflict on the client, customer, or counterparty. The Agencies believe this approach, which applies equally to all types of clients, customers, or counterparties, will reduce the potential for unintended or differing impacts on certain types of clients, customers, or counterparties. In response to one commenter's suggestion that the final rules require full negation of the materially adverse effect on the client, customer, or counterparty, the Agencies continue to believe it is appropriate to allow a transaction or activity to continue if the client, customer, or counterparty is provided an opportunity to substantially mitigate the materially adverse effect.[1604] The Agencies are concerned that requiring the conflict's impact to be fully negated under all circumstances could prevent a banking entity from providing a service to a particular customer despite that customer's knowledge of the conflict and ability to substantially reduce the effect of the conflict on that customer.

With regards to commenters' statements that information barriers and disclosure will not work to address the harm caused by conflicts, the Agencies emphasize that under the final rule, like the proposed rule, a banking entity may use disclosure or information barriers to address a conflict only in those instances where the disclosure provides the client, customer, or counterparty with the opportunity to negate or substantially mitigate any materially adverse effect of the conflict on that entity or the information barriers are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. If the banking entity is unable to effectively use disclosure or information barriers in a way that meets the rule's requirements, then the banking entity is prohibited from engaging in the conflicted transaction, class of transaction, or activity. Additionally, the Agencies note that the material conflict of interest provisions in the final rule do not preempt any duties owed to parties outside the transaction, including any duty of confidentiality.[1605]

In response to commenters' statements that the volume of information included in a disclosure or the manner in which the disclosure is presented may make it difficult for a customer to identify and understand the relevant information regarding the conflict,[1606] the Agencies note that the final rule requires disclosure of the conflict or potential conflict be clear, timely, and effective and that the disclosure includes any other necessary information. Disclosure is also required to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1607] Thus, disclosure that is only general or generic, that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, or that is hidden in a large volume of needless information would not meet this standard. The Agencies believe these provisions of the final rule are designed to ensure that customers receive sufficient information about the conflict of interest so that they are well informed and, as required by the rule, able to negate or substantially mitigate any materially adverse effect of the conflict.

In addition to requiring that customers are provided with detailed information about the conflict, the final rule, like the proposal, requires that disclosure is made prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise and is otherwise timely. As a result, under § 75.7(b)(2)(i), disclosure must be provided sufficiently close in time to the client's, customer's, or counterparty's decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and take steps that would negate or substantially mitigate the conflict. This approach is similar to the approach permitted by a variety of consumer protection statutes and regulations for addressing potential conflicts of interest in consumer transactions.[1608]

Some commenters requested that the final rule permit a conflict to be negated or substantially mitigated through generic or periodic disclosures, such as at the beginning of a trading relationship or on an annual basis. Other commenters stated that some conflicts, such as anticipated future conflicts or those that arise in the context of block trading, may require the banking entity to provide disclosure in advance of the actual conflict in order to allow the client, customer, or counterparty the opportunity to mitigate the materially adverse effect.[1609] The

[1603] *See, e.g.,* Arnold & Porter.

[1604] *See* Occupy.

[1605] *See* ISDA (Apr. 2012).

[1606] *See* Better Markets (Feb. 2012) (suggesting that a disclosure regime can facilitate abuse by enabling market participants to point to obscure and meaningless disclosure as a shield against liability); Occupy (arguing that a large volume of disclosed information can be difficult to understand or can serve to hide relevant information).

[1607] *See* final rule § 75.7(b)(1)(i) and final rule § 75.16(b)(1)(i).

[1608] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)—(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks); 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1609] *See* Public Citizen; *see also* AFR *et al.* (Feb. 2012).

Agencies emphasize, however, that disclosure provided far in advance of a particular transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating the transaction, would not suffice. At the same time, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the fact, would also not be permissible disclosure under the final rules. The Agencies believe that, in considering the effectiveness of disclosures, the type, timing and frequency of disclosures depends significantly on the customer relationship, the type of transaction, and the matter that creates the potential conflict. Therefore, while written disclosures may be appropriate in certain circumstances, the Agencies are not requiring banking entities to provide written disclosure,[1610] or obtain documentation showing that disclosure was received,[1611] because the Agencies believe it is more important that disclosure is timely than documented. For example, if disclosure were required to be in writing, this might slow a banking entity's ability to provide the disclosure to the relevant customer, which could impede the customer's ability to consider the disclosed information and take steps to negate or substantially mitigate the conflict's effect on the customer. The Agencies further note that the final rule does not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties.

As noted above, one commenter expressed concern about the burdens of disclosing inherent conflicts and stated such disclosure is unnecessary because market participants understand inherent conflicts of interest.[1612] As noted in the proposal, certain inherent conflicts, such as the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests, would not be deemed a ''material'' conflict of interest with respect to permitted activities.[1613]

The Agencies continue to believe that information barriers can be an effective means of addressing conflicts of interest that may arise through, for example, the spread of information among trading desks engaged in different trading activities that may result in potentially inappropriate informational advantage. The Agencies are not adopting one commenter's suggestion that the final rule specify the particular types of scenarios where information barriers may be effective [1614] because, as discussed below, the Agencies believe banking entities are better positioned to determine when information barriers may be effective given their trading activities and business structure.[1615] In response to one commenter's concern that information barriers may result in the banking entity's management not being aware of the firm's collective operations,[1616] the Agencies note that information barriers do not require this result. Rather, information barriers would be established between relevant personnel or functions while other personnel, including senior managers, internal auditors, and compliance personnel, would have access to each group separated by the barrier.

The final rule continues to recognize that a banking entity may address or substantially mitigate a conflict of interest through use of information barriers. In order to address and mitigate a conflict of interest through the use of the information barriers, a banking entity is required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[1617]

Importantly, the final rule also provides that, notwithstanding a banking entity's establishment of such information barriers, if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of § 75.7(b)(2)(i).[1618]

While some commenters requested that the final rule include additional limitations as part of implementing the material conflict of interest provisions in section 13(d)(2), the Agencies do not believe additional restrictions are appropriate at this time. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1619] In all cases, the question of whether a material conflict of interest exists will depend on an evaluation of the specific facts and circumstances. For example, certain

[1610] *See* Sens. Merkley & Levin (Feb. 2012); ICFR; Occupy; Alfred Brock.

[1611] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

[1612] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); *but see* Occupy.

[1613] *See* Joint Proposal, 76 FR at 68893. Thus, the Agencies are not adopting one commenter's suggestion that the final rule consider all transactions by a banking entity to involve a material conflict of interest because the banking entity is necessarily on the opposite side of a transaction with its client, customer, or counterparty. *See* Occupy.

[1614] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1615] The Agencies note examples of information barriers that may address or substantially mitigate a material conflict of interest include restrictions on information sharing, limits on types of trading, prohibitions on common officers or employees between functions. Such information barriers have been recognized in Federal securities laws as a means to address or mitigate potential conflicts of interest or other inappropriate activities. *See, e.g.,* 17 U.S.C. 78o(g).

[1616] *See* Public Citizen.

[1617] The Agencies note that a banking entity subject to Appendix B of the final rule must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits conflicts of interest with clients, customers, and counterparties. As part of maintaining and enforcing information barriers, a banking entity should have processes to review, test, and modify information barriers on a continuing basis. In addition, banking entities should have ongoing monitoring to maintain and to enforce information barriers, for example by identifying whether such barriers have not prevented unauthorized information sharing and addressing instances in which the barriers were not effective. This may require both remediating any identified breach as well as updating the information barriers to prevent further breaches, as necessary. Periodic assessment of the effectiveness of information barriers and periodic review of the written policies and procedures are also important to the maintenance and enforcement of effective information barriers and reasonably designed policies and procedures. Such assessments can be done either (i) internally by a qualified employee or (ii) externally by a qualified independent party. *See* Part VI.C.2.e., *infra.*

[1618] If a conflict occurs to the detriment of a client, customer, or counterparty despite an information barrier, the Agencies would also expect the banking entity to review the effectiveness of its information barrier and make adjustments, as necessary, to avoid future occurrences, or review whether such information barrier is appropriate for that type of conflict.

[1619] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), available at *http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.*

simple transactions may implicate conflicts of interest that cannot be mitigated by disclosure or restricted by information barriers. On the other hand, certain highly structured and complex transactions may involve conflicts of interest that can be mitigated by disclosure or restricted by information barriers.

The Agencies believe that conflicts of interest must be determined and addressed in accordance with the specific facts and circumstances presented. One commenter suggested that the proposed rule be modified so that a banking entity could conclusively rely on information barriers unless it knows or has reason to know that policies, procedures, and controls establishing barriers would not be effective in restricting the spread of information.[1620] By focusing on whether a banking entity knows or has reason to know that its policies and procedures would not be effective, rather than on what the banking entity knows or should reasonably know about a conflict of interest that may involve or result in a material adverse effect on a client, customer, or counterparty, the commenter's suggestion has the potential to allow a banking entity to engage in transactions that involve a material conflict of interest. Therefore, the Agencies have determined not to adopt the commenter's suggested approach. Similarly, the Agencies are rejecting some commenters' suggestions that the final rule prescribe the method, scope, or specific content of disclosures.[1621] The Agencies believe that specific guidance on disclosure may provide an incentive for banking entities to consider the form of disclosure provided, rather than whether disclosure can address the substance of the conflict as determined by the specific facts and circumstances at hand. Moreover, the Agencies believe banking entities are in the best position to identify and evaluate the conflicts present in their business as well as the most effective method of disclosing such conflicts. Banking entities must tailor their compliance programs to identify, monitor, and evaluate potential conflicts based on their business structure and specific activities and customer relationships.[1622]

Finally, some commenters requested that the final rule specifically address the conflict of interest provisions related to asset-backed securitizations contained in section 621 of the Dodd-Frank Act. As explained below in Part VI.B.1., some securitizations are subject to the final rule, and others such as securitizations of loans are not subject to section 13 of the BHC Act. For any securitization that meets the definition of covered fund under the final rule, relationships with and transactions by a banking entity involving those securitizations remain subject to the requirements of section 13, including the requirements of section 13(d)(2). In addition, the banking entity would be subject to the limitations contained in section 621 of the Dodd-Frank Act and any rules regarding conflicts of interest relating to securitizations implemented under that section. The final rule in no way limits the application of section 621 of that Act with respect to an asset-backed security that is subject to that section.

b. Definition of ''High-Risk Asset'' and ''High-Risk Trading Strategy''

1. Proposed Rule

Section 75.8(c) of the proposed rule defined ''high-risk asset'' and ''high-risk trading strategy'' for purposes of the proposed limitations on permitted trading activities. Proposed § 75.8(c)(1) defined a ''high-risk asset'' as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. Proposed § 75.8(c)(2) defined a ''high-risk trading strategy'' as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.[1623]

2. Comments on Proposed Limitations on High-Risk Assets and Trading Strategies

With respect to the prohibition on transactions or activities that expose banking entities to high-risk assets or high-risk trading strategies, one commenter stated the provisions were effective,[1624] while other commenters stated the proposed rule was too vague[1625] and implied that banking entities may be required to exit positions in periods of market stress, further reducing liquidity.[1626] A few commenters suggested the Agencies identify and prohibit certain types of high-risk assets or high-risk trading strategies under the rule.[1627] In contrast, one commenter asserted the Agencies should not specify certain classes of assets or trading strategies as ''high risk.''[1628] A few commenters requested greater clarity on the proposed definitions and suggested the Agencies provide additional guidance.[1629] One of these commenters suggested the Agencies simplify compliance by establishing safe harbors, setting pre-determined risk limits within risk-based approaches, or allowing individual banking entities to set practical risk-based standards that the Agencies can review.[1630]

One commenter suggested integrating the ban on high-risk activities throughout the rule and stated that, given the evolving nature of financial markets, regulators should have the flexibility to update criteria for identifying high-risk assets or high-risk trading strategies.[1631] This commenter stated the definition of high-risk trading strategies was appropriately broad and flexible, but suggested improving the rule by encompassing trading strategies that are so complex the risk or value thereof cannot be reliably and objectively determined.[1632] The commenter also suggested that the quantitative measurements collected under proposed Appendix A could be utilized to help inform whether a high-risk asset or trading strategy exists.[1633]

One commenter stated that in large concentrations, all assets can be high risk. This commenter suggested evaluating transactions on a case-by-case basis and believed all activity exempted under section 13(d)(1) of the BHC Act should be viewed as ''high-risk'' absent prior regulatory approval. This commenter further suggested that high-risk assets or trading strategies be defined to include any asset or trading strategy that would have forced a

[1620] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1621] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR; Alfred Brock; Public Citizen; AFR *et al.* (Feb. 2012); Arnold & Porter; Sens. Merkley & Levin (Feb. 2012).

[1622] For a full discussion of the final rule's compliance requirements, including a discussion of the specific compliance requirements applicable to different banking entities, see Part VI.C. of this **SUPPLEMENTARY INFORMATION**, *infra.*

[1623] *See* Joint Proposal, 76 FR at 68894. The Agencies noted that a banking entity subject to proposed Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits exposure to high-risk assets and high-risk trading strategies, and identifies a variety of assets and strategies (*e.g.,* assets or strategies with significant embedded leverage). *See* Joint Proposal, 76 FR at 68894 n.215.

[1624] *See* Alfred Brock.

[1625] *See* AFR *et al.* (Feb. 2012); Japanese Bankers Ass'n.; Investure; AllianceBernstein; Comm. on Capital Markets Regulation.

[1626] *See* Obaid Syed.

[1627] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; Occupy.

[1628] *See* Alfred Brock.

[1629] *See* Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen.

[1630] *See* Japanese Bankers Ass'n.

[1631] *See* Sens. Merkley & Levin (Feb. 2012).

[1632] *See* Sens. Merkley & Levin (Feb. 2012).

[1633] *See* Sens. Merkley & Levin (Feb. 2012).

banking entity to exit the market during the 2008 financial crisis, and that leverage, rehypothecation, concentration limits, and high frequency trading should be viewed as indicia of high-risk trading strategies. Finally, this commenter suggested the Agencies require banking entity CEOs to certify that their institution's activities do not result in a material exposure to high-risk assets or high-risk trading strategies.[1634]

3. Final rule

After considering carefully the comments received, the Agencies have modified the final rule to provide that a high-risk asset means an asset or group of assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Similarly, the final rule defines high-risk trading strategy to include any strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

Importantly, under the final rule, banking entities that engage in activities pursuant to an exemption must have a reasonably designed compliance program in place to monitor and understand whether it is exposed to high-risk assets or trading strategies. For instance, any banking entity engaged in activity pursuant to the market-making exemption in § 75.4(b) must, as part of its compliance program, have reasonably designed written policies and procedures, internal controls, analysis and independent testing regarding the limits for each trading desk, including limits on the level of exposures to relevant risk factors that the trading desk may incur. These policies and procedure and any activity conducted pursuant to the final rule will be evaluated by the Agencies, as appropriate, as part of ensuring the safety and soundness of banking entities and monitoring for exposures to high-risk activities or assets.

While some commenters stated that the definition of high risk asset or trading strategy should be more clearly defined, the Agencies believe that it is appropriate to include a broad definition of these terms that accounts for different facts and circumstances that may impact whether a particular asset or trading strategy is high-risk with respect to a banking entity. As stated by commenters, this framework is effective and flexible enough to be utilized by the Agencies in a variety of contexts. For instance, a trading strategy or asset may be high-risk to one banking entity but not another, or may be high-risk to a banking entity under some market conditions but not others. As part of evaluating whether a banking entity is exposed to a high-risk asset or trading strategy, the Agencies expect that a variety of factors will be considered, such as the presence of excess leverage, rehypothecation or excessively high concentration of assets, or unsafe and unsound trading strategies.

We believe an approach limiting this provision's applicability to certain permitted activities or creating a safe harbor for certain assets or trading strategies would be inconsistent with the statutory language, which prohibits any permitted activity that involves or results in a material exposure to a high-risk asset or high-risk trading strategy.[1635] In addition, the Agencies decline to identify any particular assets or trading strategies as per se high-risk because a determination of the specific risk posed to a banking entity depends on the facts and circumstances.[1636] Certain facts and circumstances may include, but are not limited to, the amount of capital at risk in a transaction, whether or not the transaction can be hedged, the amount of leverage present in the transaction, and the general financial condition of the banking entity engaging in the transaction. In response to one commenter's recommendation that the Agencies adopt a CEO certification requirement specific to the high-risk provisions,[1637] the Agencies believe such a requirement is unnecessary in light of the required management framework in the compliance program provision of § 75.20 of the final rule, as well as the CEO certification requirement included in the final rule.[1638]

c. Limitations on Permitted Activities That Pose a Threat to Safety and Soundness of the Banking Entity or the Financial Stability of the United States

Finally, as the Agencies did not receive any comments on the proposed rule's limitations on permitted activities that pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States and the proposed approach mirrored the statutory language, the Agencies have determined no changes to final rule are necessary.

B. Subpart C—Covered Fund Activities and Investments

As noted above and except as otherwise permitted, section 13(a)(1)(B) of the BHC Act generally prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a covered fund.[1639] Section 13(d) of the BHC Act contains certain exemptions to this prohibition. Subpart C of the final rule implements these and other provisions of section 13 related to covered funds. Additionally, subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in subpart D of the final rule, as well as Appendix B, to the extent applicable.

1. Section 75.10: Prohibition on Acquisition or Retention of Ownership Interests in, and Certain Relationships With, a Covered Fund

Section 75.10 of the final rule defines the scope of the prohibition on the acquisition and retention of ownership interests in, and certain relationships with, a covered fund. It also defines a number of key terms, including the definition of covered fund.

The term ''covered fund'' specifies the types of entities to which the prohibition contained in § 75.10(a) applies, unless the activity is specifically permitted under an available exemption contained in subpart C of the final rule.[1640] The final rule modifies the proposed definition of covered fund in a number of key aspects. The Agencies have defined the term ''covered fund'' with reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (''Investment Company Act'') with some additions and subject to a number of exclusions, several of which have been modified from permitted activity exemptions included in the proposal.

The Agencies have tailored the final definition to include entities of the type that the Agencies believe Congress intended to capture in its definition of private equity fund and hedge fund in section 13(h)(2) of the BHC Act by reference to section 3(c)(1) and 3(c)(7) of

[1634] *See* Occupy.

[1635] *See* BDA (Feb. 2012); Japanese Bankers Ass'n.

[1636] *See* Occupy.

[1637] *See* Occupy.

[1638] *See* § 75.20 and Appendix B of the final rule, also discussed in Part VI.C., *infra*.

[1639] *See* 12 U.S.C. 1851(a)(1)(B).

[1640] *See* final rule §§ 75.10(b)–(c). The term banking entity is defined in final rule § 75.2(c).

the Investment Company Act. Thus, the final definition focuses on the types of entities formed for the purpose of investing in securities or derivatives for resale or otherwise trading in securities or derivatives, and that are offered and sold in offerings that do not involve a public offering, but typically involve offerings to institutional investors and high-net worth individuals (rather than to retail investors). These types of funds are not subject to all of the securities law protections applicable with respect to funds that are registered with the SEC as investment companies, and the Agencies therefore believe that these types of entities may be more likely to engage in risky investment strategies. At the same time, the Agencies have tailored the definition to exclude entities that have more general corporate purposes and do not present the same risks for banking entities as those associated with the funds described above, as well as certain other entities as further discussed below.

The final rule also contains a revised version of the proposal's treatment of certain foreign funds as covered funds, which has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute, such as certain foreign funds that are established by U.S. banking entities and not otherwise subject to the Investment Company Act.

The Agencies have not included all commodity pools within the definition of covered fund as proposed. Instead, and as discussed in more detail below, the Agencies have included only commodity pools for which the commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC's regulations or that could qualify as exempt pools and which have not been publicly offered [1641] to persons who are not qualified eligible persons under section 4.7 of the CFTC's regulations.[1642] Qualified eligible persons are typically institutional investors, banking entities and high net worth individuals (rather than retail investors). This more tailored approach, together with the various exclusions from the covered fund definition in the final rule, is designed to include as covered funds those commodity pools that are similar to funds that rely on section 3(c)(1) or 3(c)(7) while not also including as covered funds entities, like commercial end-users or registered investment companies, whose activities do not implicate the concerns that section 13 was designed to address.

Finally, other related terms, including ''ownership interest,'' ''resident of the United States,'' ''sponsor,'' and ''trustee,'' are also defined in § 75.10(d) of the final rule.[1643] As explained below, these terms are largely defined in the same manner as in the proposal although with certain changes, including changes to help clarify the scope of these definitions as requested by commenters. Some of these terms and related provisions also have been reorganized to improve clarity. As explained in more detail below, the Agencies received a number of comments relating to some of the terms defined in § 75.10. Some comments directly relate to the scope of the proposed rule and the economic effects associated with the prohibitions on covered funds activities and investments, some of which commenters argued did not further the purposes of section 13.[1644] The Agencies have carefully considered these and other comments when defining the key terms used in the statute and in providing certain exclusions to the definition of the term covered fund. The Agencies also have sought to provide guidance below, where appropriate, on how these key terms would operate in order to better enable banking entities to understand their obligations under section 13 and the final rule.

a. Prohibition Regarding Covered Fund Activities and Investments

Section 75.10(a) of the final rule implements section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, directly or indirectly, acquiring or retaining as principal an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless otherwise permitted under subpart C of the final rule.[1645] This provision of the rule reflects the statutory prohibition.

The general prohibition in § 75.10(a) of the proposed rule applied solely to the acquisition or retention of an ownership interest in, or acting as sponsor to, a covered fund, ''as principal.'' [1646] Commenters generally supported this approach, arguing that applying the prohibition related to covered fund activities and investments by a banking entity only to instances where the banking entity acts as principal is consistent with the statutory focus on principal activity.[1647] The final rule takes this approach as discussed below.

The proposed rule and preamble accompanying it described potential exemptions from the definition of ownership interest for a variety of interests, including interests related to employee benefit plans, interests held in the ordinary course of collecting a debt previously contracted, positions as trustee, or interests acquired as agent, broker or custodian. Commenters provided information on each of these types of ownership interests, and generally supported excluding each of these from the section's prohibition on acquiring or retaining an ownership interest in a covered fund.

A significant number of commenters focused on employee benefit plans. Commenters generally argued that the prohibition in section 13(a) of the BHC Act did not encompass interests held on behalf of employees through an employee benefit plan. While the proposed rule did not explicitly cover certain ''qualified plans'' under the Internal Revenue Code, a number of commenters argued that the prohibition should not cover activity or investments related to other types of employee benefit plans that are not a ''qualified plan'' under the Internal Revenue Code.[1648] A significant number of commenters urged exclusion of interests in and relationships with foreign employee benefit plans.[1649] Commenters argued that the risks of investments made through employee benefit plans are borne by the employee beneficiaries of these plans, and any decision to cover employee benefit plans or investments made by these plans under the prohibitions in section 13 of the BHC Act would eliminate or severely restrict the availability of employee programs that are widely offered, regulated and endorsed under a system of Federal, state and foreign laws.[1650]

Commenters also supported the exemption under the proposed rule for holdings in satisfaction of a debt previously contracted in good faith.[1651]

[1641] *See infra* note 1726 and accompanying text regarding the meaning of the term ''offer'' as used in the final rule's inclusion of certain commodity pools as covered funds.

[1642] *See* final rule § 75.10(b)(1)(ii).

[1643] *See* final rule § 75.10(d)(6), (8), (9), and (10).

[1644] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Goldman (Covered Funds); Rep. Himes; SVB; Scale.

[1645] *See* final rule § 75.10(a).

[1646] *See* proposed rule § 75.10(a); *see also* Joint Proposal, 76 FR at 68896.

[1647] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012).

[1648] *See* Credit Suisse (Williams); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1649] *See, e.g.,* Credit Suisse (Williams); Arnold & Porter; UBS; NAB; Hong Kong Inv. Funds Ass'n; Australian Bankers Ass'n. (Feb. 2012).

[1650] *See, e.g.,* Arnold & Porter.

[1651] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); LSTA (Feb. 2012).

This provision of the proposal recognized that banking entities may acquire an ownership interest in or relationship with a covered fund as a result of a counterparty's failure to repay a *bona fide* debt and without an intent to engage in those activities as principal.[1652]

Several commenters urged revision to the proposal to add a specific exclusion for investments held by a banking entity in the capacity of trustee (including as trustee for a charitable trust).[1653] These commenters argued that failing to recognize and exempt these types of activities in the final rule would prevent banking entities that act as trustees from effectively meeting their trust and fiduciary obligations and from providing these services to customers. Commenters also argued that the exemption for trust activities should not be dependent on the duration of the trust because the law governing the duration of trusts is changing and varies across jurisdictions.[1654]

As with the proposed rule, the prohibition in § 75.10(a) of the final rule applies only to the acquisition or retention of an ownership interest in, or sponsorship of, a covered fund as principal. The Agencies continue to believe section 13 of the BHC Act was designed to address the risks attendant to principal activity and not those that are borne by customers of the banking entity or for which the banking entity lacks design or intent to take a proprietary interest as principal.

In order to address commenter concerns regarding the types of activity that are subject to the prohibition, the Agencies have modified and reorganized the final rule to make the scope of acting ''as principal'' clear and more consistent with the proprietary trading restrictions under the final rule.[1655] The final rule provides that the prohibition does not include acquiring or retaining an ownership interest in a covered fund by a banking entity: (1) Acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;[1656] (2) through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof);[1657] (3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the appropriate agency; or (4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.[1658]

Because these activities do not involve the banking entity engaging in an activity intended or designed to take ownership interests in a covered fund as principal, they do not appear to be the types of activities that section 13 of the BHC Act was designed to address. However, the Agencies note that in order to prevent a banking entity from evading the requirements of section 13 and the final rule, the exclusions for these activities do not permit a banking entity to engage in establishing, organizing and offering, or acting as sponsor to a covered fund in a manner other than as permitted elsewhere in the final rule. The Agencies intend to monitor these activities and investments for efforts to evade the restrictions in section 13 of the BHC Act and the final rule on banking entities' investments in and relationships with covered funds.

b. ''Covered Fund'' Definition

Section 13(h)(2) of the BHC Act defines hedge fund and private equity fund to mean an issuer that would be an investment company, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or ''such similar funds'' as the Agencies determine by rule.[1659] Given that the statute defines ''hedge fund'' and ''private equity fund'' without differentiation, the proposed rule and the final rule combine the terms into the definition of a ''covered fund.'' Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act.[1660] The proposal included as a covered fund any entity that would be an investment company but for the exclusion from that definition contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, any foreign entity that would also be an investment company but for those same exclusions were the foreign entity to be organized or offered in the United States, and a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1661] The preamble to the proposal recognized that this definition was broad and specifically requested comment on whether and how the definition of covered fund should be modified for purposes of the final rule.

Commenters contended that the definition of covered fund should not focus exclusively on whether an entity relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Commenters argued that sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act. Under the Investment Company Act, any entity that holds investment securities (*i.e.,*

[1652] *See* proposed rule § 75.14(b).

[1653] *See, e.g.,* ABA (Keating).

[1654] *See, e.g.,* ABA (Keating); Arnold & Porter; NAB.

[1655] *See* final rule § 75.3(d)(7)–(9).

[1656] A banking entity acting as agent, broker, or custodian is not acting ''as principal'' under the final rule so long as the activity is conducted for the account of, or on behalf of, a customer and the banking entity does not have or retain beneficial ownership of such ownership interest, as noted above. This provision is consistent with the final rule's treatment of banking entities acting on behalf of customers as trustee or in a fiduciary capacity.

[1657] The Agencies note that this provision does not permit joint investments between the banking entity and its employees. Rather, this provision is intended to enable banking entities to maintain deferred compensation and other similar plans formed for the benefit of employees. The Agencies recognize that, since it is possible an employee may forfeit its interest in such a plan, the banking entity may have a residual or reversionary interest in the assets referenced under the plan. However, other than such residual or reversionary interests, a banking entity may not rely on this provision to invest in a covered fund.

[1658] *See* final rule § 75.10(a)(2). For instance, as part of engaging in its traditional trust company functions, a bank or savings association typically may act through an entity that is excluded from the definition of investment company under section 3(c)(3) or 3(c)(11). This would be included within the scope of acting on behalf of customers as trustee or in a similar fiduciary capacity, provided that it meets the applicable requirements of the exclusion under the final rule.

[1659] *See* 12 U.S.C. 1851(h)(2).

[1660] 12 U.S.C. 1851(h)(2). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of ''investment company'' for: (1) Any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper); or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. *See* 15 U.S.C. 80a-3(c)(1) and (c)(7).

[1661] *See* proposed rule § 75.10(b)(1).

generally all securities other than U.S. government securities) representing at least 40 percent of the entity's total assets would be an investment company.[1662] According to commenters, this definition and the accompanying exclusions are part of a securities law and regulatory framework designed for purposes different than the prudential purpose that underlies section 13 of the BHC Act.[1663]

A number of comments received on the proposal argued that the proposed definition of covered fund was overly broad and would lead to anomalous results inconsistent with the words, structure, and purpose of section 13.[1664] For instance, many commenters asserted that the proposed rule's definition of covered fund would cause a number of commonly used corporate entities that are not traditionally thought of as hedge funds or private equity funds, such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles, to be subject to the covered fund restrictions of section 13. These commenters argued that this interpretation of section 13 would cause a disruption to the operations of banking entities and their closely related affiliates that does not relate to the intent of section 13 and therefore cause an unnecessary burden on banking entities. Commenters argued that the words, structure and purpose of section 13 allow the Agencies to adopt a more tailored definition of covered fund that focuses on vehicles used for investment purposes that were the target of section 13's restrictions.

In particular, commenters requested that the final rule exclude at least the following from the definition of covered fund: U.S. registered investment companies (including mutual funds); the foreign equivalent of U.S. registered investment companies; business development companies; wholly-owned subsidiaries; joint ventures; acquisition vehicles; financial market utilities; foreign pension or retirement funds; insurance company separate accounts; loan securitizations, including asset-backed commercial paper conduits; cash management vehicles or cash collateral pools; credit funds; real estate investment trusts; various securitization vehicles; tender option bond programs; and venture capital funds.[1665] Commenters requested some of these exclusions in order to mitigate the impact of the proposal's inclusion of commodity pools as part of the definition of covered fund.[1666]

Some commenters argued that the proposal failed to distinguish between different types of investment funds.[1667] These commenters expressed the view that the statute provides the Agencies with the discretion to distinguish between investment funds generally and a subset of funds—hedge funds and private equity funds—that may engage in particularly risky trading and investment activities. For example, several commenters argued that the proposed rule's restrictions on covered fund investments should not cover venture capital funds that provide investment capital to new businesses.[1668] Others argued an exclusion for securitization vehicles such as securitizations that are backed, in whole or in part, by assets that are not loans, including corporate debt repackagings,[1669] CLOs,[1670] ABCP conduits,[1671] insurance-linked securities,[1672] and synthetic securitizations backed by derivatives.[1673]

As a potential solution to some of these concerns, a number of commenters argued that the Agencies should define covered fund by reference to characteristics that are designed to distinguish hedge funds and private equity funds from other types of entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1674] Commenters believed this approach would help exclude some of the corporate vehicles and funds mentioned above that they did not believe were intended by Congress to be included as hedge funds and private equity funds and therefore reduce costs that, in the commenters' view, did not further the purposes of section 13.[1675]

These commenters proposed a number of different potential types of characteristics for defining hedge fund and private equity fund. Some commenters focused on certain structural or investment characteristics found in traditional private equity funds and hedge funds, such as investor redemption rights, performance compensation fees, leverage and the use of short-selling.[1676] Another commenter argued that the characteristics used to define a covered fund should focus on the types of speculative behavior that the statute was intended to address, citing characteristics such as volatility of asset performance and high leverage.[1677]

In contrast to the majority of the commenters, one commenter urged that characteristics be used to expand the proposed definition to include any

[1662] 15 U.S.C. 80a-3(a)(1)(A) and (C). The definition of securities is very broad under the Investment Company Act and has been interpreted to include instruments such as loans, that would not be regarded as securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, the determination of what constitutes an ''investment security'' under the Investment Company Act requires complex analysis and consideration of a broad set of facts and circumstances.

[1663] *See, e.g.,* NVCA.

[1664] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.;* Rep. Garrett *et al.*

[1665] *See* ABA (Keating); ABA (Abernathy); SIFMA *et al.* (Covered Funds) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); Allen & Overy (on behalf of Canadian Banks); Deutsche Bank (Repackaging Transactions); ICI (Feb. 2012); Putnam; JPMC; GE (Feb. 2012); Chamber (Feb. 2012); Rep. Himes; BOK; Ass'n. of Institutional Investors (Feb. 2012); Wells Fargo (Covered Funds); BoA; NAIB *et al.;* PNC; SunTrust; Nationwide; STANY; BNY Mellon *et al.;* RMA; Goldman (Covered Funds); Japanese Bankers Ass'n; IRSG; ISDA (Feb. 2012); IIB/EBF; Citigroup (Jan. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Eaton Vance; Fidelity; SBIA; River Cities; Ashurst; Sen. Hagan; Sen. Bennet.

[1666] As discussed below, the Agencies have modified the final rule to include only certain commodity pools within the definition of covered fund.

[1667] *See* NVCA; *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating).

[1668] *See, e.g.,* ABA (Keating); ABA (Abernathy); Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Growth Managers; River Cities; SVB; EVCA.

[1669] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Deutsche Bank (Repackaging Transactions); SIFMA (Securitization) (Feb. 2012).

[1670] *See* SIFMA (Securitization) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); JPMC; LSTA (Feb. 2012).

[1671] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); Eaton Vance; Fidelity; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012); AFME *et al.*

[1672] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1673] *See* AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); ABA (Keating).

[1674] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Credit Suisse (Williams); SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); Allen & Overy (on behalf of Foreign Bank Group).

[1675] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Ashurst; Barclays; BDA (Feb. 2012); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Nuveen Asset Mgmt.; PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds).

[1676] *See* Ass'n. of Institutional Investors (Feb. 2012); Barclays; JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* FSOC study at 62–63 (suggesting a characteristics-based approach considering compensation structure; trading/investment strategy; use of leverage; investor composition); ABA (Keating); BNY Mellon *et al.;* Northern Trust, SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); T. Rowe Price; RMA (suggesting use of characteristics derived from the SEC's Form PF for registration of investment advisers of private funds).

[1677] *See* RBC (citing FSOC study).

issuer that exhibits characteristics of proprietary trading that the statute prohibits to be done by a banking entity.[1678] According to this commenter, any fund engaging in more than minimal proprietary trading should be a covered fund and subject to the requirements of section 13.

However, not all commenters supported a characteristics-based definition. One commenter opposed a characteristics-based definition, suggesting that the final rule rely only on the statutory reference to the Investment Company Act, and arguing that using characteristics to define a covered fund (*e.g.,* leverage) could create opportunities for circumvention of the rule.[1679] Commenters that generally supported the proposed definition argued that its broad scope prevented circumvention.[1680]

One commenter argued in favor of broadening the definition of covered fund to include entities that rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) and 3(c)(7), such as section 3(c)(2) (which provides an exclusion for underwriters and brokers) or 3(c)(6) (which provides an exclusion for entities engaged in a business other than investing in securities).[1681] By contrast, other commenters argued that an entity should not be considered a covered fund if the entity relies on an exclusion or exemption contained in the Investment Company Act other than an exclusion contained in section 3(c)(1) or 3(c)(7) under that Act, such as the exclusion contained in section 3(c)(3) for bank collective investment funds.[1682]

The Agencies have carefully considered all of the comments related to the definition of covered fund. While the Agencies believe that the proposal reflected a reasonable interpretation of the statutory provision, on further review and in light of the comments the Agencies have determined to adopt a different approach. The Agencies have revised the final rule to address many of the concerns raised by commenters regarding the scope of the original proposal in a manner the Agencies believe is a better reading of the statutory provision because it is both consistent with the language, purpose and structure of section 13 and avoids unintended consequences of the less precise definitional approach of the proposal.

In the final rule, the Agencies have joined the definitions of ''hedge fund'' and ''private equity fund'' into a single definition ''covered fund'' (as in the statute) and have defined this term as any issuer that would be an investment company as defined in the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act with a number of express exclusions and additions (explained below) as determined by the Agencies. Thus, for example, an entity that invests in securities and relies on any exclusion or exemption from the definition of ''investment company'' under the Investment Company Act other than the exclusion contained in section 3(c)(1) or 3(c)(7) of that Act would not be considered a covered fund so long as it satisfies the conditions of another Investment Company Act exclusion or exemption.[1683] Such an entity would not be an investment company but for section 3(c)(1) or 3(c)(7), and the Agencies have modified the final rule to explicitly exclude such an entity.[1684]

The Agencies believe this definition is consistent with the words, structure, purpose and legislative history of section 13 of the BHC Act. As noted above, section 13(h)(2) provides that the terms ''hedge fund'' and ''private equity fund'' mean an issuer that would be an investment company as defined in the Investment Company Act (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, *or* such similar funds as the Agencies may, by rule, as provided in subsection (b)(2), determine.[1685] The statutory provision contains two parts: A first part that refers to any issuer that is ''an investment company, as defined in the Investment Company Act, but for section 3(c)(1) and 3(c)(7) of the Act''; and a second part that covers ''such similar funds as the [Agencies] may, by rule . . . determine.'' The proposed rule offered a reading of this provision as a simple concurrent definition with two self-contained, supplementary parts. Under this approach, all entities covered by part one of the definition would be included in the definitions of ''hedge fund'' and ''private equity fund,'' and the role of the Agencies under the second part was limited to considering whether and how to augment the scope of the primary statutory definition.

As noted above, commenters argued that this interpretation led to unintended consequences that were not consistent with other provisions of section 13 or the purposes of section 13, and that other interpretations of the definition of covered fund were consistent with both the words and the purpose of the statute. Also as explained above, commenters offered multiple alternative interpretations of the definition of, the scope of the prohibition on ownership interests in, and relationships with, a covered fund.[1686]

The Agencies believe that the language of section 13(h)(2) can best be interpreted to provide two alternative definitions of the entities to be covered by the statutory terms ''hedge fund'' and ''private equity fund.'' Under this reading, the first part of section 13(h)(2) contains a base definition that references the noted exclusions under the Investment Company Act (the ''default definition''), while the second part grants the Agencies the authority to adopt an alternate definition that is triggered by agency action (the ''tailored definition''). Thus, if the Agencies do not act by rule, the definition is set by reference to the Investment Company Act and the relevant exclusions alone; if the Agencies act by rule, the definitions are set by the Agencies under that rule. As noted above, the Agencies have determined to exercise the authority under the second part of the statute to define ''hedge fund'' and ''private equity fund'' in the final rule.

Relying on the Agencies' authority to adopt an alternative, tailored definition of ''hedge fund'' and ''private equity fund,'' the final rule references funds that are similar to the funds in the base

[1678] *See* Occupy.

[1679] *See* AFR *et al.* (Feb. 2012).

[1680] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Alfred Brock.

[1681] *See* Occupy (also arguing in favor of including entities that rely on rule 3a-1 (which provides an exemption for issuers that hold less than 45% of their assets in securities excluding government securities) or 3a-6 (which provides an exemption for foreign banks and insurance companies) to avoid being regulated as investment companies under the Investment Company Act).

[1682] *See, e.g.,* ABA (Keating).

[1683] For instance, bank common trust and collective funds that qualify for the exclusion from the definition of investment company pursuant to section 3(c)(3) or 3(c)(11) of the Investment Company Act are not covered funds. *See* 15 U.S.C. 78a-3(c)(3) and (c)(11). These funds are subject to supervision and regulation by a Federal banking agency, thus helping to distinguish them from traditional hedge funds and private equity funds which are generally not themselves subject to such supervision or regulation.

[1684] *See* final rule § 75.10(c)(12).

[1685] *See* 12 U.S.C. 1851(h)(2) (emphasis added).

[1686] In addition to the readings described above, one commenter argued that the section could be read to provide that both the reference to issuers covered by section 3(c)(1) or 3(c)(7) of the Investment Company Act in the first part of section 13(h)(2) and the reference to similar funds in the second part of the section should be read as qualified by the clause ''as the Agencies may by rule. . . determine.'' Under this reading, Congress granted the Agencies authority to determine by rule whether an entity described by the first part would be covered and whether an issuer would be deemed to be a similar fund under the second part. *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

alternative provided in the first alternative definition—that is, an issuer that would be an investment company under the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act. The additions and exclusions from that definition represent further determinations by the Agencies regarding the scope of that definition that were made in the course of a rulemaking conducted in accordance with section 13(b)(2) of the BHC Act.

The Agencies believe that this reading of the statutory provision is consistent with the purpose of section 13. That purpose appears to be to limit the involvement of banking entities in high-risk proprietary trading, as well as their investment in, sponsorship of, and other connections with, entities that engage in investment activities for the benefit of banking entities, institutional investors and high-net worth individuals.[1687] Further, the Agencies believe that the provision permits them to tailor the scope of the definition to funds that engage in the investment activities contemplated by section 13 (as opposed, for example, to vehicles that merely serve to facilitate corporate structures); doing so allows the Agencies to avoid the unintended results, some of which commenters identified, that might follow from a definition that is inappropriately imprecise.[1688]

The Agencies also note that nothing in the structure or history of the Dodd-Frank Act suggests that the definition of hedge fund and private equity fund was intended to necessitate a fundamental restructuring of banking entities by disallowing investments in common corporate vehicles such as intermediate holding companies, joint operating companies, acquisition vehicles and similar entities that do not engage in the types of investment activities contemplated by section 13. Moreover, other provisions of the Dodd-Frank Act and existing banking laws and regulations would be undermined or vitiated by a reading that restricts investments in these types of corporate vehicles and structures.[1689]

Based on the interpretive and policy considerations raised by commenters, the language of section 13(h)(2), and the language, structure, and purpose of the Dodd-Frank Act, the Agencies have adopted a tailored definition of covered fund in the final rule that covers issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act with exclusions for certain specific types of issuers in order to focus the covered fund definition on vehicles used for the investment purposes that were the target of section 13. The definition of covered fund under the final rule also includes certain funds organized and offered outside of the United States in order to address foreign fund structures and certain commodity pools that might otherwise allow circumvention of the restrictions of section 13. The Agencies also expect to exercise the statutory anti-evasion authority provided in section 13(e) of the BHC Act and other prudential authorities in order to address instances of evasion.[1690]

As discussed above, an alternative approach to defining a covered fund would be to reference fund characteristics. Commenters arguing for a characteristics-based approach stated that it would more precisely tailor the final rule to the intent of section 13 and limit the potential for undue burden on banking entities. A characteristics-based definition, however, could be less effective than the approach taken in the final rule as a means to prohibit banking entities, either directly or indirectly, from engaging in the covered fund activities limited or proscribed by section 13. A characteristics-based approach also could require more analysis by banking entities to apply those characteristics to every potential covered fund on a case-by-case basis, and create greater opportunity for evasion. As discussed below, the Agencies have sought to address some of the concerns raised by commenters suggesting a characteristics-based approach by tailoring the definition of covered fund to provide exclusions for certain entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and otherwise would be treated as covered funds.

Some commenters discussed the potential cost to banking entities to analyze the covered fund status of certain entities if the Agencies were to define the term covered fund by reference to sections 3(c)(1) and 3(c)(7), arguing that this analysis would be costly.[1691] A characteristics-based approach could mitigate the costs associated with an investment company analysis but, depending on the characteristics, could result in additional compliance costs in some cases to the extent banking entities would be required to implement policies and procedures to prevent potential covered funds from having characteristics that would bring them within the covered fund definition. Furthermore, banking entities may currently rely on section 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid registering various entities under the Investment Company Act, and the costs to analyze the status of these entities under a statutory-based definition of covered fund are generally already included as part of the fund formation process and the costs of determining covered fund status may thus be mitigated, especially given the exclusions provided in the final rule.

The entities excluded from the definition of covered fund are described in detail in section (c) below.

[1687] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[1688] The Agencies believe that the choice of the tailored definition is supported by the legislative history that suggests that Congress may have foreseen that its base definition could lead to unintended results and might be overly broad, too narrow, or otherwise off the mark. Part two of the statutory definition was not originally included in the bill reported by the Senate Committee on April 30, 2010. While the addition of part two did not receive specific comment, Rep. Frank, a co-sponsor and principal architect of the Dodd-Frank Act, noted that the default definition ''could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds'' and confirmed that ''[w]e do not want these overdone.'' *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored).

[1689] For example, the Dodd-Frank Act requires banking entities to serve as a source of financial strength to their insured depository institutions and requires certain banking entities to form intermediate holding companies to separate their financial and non-financial activities. *See* Sections 167, 616(d) & 626 of the Dodd-Frank Act. These provisions would be severely undermined if the prohibitions on investments and activities contained in section 13 were applied to ownership of intermediate holding companies. For instance, a bank holding company would not be able to serve as a source of strength to an intermediate holding company (or any subsidiary thereof) that is a covered fund due to the transaction restrictions contained in section 13(f). *See* 12 U.S.C. 1851(f). As another example, the Agencies have made certain modifications to the final rule to make clear that it will not affect the resolution authority of the Federal Deposit Insurance Corporation, including by excluding from the covered fund definition issuers formed by or on behalf of the Corporation for the purpose of facilitating the disposal of assets acquired in the Corporation's capacity as conservator or receiver. *See* § 75.10(c)(13).

[1690] As discussed in Part VI.C.1 of this **SUPPLEMENTARY INFORMATION** regarding the compliance program requirements of the final rule, the Agencies will consider information maintained and provided by banking entities under the compliance program mandate to help monitor potential evasions of the prohibitions and restrictions of section 13. Additionally and consistent with the statute, the final rule permits the Agencies to jointly determine to include within the definition of covered fund any fund excluded from that definition. The Agencies expect that this authority may be used to help address situations of evasion.

[1691] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

1. Foreign Covered Funds

In order to prevent evasion of the prohibition and purposes of section 13, the proposal included within the definition of covered fund any issuer organized or offered outside of the United States (''foreign covered fund'') that would be a covered fund were it organized or offered in the United States.[1692]

Commenters expressed concern that the proposed treatment of foreign covered funds was overly broad, exceeded the Agencies' statutory authority, was not consistent with principles of national treatment, and violated international treaties.[1693] Commenters expressed concern about the difficulties of applying Investment Company Act concepts to foreign funds that are structured to comply with regulatory schemes under local laws outside the United States. They also argued that it would be burdensome and costly to require foreign banking entities to interpret and apply U.S. securities laws to foreign structures that are designed primarily to be offered and sold outside the United States.[1694] Commenters also contended that foreign mutual fund equivalents, such as retail Undertakings for Collective Investments in Transferable Securities (''UCITS''),[1695] would be treated as covered funds under the proposal even though they generally are similar to U.S. registered investment companies, which are not covered funds, meaning that under the proposal the scope of foreign funds captured was broader than the scope of domestic funds.[1696] These commenters argued that a foreign fund organized and offered outside of the United States should not be treated as a covered fund simply because the foreign fund may (or could) rely on the exclusion under section 3(c)(1) or 3(c)(7) of the Investment Company Act were it to be offered in the United States.[1697]

Some commenters argued that the proposal did not clearly identify which foreign funds would be covered, thereby creating uncertainty about the scope of funds to which section 13 would apply.[1698] Several commenters argued that the proposal's foreign covered fund definition could be read to include a foreign fund, even if its securities were never offered and sold to U.S. persons, because the fund could theoretically be offered in the United States in reliance on section 3(c)(1) or 3(c)(7).[1699] Commenters argued that the definition of foreign covered fund should be tailored.[1700] Some commenters argued that foreign funds that are not made available for sale in the U.S. or actively marketed to U.S. investors should be specifically excluded from the definition of covered fund.[1701] Several other commenters supported narrowing the definition of foreign covered fund to those foreign funds with characteristics similar to domestic hedge funds or private equity funds.[1702]

After considering the comments in light of the statutory provisions and purpose of section 13, the Agencies have modified the final rule to more effectively tailor the scope of foreign funds that would be covered funds under the rule and better implement the language and purpose of section 13. As noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities, and one of the purposes of section 13 is to reduce the risk to the U.S. financial system of activities with and investments in covered funds. The Agencies proposed to include foreign funds within the definition of covered fund in order to more effectively accomplish the purpose of section 13. In particular, the Agencies were concerned that a definition of covered fund that did not include foreign funds would allow U.S. banking entities to be exposed to risks and engage in covered fund activities outside the United States that are specifically prohibited in the United States. This result would undermine section 13 and pose risks to U.S. banking entities and the stability of the U.S. financial system that section 13 was designed to prevent.

At the same time, section 13 includes other provisions that explicitly limit its extra-territorial application to the activities of foreign banks outside the United States. As explained below, section 13 specifically exempts certain activities in covered funds conducted by foreign banking entities solely outside of the United States.

Based on these considerations and the information provided by commenters, the Agencies have revised the definition of covered fund in the final rule to include certain foreign funds under certain circumstances. The final rule provides that a foreign fund is included within the definition of covered fund only for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State. Under this definition a foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund. Under the rule, a foreign fund is any entity that: (i) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or

[1692] *See* proposed rule § 75.10(b)(1)(iii).

[1693] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BNY Mellon *et al.;* BlackRock; ABA (Keating); AFTI; AFG; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal et al. (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; TCW; Govt. of Japan/Bank of Japan.

[1694] *See* JPMC; *see also* Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Govt. of Japan/Bank of Japan.

[1695] UCITS are public limited companies that, under a series of directives issued by the EU Commission, coordinate distribution and management of unit trusts or collective investment schemes in financial instruments on a cross-border basis throughout the European Union on the basis of the authorization of a single member state.

[1696] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); AFG; AFTI; BoA; French Banking Fed'n.; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* BNY Mellon *et al.;* BlackRock; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal *et al.* (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; HSBC Life; ICSA Ass'n. of Banks in Malaysia (arguing that foreign banking organization would have to determine how a fund would be regulated under U.S. law before making investments in funds in their home markets).

[1697] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); SSgA (Feb. 2012); BoA; Goldman (Covered Funds).

[1698] *See* Australian Bankers Ass'n. (Feb. 2012); BlackRock.

[1699] *See* BlackRock; SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; ABA (Keating); IIB/EBF. These commenters argued that the proposed definition of a covered fund could result in virtually every foreign fund being considered a covered fund, regardless of whether the fund is similar to a hedge fund or private equity fund.

[1700] *See, e.g.,* AGC; Ass'n. of Institutional Investors (Feb. 2012); ABA (Keating); Goldman (Covered Funds); BoA; GE (Feb. 2012); Japanese Bankers Ass'n.; EBF.

[1701] *See* Australian Bankers Ass'n. (Feb. 2012); AFG; BNY Mellon *et al.;* BlackRock; Goldman (Covered Funds); IIB/EBF.

[1702] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; Goldman (Covered Funds); Credit Suisse (Williams); ABA (Keating); IIB/EBF; Barclays; BoA; GE (Feb. 2012) (discussing the uncertainty with respect to foreign-based loan and securitization programs and whether they would be deemed covered funds).

otherwise trading in securities; and (iii) has as its sponsor the U.S. banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by the U.S. banking entity (or an affiliate thereof).[1703] A foreign fund therefore may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.

This approach is designed to include within the definition of covered fund only foreign entities that would pose risks to U.S. banking entities of the type section 13 was designed to address. The Agencies note that any foreign fund, including a foreign fund sponsored or owned by a foreign banking entity, that is offered or sold in the United States in reliance on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act would be included in the definition of covered fund under § 75.10(b)(1)(i) of the final rule unless it meets the requirements of an exclusion from that definition as discussed below.[1704] Thus, the rule is designed to provide parity—and no competitive advantages or disadvantages—between U.S. and non-U.S. funds sold within the United States.

To further ensure that this approach to foreign funds is consistent with the scope of coverage applied within the United States, the final rule excludes from the definition of covered fund any foreign issuer that, were it subject to U.S. securities laws, would be able to rely on an exclusion or exemption from the definition of investment company other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1705]

As explained below, the final rule also contains an exclusion for foreign public funds.[1706] This is designed to prevent the extension of the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies, which are by statute not covered by section 13.

2. Commodity Pools

Under the proposal, the Agencies proposed to use their authority to expand the definition of covered fund to include a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1707] A commodity pool is defined in the Commodity Exchange Act to mean any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.[1708] The Agencies proposed to include commodity pools in the definition of covered fund because some commodity pools are managed and structured in a manner similar to a covered fund.

Some commenters objected to this expansion of the definition of covered fund as beyond the scope of section 13. Commenters argued that covering commodity pools would extend section 13 of the BHC Act to any entity that engages in a single commodity, futures or swap transaction, including entities that share few, if any, of the characteristics or risk associated with private equity funds or hedge funds.[1709] For example, some commenters argued that many non-bank businesses that are not investment companies but that hedge risks using commodity interests would be treated as covered funds if all commodity pools were covered.[1710] In addition, registered mutual funds, pension funds, and many investment companies that rely on exclusions or exceptions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act would be covered as commodity pools. Commenters argued that the CFTC has ample authority to regulate the activities of commodity pools and commodity pool operators, and nothing in section 13 indicates that Congress intended section 13 to govern commodity pool activities or investments in commodity pools.[1711] Commenters also argued that expanding the definition of covered fund to include commodity pools would have the unintended consequence of limiting all covered transactions between a banking entity sponsor or investor in a commodity pool and the commodity pool itself.[1712] If a commercial end user is a commodity pool for example, this restriction could limit access to credit for that entity.

Commenters that opposed the proposal's inclusion of commodity pools generally asserted that, if commodity pools were nonetheless included as covered funds under the final rule, the definition of commodity pool should be modified so that it would include only those pools that engage ''primarily'' or ''principally'' in commodities trading and exhibit characteristics similar to those of conventional hedge funds and private equity funds.[1713] Other commenters urged the Agencies to incorporate the exemptions from the commodity pool operator registration requirements under the Commodity Exchange Act (such as rule 4.13(a)(4)).[1714]

Some commenters supported including commodity pools within the definition of covered fund,[1715] with some suggesting that this approach would be consistent with the goals of the statute.[1716] One commenter asserted that including commodity pools would be necessary to prevent banking entities from indirectly engaging in prohibited proprietary trading through commodity pools.[1717] Another commenter asserted that the inclusion of commodity pools was advisable because the CFTC has in the past viewed many commodity pools as similar to hedge funds.[1718]

After carefully considering these comments, the Agencies have determined not to include all commodity pools as covered funds as proposed. Instead, and taking into account commenters' concerns, the Agencies have taken a more tailored approach that is designed to more accurately identify those commodity pools that are similar to issuers that would be investment companies as defined the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of

[1703] *See* final rule § 75.10(b)(1)(iii).

[1704] *See also* Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997); Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984).

[1705] *See* final rule § 75.10(b)(2). Because any issuer that offers its securities under the U.S. securities laws that may rely on an exclusion or exemption from the definition of investment company other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be a covered fund, this exclusion is designed to provide equivalent treatment for foreign covered funds.

[1706] *See* § 75.10(c)(1).

[1707] *See* proposal rule § 75.10(b)(1)(ii).

[1708] Commodity interests include: (i) Commodity for future delivery, security futures product, or swap; (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under section 4c of the Commodity Exchange Act; or (iv) leveraged transaction authorized under section 23 of the Commodity Exchange Act. *See* Joint Proposal, 76 FR at 68897 n.224 and accompanying text.

[1709] *See, e.g.,* ABA (Keating) (citing *see, e.g.,* CFTC Interpretative Letter No. 86–22, Comm. Fut. L. Rep. (CCH) ¶ 23,280 (Sept. 19, 1986)); SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock; Goldman (Covered Funds); Wells Fargo (Covered Funds); BoA; EFAMA; TCW; ISDA (Feb. 2012); Arnold & Porter; BNY Mellon *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); RMA; IIB/EBF.

[1710] *See* Goldman (Covered Funds); TCW; IIB/EBF.

[1711] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock.

[1712] *See, e.g.,* BoA.

[1713] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); BlackRock; Wells Fargo (Covered Funds); BNY Mellon, *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); ABA (Keating); FIA; IIB/EBF; BoA.

[1714] *See* Credit Suisse (Williams).

[1715] *See* AFR *et al.* (Feb. 2012); Alfred Brock; Occupy; Sens. Merkley & Levin (Feb. 2012).

[1716] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Alfred Brock.

[1717] *See* Sens. Merkley & Levin (Feb. 2012).

[1718] *See* Occupy.

that Act, consistent with section 13(h)(2) of the BHC Act.

Under the final rule, as a threshold matter, a collective investment vehicle must determine whether it is a ''commodity pool'' as that term is defined in section 1a(10) of the Commodity Exchange Act.[1719] The Agencies note that collective investment vehicles need to make this determination for purposes of complying with the Commodity Exchange Act regardless of whether commodity pools are covered funds. Under section 1a(10), a commodity pool is ''any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests.'' [1720] If a collective investment vehicle meets that definition, the commodity pool would be considered a covered fund provided it meets one of two alternative tests and does not also qualify for an exclusion from the covered fund definition (*e.g.,* the exclusion for registered investment companies).

First, a commodity pool will be a covered fund if it is an ''exempt pool'' under section 4.7(a)(1)(iii) of the CFTC's regulations,[1721] meaning that it is a commodity pool for which a registered commodity pool operator has elected to claim the exemption provided by section 4.7 of the CFTC's regulations. The Agencies believe that such commodity pools are appropriately considered covered funds because, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools sell their participation units in restricted offerings that are not registered under the Securities Act of 1933 and are offered only to investors who meet certain heightened qualification standards, as discussed above.[1722] The Agencies therefore have determined that they properly are considered ''such similar funds'' as specified in section 13(h)(2) of the BHC Act.

Alternatively, a commodity pool for which exempt pool status under section 4.7 of the CFTC's regulations has not been elected may also be a covered fund if the pool features certain elements that make the pool substantively similar to exempt pools under section 4.7. The Agencies are including the alternative definition of commodity pools that are covered funds because, if the Agencies had included only pools for which exempt pool status had been elected, covered fund status for pools in which banking entities are invested could easily be avoided merely by not electing exempt pool status under section 4.7. The following is a description of the elements of a pool that would cause a pool that is not an exempt pool under section 4.7 to be a covered fund.

The first element is that a commodity pool operator for the pool is registered pursuant to the Commodity Exchange Act in connection with the operation of that commodity pool. This element is present for all pools that are exempt pools under section 4.7 because exempt pool status can only be elected by registered commodity pool operators. This element excludes from the definition of covered fund an entity that is a commodity pool, but for which the pool operator has been either exempted from registration as a commodity pool operator or excluded from the definition of commodity pool operator under the CFTC's regulations or pursuant to a no-action letter issued by CFTC staff.[1723]

The second element under the alternative definition is that substantially all of the commodity pool's participation units are owned only by qualified eligible persons under section 4.7(a)(2) and (a)(3).[1724] This element is consistent with the requirement under section 4.7 that exempt pool status can only be claimed if the participation units in the pool are only offered or sold to qualified eligible persons.[1725] Moreover, the inclusion of this element aligns the elements of the alternative test with features that define funds that rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.

The assessment as to whether the commodity pool in question satisfies this condition must be made at the time that the banking entity is required to make the following determinations: whether it can obtain new participation units in the commodity pool, whether it can retain previously purchased participation units in the commodity pool, and whether it can act as the commodity pool's sponsor. The Agencies believe this to be appropriate because it would require the banking entity to consider current information regarding the commodity pool and its participants rather than assess the composition of the pool's participants over time even though its investments in or relationships with the pool do not change, which could be difficult depending upon the length of time that the pool has been in operation and the records available at the time of determination.

Finally, the third element under the alternative definition is that the commodity pool participation units have not been publicly offered to persons other than qualified eligible persons. Consistent with CFTC regulations addressing the meaning of ''offer'' in the context of the CFTC's regulations, the term ''offer'' as used in § 75.10(b)(1)(ii)(B) ''has the same meaning as in contract law, such that, if accepted the terms of the offer would form a binding contract.'' [1726] This aspect of the alternative definition is intended to limit the ability for commodity pools to avoid classification as covered funds through an offer, either in the past or currently ongoing, to non-qualified eligible persons ''in name only'' where there is no actual offer to non-qualified eligible persons.

Accordingly, unless the pool operator can show that the pool's participation units have been actively and publicly offered to non-affiliated parties that are not qualified eligible persons whereby such non-qualified eligible persons could in fact purchase a participation unit in the commodity pool, a pool that features the other elements listed in the

[1719] *See* 7 U.S.C. 1a(10).

[1720] *Id.* The CFTC and its divisions have provided interpretative guidance with respect to the meaning of the definition of commodity pool. *See, e.g.,* 46 FR 26004, 26005 (May 8, 1981) (adopting the CFTC's regulatory definition of commodity pool in 17 CFR 4.10(d), which is substantively identical to the definition in section 1a(10) of the Commodity Exchange Act); 77 FR 11252, 11258 (Feb. 24, 2012) (explaining the need for swaps to be included in the de minimis exclusion and exemption in 17 CFR 4.5 and 4.13); CFTC Staff Letter 12–13 (Oct. 11, 2012) (providing interpretative guidance to equity real estate investment trusts); and CFTC Staff Letters Nos. 12–14 (Oct. 11, 2012) and 12–45 (Dec. 7, 2012) (providing interpretative relief that certain securitization vehicles are not commodity pools).

[1721] 17 CFR 4.7(a)(1)(iii).

[1722] Although section 3(c)(1) itself does not limit the types of investors who may invest in a fund relying on that exclusion, section 3(c)(1) provides that the fund may not conduct a public offering. A fund relying on section 3(c)(1) therefore must offer and sell its interests in offerings that are not registered under the Securities Act of 1933, which offerings generally are limited to persons who meet certain qualification standards.

[1723] *See, e.g.,* CFTC regulations 3.10(c) and 4.13 and CFTC Staff Letters Nos. 12–37 (Nov. 29, 2012) (relief from registration for operators of certain types of family office pools), 12–40 (Dec. 4, 2012) (relief from registration for operators of business development companies that meet certain conditions) and 12–44 (Dec. 7, 2012) (relief from registration for operators of mortgage real estate investment trusts that meet certain conditions). *See also supra* note 1720.

[1724] 17 CFR 4.7(a)(2) and (a)(3).

[1725] Although section 4.7 requires that all participation units be owned by qualified eligible persons, this element of the final rule has been modified to include pools for which ''substantially all'' participation units are owned by qualified eligible persons to prevent avoidance of covered fund status by distributing a small number of participation units to persons who are not qualified eligible persons.

[1726] *See* 77 FR 9734, 9741 (Feb. 17, 2012) (describing the meaning of the term ''offer'' in the context of the business conduct standards for swap dealers and major swap participants with counterparties adopted by the CFTC). The term ''offered'' as used in this section of the final rule is not intended to denote an ''offer'' for purposes of the Securities Act of 1933.

alternative definition would be a covered fund. Such a showing will not turn solely on whether the commodity pool has filed a registration statement to offer its participation units under the Securities Act of 1933 or whether the commodity pool operator has prepared a disclosure document consistent with the provisions of section 4.24 of the CFTC's regulations.[1727] Rather, the pool operator would need to show that a reasonably active effort, based on the facts and circumstances, has been undertaken by brokers and other sales personnel to publicly offer the pool's participation units to non-affiliated parties that are not qualified eligible persons.

In taking this more tailored approach to commodity pools that will be covered funds, the Agencies are more closely aligning the types of commodity pools that will be covered funds under the final rule with section 13's definition of a hedge fund and private equity fund by reference to section 3(c)(1) or section 3(c)(7), and addressing concerns of commenters that the proposal was overly broad and would lead to outcomes inconsistent with the words, structure, and purpose of section 13.[1728] The Agencies believe that the types of commodity pools described above generally are similar to funds that rely on section 3(c)(1) and 3(c)(7) in that, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools may be owned only by investors who meet certain heightened qualification standards, as discussed above.[1729] Further, the Agencies believe that the final rule's identification of the elements of a commodity pool that is a covered fund are clearly established and readily ascertainable such that once it is determined whether an entity is a commodity pool, an assessment that is already necessary to comply with the Commodity Exchange Act, then the further determination of whether an entity that is a commodity pool is also a covered fund can be made based on readily ascertainable information.

In adopting this approach, the Agencies also are utilizing the current regulatory structure promulgated by the CFTC under the CEA. As the CFTC regulates commodity pools, commodity pool operators, and commodity trading advisors that advise commodity pools, the Agencies believe that it is beneficial to utilize an already established set of rules, regulations, and guidance. The Agencies considered alternative approaches provided by the commenters, but have adopted the approach taken in the final rule for the reasons discussed above and because the Agencies believe that the final rule, by incorporating concepts with which commodity pools and their operators are familiar, more clearly delineates the commodity pools that are covered funds.[1730]

The Agencies believe that the final rule's tailored approach to commodity pools includes in the definition of covered fund commodity pools that are similar to funds that rely on section 3(c)(1) and 3(c)(7). The Agencies also note in this regard that a commodity pool that would be a covered fund even under this tailored approach will not be a covered fund if the pool also qualifies for an exclusion from the covered fund definition, including the exclusion for registered investments companies. Accordingly, this approach excludes from covered funds entities like commercial end users and registered investment companies, whose activities do not implicate the concerns section 13 was designed to address. Rather, the final rule limits the commodity pools that will be included as covered funds to those that are similar to other covered funds except that they are not generally subject to the Investment Company Act of 1940 due to the instruments in which they invest. For all of these reasons, the Agencies believe that the final rule's approach to commodity pools addresses both the Agencies' concerns about the potential for evasion and commenters' concerns about the breadth of the proposed rule, and provides that the commodity pools captured as covered funds are ''such similar funds,'' consistent with section 13(h)(2) of the BHC Act.

The Agencies acknowledge that as a result of including certain commodity pools in the definition of covered fund, the prohibitions under section 13(f) and § 75.14 may result in certain structural changes in the industry. The Agencies note that these changes (*e.g.,* bank-affiliated FCMs may not be able to lend money in certain clearing transactions to affiliated commodity pools that are covered funds) may result in certain changes in the way related entities do business with each other. However, the Agencies believe that because the industry is competitive with a significant number of alternative non-affiliate competitors, the changes would not result in a less competitive landscape for investors in commodity pools.

3. Entities Regulated Under the Investment Company Act

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[1731] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[1732] A few commenters argued that the final rule should specifically provide that all SEC-registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[1733]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to

[1727] 17 CFR 4.24 (2013).

[1728] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.;* Rep. Garrett *et al.*

[1729] Funds relying on section 3(c)(7) must be owned exclusively by qualified purchasers, as defined in the Investment Company Act. The Agencies note in this regard that section 4.7 of the CFTC's regulations use substantially the same definition of a qualified purchaser in defining the term qualified eligible person.

[1730] Operators of commodity pools currently must consider whether they are required to register with the CFTC as commodity pool operators, and whether the pools have the characteristics that would make it possible for the operator to claim an exemption under section 4.7. These concepts thus should be familiar to commodity pools and their operators, and including these concepts in the final rule should allow banking entities more easily to determine if a particular commodity pools is a covered fund than if the Agencies were to develop new concepts solely for purposes of the final rule.

[1731] *See* proposed rule § 75.10(b)(1).

[1732] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

[1733] *See* Arnold & Porter; Goldman (Covered Funds); *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC; (requesting clarification that registered investment companies are not banking entities); TCW.

facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[1734]

The Agencies did not intend to include registered investment companies and business development companies as covered funds under the proposal. Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are excluded from SEC regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which *are* regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[1735]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed in more detail below in Part VI.B.1.c.12 of this **SUPPLEMENTARY INFORMATION.**

The Agencies also understand that registered investment companies may establish and hold subsidiary entities that rely on section 3(c)(1) or 3(c)(7) in order to trade in various financial instruments for the registered investment company parent. If a registered investment company were itself a banking entity, section 13 and the final rule would prohibit the registered investment company from sponsoring or investing in such an investment subsidiary. But a registered investment company would only itself be a banking entity if it is an affiliate of an insured depository institution. As explained in the proposal, a registered investment company, such as a mutual fund or exchange traded fund, or an entity that has made an effective election to be regulated as a business development company, would not be an affiliate of a banking entity for purposes of section 13 of that Act solely by virtue of being advised, or organized, sponsored and managed by a banking entity in accordance with the BHC Act (including section 13) and the Board's Regulation Y.[1736]

Under the BHC Act, an entity (including a registered investment company) would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution.[1737] Pursuant to the BHC Act, a company controls another company if: (i) The company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors of trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company.[1738]

The Board's regulations and orders have long recognized that a bank holding company may organize, sponsor, and manage a mutual fund such as a registered investment company, including by serving as investment adviser to registered investment company, without controlling the registered investment company for purposes of the BHC Act.[1739] For example, the Board has permitted a bank holding company to own up to 5 percent of the voting shares of a registered investment company for which the bank holding company provides investment advisory, administrative, and other services, and has a number of director and officer interlocks, without finding that the bank holding company controls the fund.[1740] The Board has also permitted a bank holding company to own less than 25 percent of the voting shares of a registered investment company and provide similar services without finding that the bank holding company controls the fund, so long as the fund limits its investments to those permissible for the holding company to make itself.[1741]

The BHC Act, as amended by the Gramm-Leach-Bliley Act, and the Board's Regulation Y authorize a bank holding company that qualifies as a financial holding company to engage in a broader set of activities, and to have a broader range of relationships or investments with entities, than bank holding companies.[1742] For instance, a financial holding company may engage in, or acquire shares of any company engaged in, any activity that is financial in nature or incidental to such financial activity, including any activity that a bank holding company is permitted to engage in or acquire by regulation or order.[1743] In light of the foregoing, for purposes of section 13 of the BHC Act a financial holding company may own more than 5 percent (and less than 25 percent) of the voting shares of a registered investment company for which the holding company provides investment advisory, administrative, and other services and has a number of director and officer interlocks, without

[1734] *See* ICI (Feb. 2012); TCW.

[1735] *See* final rule § 75.10(c)(12).

[1736] *See* Joint Proposal, 76 FR at 68856.

[1737] *See* final rule § 75.2(a) (defining ''affiliate'' for purposes of the final rule).

[1738] *See* 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

[1739] *See, e.g.,* 12 CFR 211.10(a)(11); 225.28(b)(6)(i); 225.86(b)(3); Unicredito, 86 Fed. Res. Bull. 825 (2000); Societe Generale, 84 Fed. Res. Bull. 680 (1998); Commerzbank AG, 83 Fed. Res. Bull. 678 (1997); The Governor and Company of the Bank of Ireland, 82 Fed. Res. Bull. 1129 (1996); Mellon Bank Corp., 79 Fed. Res. Bull. 626 (1993); Bayerische Vereinsbank AG, 73 Fed. Res. Bull. 155 (1987).

[1740] *See, e.g.,* Societe Generale, 84 Fed. Res. Bull. 680 (1998) (finding that a bank holding company does not control a mutual fund for which it holds up to 5 percent of the voting shares and also provides investment advisory, administrative and other services, has directors or employees who comprise less than 25 percent of the board of directors of the fund (including the chairman of the board), and has three senior officer interlocks and a number of junior officer interlocks).

[1741] *See* letter dated June 24, 1999, to H. Rodgin Cohen, Esq., Sullivan & Cromwell (First Union Corp.), from Jennifer J. Johnson, Secretary of the Board of Governors of the Federal Reserve System (finding that a bank holding company does not control a mutual fund for which it provides investment advisory and other services and that complies with the limitations of section 4(c)(7) of the BHC Act (12 U.S.C. 1843(c)(7)), so long as (i) the bank holding company reduces its interest in the fund to less than 25 percent of the fund's voting shares after a six-month period, and (ii) a majority of the fund's directors are independent of the bank holding company and the bank holding company cannot select a majority of the board) (''First Union Letter''); H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies); *see also* 12 U.S.C. 1843(k)(1), (6).

[1742] *See, e.g.,* H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies).

[1743] *See* 12 U.S.C. 1843(k)(1); 12 CFR 225.86.

controlling the fund for purposes of the BHC Act.[1744]

So long as a bank holding company or financial holding company complies with these limitations, it would not, absent other facts and circumstances, control a registered investment company and the registered investment company for purposes of section 13 (and any subsidiary thereof) would not itself be a banking entity subject to the restrictions of section 13 of the BHC Act and any final implementing rules (unless the registered investment company itself otherwise controls an insured depository institution). Also consistent with the Board's precedent regarding bank holding company control of and relationships with funds, a seeding vehicle that will become a registered investment company or SEC-regulated business development company would not itself be viewed as violating the requirements of section 13 during the seeding period so long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or SEC-regulated business development company within the time period provided by section 13(d)(4) and § 75.12 for seeding a covered fund.[1745]

c. Entities Excluded From Definition of Covered Fund

As noted above, the final rule excludes a number of entities from the definition of covered fund.[1746] As discussed in more detail below, these exclusions more effectively tailor the definition of covered fund to those types of entities that section 13 was designed to focus on. The exclusions thus are designed to provide certainty, mitigate compliance costs and other burdens, and address the potential over-breadth of the covered fund definition and related requirements without such exclusions by permitting banking entities to invest in and have other relationships with entities that do not relate to the statutory purpose of section 13. These exclusions, described in more detail below, take account of information provided by many commenters regarding entities that would likely be included within the proposed definition of a covered fund, but that are not traditionally thought of as hedge funds or private equity funds.[1747] Finally, the Agencies note that providing exclusions from the covered fund definition, rather than providing permitted activity exemptions as proposed in some cases, aligns the final rule with the statute in applying the restrictions imposed by section 13(f) on transactions with covered funds only to transactions with issuers that are defined as covered funds and thus raise the concerns section 13 was designed to address.

The Agencies recognize, however, that the final rule's definition of covered fund does not include certain pooled investment vehicles. For example, the definition of covered fund excludes business development companies, entities that rely on section 3(c)(5)(C), 3(c)(3), or 3(c)(11) of the Investment Company Act, and certain foreign public funds that are subject to home-country regulation. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule.

1. Foreign Public Funds

As discussed above, under the proposal a covered fund was defined to include the foreign equivalent of any covered fund in order to address the potential for circumvention. Many commenters argued that the proposed definition could capture non-U.S. public retail funds, such as UCITS.[1748] These commenters contended that non-U.S. public retail funds should be excluded from the definition of covered fund because they are regulated in their home jurisdiction; commenters noted that similar funds registered in the United States, such as mutual funds, are not covered funds.[1749]

Some commenters were concerned that the proposed definition could inadvertently capture exchange-traded funds trading in foreign jurisdictions,[1750] separate accounts set up to fund foreign pension plans,[1751] non-U.S. issuers of asset-backed securities,[1752] and non-U.S. regulated funds specifically designed for institutional investors.[1753] Commenters also provided several potential effects of capturing foreign public funds under the covered fund definition: U.S. banking entities would incur unnecessary and substantial costs to rebrand and restructure their non-U.S. regulated funds,[1754] banking entities could be eliminated from the potential pool of counterparties, thereby affecting pricing and efficiency,[1755] U.S. banking entities may exit the UCITS market and lose competitiveness,[1756] the growth of mutual fund formation in foreign countries could be limited,[1757] and market liquidity in foreign jurisdictions could be impaired.[1758]

Some commenters supported excluding any foreign public fund that is organized or formed under non-U.S. law, authorized for public sale in the jurisdiction in which it is organized or formed, and regulated as a public investment company in that

[1744] *See* First Union Letter (June 24, 1999); *see also* 12 CFR 225.86(b)(3) (authorizing a financial holding company to organize, sponsor, and manage a mutual fund so long as (i) the fund does not exercise managerial control over the entities in which the fund invests, and (ii) the financial holding company reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits).

[1745] *See* final rule §§ 75.10(c)(12) and 75.20(e). Under the final rule, these seeding vehicles also must comply with the limitations on leverage under the Investment Company Act that apply to registered investment companies and SEC-regulated business development companies. *See* final rule § 75.10(c)(12).

[1746] *See* final rule § 75.10(c).

[1747] *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored); *see also* FSOC study at 61–63.

[1748] As discussed above, the proposed rule generally included in the covered fund definition a foreign fund that, were it organized or offered under the laws of the United States or offered to U.S. residents, would meet the definition of a domestic covered fund (*i.e.,* would need to rely section 3(c)(1) or 3(c)(7) of the Investment Company Act). Many commenters argued that this definition is too broad and could include as covered funds various types of foreign funds, like UCITS, that commenters argued should not be included. *See, e.g.,* JPMC; BlackRock.

[1749] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Hong Kong Inv. Funds Ass'n.; UBS; ICI Global; BlackRock; TCW; State Street (Feb. 2012); SSgA (Feb. 2012); IAA; JPMC; Goldman (Covered Funds); BoA; Credit Suisse (Williams); BNY Mellon, *et al.;* Union Asset; EFAMA; BVI; IRSG, SEB; IIB/EBF; GE (Feb. 2012) (commenting on the overbreadth of the definition because of the effect on foreign issuers of asset-backed securities); Allen & Overy (on behalf of Foreign Bank Group).

[1750] *See* BlackRock; Vanguard.

[1751] *See* BlackRock.

[1752] *See* ASF (Feb. 2012).

[1753] *See* Union Asset; EFAMA; BVI.

[1754] *See* Goldman (Covered Funds).

[1755] *See* AFMA.

[1756] *See* BoA.

[1757] *See* BVI.

[1758] *See* Goldman (Covered Funds).

See AFMA.

See BoA.

jurisdiction.[1759] In light of the proposal's broad definition of covered fund, some commenters recommended explicitly excluding non-U.S. regulated funds based on characteristics to distinguish the foreign funds that should be treated as covered funds.[1760] Several commenters recommended excluding non-U.S. funds based upon whether the funds are subject to a regulatory framework comparable to that which is imposed on SEC-registered funds;[1761] one commenter specifically identified European UCITS, Canadian mutual funds, Australian unit trusts, and Japanese investment trusts as examples of regulated funds to be excluded.[1762]

To address these concerns, the final rule generally excludes from the definition of covered fund any issuer that is organized or established outside of the United States and the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through one or more public offerings outside of the United States.[1763] Foreign funds that meet these requirements will not be covered funds, except that an additional condition applies to U.S. banking entities[1764] with respect to the foreign public funds they sponsor. The foreign public fund exclusion is only available to a U.S. banking entity with respect to a foreign fund sponsored by the U.S. banking entity if, in addition to the requirements discussed above, the fund's ownership interests are sold predominantly to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.

For purposes of this exclusion, the Agencies note that the reference to retail investors, while not defined, should be construed to refer to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors, professional investors or high net worth investors who may be permitted to invest in complex investments or private placements in various jurisdictions. Retail investors would therefore be expected to be entitled to the full protection of securities laws in the home jurisdiction of the fund, and the Agencies would expect a fund authorized to sell ownership interests to such retail investors to be of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund.

In order to help maintain this distinction and to avoid circumstances that could result in an evasion of section 13 and the final rule, the ownership interests of the fund must be sold predominantly in one or more public offerings outside of the United States to qualify for the exclusion. Given this restriction, a U.S. banking entity therefore could not rely on this exclusion to set up a foreign public fund for the purpose of selling a significant amount of ownership interests in the fund through one or more offerings conducted on an unregistered basis (whether in a foreign jurisdiction or in the United States). The Agencies generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States.

The requirements that a foreign public fund both be authorized for sale to retail investors and sold predominantly in public offerings outside of the United States are based in part on the Agencies' view that foreign funds that meet these requirements generally will be sufficiently similar to U.S. registered investment companies such that it is appropriate to exclude these foreign funds from the covered fund definition. A foreign fund authorized for sale to retail investors that is also publicly offered may, for example, provide greater information than funds that are sold through private offerings like funds that rely on section 3(c)(1) or 3(c)(7). Such foreign funds also may be subject to various restrictions, as deemed appropriate by foreign regulators in light of local conditions and practices, that exceed those applicable to privately offered funds. Foreign regulators may apply these or other enhanced restrictions or other requirements to funds that are offered on a broad basis to the general public for the protection of investors in those jurisdictions.

A foreign fund that purports to publicly offer its shares but in fact offers them on a more limited basis, however, may be less likely to resemble a registered investment company in these and other respects. In order to limit the foreign public fund exclusion to funds that publicly offer their shares on a sufficiently broad basis, the final rule defines the term ''public offering'' for purposes of this exclusion to mean a ''distribution'' (as defined in § 75.4(a)(3) of subpart B) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that (i) the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; (ii) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and (iii) the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.[1765]

Under the final rule, therefore, a foreign fund's distribution would not be a public offering for purposes of the foreign public fund exclusion if the distribution imposes investor restrictions based on a required minimum level of net worth or net investment assets. This would not be affected by any suitability requirements that may be imposed under applicable local law. In addition, the final rule requires that, in connection with a public offering by a foreign public fund, the offering disclosure documents must be ''publicly available.'' This requirement will provide assurance regarding the transparency for such an offering and will generally be satisfied where the documents are made accessible to all persons in such jurisdiction. Disclosure documents may be made publicly available in a variety of means, such as through a public filing with a regulatory agency or through a Web site that provides broad accessibility to persons in such jurisdiction.

In addition and as discussed above, the final rule also places an additional condition on a U.S. banking entity's ability to rely on the foreign public fund exclusion with respect to the foreign public funds it sponsors. For a U.S. banking entity to rely on the foreign public fund exclusion with respect to a foreign public fund it sponsors, the ownership interests in the fund must be sold predominantly to persons other than the sponsoring U.S. banking entity

[1759] *See* ICI Global; ICI (Feb. 2012); SSgA (Feb. 2012); BNY Mellon *et al.*

[1760] *See* UBS; ICI Global; ICI (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); T. Rowe Price; HSBC Life; Union Asset; EFAMA; BVI; EBF; Hong Kong Inv. Funds Ass'n.; IMA; Ass'n. of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); Credit Suisse (Williams).

[1761] *See* T. Rowe Price; Credit Suisse (Williams); SSgA (Feb. 2012); BNY Mellon *et al.*

[1762] *See* T. Rowe Price.

[1763] *See* final rule § 75.10(c)(1).

[1764] Although the discussion of this condition generally refers to U.S. banking entities for ease of reading, the condition also applies to foreign affiliates of a U.S. banking entity. *See* final rule § 75.10(c)(1)(ii) (applying this limitation ''[w]ith respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor'').

[1765] *See* final rule § 75.10(c)(1)(iii).

and certain persons connected to that banking entity. Consistent with the Agencies' view concerning whether a foreign public fund has been sold predominantly outside of the United States, the Agencies generally expect that a foreign public fund will satisfy this additional condition if 85 percent or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity.

This additional condition reflects the Agencies' view that the foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of section 13 of the BHC Act, including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States. The exclusion is not intended to permit a U.S. banking entity to establish a foreign fund for the purpose of investing in the fund as a means of avoiding the restrictions imposed by section 13. Permitting a U.S. banking entity to invest in a foreign public fund under this exclusion only when that fund is sold predominantly to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity permits U.S. banking entities to continue their asset management businesses outside of the United States while also limiting the opportunity for evasion of section 13 as discussed below.

This additional condition only applies to U.S. banking entities with respect to the foreign public funds they sponsor because the Agencies believe that a foreign public fund sponsored by a U.S. banking entity may present heightened risks of evasion. Absent the additional condition, a U.S. banking entity could establish a foreign public fund for the purpose of itself investing substantially in that fund and, through the fund, making investments that the banking entity could not make directly under section 13. The Agencies believe it is less likely that a U.S. banking entity effectively could evade section 13 by investing in third-party foreign public funds that the banking entity does not sponsor. In those cases it is less likely that the U.S. banking entity would be able to control the investments of the fund, and the fund thus likely would be a less effective means for the banking entity to engage in proprietary trading through the fund. The Agencies therefore have declined to apply this additional condition with respect to *any* foreign public fund in which a U.S. banking entity invests but does not act as sponsor.

The Agencies note that the foreign public fund exclusion is not intended to permit a banking entity to sponsor a foreign fund for the purpose of selling ownership interests to any banking entity (affiliated or unaffiliated) that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State (or to a limited group of such banking entities). The Agencies intend to monitor banking entities' investments in foreign public funds to ensure that banking entities do not use the exclusion for foreign public funds in a manner that functions as an evasion of section 13 in this or any other way. The Agencies expect that one area of focus for such monitoring would be significant investments in a foreign public fund, including a fund that is unaffiliated with any banking entity located in or organized under the laws of the United States or of any State, where such investments represent a substantial percentage of the ownership interests in such fund.

In order to conduct this monitoring more effectively, the Agencies also are adopting certain documentation requirements concerning U.S. banking entities' investments in foreign public funds, as discussed in more detail below in Part VI.C.1 of this **SUPPLEMENTARY INFORMATION**. Under the final rule, a U.S. banking entity with more than $10 billion in total consolidated assets will be required to document its investments in foreign public funds, broken out by each foreign public fund and each foreign jurisdiction in which any foreign public fund is organized, if the U.S. banking entity and its affiliates' ownership interests in foreign public funds exceed $50 million at the end of two or more consecutive calendar quarters. This requirement thus is tailored to apply only to U.S. banking entities above a certain size that also have substantial investments in foreign public funds.[1766] The Agencies believe this approach appropriately balances the Agencies' evasion concerns and the burdens that documentation requirements impose.

For all of the reasons discussed above, the Agencies believe that the final rule's approach to foreign public funds is consistent with the final rule's exclusion of registered or otherwise exempt (without reliance on the exemptions in section 3(c)(1) or 3(c)(7)) funds in the United States. It also limits the extraterritorial application of section 13 of the BHC Act and reduces the potential economic and other burdens commenters argued would result for banking entities. The Agencies believe that this exclusion represents an appropriate balancing of considerations that should not significantly increase the risks to the U.S. financial system that section 13 was designed to limit.

2. Wholly-Owned Subsidiaries

Under the proposed rule, a banking entity would have been permitted to invest in or sponsor a wholly-owned subsidiary that relies on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company under that Act if the subsidiary was carried on the balance sheet of its parent and was engaged principally in performing *bona fide* liquidity management activities.[1767]

Commenters argued that, instead of providing a permitted activity exemption for banking entities to invest in or sponsor certain wholly-owned subsidiaries as proposed, all wholly-owned subsidiaries should be excluded from the definition of covered fund under the final rule because wholly-owned subsidiaries are typically used for organizational convenience and generally do not have the characteristics, risks, or purpose of a hedge fund or private equity fund, which involves unaffiliated investors owning interests in the structure for the purpose of sharing in the profits and losses from investment activities.[1768] Commenters explained that publicly traded companies often establish wholly-owned intermediate companies for the purpose of holding securities of operating entities or other corporate vehicles necessary to the business of the entity. Because these intermediate companies invest entirely (or substantially) in the securities of other entities, these intermediate companies may be investment companies for purposes of the Investment Company Act but for the exclusion provided by section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1769]

Commenters contended that requiring banking entities to divest their interests in wholly-owned subsidiaries and cease certain intercompany transactions would have a material adverse effect on the safety, soundness, efficiency and stability of the U.S. and global financial systems, which could in turn have a material adverse effect on the wider

[1766] *See* final rule § 75.20(e).

[1767] *See* proposed rule § 75.14(a)(2)(iv); Joint Proposal, 76 FR at 68913.

[1768] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012), JPMC; Goldman (Covered Funds), NAIB *et al.*; GE (Feb. 2012); BoA; Chamber (Feb. 2012); Wells Fargo (Covered Funds); ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); Credit Suisse (Williams); Rep. Himes; BOK.

[1769] *See* 15 U.S.C. 80a-3(a)(1)(A) & (C).

economy in terms of reduced credit, increased unemployment and reduced output.[1770] Commenters also argued that an exclusion for wholly-owned subsidiaries is necessary in order to avoid a conflict with other important requirements in the Dodd-Frank Act. For example, commenters alleged that including wholly-owned subsidiaries within the definition of covered fund for purposes of section 13 would create a conflict with the requirement that a banking entity that is a bank holding company serve as a source of strength to its subsidiaries because the prohibition in section 13(f) on transactions between a banking entity and covered funds owned or sponsored by the banking entity would effectively prohibit the banking entity from providing financial resources to wholly-owned intermediate holding companies and their subsidiaries.[1771] Other commenters argued that banking entities would bear extensive compliance costs and operational burdens and likely would be restricted from structuring themselves effectively.[1772]

Commenters proposed several alternatives to address these concerns. For instance, commenters recommended that the final rule exclude all wholly-owned subsidiaries from the definition of covered fund.[1773] Commenters also urged that the final rule include ownership interests held by employees of a banking entity with any ownership interests held directly by the banking entity for purposes of qualifying for any exclusion granted by the rule for wholly-owned subsidiaries.[1774] Another commenter recommended the exclusion of subsidiaries, wholly owned or not, that engage in *bona fide* liquidity management.[1775]

In light of these comments and consistent with the purposes of section 13 and the terms of the Dodd-Frank Act as discussed in more detail above, the Agencies have revised the final rule to exclude wholly-owned subsidiaries from the definition of covered fund, including those not engaged in liquidity management.[1776] A wholly-owned subsidiary, as defined in the final rule, is an entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that (i) up to five percent of the entity's ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity (or an affiliate thereof); and (ii) within the five percent ownership interests described in clause (i), up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.[1777]

Although the final rule includes ownership interests held by certain former directors and employees for purposes of qualifying for the exclusion, the exclusion requires that an interest held by a former (or current) director or employee must actually be held by that person (or by the banking entity) and must have been acquired while employed by or in the service of the banking entity. For example, if a former employee subsequently transfers his/her interest to a third party (other than to immediate family members of the employee or through intestacy of the employee), then the ownership interest would no longer be held by the banking entity or persons whose ownership interests may be aggregated with interests held by the banking entity for purposes of the exclusion for wholly-owned subsidiaries under the final rule.

The final rule also permits up to 0.5 percent of the ownership interest of a wholly-owned subsidiary to be held by a third party if the interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns, and the ownership interest is included when calculating the five percent cap on employee and director ownership. The Agencies understand that it is often important, or in certain circumstances required, under the laws of various jurisdictions for a parent company to establish corporate separation of a subsidiary through the issuance of a small amount of ownership interest to a third party.

The Agencies believe that permitting limited employee and director ownership of a vehicle and accommodating the foreign law requirements discussed above is consistent with a vehicle's treatment as a wholly-owned subsidiary. Under the final rule, the banking entity (or an affiliate thereof) will control the vehicle because it must, as principal, own at least 95% of the vehicle.[1778] These conditions are designed to exclude from the covered fund definition vehicles that are formed for corporate and organizational convenience, as discussed above, and that thus do not engage in the investment activities prohibited by section 13. The exclusion also should reduce the disruption to the operations of banking entities that commenters asserted would result from the proposed rule.[1779]

Importantly, the Agencies note that a wholly-owned subsidiary of a banking entity—although excluded from the definition of covered fund—still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of section 13 of the BHC Act and the final rule.[1780] Accordingly, a wholly-owned subsidiary of a banking entity would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading) and may not engage in activity in violation of the prohibitions of section 13 and the final rule.

3. Joint Ventures

The proposed rule would have permitted a banking entity to invest in or manage a joint venture between the banking entity and any other person,

[1770] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1771] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Rep. Himes.

[1772] *See, e.g.,* Goldman (Covered Funds); BoA.

[1773] *See* Rep. Himes; Fin. Services Roundtable (June 14, 2011); SIFMA *et al.* (Covered Funds) (Feb. 2012); BOK; Chamber (Feb. 2012); ABA (Keating); GE (Feb. 2012); Wells Fargo (Covered Funds); Goldman (Covered Funds); Ass'n. of Institutional Investors (Feb. 2012); BoA; NAIB *et al.*

[1774] *See* Wells Fargo (Covered Funds); Credit Suisse (Williams).

[1775] *See* Credit Suisse (Williams).

[1776] Although not a condition of the exclusion, banking entities may use wholly-owned subsidiaries to engage in *bona fide* liquidity management. As discussed below, however, a wholly-owned subsidiary is itself a banking entity, and thus is subject to all of the requirements that apply to banking entities, including the requirements applicable to a banking entity's liquidity management activities under § 75.3(d)(3).

[1777] *See* final rule § 75.10(c)(2).

[1778] *Cf.* Section 2(a)(43) of the Investment Company Act (defining a ''wholly-owned subsidiary'' of a person to mean ''a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person'').

[1779] The Agencies also note that depositors for asset-backed securities offerings are important to the process of securitization. *See, e.g.,* ASF (July 2012) (noting that a depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities). *See also,* Rule 191 under the Securities Act of 1933 (17 CFR 230.191) (depositor as issuer for registered asset-backed securities offerings). Commenters raised a question about the treatment of depositors under the Investment Company Act, and therefore, whether they would technically fall within the definition of covered fund. *See* ASF (July 2012); GE (Aug. 2012). For purposes of the covered fund prohibitions, the Agencies note that depositors may fall within the wholly-owned subsidiary exclusion from the covered fund definition.

[1780] *See* 12 U.S.C. 1851(h)(1) (defining banking entity to include any affiliate or subsidiary of a banking entity).

provided that the joint venture was an operating company and did not engage in any activity or any investment not permitted under the proposed rule. As noted in the proposal, many joint ventures rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1781] Joint ventures are a common form of business, especially for firms seeking to enter new lines of business or new markets, or seeking to share complementary business expertise.

Commenters supported this aspect of the proposal and argued that joint ventures do not share the same characteristics as a hedge fund or private equity fund. However, they expressed concern that joint ventures were defined too narrowly under the proposal because the exclusion was limited to joint ventures that were operating companies.[1782] Some commenters criticized the lack of guidance regarding the meaning of operating company.[1783] One commenter proposed defining operating company as any company engaged in activities that are permissible for a financial holding company under sections 3 or 4 of the BHC Act, other than a company engaged exclusively in investing in securities of other companies for resale or other disposition.[1784]

Another commenter argued that joint ventures are often used to share risk from non-performing loans, credit card receivables, consumer loans, commercial real estate loans or automobile loans.[1785] According to this commenter, these joint ventures, while not generally viewed as operating companies, promote safety and soundness by allowing a banking entity to limit the size of its exposure to permissible investments or to more efficiently transfer the risk of existing assets to a small number of partners. Commenters stated that banking entities often employ similar types of non-operating company joint ventures to engage in merchant banking activities or other permissible banking activities, and that the final rule should not prevent a banking entity from sharing the risk of a portfolio company investment with third parties.[1786] A number of commenters argued that treating joint ventures as covered funds would create the same inconsistencies with other provisions and principles embodied in the Dodd-Frank Act noted for wholly-owned subsidiaries, were they to be treated as covered funds.[1787] Several commenters argued that the proposed exemption, as drafted, was unworkable because it did not appear to provide an exception to the intercompany limitations on transactions under section 13(f), which prohibits transactions between a banking entity and a related covered fund.[1788]

Commenters proposed several alternatives to address these issues. Several commenters recommended that the final rule eliminate the operating company condition under the proposed exemption.[1789] Other commenters recommended excluding joint ventures that have an unspecified but limited number of partners (such as five or fewer joint venture partners).[1790] One commenter recommended excluding all ''controlled joint ventures'' but did not provide an explanation of how to define that term.[1791] Another commenter suggested defining a joint venture in one of the following ways: (1) Any company with a limited number of co-venturers that is managed pursuant to a shareholders' agreement, as opposed to managed by a general partner;[1792] or (2) a joint venture in which: (a) There are a limited number of unaffiliated partners; (b) the parties operate the venture on a joint basis or in proportion to their relative ownership, including pursuant to a shareholders' agreement; (c) material decisions are made by one party (for example, a general partner); and (d) the joint venture does not engage in any activity or investment not permitted under section 13, other than activities or investments incidental to its permissible business.[1793]

In response to commenter concerns, the final rule excludes joint ventures from the definition of covered fund with some modifications from the proposal to more clearly identify entities that are excluded. Under the final rule, a joint venture is excluded from the definition of covered fund if the joint venture is between the banking entity or any of its affiliates and no more than 10 unaffiliated co-venturers, is in the business of engaging in activities that are permissible for the banking entity other than investing in securities for resale or other disposition, and is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[1794] Banking entities, therefore, will continue to be able to share the risk and cost of financing their banking activities through these types of entities which, as noted by commenters as discussed above, may allow banking entities to more efficiently manage the risk of their operations.

The Agencies have specified a limit on the number of joint venture partners at the request of many commenters that suggested such a limit be added (though typically without suggesting the specific number of partners). The Agencies believe that a limit of 10 partners allows flexibility in structuring larger business ventures without involving such a large number of partners as to suggest the venture is in reality a hedge fund or private equity fund established for investment purposes. The Agencies will monitor joint ventures—and other excluded entities—to ensure that they are not used by banking entities to evade the provisions of section 13.

The final rule's requirement that a joint venture not be an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities prevents a banking entity from relying on this exclusion to evade section 13 of the BHC Act by owning or sponsoring what is or will become a covered fund. Consistent with this restriction and to prevent evasion of section 13, a banking entity may not use a joint venture to engage in merchant banking activities because that involves acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment.[1795]

As with wholly-owned subsidiaries, if a banking entity owns 25 percent or more of the voting securities of the joint venture or otherwise controls an entity

[1781] *See* Joint Proposal, 76 FR at 68913.

[1782] *See,, e.g.,* ABA (Keating); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Aug. 2012); Goldman (Covered Funds); NAIB *et al.;* Rep Himes; Sen. Bennet; *see also* 156 Cong Rec. H5226 (daily ed. June 30, 2010) (statement of Rep. Himes).

[1783] *See, e.g.,* ABA (Keating); NAIB *et al.;* GE (Aug. 2012); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); Wells Fargo (Covered Funds); Credit Suisse (Williams); Goldman (Covered Funds).

[1784] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1785] *See* Goldman (Covered Funds).

[1786] *See* ABA (Keating); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1787] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); Chamber (Feb. 2012).

[1788] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); GE (Feb. 2012); Chamber (Feb. 2012).

[1789] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); Credit Suisse (Williams).

[1790] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[1791] *See* Goldman (Covered Funds).

[1792] *See* ABA (Keating); Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); *see also* GE (Feb. 2012); NAIB *et al.*

[1793] *See* Goldman (Covered Funds).

[1794] *See* final rule § 75.10(c)(3).

[1795] *See* 12 U.S.C. 1843(k)(4)(H).

that qualifies for the joint venture exclusion, the joint venture would then itself be a banking entity and would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading).

The Agencies note that the statute defines banking entity to include not only insured depository institutions and bank holding companies, but also their affiliates. In the context of a company that owns an insured depository institution but is not a bank holding company or savings and loan holding company, the insured depository institution's affiliates may engage in commercial activities impermissible for banks and bank holding companies. However, section 13 of the BHC Act and the final rule do not authorize a banking entity to engage in otherwise impermissible activities. Because of this, the scope of activities in which a joint venture may engage under the final rule will depend on the status and identity of its co-venturers. For instance, a joint venture between a bank holding company and unaffiliated companies may not engage in commercial activities impermissible for a bank holding company.

4. Acquisition Vehicles

Similar to wholly-owned subsidiaries and joint ventures, the proposed rule would have permitted a banking entity to invest in or sponsor an acquisition vehicle provided that the sole purpose and effect of the acquisition vehicle was to effectuate a transaction involving the acquisition or merger of an entity with or into the banking entity or one of its affiliates. As noted in the proposal, banking entities often form corporate vehicles for the purpose of accomplishing a corporate merger or asset acquisition.[1796] Because of the way they are structured, acquisition vehicles may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1797]

Commenters supported the exclusion of acquisition vehicles from the restrictions governing covered funds, and argued that acquisition vehicles do not share the same characteristics as a hedge fund or private equity fund.[1798] However, similar to concerns articulated above with respect to wholly-owned subsidiaries and joint ventures, commenters argued that the proposed rule, as drafted, left uncertain how other provisions of section 13 would apply to these vehicles.[1799]

In light of the comments, the final rule has been modified to exclude acquisition vehicles from the definition of covered fund, rather than provide a permitted activity exemption for banking entities to invest in or sponsor the vehicles, so long as the vehicle is formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction and the vehicle exists only for such period as necessary to effectuate the transaction.[1800] The final rule thus reflects modifications from the exemption for acquisition vehicles in the proposal, which was available for acquisition vehicles where the sole purpose and effect of the entity was to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity.[1801] The Agencies modified the conditions in the final rule, as discussed above, to more clearly reflect the limited activities in which an excluded acquisition vehicle may engage and to exclude acquisition vehicles from the definition of covered fund, rather than only permit banking entities to invest in or sponsor them pursuant to an exemption.

The Agencies also note that an acquisition vehicle that survives a transaction would likely be excluded from the definition of covered fund under the separate exclusion for either joint ventures or wholly-owned subsidiaries described above. An acquisition vehicle that is controlled by a banking entity would be a banking entity itself and would be subject to the restrictions of section 13 and the final rule that apply to a banking entity.

5. Foreign Pension or Retirement Funds

Under the proposed rule, a foreign pension plan that relied on section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company (or that was a commodity pool), would have been a covered fund. Commenters argued that including pension funds within the definition of covered fund would produce many unexpected results for pension plans as well as plan participants.[1802]

Commenters generally argued that foreign pension or retirement funds are established by a foreign company or foreign sovereign for the purpose of providing a specific group of foreign persons with income during retirement or when they reach a certain age or meet certain predetermined criteria and are typically eligible for preferential tax treatment, and are not formed for the same purposes as hedge funds or private equity funds.[1803] Commenters argued that the definition of covered fund should not include certain foreign pension or retirement funds, including managed investment arrangements and wrap platforms, such as so-called ''superannuation funds,'' that are managed by foreign banks as part of providing retirement or pension schemes to foreign citizens pursuant to foreign law and are generally not available for sale to U.S. citizens. Commenters asserted that many foreign banking entities act as sponsor to and organize and offer foreign pension funds abroad as part of a foreign sovereign program to provide retirement, pension, or similar benefits to its citizens or workforce.[1804] These commenters contended that a foreign pension plan might itself rely on the exclusion in section 3(c)(1) or 3(c)(7) in order to avoid being an investment company if it is offered to citizens of the foreign sovereign present in the United States.[1805]

Several commenters argued that foreign pension and retirement plans should be excluded from the definition of covered fund on the same basis as U.S. pension and retirement funds that are ERISA-qualified funds that rely on the exclusion from the definition of investment company provided under section 3(c)(11) of the Investment Company Act.[1806] Commenters alleged that without an exclusion for foreign

[1796] *Cf.* Joint Proposal, 76 FR at 68897.

[1797] *See* Joint Proposal, 76 FR at 68913; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1798] *See, e.g.,* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Feb. 2012); Sen. Bennet; Sen. Carper *et al.*

[1799] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; GE (Feb. 2012).

[1800] *See* final rule § 75.10(c)(4).

[1801] The proposed rule contained an exemption for investments in acquisition vehicles, provided that the ''the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the covered banking entity or one of its affiliates.'' *See* proposed rule § 75.14(a)(2)(ii). The final rule excludes an acquisition vehicle, which is defined as an issuer that is ''[f]ormed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction'' and that ''exists only for such period as necessary to effectuate the transaction.'' *See* final rule § 75.10(c)(4).

[1802] As explained above, commenters also argued that a foreign pension plan should not be considered a banking entity if the plan is sponsored by a banking entity or is established for the benefit of employees of the banking entity. If deemed a banking entity, the pension plan could become subject to the limits on section 13 on investing in covered funds. *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; Credit Suisse (Williams). The final rule addresses these comments with the exclusions described above.

[1803] *See, e.g.,* Allen & Overy (on behalf of Canadian Banks).

[1804] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1805] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

[1806] *See* Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

pension or retirement funds, section 13 of the BHC Act would have an extra-territorial effect on pension or retirement benefits abroad that would be severe and beyond what was contemplated by section 13 of the BHC Act.

In light of comments received on the proposal, the final rule excludes from the definition of covered fund a plan, fund, or program providing pension, retirement, or similar benefits that is: (i) Organized and administered outside of the United States; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and (iii) established for the benefit of citizens or residents of one or more foreign sovereign or any political subdivision thereof.[1807] This is similar to the treatment provided to U.S. pension funds by virtue of the exclusion from the definition of investment company under the Investment Company Act for certain broad-based employee benefit plans provided by section 3(c)(11) of that Act. The exclusion from the covered fund definition for foreign plans would be available for *bona fide* plans established for the benefit of employees or citizens outside the U.S. even if some of the beneficiaries of the fund reside in the U.S. or subsequently become U.S. residents.

The Agencies believe this exclusion is appropriate in order to facilitate parallel treatment of domestic and foreign pension and retirement funds to the extent possible and to assist in ensuring that section 13 of the BHC Act does not apply to foreign pension, retirement, or similar benefits programs.[1808]

6. Insurance Company Separate Accounts

Under the proposed rule, insurance company separate accounts would have been covered funds to the extent that the separate accounts relied on section 3(c)(1) or 3(c)(7). Such reliance would generally occur in circumstances where policies funded by the separate account are distributed in an unregistered securities offering solely to qualified purchasers or on a limited basis to accredited investors. While the proposed rule did not generally exclude insurance company separate accounts from the definition of covered fund, the proposed rule did provide a limited exemption for investing in or acting as sponsor to separate accounts that were used for the purpose of allowing a banking entity to purchase bank owned life insurance (''BOLI''), subject to certain restrictions.[1809]

Various state or foreign laws allow regulated insurance companies to create separate accounts that are generally not separate legal entities but represent a segregated pool of assets on the balance sheet of the insurance company that support a specific policy claim on the insurance company. These accounts have assets and obligations that are separate from the general account of the insurance company. Insurance companies often utilize these separate accounts to allow policyholders of variable annuity and variable life insurance to allocate premium amounts for the purpose of engaging in various investment strategies that are tailored to the requirements of the individual policyholder. The policyholder, and not the insurance company, primarily benefits from the results of investments in the separate account. These separate accounts are generally investment companies for purposes of the Investment Company Act, unless an exclusion from that definition is applicable,[1810] and, as noted above, may rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

While most commenters supported the proposal's recognition that interests in BOLI separate accounts should be permitted, commenters generally argued that the final rule should also provide a broader exclusion from the definition of covered fund for all insurance company separate accounts. Commenters argued that covering separate accounts could lead to unintended consequences and was inconsistent with the statutory recognition that the business of insurance should continue to be accommodated.[1811] These commenters argued that covering separate accounts within the definition of covered fund would disrupt a substantial portion of customer-driven insurance or retirement planning activity and pose a burden on insurance companies and holders of insurance policies funded by separate accounts, a result commenters alleged Congress did not intend.[1812]

In response to commenter concerns and in order to more appropriately accommodate the business of insurance in a regulated insurance company, the final rule excludes an insurance company separate account from the definition of covered fund under certain circumstances. To prevent this exclusion from being used to evade the restrictions on investments and sponsorship of covered funds by a banking entity, the final rule provides that no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.[1813] In this manner, the final rule appropriately accommodates the business of insurance by permitting an insurance company that is a banking entity to continue to provide its customers with a variety of insurance products through separate account structures in accordance with applicable insurance laws while protecting against the use of separate accounts as a means by which banking entities might take a proprietary or beneficial interest in an account that engages in prohibited proprietary trading and thereby evade the requirements of section 13 of the BHC Act. The exclusion of insurance company separate accounts from the definition of covered fund therefore is designed to reduce the potential burden of the final rule on insurance companies and holders of insurance policies funded by separate accounts while also continuing to prohibit banking entities from taking ownership interests in, and sponsoring or having certain relationships with, entities that engage in investment and trading activities prohibited by section 13.

7. Bank Owned Life Insurance Separate Accounts

As explained above, bank owned life insurance (''BOLI'') is generally offered through a separate account held by an insurance company. In recognition of the fact that banking entities have for many years invested in life insurance policies that covered key employees, in accordance with supervisory policies established by the Federal banking agencies, the proposal contained a provision that would permit banking

[1807] *See* final rule § 75.10(c)(5).

[1808] Additionally and as discussed above, the prohibitions of section 13 and the final rule do not apply to an ownership interest that is acquired or retained by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of persons who are or were employees of the banking entity.

[1809] *See* proposed rule § 75.14(a)(1).

[1810] *See* In re The Prudential Ins. Co. of Am., 41 S.E.C. 335, 345 (1963), *aff'd,* The Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383 (3d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[1811] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* STANY.

[1812] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* STANY.

[1813] *See* final rule § 75.10(c)(6).

entities to invest in and sponsor BOLI separate accounts.[1814]

Many commenters supported the exemption in the proposal for BOLI separate accounts, arguing that permitting this kind of activity was appropriate and consistent with safety and soundness as well as financial stability.[1815] Conversely, one commenter objected to the proposed rule's exemption for investments in BOLI separate accounts, contending that such an exemption did not promote and protect the safety and soundness of banking entities or the financial stability of the United States.[1816]

After considering comments received on the proposal, the final rule excludes BOLI separate accounts from the definition of covered fund but maintains the substance of the conditions from the proposal designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that section 13 of the BHC Act was designed to address. In particular, in order for a separate account to qualify for the BOLI exclusion from the definition of covered fund, the final rule requires that the separate account be used solely for the purpose of allowing one or more banking entities (which by definition includes their affiliates) to purchase a life insurance policy for which such banking entity(ies) is a beneficiary.[1817] Additionally, if the banking entity is relying on this exclusion, the banking entity that purchases the insurance policy (i) must not control the investment decisions regarding the underlying assets or holdings of the separate account,[1818] and (ii) must participate in the profits and losses of the separate account in compliance with applicable supervisory guidance regarding BOLI.[1819]

When made in the normal course, investments by banking entities in BOLI separate accounts do not involve the types of speculative risks section 13 of the BHC Act was designed to address. Rather, these accounts permit the banking entity to effectively hedge and cover costs of providing benefits to employees through insurance policies related to key employees. Moreover, applying the prohibitions of section 13 to investments in these accounts would eliminate an investment that helps banking entities to efficiently reduce their costs of providing employee benefits, and therefore potentially introduce a burden to banking entities that would not further the statutory purpose of section 13. The Agencies expect this exclusion to be used by banking entities in a manner consistent with safety and soundness.

8. Exclusion for Loan Securitizations and Definition of Loan

a. Definition of Loan

The proposal defined the term ''loan'' for purposes of the restrictions on proprietary trading and the covered funds provisions and, as discussed in more detail below, provided an exemption for loan securitizations in two separate sections of the proposed rule. As proposed, loan was defined as ''any loan, lease, extension of credit, or secured or unsecured receivable.'' [1820] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security issued in connection with a loan securitization or otherwise backed by loans.

Some commenters requested that the Agencies narrow the proposed definition of ''loan.'' [1821] One of these commenters was concerned that the proposed definition could apply to any banking activity and argued that the definition of loan for purposes of the final rule should not include securities.[1822] Another commenter, citing a statement made by Senator Merkley, asserted that Congress did not intend the rule of construction for the sale and securitization of loans in section 13(g)(2) to include ''loans that become financial instruments traded to capture the change in their market value.'' [1823]

Other commenters requested that the Agencies expand the proposed definition of ''loan'' to capture many traditional extensions of credit that the proposal would otherwise exclude.[1824] Examples of traditional credit extensions that commenters requested be specifically included within the definition of ''loan'' included loan participations,[1825] variable funding notes or certificates,[1826] note purchase facilities,[1827] certain forms of revolving credit lines,[1828] corporate bonds,[1829] municipal securities,[1830] securities lending agreements and reverse repurchase agreements,[1831] auto lease securitizations,[1832] and any other type of credit extension that banking entities traditionally have been permitted to issue under their lending authority.[1833]

The definition of ''loan'' in the final rule applies both in the context of the

[1814] *See* proposed rule § 75.14(a)(1).

[1815] *See* ACLI (Jan. 2012); Mass. Mutual; Jones of Northwestern; AALU; BBVA; BoA; Chris Barnard; Clark Consulting (Feb. 7, 2012); Clark Consulting (Feb. 13, 2012); Gagnon of GW Financial.

[1816] *See* Occupy.

[1817] *See* final rule § 75.10(c)(7).

[1818] This requirement is not intended to preclude a banking entity from purchasing a life insurance policy from an affiliated insurance company.

[1819] *See, e.g.,* Bank Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance (Dec. 7, 2004).

[1820] *See* proposed rule § 75.2(q).

[1821] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1822] *See* Public Citizen. This commenter argued that the loan definition should be limited to the plain meaning of the term ''loan'' and noted that a loan is not a security. *Id.*

[1823] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1824] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); Goldman (Covered Funds); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One individual commenter supported the proposed definition of loan. *See* Alfred Brock. For example, one commenter requested that definition of ''loan'' be revised to include ''(i) any loan, lease (including any lease residual), extension [of] credit, or secured or unsecured receivables, (ii) any note, bond or security collateralized and payable from pools of loans, leases (including Lease residuals), extensions of credit or secured or unsecured receivables, and (iii) any contractual rights arising from, or security interests or liens, assets, property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the foregoing.'' *See* RBC. Another commenter requested that the definition of ''loan'' be revised to include ''any type of credit extension (including bonds, other [banking entity-eligible] debt securities, asset-backed securities [as defined in their letter], variable funding notes and securities lending agreements, repurchase agreements, reverse repurchase agreements and other similar extensions of credit) that a banking entity could hold or deal in.'' *See* SIFMA (Securitization) (Feb. 2012).

[1825] *See* JPMC.

[1826] *See* ASF (Feb. 2012); Credit Suisse (Williams); JPMC (arguing that such notes operate in economic substance as loans); SIFMA (Securitization) (Feb. 2012).

[1827] *See* ASF (Feb. 2012). This commenter asserted that a note purchase facility is negotiated by the asset-backed commercial paper conduit and allows the asset-backed commercial paper conduit to purchase asset-backed securities issued by an intermediate special purpose vehicle and backed by loans or asset-backed securities backed by loans. *Id.*

[1828] *See* ASF (Feb. 2012).

[1829] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); JPMC.

[1830] *See* ASF (Feb. 2012). This commenter argued that certain municipal securities may be ABS, including revenue bonds that involve the issuance of senior and subordinate bonds. *Id.*

[1831] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1832] *See* SIFMA (Securitization) (Feb. 2012). This commenter contended that because securitization transactions have been viewed by the Agencies and courts as 'legally transparent' (*i.e.,* as simply another way for banking entities to buy and sell the loans or other assets underlying such securities), auto lease securitizations supported by a beneficial interest in a titling trust should be treated as securitizations of the underlying auto leases and should fall within the loan securitization exemption. This commenter also argued that if the definition of ''loan'' is not expanded to include securities, then banking entities could not act as sponsors for auto lease securitizations (including resecuritizations) supported by a beneficial interest in a titling trust.

[1833] *See* Credit Suisse (Williams); Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

proprietary trading restrictions as well as in determining the scope of the exclusion of loan securitizations and asset-backed commercial paper conduits from the definition of covered fund. The final rule modifies the proposed definition and defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1834] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1835] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading.

The definition of loan in the final rule excludes loans that are securities or derivatives, including securities or derivatives of or based on such instruments. The definition of ''loan'' does not specify the type, nature or structure of loans included within the definition, other than by excluding securities and derivatives. In addition, the definition of loan does not limit the scope of parties that may be lenders or borrowers for purposes of the definition. The Agencies note that the parties' characterization of an instrument as a loan is not dispositive of its treatment under the Federal securities laws or Federal laws applicable to derivatives. The determination of whether a loan is a security or a derivative for purposes of the loan definition is based on the Federal securities laws and the Commodity Exchange Act. Whether a loan is a ''note'' or ''evidence of indebtedness'' and therefore a security under the Federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan.[1836] For example, loans that are structured to provide payments or returns based on, or tied to, the performance of an asset, index or commodity or provide synthetic exposure to the credit of an underlying borrower or an underlying security or index may be securities or derivatives depending on their terms and the circumstances of their creation, use, and distribution.[1837] Regardless of whether a party characterizes the instrument as a loan, these kinds of instruments, which may be called ''structured loans,'' must be evaluated based on the standards associated with evaluating derivatives and securities in order to prevent evasion of the restrictions on proprietary trading and ownership interests in covered funds.

b. Loan Securitizations

An exemption for loan securitizations was contained in two separate sections of the proposed rule. The first, in section 75.13(a), was proposed as part of ''other permitted covered fund activities and investments.'' The second, in § 75.14(d), was proposed as part of ''covered fund activities determined to be permissible.'' These proposed provisions would have acted in concert to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a loan securitization regardless of the relationship that the banking entity had with the securitization. The Agencies have evaluated all comments received on securitizations. These sections of the proposed rule were intended to implement the rule of construction contained in section 13(g)(2) of the BHC Act which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise permitted by law.[1838] The language of the proposed exemption for loan securitizations would have permitted a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which were solely comprised of: (i) Loans (as defined); (ii) rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or rights or assets and (B) are used for hedging purposes with respect to the securitization structure.[1839] The proposed rule in § 75.13(d) was further augmented by the proposed rule in § 75.14(a)(2) so that a banking entity would be permitted to purchase loan securitizations and engage in the sale and securitization of loans. This was accomplished through the authorization in proposed section 75.14(a)(2) of a banking entity's acquisition or retention of an ownership interest in such securitization vehicles that the banking entity did not organize and offer, or for which it did not act as sponsor, provided that the assets or holdings of such vehicles were solely comprised of the instruments or obligations identified in the proposed exemption.

The proposed rules would have allowed a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in certain securitization vehicles (which could be a covered fund for purposes of the proposed rules) that the banking entity organized and offered, or acted as sponsor to, without being subject to the ownership and sponsor limitations contained in the proposed rule.[1840] As noted in the proposing release, the Agencies recognized that by defining ''covered fund'' broadly, and, in particular, by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act, securitization vehicles may be affected by the restrictions and requirements of the proposed rule. The Agencies attempted to mitigate the potential adverse impact on the securitization market by excluding loan securitizations from the restrictions on sponsoring or acquiring and retaining ownership interests in covered funds, consistent with the rule of construction contained in section 13(g)(2) of the BHC Act.[1841] As a result, under the proposal, loan securitizations would not be limited or restricted because banking entities would be able to find investors or buyers for their loans or loan securitizations. The proposing release included several requests for comment on the proposed loan securitization exemption and the application of the covered fund prohibitions to securitizations.

Some commenters supported a narrow exemption for loan securitizations and in some cases suggested that the proposed exemption could be narrowed even further. For example, one commenter argued that the definition of ''loan'' for purposes of the exemption could include any extension of credit and any banking activity.[1842] Also, in response to the

[1834] *See* final rule § 75.2(s).

[1835] 12 U.S.C. 1851(h)(4).

[1836] *See* 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10); Reves v. Ernst & Young, 494 U.S. 56 (1990) ; Trust Company of Louisiana v. N.N.P. Inc., 104 F.3d 1478 (5th Cir. 1997); Pollack v. Laidlaw Holdings, 27 F.3d 808 (2d Cir. 1994); *but see* Marine Bank v. Weaver, 455 U.S. 551 (1982); Banco Espanol de Credito v. Security Pacific National Bank, 973 F.2d 51 (2d Cir. 1992); Bass v. Janney Montgomery Scott, Inc., 210 F.3d 577 (6th Cir. 2000); Piaubert v. Sefrioui, 2000 WL 194140 (9th Cir. 2000).

[1837] *Id.*

[1838] *See* 12 U.S.C. 1851(g)(2).

[1839] *See* proposed rule § 75.13(d); Joint Proposal, 76 FR at 68912.

[1840] *Id.*

[1841] *See* Joint Proposal, 76 FR at 68931.

[1842] *See, e.g.,* Public Citizen. This commenter argued that any exemption should prevent evasion, should ensure that each exempted securitization reduces risk and should be designed to only serve client needs. A different commenter recommended a safe harbor available only to a particular pre-specified, transparent and standardized securitization structure, where Agencies would need to justify why the specified structure protects

Continued

proposing release,[1843] some commenters suggested that any exemption for securitizations should seek to prevent evasion of the covered fund prohibitions by issuers with ''hedge-fund or private equity fund-like characteristics'' or issuers with ''hidden proprietary trading operations.'' [1844]

On the other hand, many commenters believed that the proposed exemption from the covered fund prohibitions for loan securitizations should be expanded to cover securitizations generally and not just loan securitizations. These commenters provided various arguments for their request to exempt all securitizations from the covered fund prohibitions, including that the regulation of securitizations was addressed in other areas of the Dodd-Frank Act,[1845] that securitization is essentially a lending activity,[1846] and that securitizations have ''long been recognized as permissible activities for banking entities.'' [1847]

Commenters recommending a broader exclusion for securitizations also provided a wide variety of specific suggestions or concerns. Some commenters suggested that permissible assets for a loan securitization include assets other than loans acquired in the course of collecting a debt previously contracted, restructuring a loan, during a loan work out or during the disposition of a loan or other similar situation.[1848] Commenters noted that, for example, rules 2a–7 and 3a–7 under the Investment Company Act define eligible assets for a securitization as not only including financial assets but also ''any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.'' [1849] Commenters requested that various additional rights or assets be added to the list of permissible assets held by a loan securitization such as cash and cash accounts,[1850] cash equivalents,[1851] and various other high quality short term investments, liquidity agreements or credit enhancements, certain beneficial interests in titling trusts used in lease securitizations or lease residuals.[1852] One commenter suggested that a loan securitization be permitted to include ''any contractual rights arising from or supporting obligations underlying or relating to the loans.'' [1853]

Others requested that loan securitizations also be permitted to hold repurchase agreements or unlimited amounts of various forms of securities, including municipal securities, asset-backed securities, credit-linked notes, trust certificates and ''equity like-rights.'' [1854] Some commenters requested that loan securitizations be permitted to hold a limited amount of certain rights such as securities.[1855] Commenters also had suggestions about the types of derivatives that an exempted securitization vehicle be permitted to hold.[1856] For example, one industry association requested that the loan securitization exemption include securitizations where up to 10 percent of the assets are held in the form of synthetic risk exposure that references ''loans that could otherwise be held directly'' under the proposal in order to achieve risk diversification.[1857] This commenter stated its belief that the rule of construction requires that synthetic exposures be permitted because they are used in certain types of loan securitizations.

In addition to requests that specific types of underlying assets be permitted under the loan securitization exemption, the Agencies also received comments about specific types of asset classes or structures. Some commenters suggested certain asset classes or structures should be an excluded securitization from the covered fund prohibitions including insurance-linked securities, collateralized loan obligations, tender option bonds, asset-backed commercial paper conduits (ABCP conduits), resecuritizations of asset-backed securities, and corporate debt re-packagings.[1858] In some cases, commenters believed that the Agencies should use their authority under section 13(d)(1)(J) of the BHC Act to exempt these types of vehicles. Some commenters identified other vehicles such as credit funds and issuers of covered bonds that they believed should be excluded from the covered fund

against the systemic risks associated with securitization. *See* AFR (Nov. 2012).

[1843] *See* Request for Comment No. 231 in the Proposing Release (noting that many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (*e.g.,* CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities) and requesting comment on how to prevent hedge funds or private equity funds from structuring around an exemption for asset-backed securities from the covered fund prohibitions).

[1844] *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. *But see* Credit Suisse (Williams) (arguing it would be difficult to use the typical structure and operation of securitizations to avoid the prohibition on proprietary trading because the structures are not set up to engage in the kind of proprietary trading about which Congress was concerned).

[1845] *See* AFME *et al.*; Ass'n. of German Banks; Cleary Glottlieb; Credit Suisse (Williams); GE (Feb. 2012); IIB/EBF; RBC; SIFMA (Securitization) (Feb. 2012).

[1846] *See, e.g.,* Credit Suisse (Williams).

[1847] *See* Credit Suisse (Williams); JPMC. These commenters cited the sponsoring of asset-backed commercial paper conduits as an example of permissible bank securitization activity.

[1848] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); JPMC.

[1849] *See* GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012).

[1850] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams) (including cash that did not arise directly from the underlying loans); JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012).

[1851] *See* Cleary Gottlieb; Credit Suisse (Williams).

[1852] *See* JPMC (requesting high quality, highly liquid investments, including Treasury securities and highly rated commercial paper); LSTA (Feb. 2012); LSTA (July 2012) (requesting short-term highly liquid investments such as obligations backed by the full faith and credit of the United States, deposits insured by the Federal Deposit Insurance Corporation, various obligations of U.S. financial institutions and investments in money market funds); ASF (Feb. 2012); Commercial Real Estate Fin. Council; RBC (requesting short-term, high quality investments); Allen & Overy (on behalf of Foreign Bank Group) (requesting short-term eligible investments); Credit Suisse (Williams) (requesting government guaranteed securities, money market funds and other highly credit-worthy and liquid investments); Cleary Gottlieb (requesting money-market interests; SIFMA (Securitization) (Feb. 2012) (requesting associated investments which are customarily employed in securitization transactions). One commenter further noted that such investments are required by securitization documents. *See* Commercial Real Estate Fin. Council.

[1853] RBC. This commenter argued that the loan securitization exemptions as proposed would not permit ''traditional securitizations and securitizations with the characteristics of traditional securitizations'' and ''would effectively eliminate a substantial portion of the very securitization activities carried on by banks that the [loan securitization exemptions] are designed to preserve.''

[1854] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1855] *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; LSTA (Feb. 2012). LSTA (Feb. 2012) specifically requested that entities issuing collateralized loan obligations that are primarily backed by loans or loan participations also be permitted to hold a limited amount of corporate credit obligations. This commenter provided recommendations about such limitations—if the amount of such corporate credit obligations exceeded 10 percent, a CLO would not be able to purchase any assets other than senior, secured syndicated loans and temporary investments (as defined in the letter). If the amount of such assets exceeded 30 percent, the entity should not be able to purchase any assets other than loans.

[1856] *See* AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1857] *See* ASF (Feb. 2012). Permissible synthetic exposure would include ''credit default swaps, total return swaps or other agreements referencing corporate loans or corporate bonds pursuant to which the issuer is the seller of credit protection or otherwise 'long' the credit exposure of the reference corporate loan or bond, and receives a yield derived from the yield on the reference corporate loan or bond.''

[1858] *See* AFME *et al.*; ASF (July 2012); GE (Aug. 2012); Capital Group; Goldman (Covered Funds); LSTA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

prohibitions.[1859] On the other hand, the Agencies also received comment letters that argued that certain securitizations should not be exempted from the covered fund prohibitions, including resecuritizations, CDO-squared, and CDO-cubed securitizations because of concern about their complexity and lack of reliable performance data or ability to value those securities.[1860]

Because a loan securitization could still be a covered fund, several commenters expressed concern that the proposed loan securitization exemption, as drafted, did not exempt loan securitizations from the prohibitions of section 13(f) of the BHC Act. As a result, one commenter noted that the proposed loan securitization exemptions would not have their intended result of excluding loan securitizations from the BHC Act restrictions applicable to covered funds.[1861]

Certain securitization transactions may involve the issuance of an intermediate asset-backed security that supports the asset-backed securities that are issued to investors, such as in auto lease securitizations and ABCP conduits. Commenters suggested that the Agencies should look through intermediate securitizations to the assets that support the intermediate asset-backed security to determine if those assets would satisfy the definition of ''loan'' for purposes of the loan securitization exemption. If those assets are loans, these commenters suggested that the entire securitization transaction should be deemed a loan securitization, even if the assets supporting the asset-backed securities issued to investors are not loans.[1862] However, some commenters argued that each step in a multi-step securitization should be viewed separately to ensure compliance with the specific restrictions in the proposal because otherwise a multi-step securitization could include impermissible assets.[1863] Some commenters also raised question about whether depositors would fall within the definition of ''investment company'' under the Investment Company Act and, therefore, may fall within the proposed definition of covered fund.[1864]

After considering carefully the comments received on sections of the proposed rule, the Agencies have determined to adopt a single section in the final provision relating to loan securitizations that would exclude loan securitizations that meet certain criteria contained in the rule from the definition of covered fund. The rule, as adopted, takes into account comments received on each of the conditions specified in the two loan securitization sections of the proposed provisions and has adopted those conditions with some clarifying changes from the proposed language. In addition, in response to comments, as discussed more fully below, the Agencies are adopting additional exclusions from the definition of covered fund for certain types of vehicles if they are backed by the same types of assets as the assets that are permitted to be held in the loan securitization exclusion. These additional exclusions are tailored to vehicles that are very similar to loan securitizations but have particular structural issues, which are described in more detail below.

In light of the comments received on the proposal, the final rule was revised to exclude from the definition of covered fund an issuing entity of asset-backed securities, as defined in Section 3(a)(79) of the Exchange Act,[1865] if the underlying assets or holdings are comprised solely of: (A) loans, (B) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans, (C) certain interest rate or foreign exchange derivatives, and (D) certain special units of beneficial interests and collateral certificates (together, ''loan securitizations'').[1866] In addition, as discussed below, the Agencies are adopting specific exclusions for certain vehicles that issue short term asset-backed securities and for pools of assets that are part of covered bond transactions which pools also meet the conditions delineated above.[1867]

Although commenters argued that various types of assets should be included within the definition of loan or otherwise permitted to be held under the loan securitization exclusion, the loan securitization exclusion in the final rule has not been expanded to be a broad exclusion for all securitization vehicles. Although one commenter suggested that any securitization is essentially a lending activity,[1868] the Agencies believe such an expansion of the exclusion would not be consistent with the rule of construction in section 13(g)(2) of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' The Agencies believe that a broad definition of loan and therefore a broad exemption for transactions that are structured as securitizations of pooled financial assets could undermine the restrictions Congress intended to impose on banking entities' covered fund activities, which could enable market participants to use securitization structures to engage in activities that otherwise are constrained for covered funds. The Agencies believe the purpose underlying section 13 is not to expand the scope of assets in an excluded loan securitization beyond loans as defined in the final rule and the other assets that the Agencies are specifically permitting in a loan securitization.

[1859] *See* Goldman (Covered Funds) (requesting exclusion for credit funds). AFME *et al.* (requesting exclusion for covered bonds); FSA (Apr. 2012) (requesting exclusion for covered bonds); UKRCBC (requesting exclusion for covered bonds).

[1860] *See* Sens. Merkley & Levin (Feb. 2012). These commenters argued that there should be increased capital charges in line with the complexity of a securitization and using the ''high risk asset limitations on permitted activities to bar any securitization by a bank from using complex structures, re-securitization techniques, synthetic features, or other elements that may increase risk or make a risk analysis less reliable.''

[1861] *See* AFME *et al.*; SIFMA (May 2012) (arguing that because of the narrowness of the proposed exemption and because it would not exempt securitizations from prohibitions on covered transactions imposed by section 13(f), the rule as proposed ''will effectively prevent banking entities from sponsoring and owning a large variety of asset-backed securities, in contravention of the rule of construction.'')

[1862] *See* AFME *et al.*; ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1863] *See* Occupy; Public Citizen. Occupy contended that the structured security issued in a multi-step securitization can hide underlying risks under layers of structured complexity. *See* Occupy. Public Citizen argued that prohibiting such activity would ensure that securitizations do not become proprietary trading vehicles for banking entities that are effectively off-balance sheet. *See* Public Citizen. *See infra* Part VI.B.1.c.8.b.iv. of this **SUPPLEMENTARY INFORMATION**.

[1864] A depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities. *See* ASF (July 2012); GE (Aug. 2012). For purposes of this rule, the Agencies believe the wholly owned subsidiary exclusion is available for depositors. *See supra* note 1779.

[1865] 15 U.S.C. 78c(a)(79). This definition was added by Section 941 of the Dodd-Frank Act.

[1866] *See* final rule § 75.10(c)(8). Consistent with the proposal, certain securitizations, regardless of asset composition, would not be considered covered funds because the securitization issuer is deemed not to be an investment company under Investment Company Act exclusions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act. For example, this would include issuers that meet the requirements of section 3(c)(5) or rule 3a–7 of the Investment Company Act, and the asset-backed securities of such issuers may be offered in transactions registered under the Securities Act.

[1867] As discussed below, the Agencies are adopting an exclusion from the definition of covered funds for the pools of assets that are involved in the covered bond financings. Although the cover pools must satisfy the same criteria as the excluded loan securitizations, a separate exclusion is needed because the securities involved in the covered bond issuance are not asset-backed securities.

[1868] *See, e.g.,* Credit Suisse (Williams).

While not expanding the permitted assets under the loan securitization exclusion, the Agencies have made modifications in response to commenters to ensure that the provisions of the final rule appropriately accommodate the need, in administering a loan securitization transaction on an ongoing basis, to hold various assets other than the loans that support the asset-backed securities. Moreover, the Agencies do not believe that the assets permitted under the loan securitization need to be narrowed further to prevent evasion and hidden proprietary trading as requested by certain commenters because the Agencies believe that the potential for evasion has been adequately addressed through modifications to the definition of loan and more specific limitations on the types of securities and derivatives permitted in an excluded loan securitization. The Agencies have revised the scope of the loan securitization exclusion to accommodate existing market practice for securitizations as discussed by commenters while limiting the availability of the exclusion for these particular types of securitization transactions to issuers of asset-backed securities supported by loans.

The Agencies are not adopting specific exclusions for other securitization vehicles identified by commenters, including insurance-linked securities, collateralized loan obligations, and corporate debt re-packagings.[1869] The Agencies believe that providing such exclusions would not be consistent with the rule of construction in section 13(g)(2) of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' These other types of securitization vehicles referenced by commenters are used to securitize exposures to instruments which are not included in the definition of loan as adopted by the final rule. Moreover, the Agencies note in response to commenters that resecuritizations of asset-backed securities and CDO-squared and CDO-cubed securitizations could be used as a means of evading the prohibition on the investment in the ownership interests of covered funds.

As with the proposed rules, the Agencies are excluding certain loan securitizations from the definition of covered fund and therefore the prohibitions applicable to banking entities' involvement in covered funds in order to implement Congressional intent expressed in the rule of construction in section 13(g)(2) of the BHC Act.[1870] The Agencies believe that, as reflected in the rule of construction, the continued ability of banking entities to participate in loan securitizations is important to enable banks of all sizes to be able to continue to provide financing to loan borrowers at competitive prices. Loan securitizations provide an important avenue for banking entities to obtain investor financing for existing loans, which allows such banks greater capacity to continuously provide financing and lending to their customers. The Agencies also believe that loan securitizations that meet the conditions of the rule as adopted do not raise the same types of concerns as other types of securitization vehicles that could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act.

Under the rule as adopted, loan securitizations that meet the conditions of the rule as adopted are excluded from the definition of covered fund and, consequently, banking entities are not restricted as to their ownership of such entities or their ongoing relationships with such entities by the final rule. As the Agencies stated in the proposal, permitting banking entities to acquire or retain an ownership interest in these loan securitizations will allow for a deeper and richer pool of potential participants and a more liquid market for the sale of such securitizations, which in turn should result in the continued availability of funding to individuals and small businesses, as well as provide an efficient allocation of capital and sharing of risk. The Agencies believe that excluding these loan securitizations from the definition of covered fund is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction regarding loan securitizations.[1871]

i. Loans

The first condition of the loan securitization exclusion from the definition of covered fund is that the underlying assets or holdings are comprised of loans. In the proposal, ''loan'' was a defined term for purposes of the restrictions on proprietary trading and the covered funds provisions. As proposed, a loan was defined as a loan, lease, extension of credit, or secured or unsecured receivable.[1872] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans.

As discussed above under ''Definition of Loan,'' the Agencies received comments regarding the loan definition in the securitization context. In particular, one commenter, citing a statement made by Senator Merkley, argued that Congress did not intend the loan securitization exemption to include ''loans that become financial instruments traded to capture the change in their market value.'' [1873]

The Agencies, after considering carefully the comments received, have adopted a definition of loan that is revised from the proposed definition. The final rule defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1874] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1875] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading. Further, for purposes of the loan securitization exclusion, the loan securitization must own the loan directly; a synthetic exposure to a loan, such as through holding a derivative, such as a credit default swap, will not satisfy the conditions for the loan securitization exclusion.[1876] As such, a securitization that owns a tranche of another loan securitization is not itself a loan securitization, even if the ownership of such tranche by a banking entity would otherwise be permissible under the final rule.

As discussed above under ''Definition of Loan,'' the definition of loan in the final rule has not been expanded as requested by some commenters but has

[1869] Commenters' concerns regarding credit funds are discussed below in Part VI.B.1.d.6. of this **SUPPLEMENTARY INFORMATION**.

[1870] As discussed below, the Agencies are excluding those loan securitizations that hold only loans (and certain other assets identified in the final rule), consistent with the rule of construction in section 13(g)(2) of the BHC Act.

[1871] The Agencies note that the loan securitization and other securitization exclusions apply only to the definition of covered fund, and therefore the covered fund-related provisions of the rule, and not to its prohibition on proprietary trading. The Agencies recognize that trading in loans is not subject to the proprietary trading restrictions.

[1872] *See* proposed rule § 75.2(q).

[1873] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1874] *See* § 75.2(r).

[1875] 12 U.S.C. 1851(h)(4).

[1876] Under the final provision, the issuing entity for the SUBIs and collateral certificate may rely on the loan securitization exclusion because of the separate provisions allowing such a holding.

been clarified in some respects in response to comments. The final rule explicitly excludes securities or derivatives.[1877] In addition, the definition of loan has not been modified to include repurchase agreements or reverse repurchase agreements regardless of the character of the underlying asset. The Agencies are concerned that parties, under the guise of a ''loan'' might instead create instruments that provide the same exposures to securities and derivatives that otherwise are prohibited by section 13 and might attempt to use the loan securitization exclusion to acquire ownership interests in covered funds holding those types of instruments, counter to the terms and the purpose of section 13 of the BHC Act. As the Agencies have noted previously, the rules relating to covered funds and to proprietary trading are not intended to interfere with traditional lending practices or with securitizations of loans generated as a result of such activities. Although the Agencies have revised the definition of loan in response to commenters' concerns as discussed above, the Agencies are not adopting a separate definition of loan for securitization transactions as requested by commenters. The Agencies believe that the definition of loan adopted in the final rule appropriately encompasses the financial instruments that result from lending money to customers.

ii. Contractual Rights or Assets

Under the proposed loan securitization definition, a covered fund that is an issuer of asset-backed securities would have been permitted to hold contractual rights or assets directly arising from those loans supporting the asset-backed securities.[1878] The proposal did not identify or describe such contractual rights or assets.

Commenters requested that the Agencies expand the list of contractual rights and assets that an issuer of asset-backed securities would be permitted to hold under the proposed loan securitization exemption.[1879] Examples of the additional rights and assets requested by commenters include cash and cash accounts;[1880] cash equivalents;[1881] liquidity agreements, including asset purchase agreements, program support facilities and support commitments;[1882] credit enhancements:[1883] asset-backed securities;[1884] municipal securities;[1885] repurchase agreements;[1886] credit-linked notes;[1887] trust certificates;[1888] lease residuals;[1889] debt securities;[1890] and derivatives.[1891] As an alternative, commenters requested that an issuer of asset-backed securities be permitted to hold under the proposed loan securitization exemption certain of such additional rights and/or assets up to a threshold, such as a specified

[1877] The determination of whether an instrument falls outside the definition of loan because it is a security or a derivative is based on the Federal securities laws and the Commodity Exchange Act. Whether a loan, lease, extension of credit, or secured or unsecured receivable is a note or evidence of indebtedness that is defined as a security under the Federal securities laws will depend on the particular facts and circumstances, including the economic terms of the transaction. *See supra* note 1836 and accompanying text.

[1878] *See* proposed rule § 75.13(d).

[1879] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Vanguard.

[1880] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams).

[1881] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of cash equivalents: government guaranteed securities, money market funds, and ''other highly credit-worthy and liquid investments'' (Credit Suisse (Williams)); and high quality, highly liquid investments, including Treasury securities and highly rated commercial paper (JPMC). In addition, LSTA (Feb. 2012) requested inclusion of the following: (i) short-term highly liquid investments; (ii) direct obligations of, and obligations fully guaranteed as to full and timely payment by, the United States (or by any agency thereof to the extent such obligations are backed by the full faith and credit of the United States); (iii) demand deposits, time deposits or certificates of deposit that are fully insured by the Federal Deposit Insurance Corporation; (iv) corporate, non-extendable commercial paper; (v) notes that are payable on demand or bankers' acceptances issued by regulated U.S. financial institutions; (vi) investments in money market funds or other regulated investment companies; time deposits having maturities of not more than 90 days; (vii) repurchase obligations with respect to direct obligations and guaranteed obligations of the U.S. entered into with a regulated U.S. financial institution; and (viii) other investments with a maturity one year or less, with the requirement that each of the investments listed have, at the time of the securitization's investment or contractual commitment to invest therein, a rating of the highest required investment category.

[1882] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012).

[1883] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012). For example, SIFMA (Securitization) (Feb. 2012) requested inclusion of third party credit enhancements such as guarantees and letters of credit. Commenters requested inclusion of the following examples of credit enhancements: (i) external credit support of borrower obligations under such loans, including a credit support facilities, third party or parent guarantee, insurance policy, letter of credit or other contractual commitment to make payments or perform other obligations of the borrower under the loans (ASF (Feb. 2012)); and (ii) property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the loans (RBC).

[1884] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of asset-backed securities: (i) SUBI certificates (beneficial interests in titling trusts typically used in lease securitizations) (AFME *et al.;* ASF (Feb. 2012); GE (Aug. 2012); SIFMA (Securitization) (Feb. 2012)); (ii) ownership interests and bonds issued by CLOs (JPMC); a broad array of receivables that support asset-backed commercial paper (ICI (Feb. 2012)); certain notes, certificates or other instruments backed by loans or financial assets that are negotiated by the purchasing asset-backed commercial paper conduit (ASF (Feb. 2012); GE (Feb. 2012)); municipal securities that are technically ABS, including revenue bonds that involve the issuance of senior and subordinate bonds (ASF (Feb. 2012)); ownership interests in credit funds (as defined in their letter) (SIFMA *et al.* (Covered Funds) (Feb. 2012)); any note, bond or security collateralized and payable from pools of loans, leases (including lease residuals), extensions of credit or secured or unsecured receivables (RBC); asset-backed securities issued by intermediate vehicles in a securitization collateralized predominantly by loans and financial assets, and other similar instruments (Credit Suisse (Williams)); and asset-backed securities backed by loans or receivables that are originated by or owned by the sponsor of such securitization or which are issued by an entity that is organized under the direction of the same sponsor as the issuer of the covered fund (ASF (Feb. 2012)).

[1885] *See* ICI (Feb. 2012); Vanguard.

[1886] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1887] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1888] *See* Credit Suisse (Williams).

[1889] *See* ASF (Feb. 2012); GE (Feb. 2012); GE (Aug. 2012); RBC.

[1890] *See* GE (Aug. 2012).

[1891] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of derivatives: (i) credit derivatives (without explanation) as a means of diversifying the portfolio (Japanese Bankers Association); (ii) synthetic securities that reference corporate credits or other debt (Credit Suisse (Covered Fund)); (iii) credit instruments or other obligations that the banking entity could originate or invest or deal in directly, including tranched or untranched credit linked notes exposed to the credit risk of such reference assets through a credit default swap or other credit derivative entered into by the related ABS Issuer (SIFMA (Securitization) (Feb. 2012)); (iv) any derivatives structured as part of the securitization of loans (without explanation) (Allen & Overy (on behalf of Foreign Bank Group)); (v) hedge agreements (Credit Suisse (Williams)); and (vi) any derivative, including a credit default swap, as and to the extent a banking entity could use such derivative in managing its own investment portfolio (SIFMA (Securitization) (Feb. 2012)).

percentage of the assets of such covered fund.[1892]

In response to comments, the final rule modifies the loan securitization exclusion from the proposal to identify the types of contractual rights or assets directly arising from those loans supporting the asset-backed securities that a loan securitization relying on such exclusion may hold. Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold contractual rights or assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans (''servicing assets'').[1893] The servicing assets are permissible in an excluded loan securitization transaction only to the extent that they arise from the structure of the loan securitization or from the loans supporting a loan securitization. If such servicing assets are sold and securitized in a separate transaction, they will not qualify as permissible holdings for the loan securitization exclusion.[1894]

In adopting this approach, the Agencies considered commenters' concerns and determined to revise the condition to be more consistent with the definition and treatment of servicing assets in other asset-backed securitization regulations, such as the exemption from the definition of ''investment company'' under rule 3a–7 promulgated under the Investment Company Act.[1895]

Although the Agencies have revised the proposal in response to commenters' concerns, the final rule does not permit a loan securitization to hold as servicing assets a number of instruments specifically requested by commenters whether in their entirety or as a percentage of the pool. Under the final rule, servicing assets do not include securities or derivatives other than as specified in the rule.

Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold securities if those securities fall into one of three categories.[1896] First, such loan securitizations may hold securities that are cash equivalents. For purposes of the exclusion for loan securitizations, the Agencies interpret ''cash equivalents'' to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities.[1897] Depending on the specific funding needs of a particular securitization, ''cash equivalents'' might include deposits insured by the Federal Deposit Insurance Corporation, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper.[1898] Second, such loan securitizations may hold securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities. Finally, such loan securitizations may hold securities that qualify as SUBIs or collateral certificates subject to the provisions set forth in the rule for such intermediate asset-backed securities.

The Agencies have specifically limited the types of securities held as eligible assets in a loan securitization that may be excluded from the definition of covered fund under the final rule, even in limited amounts, in order to assure that the types of securities are cash equivalents or otherwise related to the loan securitization and to prevent the possible misuse of the loan securitization exclusion to circumvent the restrictions on proprietary trading, investments in covered funds and prohibitions in section 13(f) of the BHC Act.[1899] The Agencies believe that types of securities other than those specifically included in the final rule could be misused in such manner, because without limitations on the types of securities in which an excluded loan securitization may invest, a banking entity could structure an excluded loan securitization with provisions to engage in activities that are outside the scope of the definition of loan as adopted and also to engage in impermissible proprietary trading. Further, the Agencies do not believe that the use of thresholds with respect to such other types of securities as an alternative is appropriate because similarly, such a securitization would then involve a securitization of non-loan assets, outside the scope of what the Agencies believe the rule of construction was intended to cover. By placing restrictions on the securities permitted to be held by an excluded loan securitization, the potential for evasion is reduced. Loan securitizations are intended, as contemplated by the rule of construction, to permit banks to continue to engage in securitizations of loans. Including all types of securities within the scope of permitted assets in an excluded loan securitization would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

iii. Derivatives

Under the proposed loan securitization definition, an exempted loan securitization would be permitted to hold interest rate or foreign exchange derivatives that materially relate to the terms of any loans supporting the asset-backed securities and any contractual rights or assets directly arising from such loans so long as such derivatives are used for hedging purposes with respect to the securitization structure.[1900] The Agencies indicated in the proposing release that the proposed loan securitization definition would not allow an exempted loan securitization to use credit default swaps.[1901]

Commenters criticized the proposed limitations on the use of derivatives included in the proposed loan securitization definition.[1902] In particular, one commenter indicated that the use of credit derivatives such as credit default swaps is important in loan securitizations to provide diversification

[1892] *See* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); LSTA (Feb. 2012); LSTA (July 2012).

[1893] *See* final rule § 75.10(c)(8)(i)(B). The use of the term ''servicing assets'' is not meant to imply that servicing assets are limited to those contractual rights or assets related to the servicer and the performance of the servicer's obligations.

[1894] For example, under the final rule, mortgage insurance policies supporting the mortgages in a loan securitization are servicing assets permissible for purposes of § 75.10(c)(8)(i)(B). However, a separate securitization of the payments on those mortgage insurance policies would not qualify for the loan securitization exclusion.

[1895] The Agencies believe that for purposes of the final rule, in the context of securitization, such related or incidental assets in a loan securitization should support or further, and therefore, be secondary to the loans held by the securitization vehicle.

[1896] *See* final rule § 75.10(c)(8)(iii).

[1897] If either the loans supporting the loan securitization or the asset-backed securities issued by the loan securitization are denominated in a foreign currency, for purposes of the exclusion a loan securitization would be permitted to hold foreign currency, cash equivalents denominated in foreign currency and foreign exchange derivatives that comply with § 75.10(c)(8)(iv).

[1898] Servicing assets should not introduce significant additional risks to the transaction, including foreign currency risk or maturity risk. For instance, funds on deposit in an account that is swept on a monthly basis should not be invested in securities that mature in 90 days.

[1899] Commenters expressed concerns about the use of securitization vehicles for evasion. *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1900] *See* Joint Proposal, 76 FR at 68912.

[1901] *Id.*

[1902] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012) (requesting that an excluded loan securitization be permitted to hold up to 10% of its assets in the form of synthetic risk exposure to loans); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012) (for CLOs); SIFMA (Securitization) (Feb. 2012).

of assets.[1903] Another commenter noted the use of such instruments to manage risks with respect to corporate loan and debt books by accessing capital from a broad group of capital markets investors and facilitates making markets.[1904] In contrast, two commenters generally supported the limitations on the use of derivatives under the proposed loan securitization definition and indicated that excluding credit default swaps from the loan securitization definition was appropriate.[1905]

With respect to the use of derivatives, the Agencies are adopting the loan securitization exclusion substantially as proposed with certain modifications to reflect a restructuring of this provision in order to more closely align the permissible uses of derivatives under the loan securitization exclusion with the loans, the asset-backed securities, or the contractual rights and other assets that a loan securitization relying on the loan securitization exclusion may hold. As adopted, for a loan securitization to be eligible for the loan securitization exclusion, the loan securitization may hold only interest rate or foreign exchange derivatives that meet the following requirements: (i) the written terms of the derivatives directly relate to either the loans or the asset-backed securities that such loan securitization may hold under the other provisions of the loan securitization exclusion; and (ii) the derivatives reduce interest rate and/or foreign exchange risk with respect to risks related to either such loans, the asset-backed securities or the contractual rights or other assets that a loan securitization may hold.[1906]

The first requirement that the written terms of the derivatives ''directly relate'' to either the loans or the asset-based securities themselves is intended to quantitatively and qualitatively limit the use of derivatives permitted under the loan securitization exclusion.[1907] The Agencies would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding principal balance of the asset-backed securities.[1908] Moreover, under the loan securitization exclusion, the type of derivatives must be related to the types of risks associated with the underlying assets and may not be derivatives designed to supplement income based on general economic scenarios, income management or unrelated risks.

The second requirement that derivatives reduce the interest rate and/or foreign exchange risks related to either such loans, contractual rights or other assets, or such asset-backed securities is intended to permit the use of derivatives to hedge interest rate and/or foreign exchange risks that result from a mismatch between the loans and the asset-backed securities.[1909]

The Agencies believe that the statutory rule of construction should be implemented in a manner that does not limit or restrict the sale and securitization of loans. The Agencies further believe that the sale and securitization of credit exposures other than ''loans'' as defined in the rule, such as through securities or derivatives, could be abused. The derivatives that may be held in a loan securitization for purposes of the exclusion may not be used for speculative purposes. Consistent with the proposal, the loan securitization exclusion does not permit a loan securitization relying on such exclusion to hold credit default swaps or other types of derivatives whether or not they are related either to the underlying loans or the asset-backed securities.[1910] Under the final rule, a synthetic securitization in which the asset-backed securities are supported by cash flow from derivatives, such as credit default swaps and total return swaps, would not be permitted to rely on the loan securitization exclusion because such derivatives are excluded from the final rule's definition of loan specifically, as a derivative. Similarly, a loan securitization that relies on the loan securitization exclusion would not be permitted to hold a credit default swap or total return swap that references a loan that is held by the loan securitization. Under the final rule as adopted, an excluded loan securitization would not be able to hold derivatives that would relate to risks to counterparties or issuers of the underlying assets referenced by these derivatives because the operation of derivatives, such as these, that expand potential exposures beyond the loans and other assets, would not in the Agencies' view be consistent with the limited exclusion contained in the rule of construction under section 13(g)(2) of the BHC Act, and could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act. The Agencies believe that the use of derivatives by an issuing entity for asset-backed securities that is excluded from the definition of covered fund under the loan securitization exclusion should be narrowly tailored to hedging activities that reduce the interest rate and/or foreign exchange risks directly related to the asset-backed securities or the loans supporting the asset-backed securities because the use of derivatives for purposes other than reducing interest rate risk and foreign exchange risks would introduce credit risk without necessarily relating to or involving a reduction of interest rate risk or foreign exchange risk.

On the other hand, while the Agencies are not expanding the types of permitted derivatives to be held in a loan securitization, the Agencies in the final rule are not restricting the use of all derivatives under the loan securitization exclusion as requested by certain commenters. The Agencies believe that a loan securitization that is excluded from the definition of covered fund should be allowed to engage in activities that reduce interest rate and

[1903] *See* Japanese Bankers Ass'n. This commenter indicated that credit derivatives are important in securitizations to provide diversification when the desired mix of assets cannot be achieved.

[1904] *See* ASF (Feb. 2012). This commenter argued that for some loan securitizations, investors may seek a broader pool of credit exposures than the bank has available or can obtain to securitize in order to achieve risk diversification.

[1905] *See* AFR *et al.* (Feb. 2012); Public Citizen. One of these commenters stated that the credit default exclusion was appropriate because ''synthetic securitizations and resecuritizations were a key contributor to financial contagion during the crisis.'' *See* AFR *et al.* (Feb. 2012). Another commenter argued that the loan securitization definition should not permit the use of derivatives. *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity. This commenter also argued that the inclusion of derivatives in the loan securitization definition exceeded the Agencies' statutory authority. *Id.* Two senators indicated that ''complex securitizations'' including those with ''synthetic features'' and ''embedded derivatives'' should not be allowed to rely on the exclusion for loan securitizations. *See* Sens. Merkley & Levin (Feb. 2012).

[1906] *See* final rule § 75.10(c)(8)(iv).

[1907] Under the final rule, the Agencies expect that a loan securitization relying on the loan securitization exclusion would not have a significant amount of interest rate and foreign exchange derivatives with respect to risks arising from contractual rights or other assets.

[1908] For example, a $100 million securitization cannot be hedged using an interest rate hedge with a notional amount of $200 million.

[1909] The derivatives permitted in a securitization that may rely on the loan securitization exclusion would permit a securitization to hedge the risk resulting from differences between the income received by the issuing entity and the amounts due under the terms of the asset-backed securities. For example, fixed rate loans could support floating rate asset-backed securities; loans with an interest rate determined by reference to the Prime Rate could support asset-backed securities with an interest rate determined by reference to LIBOR; or Euro-denominated loans could support U.S. Dollar-denominated asset-backed securities.

[1910] Loan securitizations excluded from the covered fund definition may only hold certain directly related derivatives as specified in § 75.11(c)(8)(iv) and as discussed in this Part.

foreign exchange risk because the hedging of such risks is consistent with the prudent risk management of interest rate and currency risk in a loan portfolio while at the same time avoiding the potential for additional risk arising from other types of derivatives.[1911] The Agencies do not believe that the exemption for hedging activity applicable to market making and underwriting under the final rule is the appropriate measure for permitted derivatives in a loan securitization that would be excluded from definition of covered fund [1912] because the hedging exemptions for market making and underwriting are not tailored to the hedging requirements of a securitization transaction.[1913] The Agencies also do not believe that they lack the statutory authority to permit a loan securitization relying on the loan securitization exclusion to use derivatives, as suggested by one commenter,[1914] because the Agencies believe that the permitted derivatives relate directly to loans that are permitted and have limited the quality and quantity of derivatives that an excluded loan securitization is permitted to hold directly to the reduction of risks that result from the loans and the loan securitization.

While loan securitizations that include non-loan assets are not excluded from the definition of covered fund, banking entities are not prohibited from owning interests or sponsoring these covered funds under the final rule. Under the final rule, these securitizations would be covered funds, and banking entities engaged with these covered funds would be subject to the limitations on ownership interests and relationships with these covered funds imposed by section 13 of the BHC Act.

iv. SUBIs and Collateral Certificates

Commenters also argued that, under the proposed exemption for loan securitizations, securitizations that are backed by certain intermediate asset-backed securities would not satisfy the conditions for the exemption and therefore would be subject to the covered fund prohibitions.[1915] For example, commenters noted that, in a securitization of leases with respect to equipment where a titling trust is used to hold ownership of the equipment, a titling trust will typically own the equipment and the right to payment on the leases, and then will issue a security or other instrument, often referred to as a special unit of beneficial interest (SUBI), that represents an ownership interest in the titling trust to the securitization issuer.[1916] As another example, certain securitizations frequently use a master trust structure allowing the trust to issue more than one series of asset-backed security collectively backed by a common revolving pool of assets. In such a structure, a master trust may hold assets (such as loans) and issue a collateral certificate supported by those assets to an issuing trust that issues asset-backed securities to investors. The assets held by the master trust are typically a pool of revolving accounts that may be paid in full each month (*e.g.,* credit card receivables) or a revolving pool of short-term loans that are replaced with new loans as they mature (*e.g.,* floor plan loans).[1917] One commenter opposed the inclusion of securitizations backed by intermediate asset-backed securities, arguing that each step should be viewed separately to ensure compliance to prevent the inclusion of impermissible assets such as prohibited derivatives.[1918]

In response to comments, the Agencies are modifying the proposal to provide that a securitization backed by certain intermediate asset-backed securities will qualify for the loan securitization exclusion. The Agencies recognize that securitization structures that use these types of intermediate asset-backed securities are essentially loan securitization transactions, because the intermediate asset-backed securities in the asset pool are created solely for the purpose of facilitating a securitization [1919] and once created, are issued directly into a securitization vehicle rather than to any third party investor.

Under the final rule, a loan securitization that is excluded from the definition of covered fund may include SUBIs or collateral certificates, provided that four conditions are met.[1920] First, the special purpose vehicle issuing the SUBI or collateral certificate itself must meet the conditions of the loan securitization exclusion, as adopted in the final rule.[1921] Under this provision, for example, the special purpose vehicle, in addition to the issuing entity, may hold an interest rate or foreign exchange derivative or other assets only if the derivative or asset is permitted to be held in accordance with the requirements for derivatives in respect of the loan securitization exclusion. Second, the SUBI or collateral certificate must be used for the sole purpose of transferring economic risks and benefits of the loans (and other permissible assets) [1922] to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures. Third, the SUBI or collateral certificate must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization. Fourth, the special purpose vehicle issuing the SUBI or collateral certificate and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction. The Agencies believe that the fourth condition will ensure that the resecuritizations of asset-backed securities purchased in the secondary market, which the Agencies do not believe would constitute a loan securitization, will not be able to use these special provisions tailored only for transactions utilizing SUBIs and collateral certificates in order to fall within the loan securitization exclusion.

The Agencies believe that these conditions provide that only securitizations backed by SUBIs and collateral certificates involving loans—and not other types of securities or other types of assets—will be able to use the loan securitization exclusion. These conditions are intended to assure that for purposes of the loan securitization exclusion that only SUBI and collateral certificates that essentially represent the underlying loans are included consistent with the terms and the purpose of section 13 of the BHC Act, while also not adversely affecting

[1911] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1912] *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity.

[1913] For example, a banking entity may hold an ownership interest in a covered fund in order to hedge employee compensation risks. Because securitizations do not have employees, such a hedging exemption would not be applicable to a securitization structure.

[1914] *See* Occupy.

[1915] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Aug. 2012); PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1916] *See* SIFMA (Securitization) (Feb. 2012).

[1917] *See, e.g.,* ASF (Feb. 2012). UK RMBS master trusts also use a master trust structure. *See* AFME *et al.;* ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1918] *See* Occupy.

[1919] The use of SUBIs, for example, allows the sponsor to avoid administrative expenses in retitling the physical property underlying the leases.

[1920] *See* final rule § 75.10(c)(8)(v).

[1921] The provision will allow for the existing practice of a master trust to hold a collateral certificate issued by a legacy master trust.

[1922] This would include a collateral certificate issued by a legacy master trust that meets the requirements of the loan securitization exclusion.

securitization of ''loans'' as defined in the final rule.[1923] The Agencies believe that the limitation of the types of asset-backed securities permitted in an excluded loan securitization (only SUBIs and collateral certificates) and the restrictions placed on those SUBIs and collateral certificates that are permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

v. Impermissible Assets

As discussed above, commenters on the loan securitization proposals argued that various types of assets should be included within the definition of loan or otherwise permitted to be held by the loan securitization that would be entitled to rely on the proposed exemptions.

After considering comments, the Agencies have determined to retain the narrower scope of the permitted assets in a loan securitization that is eligible for the loan securitization exclusion. The Agencies have revised the language regarding loan securitizations from the proposal to specify certain types of assets or holdings that a loan securitization would not be able to hold if it were eligible to rely on the exclusion from the definition of covered fund for loan securitizations.[1924] The Agencies recognize that securitization structures vary significantly and, accordingly, the loan securitization exclusion as adopted in the final rule accommodates a wider range of securitization practices. The Agencies believe that these limitations provide that only securitizations backed by loans—and not securities, derivatives or other types of assets—will be able to use the loan securitization exclusion consistent with the terms and the purpose of section 13 of the BHC Act.[1925] The Agencies believe that the limitation of the types of assets permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

Under the final rule, in order to be excluded from the definition of covered fund, a loan securitization may not hold (i) a security, including an asset-backed security, or an interest in an equity or debt security (unless specifically permitted, such as with respect to a SUBI or collateral certificate as described above), (ii) a derivative other than an interest rate or foreign exchange derivative that meets the requirements described above,[1926] or (iii) a commodity forward contract.[1927] The Agencies have determined that a loan securitization relying on the loan securitization exclusion may not include a commodity forward contract because a commodity forward contract is not a loan.[1928]

9. Asset-Backed Commercial Paper Conduits

Under the proposed rule, certain securitization vehicles, including ABCP conduits, would not have been covered by the loan securitization exclusion and, therefore, would have been deemed to be a covered fund.[1929] ABCP is a type of liability that is typically issued by a special purpose vehicle (commonly referred to as a ''conduit'') sponsored by a financial institution or other entity. The short term asset-backed securities issued by the conduit are supported by a managed pool of assets, which may change over the life of the entity. Depending on the type of ABCP conduit, the securitized assets ultimately supporting the short term asset-backed securities may consist of a wide range of assets including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans in addition to asset-backed securities supported by such assets. The term of ABCP typically is short, and the liabilities are ''rolled'' (*i.e.,* replaced or refinanced) at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.[1930] In this regard, in the proposing release, the Agencies requested comment on the proposed rule's definition of ''covered fund'' with respect to asset-backed securities and/or securitization vehicles [1931] and received numerous comments requesting a variety of exemptions for ABCP conduits.[1932]

A number of commenters requested that the final rule exclude ABCP conduits from the definition of covered fund [1933] or that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act [1934] to similar effect.[1935] One commenter argued that ABCP conduits do not have the characteristics of a private equity fund or hedge fund,[1936] even though they typically rely on the exemptions set forth in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Another commenter argued that the proposed rule's definition of covered fund would negatively impact asset-backed securitizations (including ABCP conduits), and suggested that the Agencies define covered funds, in part, as those that both (i) rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and (ii) have the traditional characteristics of private equity funds or hedge funds.[1937] Another commenter stated that the rule of construction set forth in section 13(g)(2) of the BHC Act [1938] is a clear indication that section 13 of the BHC Act was not intended to apply to securitization vehicles such as ABCP conduits.[1939] Another commenter stated that the lending that occurs through ABCP conduits is the type of activity that Congress and the Executive Branch have urged banks to expand in order to support economic growth and job creation,[1940] while another commenter stated that ABCP conduits provide low cost, reliable financing for registered investment companies, which poses little risk to the safety and soundness of banks because Federal law requires registered investment companies to

[1923] *See, e.g.,* rule 190 under the Securities Act. *See also, e.g.,* ASF (Feb. 2012) (noting that certain rules under the Securities Act and staff interpretations have carved out SUBIs and collateral certificates from certain disclosure and other requirements).

[1924] *See* final rule § 75.10(c)(8)(ii).

[1925] The Agencies discuss earlier in this Part the permissible assets an excluded loan securitization may hold and the Agencies' belief that excluding loan securitizations as defined in the final rule is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction in section 13(g)(2). *See, e.g., supra* note 1871 and accompanying and following text.

[1926] *See* final rule § 75.10(c)(8)(iv); *see also* 7 U.S.C. 27(a)–(b).

[1927] See the discussion above in Part VI.B.1.c.8 of this **SUPPLEMENTARY INFORMATION.**

[1928] For a discussion of commodity forward contracts, see Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208 (Aug. 13, 2012) (Release Nos. 33–9338 and 34–67453, July 18, 2012).

[1929] *See* proposed rule § 75.13(d).

[1930] Structured investment vehicles (''SIVs'') and securities arbitrage ABCP programs both purchase securities (rather than receivables and loans). SIVs typically lack liquidity facilities covering all of these liabilities issued by the SIV, while securities arbitrage ABCP programs typically have such liquidity coverage, though the terms are more limited than those of the ABCP conduits eligible for the exclusion pursuant to the final rule.

[1931] *See* Joint Proposal, 76 FR at 68899.

[1932] *See, e.g.,* ASF (Feb. 2012); BoA; Capital Group; Eaton Vance; Fidelity; ICI (Feb. 2012); Japanese Bankers Ass'n.; PNC; RBC.

[1933] *See, e.g.,* ICI (Feb. 2012); PNC *et al.;* SIFMA (May 2012).

[1934] *See* 12 U.S.C. 1851(d)(1)(J).

[1935] *See* ICI (Feb. 2012).

[1936] *See* PNC.

[1937] *See* Barclays.

[1938] *See* 12 U.S.C. 1851(g)(2).

[1939] *See* ICI (Feb. 2012).

[1940] *See* Credit Suisse (Williams).

maintain prescribed asset coverage in connection with borrowings.[1941]

Two commenters contended that, while certain issuers of asset-backed securities may rely on section 3(c)(5) of the Investment Company Act or rule 3a–7 thereunder, and, therefore, not be brought under the proposed rule's definition of covered fund, ABCP conduits typically cannot rely on this section or rule either because to do so would be too restrictive (in the case of section 3(c)(5)) or because they cannot meet the rule's requirements.[1942]

One commenter, employing ABCP conduits as an example, stated that failing to exempt securitization vehicles from the covered fund prohibitions would preclude banking entities from engaging in activities that have long been recognized as permissible activities for banking entities and that are vital to the normal functioning of the securitization markets, and will have a significant and negative impact on the securitization markets and on the ability of banking entities and other companies to provide credit to their customers.[1943] This commenter further stated that ABCP conduits are an efficient and attractive way for banking entities to lend their own credit-worthiness to expand the pool of possible lenders willing to finance key economic activity while maintaining a low cost of funding for consumers, and because of the liquidity support provided by the sponsoring banking entity, the sponsoring banking entity to the ABCP conduit has full exposure to the assets acquired by or securing the amounts lent by the ABCP conduit and the banking entity subjects those assets and the obligors to the same analysis as it would engage in if the bank were lending directly against those assets.[1944] Another commenter stated that the provision of credit to companies to finance receivables through ABCP conduits is an area of traditional banking activity that should be distinguished from the type of high-risk, conflict-ridden financial activities that Congress sought to restrict under section 13 of the BHC Act.[1945]

To this end, commenters proposed several means to exclude ABCP conduits from the proposed rule's restrictions and requirements, including an expansion of the loan securitization exemption to treat two-step securitization transactions as a single loan securitization,[1946] a separate exclusion for ABCP conduits,[1947] an expansion of the definition of loan,[1948] or as part of a broad exclusion for all issuers of asset-backed securities.[1949] In order to allow ABCP conduits to qualify as loan securitizations, commenters suggested that the loan securitization exclusion should permit a limited amount of securities purchased in the secondary market.[1950] Commenters also proposed changes to the permissible assets such as allowing a loan securitization to hold liquidity and support commitments, asset-backed securities and certain financial assets in addition to loans that by their terms convert to cash within a finite period of time.[1951] Another commenter argued that the loan securitization exemption should allow banking entities to sponsor, control, and invest in ABCP conduits that facilitate the securitization of customer loans and receivables.[1952] In contrast, one commenter supported the restriction of the loan securitization exemption to the plain meaning of what constitutes a loan and advocated that the Agencies not include ABCP conduits under the exemption.[1953]

In addition to the effect the proposed rule's definition of covered fund would have on ABCP conduits, commenters also noted that section 13(f) of the BHC Act[1954] would prohibit certain transactions between a banking entity sponsor and a covered fund securitization.[1955] Two commenters requested a specific exemption from § 75.16 of the proposed rule for ABCP conduits based on the interpretation that the proposed rule subjects covered funds exempted under the loan securitization exemption or other exemptions to § 75.16.[1956] Commenters argued that without liquidity and credit support, ABCP conduits are not viable,[1957] cannot effectively operate,[1958] could not function,[1959] or would not be marketable.[1960] One commenter argued that prohibiting a banking entity from providing liquidity facilities to ABCP conduits is tantamount to requiring the banking entity to wind down the operation of such ABCP conduits.[1961]

In response to the comments received and in light of the rule of construction contained in section 13(g)(2) of the BHC Act, the Agencies have determined in the final rule to exclude from the definition of covered fund an ABCP conduit that is a ''qualifying asset-backed commercial paper conduit'' as defined in the final rule is excluded from the definition of covered fund.[1962]

[1941] *See* Eaton Vance.

[1942] *See* RBC; ASF (Feb. 2012).

[1943] *See* Credit Suisse (Williams).

[1944] *Id.*

[1945] *See* ICI (Feb. 2012). This commenter emphasized the importance of the ABCP conduit market to money market funds, noting that as of November 2011, taxable money market funds held $126 billion of the $348.1 billion of securities issued by ABCP conduits outstanding, which represented approximately 5.4% of taxable money market funds' total assets. Another commenter noted that approximately $66.7 billion of automobile loans and leases, $52.1 billion of student loans, $22.3 billion of credit card charges, $49.4 billion of loans to commercial borrowers and $50.7 billion of trade receivables were financed by the U.S. ABCP conduit market as of October 31, 2011, and that the total outstanding amount of securities sold by ABCP conduits in the U.S. market was $344.5 billion as of January 18, 2012. *See* ASF (Feb. 2012).

[1946] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); PNC; SIFMA (Securitization) (Feb. 2012).

[1947] *See* ASF (Feb. 2012); Capital Group (alleging that ABCP does not pose the risks that the rule is meant to combat); GE (Feb. 2012). One commenter proposed an exemption for ABCP conduits that included a requirement of 100% liquidity support from a regulated, affiliated entity, and such liquidity support may be conditional or unconditional. *See* RBC.

[1948] *See* Credit Suisse (Williams) (alleging that ABCP conduits acquire ownership of loans indirectly through the purchase of variable funding notes, trust certificates, asset-backed securities, repurchase agreements and other instruments that may be considered securities, all of which economically are consistent with providing funding or extensions of credit to customers); ICI (Feb. 2012) (requesting that the definition of loan include the broad array of receivables that back ABCP).

[1949] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1950] *See* ASF (Feb. 2012) (requesting that ABCP conduits be permitted to own asset-backed securities purchased on the secondary market only if the aggregate principal amount of such securities does not exceed 5% of the aggregate principal or face amount of all assets held by the ABCP conduit in order to diversify their asset base and avoid the negative consequences of divestiture of such assets); RBC (requesting that loan securitizations be permitted to hold cash equivalents and assets, other than loans, which, by their terms, convert to cash within a finite period of time so long as such assets comprise no more than 10% of their total assets based on book value).

[1951] *See* ASF (Feb. 2012) (arguing that the loans, receivables, leases, or other assets purchased by the ABCP conduit might have fit the definition of loan in the proposed rules but for the proposal's express assertion that the definition of loan does not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans). *See* Joint Proposal, 76 FR at 68865; GE (Feb. 2012); RBC.

[1952] *See* PNC.

[1953] *See* Public Citizen.

[1954] *See* 12 U.S.C. 1851(f); *see also* § 75.16 of the proposed rule.

[1955] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Fidelity; IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1956] *See* ICI (Feb. 2012); Fidelity.

[1957] *See* JPMC.

[1958] *See* ASF (Mar. 2012).

[1959] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1960] *See* ASF (Feb. 2012); Fidelity.

[1961] *See* ASF (Mar. 2012).

[1962] *See* final rule § 75.10(c)(9)(i). The rule of construction contained in section 13(g)(2) of the BHC Act provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise

Under the final rule, a qualifying asset-backed commercial paper conduit is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization [1963] and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.[1964] In addition, a qualifying asset-backed commercial paper conduit must issue only asset-backed securities, comprising of a residual and securities with a term of 397 days or less and in addition, a ''regulated liquidity provider,'' as defined in the final rule, must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term asset-backed securities issued by the qualifying asset-backed commercial paper conduit in the event that funds are required to redeem the maturing securities.[1965]

Under the final rule, a regulated liquidity provider is (i) a depository institution as defined in section 3 of the Federal Deposit Insurance Act; [1966] (ii) a bank holding company or a subsidiary thereof; [1967] (iii) a savings and loan holding company,[1968] provided all or substantially all of the holding company's activities are permissible for a financial holding company,[1969] or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in section 211.21 of the Federal Reserve Board's Regulation K [1970] has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or (v) a sovereign nation.[1971] In order for a sovereign nation to qualify as a regulated liquidity provider, the liquidity provided must be unconditionally guaranteed by the sovereign, which would include its departments and ministries, including the central bank.

In this regard, under the final rule, the exclusion from the definition of covered fund in respect of ABCP conduits is only available to an issuer of short-term asset-backed securities supported by loans and certain asset-backed securities supported by loans that were issued or initially sold to the ABCP conduit, and the short term asset-backed securities issued by the ABCP conduit are supported by a liquidity facility that provides 100 percent liquidity coverage from a regulated liquidity provider. The exclusion, therefore, is not available to ABCP conduits that lack 100 percent liquidity coverage. The liquidity coverage may be provided in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement and 100 percent liquidity coverage means that, in the event the qualifying asset-backed commercial paper conduit is unable for any reason to repay maturing asset-backed securities issued by the issuing entity, the total amount for which the regulated liquidity provider may be obligated is equal to 100 percent of the amount of asset-backed securities outstanding plus accrued and unpaid interest. In addition, amounts due pursuant to the required liquidity coverage may not be subject to the credit performance of the asset-backed securities held by the qualifying asset-backed commercial paper conduit or reduced by the amount of credit support provided to the qualifying asset-backed commercial paper conduit. Under the final rule, liquidity coverage that only funds an amount determined by reference to the amount of performing loans, receivables, or asset-backed securities will not be permitted to satisfy the liquidity requirement for a qualifying asset-backed commercial paper conduit.

As discussed above, the final rule defines a qualifying asset-backed commercial paper conduit as having certain elements. First, a qualifying asset-backed commercial paper conduit must issue only a residual interest and short-term asset-backed securities. This requirement distinguishes ABCP conduits from covered funds that issue partnership interests and mitigates the potential that a qualifying ABCP conduit would be used for evasion of the covered fund prohibitions. The Agencies chose a maximum term of 397 days for these securities because this time frame corresponds to the maximum maturity of securities allowed to be purchased by money market funds under Rule 2a-7 of the Investment Company Act.

Second, the asset-backed securities issued by the ABCP conduit must be supported only by loans and certain asset-backed securities that meet the requirements of the loan securitization exclusion. By placing restrictions on the assets permitted to be held by an excluded loan securitization, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for qualifying ABCP conduits is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banks to continue to engage in securitizations of loans. Including all types of securities and other assets within the scope of permitted assets in a qualifying ABCP conduit, as with loan securitizations, would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

Third, the asset-backed securities supporting a qualifying asset-backed commercial paper conduit must be purchased as part of the initial issuance of such asset-backed securities. Asset-backed securities purchased by an ABCP conduit in the secondary market will not be permitted because such a purchase would not be part of an initial issuance and the banking entity that established and manages the ABCP conduit would not have participated in the negotiation of the terms of such asset-backed securities. Without a more direct connection between the banking entity and the ABCP conduit, the purchase of such asset-backed securities in the secondary market would resemble investments in securities.

Fourth, under the final rule, the ABCP conduit exclusion will not be available to ABCP conduits that lack 100 percent liquidity coverage. The Agencies believe that the 100 percent liquidity coverage requirement distinguishes the conduits eligible for the exemption, which sometimes hold and securitize a customer's loans through an intervening special-purpose vehicle instead of holding the loans directly, and are supported by a 100 percent liquidity guarantee, from other types of conduits with partial liquidity guarantees (such as structured investment vehicles) that have sometimes been operated by banking entities for the purpose of financing portfolios of securities acquired or retained as part of their activities in the securities markets.

The Agencies recognize that ABCP conduits that do not satisfy the elements of the ABCP conduit exclusion may be covered funds and therefore would be subject to section 13(f) of the BHC

permitted by law. As noted above and explained below, a qualifying asset-backed commercial paper conduit under the final rule is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.

[1963] *See* final rule § 75.10(c)(8).

[1964] *See* final rule § 75.10(c)(9)(i)(B).

[1965] *See* final rule § 75.10(c)(9)(ii) and (iii).

[1966] *See* 12 U.S.C. 1813.

[1967] *See* 12 U.S.C. 1841.

[1968] *See* 12 U.S.C. 1467a.

[1969] *See* 12 U.S.C. 1843(k).

[1970] *See* 12 CFR 211.21.

[1971] *See* final rule § 75.10(c)(9)(iii).

Act.[1972] As a result of section 13(f) of the BHC Act, which prohibits certain transactions between banking entities and a covered fund securitization that the banking entity sponsors or for which it provides investment management services, the banking entity would be prohibited from providing liquidity support for the ABCP conduit.

Similarly, while some commenters requested that the loan securitization exclusion permit the holding of a limited amount of securities purchased in the secondary market, the final rule does not provide for this in the context of ABCP conduits. The Agencies believe that the limitations on the types of securities that a qualifying asset-backed commercial paper conduit may invest in are needed to avoid the possibility that a banking entity could use a qualifying asset-backed commercial paper conduit to securitize non-loan assets or to engage in proprietary trading of such securities prohibited under the final rule. Thus this limitation reduces the potential for evasion of the covered fund provisions of section 13 of the BHC Act. In developing the exclusion from the definition of covered fund for qualifying asset-backed commercial paper conduits in the final rule, the Agencies considered the factors set forth in sections 13(g)(2) and 13(h)(2) of the BHC Act. The final rule includes conditions designed to ensure that an ABCP conduit established and managed by a banking entity serves as a means of facilitating that banking entity's loan securitization activity rather than financing that banking entity's capital market investments. The final rule distinguishes between qualifying asset-backed commercial paper conduits and other ABCP conduits in order to adhere to the tenets of section 13 of the BHC Act while accommodating the market practices discussed by the commenters by facilitating reasonable access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. As discussed above, the Agencies understand that some existing ABCP conduits may need to be restructured to conform to the requirements of the ABCP conduit exclusion.

To the extent that the definition of covered fund, the loan securitization exclusion and the ABCP conduit exclusion do not eliminate the applicability of the final rule provisions to certain covered funds, there may be adverse effects on the provision of capital to customers,[1973] to securitization markets,[1974] and to the creation of new securitization products to meet investor demands that Congress may not have contemplated. [1975] However, financial institutions that are not banking entities and therefore are not subject to the restrictions on ownership can continue to engage in activities relating to securitization, including those securitizations that fall under the definition of covered fund. Furthermore, new securitizations may be structured so as to qualify for the loan securitization exclusion or other exclusions under the final rule. For these reasons, the impact on securitizations that are not excluded under the final rule may be mitigated.

The Agencies believe that the final rule excludes from the definition of covered fund typical structures used in the most common loan securitizations representing a significant majority of the current securitization market, such as residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases and equipment leases. Additionally, the Agencies believe that esoteric asset classes supported by loans may also be able to rely on the loan securitization exclusion, such as time share loans, container leases and servicer advances.

10. Covered Bonds

Several commenters called for covered bond structures to be excluded from the definition of covered fund.[1976] They indicated that the proposed rule may interfere with and restrict non-U.S. banks' ability to establish or issue covered bonds. As described by several commenters, covered bonds are full recourse debt instruments typically issued by a non-U.S. entity that are fully secured or ''covered'' by a pool of high-quality collateral (*e.g.,* residential or commercial mortgage loans or public sector loans).[1977] Certain of these covered bond structures utilize a special purpose vehicle (''SPV'') that holds a collateral pool. As such, under the proposed rule, an SPV could be a covered fund that relies on the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

According to one commenter, the majority of covered bonds are issued under specific legislative frameworks which define permitted characteristics for covered bond issuances, including the kinds and quality of collateral that may be included in cover pools, the specific legal framework for issuance of covered bonds, and the procedures for resolution in the event that the issuer becomes insolvent.[1978] Some commenters expressed concern about the possibility that certain covered bond structures could fall within the definition of covered fund, as proposed. In particular, commenters expressed concern about covered bond structures in the United Kingdom that also would be relevant in principle with respect to covered bond structures used in other European Union (''EU'') jurisdictions (*e.g.,* the Netherlands and Italy) and certain non-EU jurisdictions (*e.g.,* Canada, Australia, and New Zealand).[1979] Another commenter indicated that covered bonds issued by certain French entities that hold a revolving pool of loans may be impacted by the proposed rule.[1980]

Certain commenters argued that in order to achieve the intended economic effect of providing recourse to both the bank issuing covered bonds and to the collateral pool, the issuing bank may enter into a number of agreements with the SPV that holds the collateral. This includes transactions where the bank takes on credit exposure to the SPV (*e.g.,* through derivatives and securities lending, provision of loans, and/or investments in securities of the SPV).[1981] The issuing bank typically also provides asset and liability management services to the SPV and may also repurchase certain assets from the SPV.[1982] Commenters also contended that under certain legislative frameworks, the SPV issues the covered bonds and holds the collateral, and a sponsoring bank lends money to the SPV.[1983] According to commenters, the

[1972] *See* 12 U.S.C. 1851(f); *see also* § 75.16 of the proposed rule.

[1973] *See, e.g.,* ASF (Feb. 2012).

[1974] *See* Credit Suisse (Williams) (employing ABCP conduits as an example); ASF (Feb. 2012) (describing the constriction of the market for asset-backed securities if banking entities are restricted from owning debt classes of new asset backed securities).

[1975] *See* RBC; ASF (Feb. 2012).

[1976] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012).

[1977] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); FSA (Apr. 2012); UKRCBC.

[1978] *See* UKRCBC. For example, a commenter indicated that in the European Union, Article 52(4) of the EU UCITS Directive sets out the defining characteristics of covered bonds, and this directive is implemented by specific legislative frameworks.

[1979] *See* UKRCBC; FSA (Apr. 2012). One commenter argued that there are two main models used for covered bond structures in Europe—the integrated model (where the collateral pool continues to be owned directly by the bank issuer and is segregated by special legislation) and the structured model (where the pool is transferred to a special purpose vehicle and is segregated by operation of legal principles). *See* UKRCBC.

[1980] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1981] *See* FSA (Apr. 2012).

[1982] *See* UKRCBC.

[1983] *See* Allen & Overy (on behalf of Foreign Bank Group).

broad definition of covered fund in the proposed rule could capture an SPV that holds the collateral, so transactions between an SPV and the issuing bank or sponsor bank may be prohibited.[1984] These commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule, would have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1985]

According to certain commenters, SPVs whose sole function is as part of an offering of covered bonds should be excluded from the definition of covered fund in the final rule. These commenters provided that the proposed rule was not clear on whether these SPVs, which effectively function as collateral devices for the covered bond, would be excluded from the definition of covered fund.[1986] One commenter indicated that the key concern was primarily due to the wide definition of covered fund in the proposed rule.[1987] Other commenters indicated that the final rule should not apply to covered bond transactions because they are not traditionally recognized or regulated as asset-backed securities transactions, and they are not the type of transactions that the rule was intended to address.[1988]

As a result of comments received on covered bond vehicles, the final rule specifically excludes from the definition of covered fund certain entities that own or hold a dynamic or fixed pool of assets that covers the payment obligations of covered bonds. In order to qualify for the exclusion, the assets or holdings in the cover pool must satisfy the conditions in the loan securitization exclusion, except for the requirement that the securities they issue are asset-backed securities (the ''permitted cover pool'').[1989] The Agencies believe this approach is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act. The rule of construction in section 13(g)(2) of the BHC Act specifically refers to the ''sale and securitization of loans'' and the Agencies would not want a banking entity to use an excluded cover pool to engage in proprietary trading of such securities prohibited under the final rule. The Agencies believe this restriction reduces the potential for evasion of the final rule.

By placing restrictions on the assets permitted to be held by a cover pool, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for cover pools is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banking entities to continue to engage in lending activities and the financing those lending activities. Including all types of securities and other assets within the scope of permitted assets in a cover pools would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction. Additionally, because the exclusion for cover pools is only available to foreign banking organizations, allowing such cover pools to hold securities would provide unequal treatment of covered bonds as compared to a loan securitization sponsored by a U.S. banking entity.

Under the definition of covered bond in the final rule, the debt obligation may be issued directly by a foreign banking organization or by an entity that owns a permitted cover pool. In both cases, the payment obligations of the debt obligation must be fully and unconditionally guaranteed. If the debt obligation is issued by a foreign banking organization, such debt obligation will be a ''covered bond'' under the final rule if the payment obligations are fully and unconditionally guaranteed by an entity that owns a permitted cover pool.[1990] If the debt obligation is issued by an entity that owns a permitted cover pool, such debt obligation will be a ''covered bond'' under the final rule if (i) the payment obligations are fully and unconditionally guaranteed by a foreign banking organization and (ii) the issuer of the debt obligation is a wholly-owned subsidiary (as defined) by such foreign banking organization.[1991] Thus, under the final rule, a covered bond structure in which an entity holds the cover pool and issues securities that are fully and unconditionally guaranteed by a foreign banking organization may also be able to rely on the loan securitization exclusion if it meets all of the requirements of that exclusion.

The Agencies recognize that many covered bond programs may involve foreign covered bond programs (and their related cover pools) that are permitted by their respective laws to own residential mortgage-backed securities and other non-loan assets. As a result, the exclusion for covered bonds in the final rule may not be available to many of the existing cover pools that support outstanding covered bonds. The Agencies recognize that this approach may not exclude all foreign covered bond programs. Although certain commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule,[1992] the Agencies believe that the exclusion for qualifying covered bonds, including the limitations on the types of securities that a loan securitization can hold, is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act and appropriate for the reasons discussed directly above and under ''Definition of Loan.'' The Agencies also recognize that commenters argued that including covered bonds as covered funds could have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1993] The Agencies note that, although they do not know the composition of the cover pools, the Agencies believe that foreign banking organizations should be able to look at the composition of their cover pools to evaluate how to meet the requirements of the exclusion — and thus to avoid or mitigate the adverse effects commenters asserted would occur—as they determine appropriate.

11. Certain Permissible Public Welfare and Similar Funds

Section 13(d)(1)(E) of the BHC Act permits a banking entity to make and retain: (i) Investments in one or more small business investment companies (''SBICs''), as defined in section 103(3) of the Small Business Investment Act of 1958 (SBA) (15 U.S.C. 662) [1994]; (ii)

[1984] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012).

[1985] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012); AFME *et al.* For a discussion of possible economic effects, *see* FSA (Feb. 2012); UKRCBC; Allen & Overy (on behalf of Foreign Bank Group).

[1986] *See* ASF (Feb. 2012); AFME *et al.;* UKRCBC.

[1987] *See* UKRCBC.

[1988] *See, e.g.,* AFME *et al.*

[1989] *See* final rule § 75.10(c)(10).

[1990] *See* final rule § 75.10(c)(10)(ii)(A).

[1991] *See* final rule § 75.10(c)(10)(ii)(B). As discussed above in the section describing the wholly-owned subsidiary exclusion from the definition of covered fund, the Agencies are permitting 0.5 of a wholly-owned subsidiary to be owned by an unaffiliated party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

[1992] *See supra* note 1985 and accompanying text.

[1993] *Id.*

[1994] The Agencies note that section 13(d)(1)(E) of the BHC Act incorrectly provides that the term ''small business investment company'' is defined in section 102 of the SBA, while the definition is in fact contained in section 103(3) of the SBA as codified at 15 U.S.C. 662. The statute includes the correct citation to 15 U.S.C. 662. The Agencies are correcting this technical error in the final rule by updating the reference to section 102 to section 103(3).

investments that are designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24); and (iii) investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[1995] The proposed rule permitted banking entities to invest in and act as sponsor [1996] to these entities, but did not explicitly exclude them from the definition of covered fund.[1997]

Commenters generally supported the proposed exemption for investments in and sponsorship of funds designed to promote the public welfare, SBICs, and other tax credit funds given the valuable funding and assistance these investments provide in facilitating community and economic priorities and the role these investments play in the ability of banking entities, especially community and regional banks, to achieve their financial and Community Reinvestment Act (''CRA'') goals. However, commenters raised some issues with respect to the proposed exemption and sought clarification on its application to specific investments.[1998] Of primary concern to commenters was the impact of the prohibition in section 13(f) of the BHC Act on the ability of a banking entity sponsoring a tax credit fund or its affiliate to guarantee certain obligations of the fund in order to provide assurance to investors that the investment has been properly structured to enable the investor to receive the tax benefits on which the investment are sold.[1999] Some commenters noted that failure to address this issue in the final rule would damage a large segment of this market and therefore urged the Agencies to exempt these investments from the application of section 13(f) or, in the alternative, from the definition of covered fund.[2000]

In addition, commenters requested clarification that specific types of public welfare, SBIC, and other tax credit investments would be eligible for the exemption, including Low Income Housing Tax Credits, Renewable Energy Tax Credits, New Markets Tax Credits, and Rural Business Investment Companies.[2001] One commenter requested that applicants for an SBIC license that have received permission from the Small Business Administration to file a formal SBIC license application be viewed the same as an SBIC.[2002] Other commenters sought coverage of investments in non-SBIC funds that provide capital to small and middle-market companies,[2003] investments in any state administered tax credit program,[2004] and investments outside the United States that are of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24).[2005]

In light of the comments received, the final rule excludes from the definition of covered fund an issuer that is an SBIC (or that has received from the Small Business Administration notice to proceed to qualify for a license as an SBIC, which notice or license has not been revoked) or the business of which is to make investments that are: (i) Designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or (ii) qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[2006]

By excluding SBICs and other public interest funds from the definition of covered fund—rather than provide a permitted activity exemption as proposed—the Agencies addressed commenters' concerns regarding the burdens imposed by section 13(f). The Agencies believe that excluding these investments from the definition of covered fund addresses the issues many commenters raised with respect to the application of section 13(f) of the BHC Act, and gives effect to the statutory exemption of these investments in a way that appropriately facilitates national community and economic development objectives. The Agencies believe that permitting a banking entity to sponsor and invest in these types of public interest entities will result in banking entities being able to provide valuable expertise and services to these entities and to provide funding and assistance to small businesses and low- and moderate-income communities. The Agencies believe that providing the exclusion will also allow banking entities to continue to provide capital to community-improving projects and in some instances promote capital formation.

12. Registered Investment Companies and Excluded Entities

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[2007] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[2008] A few commenters argued that the final rule should specifically provide that all SEC-

[1995] *See* 12 U.S.C. 1851(d)(1)(E).

[1996] The proposal implemented a proposed determination by the Agencies under 13(d)(1)(J) ''that a banking entity may not only invest in such entities as provided under section 13(d)(1)(E) of the BHC Act, but also may sponsor an entity described in that paragraph and that such activity, since it generally would facilitate investment in small businesses and support the public welfare, would promote and protect the safety and soundness of banking entities and the financial stability of the United States.'' Joint Proposal, 76 FR at 68908 n.292.

[1997] *See* proposed rule § 75.13(a).

[1998] *See* Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); PNC; Raymond James; SIFMA et al. (Covered Funds) (Feb. 2012); SBIA.

[1999] *See* AHIC; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SBIA; Union Bank; U.S. Bancorp.

[2000] *See* ABA (Keating); Lone Star; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SVB; U.S. Bancorp.

[2001] *See* NCHSA; SBIA; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC).

[2002] *See* SBIA; *see also* SEC Rule 3c-2.

[2003] *See* ABA (Keating); PNC.

[2004] *See* USAA.

[2005] *See* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2006] *See* final rule § 75.10(c)(11). This provision would cover any issuer that engages in the business of making tax credit investments (*e.g.,* Low Income Housing Tax Credit, New Markets Tax Credit, Renewable Energy Tax Credit, Rural Business Investment Company) that are either designed to promote the public welfare of the type permitted under 12 U.S.C. 24 (Eleventh) or are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as provided for under § 75.10(c)(11).

[2007] *See* proposed rule § 75.10(b)(1).

[2008] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[2009]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[2010]

Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are excluded from SEC regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which are regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[2011]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed above.

In order to prevent banking entities from purporting to use this exclusion for vehicles that the banking entity does not reasonably expect to become a registered investment company or business development company, the exclusion is available only with respect to a vehicle that the banking entity operates (i) pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or business development company within the time period provided by the final rule for seeding a covered fund; (ii) consistently with the leverage requirements under the Investment Company Act of 1940 that are applicable to registered investment companies and SEC-regulated business development companies.[2012] A banking entity that seeds a covered fund for any purpose other than to register it as an investment company or establish a business development company must comply with the requirements of section 13(d)(1)(G) of the BHC Act and § 75.11 of the final rule as described above. The Agencies will monitor this seeding activity for attempts to use this exclusion to evade the requirements governing the ownership of and relationships with covered funds under section 13 of the BHC Act and the final rule.[2013]

13. Other Excluded Entities

Section 13(h)(2) permits the Agencies to include similar funds within the definition of covered fund, but the proposal did not contain a process for excluding from the definition of covered fund other entities that do not engage in the investment activities contemplated by section 13. Many commenters argued that the breadth of entities that may be required to rely on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act could result in additional unidentified entities becoming subject to the definition of covered fund.[2014] In order to ensure that the final rule effectively addresses the full scope of entities that may inadvertently be included within the definition of covered fund, a number of commenters urged that the final rule include a mechanism to exclude other entities from the term ''covered fund'' by rule or order if the Agencies determine such an exclusion is appropriate.[2015]

As evidenced by the extensive comments discussed above identifying the many types of corporate structures and other vehicles (not just investment funds) that rely on sections 3(c)(1) and 3(c)(7) but do not engage in investment activities of the type contemplated by section 13, the scope of an overly broad definition of covered fund may impose significant burdens on banking entities that are in conflict with the purposes of section 13 of the BHC Act. In response to commenters' concerns and to address the potential that the final rule's definition of covered fund might encompass entities that do not engage in the investment activities contemplated by section 13, the final rule includes a provision that provides that the Agencies may jointly determine to exclude an issuer from the definition of covered fund if the exclusion is consistent with the purposes of section 13 of the BHC Act.[2016]

As noted above, the statute permits the Agencies to act by rule to modify the definition of covered fund. After issuing the proposed rule and receiving comment on it, the final rule provides that the Agencies may act jointly to provide an exclusion.[2017] The Agencies are working to establish a process within which to evaluate requests for exclusions and expect to provide additional guidance on this matter as the Agencies gain experience with the final rule.[2018] As a result, the definition of covered fund would remain unified and consistent. The final rule also provides that a determination by the Agencies to exclude an entity from the definition of covered fund will be promptly made public in order to ensure that both banking entities and the public may understand what entities are and are not included within the definition of covered fund.

[2009] *See* Arnold & Porter; Goldman (Covered Funds); *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC (requesting clarification that registered investment companies are not banking entities); TCW.

[2010] *See* ICI (Feb. 2012); TCW.

[2011] *See* final rule § 75.10(c)(12).

[2012] *See* final rule §§ 75.10(c)(12)(i); 10(c)(12)(iii); 75.20(e).

[2013] The Agencies also note that banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years must maintain records that include, among other things, documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity in determining that such fund is not a covered fund. *See* final rule § 75.20(e).

[2014] *See also* FSOC study.

[2015] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[2016] *See* final rule § 75.10(c)(14).

[2017] As discussed above, the Agencies also may determine jointly that an entity excluded from the definition of covered fund under § 75.10(c) is in fact a covered fund, and consequently banking entities' investments in and transactions with such fund would be subject to limitations and/or divestiture. The Agencies intend to utilize this authority to monitor for and address, as appropriate, instances of evasion. *See, e.g.,* 12 U.S.C. 1851(e)(2).

[2018] A joint determination specified under § 75.10(c)(14) may take a variety of forms.

d. Entities Not Specifically Excluded From the Definition of Covered Fund

In addition to the entities identified above which are excluded from the definition of covered fund under the final rule, commenters argued that a number of other entities such as financial market utilities, venture capital funds, credit funds, cash management vehicles or cash collateral pools may also be an investment company but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act and requested that these entities expressly be excluded from the final rule's definition of covered fund. The Agencies have considered carefully the comments received on each of these entities but, for the reasons explained below, have declined to provide a separate exclusion for them from the definition of covered fund at this time. As discussed below, some of these entities are not covered funds for various reasons or may, with relatively little cost, conform to the terms of an exclusion or exemption from the definition of covered fund. As noted above, to the extent that one of these entities qualifies for one or more of the other exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

A number of commenters requested that certain existing covered funds be either excluded from the definition of covered fund or grandfathered and not be subject to the limitations of section 13 of the BHC Act.[2019] The Agencies note, however, that section 13 specifically addresses a banking entity's preexisting investments in covered funds by providing a conformance period, which banking entities may use to bring their activities and investments into compliance with the requirements of section 13 and the final rule. To the extent that section 13 could be interpreted to permit the Agencies to take a different approach, despite addressing banking entities' preexisting covered fund investments directly, the Agencies believe it would be inconsistent with the purposes of section 13 to permit banking entities to continue to hold ownership interests in covered funds beyond the conformance period provided by the statute. Section 13's prohibition on banking entities' investments in and relationships with covered funds and the requirement that banking entities divest or conform these investments appear to reflect the statutory purpose that banking entities be limited in their ability to continue to be exposed to these investments outside of the statutorily-provided conformance period. The Agencies believe that permitting banking entities to hold ownership interests indefinitely beyond the conformance period provided by the statute appears inconsistent with this purpose.

1. Financial Market Utilities

Several commenters contended that financial market utilities (''FMUs'') could be covered funds because they might rely on section 3(c)(1) or 3(c)(7) for an exclusion from the definition of investment company under the Investment Company Act and may not qualify for an alternative exemption.[2020] These commenters argued that banking entities have long been investors in domestic and foreign FMUs, such as securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems. These commenters expressed concern that, unless FMUs are expressly excluded from the definition of covered fund, banking entities could be prohibited from entering into any new covered transactions with related FMUs and would be required to divest their investments in FMUs, thereby disrupting the operations of those FMUs and financial markets generally.

After carefully considering commenters' concerns, the Agencies believe that FMUs are not investment vehicles of the type section 13 of the BHC Act was designed to address, but rather entities that generally engage in other activities, including acting as central counterparties that reduce counterparty risk in clearing and settlement activities. Congress recognized, in the Payment, Clearing, and Settlement Supervision Act of 2010 (title VIII of the Dodd-Frank Act),[2021] that properly designed, operated, and supervised financial market utilities as defined in that Act mitigate systemic risk and promote financial stability.[2022]

However, the Agencies have not provided an exclusion from the covered fund definition for FMUs because these kinds of entities do not generally appear to rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act, and therefore do not appear to need an exclusion. For example, section 3(b)(1) of the Investment Company Act excludes from the definition of investment company—and thus from the definition of a covered fund—entities primarily engaged in a business other than that of an investment company.[2023] If an FMU is primarily engaged in a business other than those that would make it an investment company, for example, if the FMU is primarily engaged in transferring, clearing, or settling payments, securities, or other financial transactions among or between financial institutions,[2024] the FMU could rely on the exclusion to the definition of investment company provided by section 3(b)(1) and would not need to rely on section 3(c)(1) or 3(c)(7) and, as such, would not be a covered fund.

2. Cash Collateral Pools

Some commenters expressed concern that cash collateral pools, which are part of securities lending programs, could be included in the definition of covered fund.[2025] According to these commenters, banking entities, including bank custodians acting as lending agent for customer's securities lending activities, typically manage these pools as fiduciaries for their customers.[2026] These commenters argued that collateral pools are part of a banks' traditional custody and advisory services and have been an integral part of any lending agent's role (whether custodial or non-custodial) for years.[2027]

Cash collateral pools are typically formed when, as part of a securities lending program, a customer of a bank authorizes the bank to take securities from the customer's account and lend them in the open market. The agent bank then lends those securities and receives collateral in return from the borrower; a securities lending customer of a bank typically elects to have cash collateral provided by a borrower pooled by the agent bank with other cash collateral provided to other clients.[2028] These investment pools may exist in the form of trusts, partnerships, limited liability companies, or separate

[2019] *See, e.g.,* PNC; SVB; SIFMA (Securitization) (Feb. 2012); AFME *et al.;* BoA. *See also, e.g.,* Credit Suisse (Williams).

[2020] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2021] 12 USC 5461 *et seq.*

[2022] *See id.*

[2023] Section 3(b)(1) of the Investment Company Act excludes from the definition of investment company ''[a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.''

[2024] *See* 12 U.S.C. 1562(6); 12 CFR Part 234.

[2025] *See* RMA; State Street (Feb. 2012); *see also* BNY Mellon *et al.*

[2026] *See* RMA; State Street (Feb. 2012).

[2027] *See* RMA; BNY Mellon *et al.* (citing Comptroller's Handbook: Custody Services (Jan. 2002)).

[2028] *See* RMA.

accounts maintained by more than one party and these structures may rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid being an investment company.[2029] While their ownership interest may be nominal in amount, the agent banks may hold a general partnership, limited liability company membership or trustee interest in the cash collateral pool.[2030] As part of these arrangements, custodian banks routinely offer borrower default indemnifications to the securities lender in a securities lending transactions.

Commenters raised concerns that these indemnification agreements could be considered a covered transaction prohibited by section 13(f) of the BHC Act.[2031] Since some cash collateral pools are established outside of the United States, commenters requested that the final rule permit banking entities to have interests in and relationships with both U.S. and non-U.S. cash collateral pools.[2032] These commenters suggested that cash collateral pools be excluded from the definition of covered fund or, in the alternative, that the Agencies make clear that cash collateral pools managed by agent banks qualify for the exemption in § 75.11 of the proposed rule for organizing and offering a covered fund and that the prime brokerage exemption from the restrictions of section 13(f) would permit the indemnification and income or settlement services agent banks typically provide to the pools.[2033] These commenters also suggested that the Agencies use their authority under section 13(d)(1)(J) to provide an exemption for banking entities to continue to have interests in and provide services to these types of pools.[2034]

After carefully considering comments received, the final rule does not provide a specific exclusion from the definition of covered fund for cash collateral pools. The Agencies have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for cash collateral pools.

The Agencies note, however, that some cash collateral pools may not be covered funds because they rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2035] Banking entities may determine to register cash collateral pools with the SEC as investment companies or to operate them as separate accounts to exclude the pools from the covered fund definition or, if the pools remain covered funds, to organize and offer them in compliance with the requirements of § 75.11 of the final rule.

In response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not a covered transaction subject to 13(f) or a guarantee of the performance or obligations of a covered fund prohibited under § 75.11 of the final rule. Those restrictions apply to transactions with the covered fund or guarantees of the covered fund's performance. Borrower default indemnifications are provided to the bank's securities lending customer, not to the cash collateral pool.

3. Pass-Through REITS

Some banking entities may issue real estate investment trust (''REIT'') preferred securities to the public directly from a subsidiary that qualifies for the exclusion in section 3(c)(5) or section 3(c)(6) of the Investment Company Act. These entities would not be considered a ''covered fund'' because they may rely on an exclusion from the definition of an investment company other than the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2036] However, in order to meet the demands of customers and avoid undesirable tax consequences, some banking entities structure their REIT offerings by using a passive, pass-through statutory trust between the banking entity and the REIT to issue REIT preferred securities to the public.[2037] Because the pass-through trust holds the preferred securities of the underlying REIT (which would itself not be a covered fund), as well as provides administrative and ministerial functions for the REIT (including passing through dividends from the underlying REIT), the pass-through trust may not itself rely on the exclusion contained in section 3(c)(5) or 3(c)(6) and, thus, typically relies on section 3(c)(1) or 3(c)(7).[2038]

Some commenters urged the Agencies to provide an exclusion for pass-through REITS from the definition of covered fund.[2039] These commenters argued that because the pass-through trust exists as a corporate convenience as part of issuing REIT preferred securities to the banking entity and its customers, it is not the type of entity that the covered fund prohibition in section 13 of the BHC Act was intended to address. These commenters also argued that pass-through REITs enable banking entities to offer preferable tax treatment to holders of the REIT preferred securities and that if pass-through REITs were included as covered funds, because of the limitations on covered transactions contained in section 13(f), the minority interests in the preferred securities issued by the REIT would no longer be able to be included in a banking entity's tier 1 capital, thereby negatively impacting the safety and soundness of the banking entity.[2040]

The Agencies are not providing a specific exclusion from the definition of covered fund for pass-through REITs because the Agencies are concerned that such an exclusion could enable banking entities to structure non-loan securitization transactions using a pass-through entity in a manner inconsistent with the final rule's treatment of similar vehicles that invest in securities.

[2029] *See* RMA.

[2030] *See* RMA.

[2031] *See* State Street; RMA. Commenters also argued that as part of offering pooled cash collateral management, agent banks have traditionally provided short-term extensions of credit and contractual income and settlement services to lending clients and cash collateral pools to facilitate trade settlement and related cash collateral investment activities. *See* RMA. One commenter further argued that if banks are required to ''outsource'' cash collateral pools and/or the related short-term credit services provided to the pools, ''participation in securities lending programs would only be cost effective for the largest lending clients'' and, as a result, ''many small and intermediate securities lending clients would be denied the incremental revenue securities lending can provide''; ''securities lending programs could lose significant diversification in lending clients, lendable assets, borrowers and agent banks''; and, as a result of lost revenues, ''the actual costs of [ ] custodial or other services provided to clients that no longer participate in lending would increase.'' *Id.*

[2032] *See* RMA.

[2033] *See* RMA.

[2034] *See* RMA.

[2035] For instance, the Agencies understand that a banking entity may set up a cash collateral pool in reliance on the exclusion contained in section 3(c)(3) of the Investment Company Act, or may be able to structure these pools as SEC-registered money market funds operated in accordance with rule 2a–7 under the Investment Company Act.

[2036] *See* PNC.

[2037] *See* PNC.

[2038] *See* ABA (Keating); PNC.

[2039] *See* ABA (Keating); PNC.

[2040] *See* PNC; ABA (Keating). These commenters argued that most REIT preferred securities contain a conditional exchange provision that allows the primary regulator to direct that the preferred securities be automatically exchanged for preferred shares of the bank or parent BHC upon occurrence of a conditional exchange event. Because this arrangement involves the purchase of securities issued by an affiliate or the purchase of assets, it would be prohibited under section 13(f) of the BHC Act if the pass-through REIT were a covered fund.

Furthermore, banking entities have alternative manners in which they may issue or hold REIT preferred securities, including through REITs directly, which do not raise the same concerns about evasion.[2041]

4. Municipal Securities Tender Option Bond Transactions

The Agencies received a number of comments addressing how the final rule should treat municipal securities tender option bond vehicles. A number of commenters argued that issuers of municipal securities tender option bonds would fall under the definition of covered fund in the proposed rule because these issuers typically rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2042] According to commenters, a typical tender option bond transaction consists of the deposit of a single issue of highly-rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security (the ''floaters''), and an inverse floating rate security (the ''residual'') with no tranching involved. According to commenters, the holders of the floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par. The put right is supported by a liquidity facility delivered by a highly-rated provider (in many cases, the banking entity sponsoring the trust) and allows the floaters to be treated as a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer-term investor (in many cases the banking entity sponsoring the trust, or an insurance company, mutual fund, or hedge fund). According to commenters, the residual investors take all of the market and structural risk related to the tender option bonds structure, with the investors in floaters taking only limited, well-defined insolvency and default risks associated with the underlying municipal bonds generally equivalent to the risks associated with investing in the municipal bonds directly. According to commenters, the structure of tender option bond transactions is governed by certain provisions of the Internal Revenue Code in order to preserve the tax-exempt treatment of the underlying municipal securities.

Many commenters requested a specific exclusion for municipal tender option bond vehicles from the definition of a covered fund.[2043] These commenters argued that, without an exclusion from the definition of covered fund, banking entities would be prohibited from owning or sponsoring tender option bonds and from providing credit enhancement, liquidity support, remarketing, and other services required in connection with a tender option bond program.[2044] Commenters argued that tender option bond vehicles should be excluded because section 13(d)(1)(A) of the BHC Act already allows banking entities to own and dispose of municipal securities directly,[2045] tender option bonds are economically similar to repurchase agreements, which are expressly excluded from the proprietary trading restrictions of the proposed rule, and, because they are safe and low risk are similar to the types of transactions that the proposed rule would have exempted.[2046] Commenters also argued that tender option bonds are different from other covered funds that rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act[2047] and play an important role in the municipal bond markets.[2048] Commenters requested that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act to exclude tender option bonds because they argued that tender option bonds promote the safety and soundness of banking entities and the financial stability of the United States by providing for a deeper, richer pool of potential investors, a larger and more liquid market for municipal securities that results in lower borrowing costs for municipalities and other issuers of municipal securities, and greater efficiency and risk diversification.[2049] Commenters also suggested a number of other ways to exclude tender option bonds, including defining ownership interest to exclude any interest in a tender option bond transaction;[2050] defining banking entity to exclude tender option bond issuers;[2051] expanding the loan securitization exclusion to include tender option bond issuers;[2052] and revising the definition of sponsor to exclude sponsors of tender option bond vehicles.[2053] One commenter urged the Commission to consider amending the exemption under rule 3a–7 under the Investment Company Act or providing formal guidance regarding the status of tender option bond programs.[2054] In addition, some commenters requested an exclusion for tender option bond transactions from the provisions of section 13(f) of the BHC Act.[2055]

After carefully considering the comments received, the final rule does not provide a specific exclusion from the definition of covered fund or from the prohibitions and requirements of the final rule for tender option bond vehicles.[2056] The Agencies have determined to provide specific exclusions for entities that they believe fall within the rule of construction contained in section 13(g)(2) of the BHC Act, which expressly relates to the sale and securitization of loans,[2057] do not

[2041] The Agencies recognize that banking entities may have relied on pass-through REIT structures to issue preferred securities in the past and prohibiting such transactions may pose inefficiencies. Furthermore, it may not be possible to unwind or conform past issuances without significant effort by the banking entity and negotiation with the holders of the preferred securities. As noted above, in these circumstances, section 13 provides a conformance period which banking entities may take advantage of in order to bring their activities and investments into compliance with the requirements of section 13 and the final rule.

[2042] *See, e.g.,* Ashurst; SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Cadwalader (Municipal Securities); Vanguard; ICI (Feb. 2012); ASF (Feb. 2012); Fidelity; Wells Fargo (Covered Funds). Commenters also noted that tender option bond programs as currently structured may not meet the requirements of section 3(a)(5) of the Investment Company Act or rule 3a–7 thereunder, or any other exclusion or exemption under the Investment Company Act. *See* Ashurst; RBC; ASF (Feb. 2012).

[2043] *See, e.g.,* ASF (Feb. 2012); BDA (Feb. 2012); Eaton Vance; Fidelity; ICI (Feb. 2012); RBC; SIFMA (Municipal Securities) (Feb. 2012); SIFMA (May 2012); State Street (Feb. 2012); Vanguard.

[2044] *See* Ashurst; ASF (Feb. 2012).

[2045] *See* ASF (Feb. 2012); SIFMA (Municipal Securities) (Feb. 13, 2012); Citigroup (Jan. 2012). *See also* Cadwalader (Municipal Securities) (alleging that the legislative history of section 13 of the BHC Act suggests that the exemption relating to municipal securities should not be construed to apply only to the section of the rule pertaining to the proprietary trading prohibitions); BDA (Feb. 2012) (arguing that any fund or trust the assets of which are entirely invested in any of the obligations that are excluded from the proprietary trading prohibitions should also be excluded from the definition of covered fund).

[2046] *See, e.g.,* Ashurst; Cadwalader (Municipal Securities); Eaton Vance; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 13, 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds); Citigroup (Jan. 2012).

[2047] *See, e.g.,* ASF (Feb. 2012); State Street (Feb. 2012); Citigroup (Jan. 2012); Vanguard; Wells Fargo (Covered Funds); Cadwalader (Municipal Securities); Ashurst.

[2048] *See* Cadwalader (Municipal Securities); ICI (Feb. 2012); Ashurst; ASF (Feb. 2012).

[2049] *See* Cadwalader (Municipal Securities).

[2050] *See* RBC.

[2051] *See* ICI (Feb. 2012).

[2052] *See* ASF (Feb. 2012).

[2053] *See* RBC.

[2054] *See* Ashurst.

[2055] *See, e.g.,* RBC; ASF (Mar. 2012); ASF (Feb. 2012).

[2056] The Agencies received a variety of requests requesting specific treatment of tender option bond transactions. *See, e.g., supra* notes 2050–2055. As discussed above, the Agencies believe that, in light of the comments received, tender option bond vehicles do not fall within the rule of construction contained in section 13(g)(2) of the BHC Act and, as a result, the final rule does not provide such treatment.

[2057] *See* 12 U.S.C. 1851(g)(2).

function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations. The Agencies do not believe that these considerations support a separate exclusion for tender option bond vehicles, which have municipal securities as underlying assets and not loans.

The Agencies recognize commenters' concerns about the treatment of tender option bonds under the final rule, as discussed above. However, as there is no corresponding rule of construction in section 13 of the BHC Act for financial instruments other than loans, the Agencies do not believe that the resecuritization of municipal debt instruments should be treated differently than the resecuritization of other debt instruments.[2058] Notwithstanding the statutory treatment of municipal securities for purposes of the proprietary trading restrictions, the Agencies also do not believe that tender option bond vehicles fall within the rule of construction contained in section 13(g)(2) of the BHC Act, because, in light of commenters' descriptions of these vehicles, tender option bond vehicles are more in the nature of other types of bond repackaging securitizations and other non-excluded securitization vehicles.[2059] The final rule, however, does not prevent a banking entity from owning or otherwise participating in a tender option bond vehicle; it requires that these activities be conducted in the same manner as with other covered funds.

In this regard, under the final rule, a banking entity would need to evaluate whether a tender option bond vehicle is a covered fund as defined in the final rule. If a tender option bond vehicle is a covered fund and an exclusion from that definition is not available, then banking entities sponsoring such a vehicle will be subject to the prohibitions in § 75.14 of the final rule and the provisions of section 13(f) of the BHC Act.[2060]

As tender option bond vehicles are considered issuers of asset-backed securities subject to the risk retention requirements of section 15G of the Exchange Act, banking entities may look to the provisions of the final rule governing the limits applicable to banking entities' interests in and relationships with those funds. Under the final rule, as in the statute, a banking entity that conducts the activities described in section 13(f) of the BHC Act is subject to the restrictions on transactions with a tender option bond vehicle, including guaranteeing or insuring the performance of the tender option bond vehicle, contained in section 13(f) of the BHC Act. As a result, a banking entity is not permitted to provide credit enhancement, liquidity support, and other similar services if it serves in a capacity covered by section 13(f) with the tender option bond program.[2061] An unaffiliated third party may provide such services if it does not have a relationship with the tender option bond vehicle that triggers application of section 13(f). The extent to which the final rule causes a disruption to the securitization of, and market for, municipal tender option bonds may also affect the economic burden and effects on the municipal bond market and its participants, including money market mutual funds[2062] and issuers of municipal securities. The Agencies recognize that a potential economic burden may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities customarily included in municipal tender option bond vehicles[2063] and therefore potential effects on the depth and liquidity of the market for certain types of municipal securities.[2064]

5. Venture Capital Funds

Some private equity funds that make investments in early-stage start-up companies or other companies with significant growth potential (''venture capital funds'') would be investment companies but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Venture capital funds would therefore qualify as a covered fund under the proposal. The proposal specifically requested comment on whether venture capital funds should be excluded from the definition of ''covered fund.''

Some commenters argued that venture capital funds should be treated differently than other covered funds and excluded from the definition. These commenters argued that, unlike conventional hedge funds and private equity funds, venture capital funds do not possess high leverage and do not engage in risky trading activities of the type section 13 of the BHC Act was designed to address.[2065] These commenters contended that investments and relationships by banking entities in venture capital funds would be consistent with safety and soundness; provide important funding and expertise and other services to start-up companies; and provide positive benefits to employment, GDP, growth, and innovation.[2066] These commenters argued that restricting banking entities' ability to invest in or sponsor venture capital funds would have a negative impact on companies and the U.S. economy generally.[2067] Some commenters asserted that bank investments in venture capital funds are important to the success of venture capital,[2068] with some citing a consulting firm's data indicating that approximately 7 percent of all venture capital is provided by banks.[2069] One commenter argued, therefore, that ''preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term,'' and the funding gap that would result if banks could not invest in venture capital funds would not be met

[2058] For these same reasons, and based on the definitions of sponsor and banking entity in section 13, the Agencies have not modified those definitions in the final rule to exclude sponsors of tender options bonds and tender bond issuers, respectively, as some commenters requested. *See supra* notes 2051 and 2053 and accompanying text.

[2059] Commenters also argued that to the extent tender option bond programs are not excluded from the definition of covered fund, the definition of ownership interest should exclude any interest in a tender option bond program (*see* RBC) or that where a third party owns the residual, the banking entity should not be treated as having an ownership interest, even when it owns a small interest for tax purposes or becomes the owner through liquidity or remarketing agreements (*see* Cadwalader (Municipal Securities)). The definition of ownership interest in the final rule focuses on the attributes of the interest, as discussed below, and not the particular type of covered fund involved. The Agencies are not providing separate definitions of or exclusions from the ownership interest definition based on the type of vehicle or financing involved. *See infra* note 2103 and preceding and following text. Banking entities will need to evaluate whether the interests they may acquire are ownership interests as defined under the final rule.

[2060] *See* 12 U.S.C. 1851(f).

[2061] As discussed above, while commenters requested treatment of municipal tender option bond vehicles that would cause section 13(f) of the BHC Act not to apply to them, the final rule does not exclude these vehicles from the definition of covered fund or the prohibitions relating to covered funds. As a result, section 13(f) of the BHC Act will apply to a banking entity that is sponsoring a tender option bond vehicle.

[2062] *See* ASF (Feb. 2012); Nuveen Asset Mgmt.

[2063] *See* Ashurst.

[2064] *See* Eaton Vance.

[2065] *See* SVB; NVCA; Rep. Eshoo; Sen. Boxer; Rep. Goodlatte; Rep. Schweikert; Rep. Speier; Rep. Honda; Rep. Lofgren; Rep. Peters *et al.*

[2066] *See, e.g.,* NVCA; SVB; Scale.

[2067] *See, e.g.,* SVB; Scale; Sen. Boxer; SIFMA *et al.* (Covered Funds) (Feb. 2012) (citing a colloquy between Sen. Dodd and Sen. Boxer supporting an exemption for venture capital funds (156 Cong. Rec. H5226 (daily ed., June 30, 2010)).

[2068] *See* River Cities; Scale. *See also* Sofinnova; Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Mohr Davidow; ATV; BlueRun; Westly; Charles River; Flybridge; SVB.

[2069] *See, e.g.,* SVB.

by other market participants if bank investments in venture capital were restricted.[2070] Several commenters recommended that venture capital funds be excluded if they: (i) Do not fundamentally engage in proprietary trading; (ii) do not use leverage to increase investment returns; and (iii) typically invest in high-growth start-up companies as compared to more mature publicly traded companies.[2071]

Conversely, one commenter alleged that there was no credible way to exclude venture capital funds without providing a means to circumvent the requirements of section 13 and the final rule.[2072] Another commenter argued that venture capital funds do in fact engage in risky activities and that, instead of making investments in venture capital funds, banking entities may directly extend credit to start-up companies in a safe and sound manner.[2073]

The final rule does not provide an exclusion for venture capital funds. The Agencies believe that the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund. Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act and accorded distinct treatment for venture capital fund advisers by exempting them from registration requirements under the Investment Advisers Act.[2074] This indicates that Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so.[2075] No such distinction appears in section 13 of the BHC Act. Because Congress chose to distinguish between private equity and venture capital in one part of the Dodd-Frank Act, but chose not to do so for purposes of section 13, the Agencies believe it is appropriate to follow this Congressional determination.

In addition to the language of the statute, it appears to the Agencies that the activities and risk profiles for banking entities regarding sponsorship of, and investment in, venture capital funds and private equity funds are not readily distinguishable. Many key structural and operational characteristics of venture capital funds are substantially similar to those of hedge funds and private equity funds, thereby making it difficult to define venture capital funds in a manner that would not provide banking entities with an opportunity to evade the restrictions of section 13 of the BHC Act.

For instance, in addition to relying on the same exemptions under the Securities Act,[2076] venture capital funds, private equity funds and hedge funds all rely on the exclusion in section 3(c)(1) or 3(c)(7) from the definition of investment company under the Investment Company Act. Moreover, like private equity funds, venture capital funds pool funds from multiple investors and invest those funds in interests of portfolio companies for the purpose of profiting from the resale of those interests. Indeed, funds that are called ''venture capital funds'' may invest in the very same entities and to the same extent as do funds that call themselves private equity funds. Venture capital funds, like private equity funds, also typically charge incentive compensation to fund investors based on the price appreciation achieved on the investments held by the fund and provide a return of principal plus gains at specific times during the limited life of the fund. Not including venture capital funds in the definition of covered fund, therefore, could allow banking entities, either directly or indirectly, to engage in the type of activities section 13 was designed to address.

While the final rule does not provide a separate exclusion for venture capital funds from the definition of covered fund, the Agencies recognize that certain venture capital investments by banking entities provide capital and funding to nascent or early-stage companies and small businesses and also may provide these companies expertise and other services.[2077] Other provisions of the final rule or the statute may facilitate, or at least not impede, other forms of investing that may provide the same or similar benefits. For example, in addition to permitting a banking entity to organize and offer a covered fund in section 13(d)(1)(G), section 13 of the BHC Act does not prohibit a banking entity, to the extent otherwise permitted under applicable law, from making a venture capital-style investment in a company or business so long as that investment is not through or in a covered fund, such as through a direct investment made pursuant to merchant banking authority[2078] or through business development companies which are not covered funds and, like venture capital funds, often invest in small, early-stage companies.[2079]

Thus, to the extent that banking entities are required to reduce their investments in venture capital funds, certain of these investments may be redirected to the types of entities in which venture capital funds invest through alternative means. To the extent that banking entities may reduce their investments in venture capital funds that are covered funds, the potential funding gap for venture capital funds may also be offset, in whole or in part, by investments from firms that are not banking entities and thus not subject to section 13's restrictions.

6. Credit Funds

Several commenters requested that the final rule explicitly exclude from the definition of covered fund entities that are generally formed as partnerships with third-party capital and invest in loans or make loans or otherwise extend the type of credit that banks are

[2070] *See* SVB.

[2071] *See, e.g.,* SVB (arguing that the definition of ''venture capital fund'' in section 203(l)–1 of the Investment Advisers Act and the SEC's Form PF reporting requirements for investment advisers to private funds would be instructive for defining an exclusion for venture capital funds for purposes of section 13 of the BHC Act).

[2072] *See* Occupy.

[2073] *See* Sens. Merkley & Levin (Feb. 2012).

[2074] *See* S. Rep. No. 111–176, at 71–3 (2010) (''S. Rep. No. 111–176''); H. Rep. No. 111–517, at 866 (2010) (''H. Rep. No. 111–517''). H. Rep. No. 111–517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference. *See* S. Rep. No. 111–176, at 74 (''The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title.''). *Compare* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. Sec. 408 (2010) (as passed by the Senate) with The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) (''H.R. 4173'') and Dodd-Frank Act (2010).

[2075] *But see* Rep. Honda.

[2076] These funds all typically offer their shares on an unregistered basis in reliance on section 4(a)(2) of the Securities Act of 1933 or Regulation D thereunder (17 CFR 230.500 through 230.508).

[2077] As noted above, some commenters quantified the importance of banking entities to the provision of venture capital by providing information indicating that approximately 7 percent of all venture capital is provided by banks. *See, e.g.,* SVB (citing ''The Venture Capital Industry: A Preqin Special Report,'' published by Preqin, Ltd. (Oct. 2010)). The 7% estimate commenters identified includes information on investors based in North America, Europe, and Asia; thus, although potentially indicative of the extent of venture capital investing by banking entities in venture capital funds, the estimate does not specifically address the proportion of investment by banking entities in venture capital funds that are covered funds, as those terms are defined in the final rule.

[2078] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq.*

[2079] *See* 15 U.S.C. 80a–54. Companies that have elected to be treated as a business development company are subject to limits under the Investment Company Act, including: (i) Limits on how much debt the business development company may incur; (ii) prohibitions on certain affiliated transactions; (iii) regulation and examination by the SEC; and (iv) registration and filing requirements.

authorized to undertake on their own balance sheet (''credit funds'').[2080] Two commenters contended that the language of section 13(g)(2) indicates that Congress did not intend section 13 of the BHC Act to limit a banking entity's ability to extend credit.[2081] They argued that lending is a fundamental banking activity, whether accomplished through direct loans or through a fund structure. These commenters argued that credit funds functioned like syndicated loans that enable borrowers to secure credit during periods of market distress and reduce the concentration of risk for both individual banking entities and the banking system as a whole.

Commenters suggested different approaches for excluding credit funds from the definition of covered fund. One commenter recommended excluding an entity that would otherwise be a covered fund if more than 50 percent of its assets consist of loans.[2082] Another commenter proposed defining a credit fund as an entity that met a number of criteria designed to ensure the entity only held loans or otherwise engaged in prudent lending activity.[2083] Another commenter requested that the Agencies use their authority under section 13(d)(1)(J) to permit a banking entity to sponsor, invest in, or enter into covered transactions with related credit funds that are covered funds.[2084]

The Agencies, however, are unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of section 13 and not raise concerns about banking entities being able to evade the requirements of section 13. Moreover, the Agencies also believe that the final rule largely addresses commenters' concerns in other ways because some credit funds may be able to rely on another exclusion from the definition of covered fund in the final rule such as the exclusion for joint ventures or the exclusion, discussed above, for loan securitizations. To the extent that a credit fund may rely on another exclusion from the definition of covered fund, it would not be a covered fund under section 13 of the BHC Act.

7. Employee Securities Companies

Several commenters argued that employee securities companies (''ESCs'') should be explicitly excluded from the definition of covered fund.[2085] One commenter alleged that, though many ESCs could qualify for the exemption in section 6(b) of the Investment Company Act, they often opt to rely on section 3(c)(1) or 3(c)(7) instead due to the fact that the section 6(b) exemption is available only upon application to the SEC.[2086] According to this commenter, the limitations contained in section 13 on employee investments and intercompany transactions with covered funds would severely limit the ability of a banking entity to design competitive employee compensation arrangements.[2087] This commenter also argued that an exclusion should be provided for any investment vehicle that satisfies the definition of an ESC under section 2(a)(13) of the Investment Company Act.

After considering carefully the comments received on the proposed rule, the final rule does not provide a specific exclusion for ESCs because the Agencies believe that these vehicles may avoid being a covered fund by either complying with the conditions of another exclusion from the definition of covered fund or seeking and receiving an exemption available under section 6(b) of the Investment Company Act. As such, the Agencies believe a banking entity has a reasonable alternative to design competitive employee compensation arrangements. The Agencies recognize that preparing an application under section 6(b) of the Investment Company Act or modifying an ESC's activities to meet the terms of another exclusion from the covered fund definition is not without costs, but have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the purpose of section 13, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for ESCs.

The Agencies also note that non-qualified plans are not exempt from the Investment Company Act under 3(c)(11) and thus would be covered funds if they are operating in reliance on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Some of these non-qualified plans may be formed as employees' securities companies, however, and could qualify for an exemption under section 6(b) of the Investment Company Act for employees' securities companies as discussed above.

e. Definition of ''Ownership Interest''

The proposed rule defined ''ownership interest'' in a covered fund to mean any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, as well as any derivative of such an interest.[2088] This definition focused on the attributes of the interest and whether it provided a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. The proposal thus would also have included a debt security or other interest in a covered fund as an ownership interest if it exhibited substantially the same characteristics as an equity or other ownership interest (*e.g.,* provides the holder with voting rights, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments).[2089] As described further below, the proposed rule excluded carried interest (termed ''restricted profit interest'' in the final rule) from the definition of ownership interest.

Many commenters argued that the proposed definition of ownership interest was too broad and urged excluding one or more types of interests from the definition. A number of commenters raised concerns regarding the difficulty of applying the ownership interest definition to securitization structures and questioned whether the definition of ownership interest might apply to a debt security issued by, or a debt interest in, a covered fund that has some characteristics similar to an equity

[2080] *See, e.g.,* Goldman (Covered Funds); ABA (Keating); Credit Suisse (Williams); Comm. on Capital Markets Regulation; Chamber (Feb. 2012).

[2081] *See* ABA (Keating); Goldman (Covered Funds).

[2082] *See* Credit Suisse (Williams).

[2083] *See* Goldman (Covered Funds).

[2084] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also.* ABA (Keating); Chamber (Feb. 2012).

[2085] *See, e.g.,* ABA (Keating), Credit Suisse (Williams), Arnold & Porter (as it relates to commodity pools). Section 2(a)(13) of the Investment Company Act generally defines an ESC as ''any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned'' by employees and certain related persons (*e.g.,* employees' immediate family members).

[2086] Section 6(b) of the Investment Company Act provides, in part, that ''[u]pon application by any employees' security company, the Commission shall by order exempt such company from the provisions of this title and of the rules and regulations hereunder, if and to the extent that such exemption is consistent with the protection of investors.''

[2087] *See* Credit Suisse (Williams).

[2088] *See* proposed rule § 75.10(b)(3).

[2089] *See* Joint Proposal, 76 FR at 68897.

or other ownership interest.[2090] One commenter argued that the ownership interest definition should not include debt instruments with equity features unless the Agencies determine with respect to a particular debt instrument, after appropriate notice and opportunity for hearing, that the equity features are so pervasive that the debt instrument is the functional equivalent of an equity interest or partnership interest and was structured to evade the prohibitions and restrictions in the proposal.[2091] Several commenters argued that the Agencies should explicitly exclude certain debt instruments with equity features from the ownership interest definition.[2092] Finally, certain commenters argued that, because the application of the ownership interest definition to securitization structures was problematic, alternative regulatory treatment was appropriate.[2093]

One commenter expressed concern over the proposal's inclusion of ''derivatives'' of ownership interests in the definition of ownership interest and recommended certain derivative interests of ownership interests in hedge funds and private equity funds not be included within the definition of ownership interest.[2094] This commenter also recommended that the Agencies expressly exclude from the definition of ownership interest lending arrangements with a covered fund that contain protective covenants linking the interest rate on the loan to the profits of the borrowing fund.[2095]

As discussed in detail below, the Agencies are adopting the definition of ''ownership interest'' largely as proposed but clarifying the scope of that definition, including with respect to the inclusion of interests that are linked to profits and losses of a covered fund and the exclusion for a restricted profit interest in a covered fund.[2096] The definition is centered on equity interests, partnership interests, membership interests, trust certificates, and similar interests, and would not generally cover typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate. However, as under the proposal, to the extent that a debt security or other interest in a covered fund exhibits specified characteristics that are similar to those of equity or other ownership interests (*e.g.,* provides the holder with the ability to participate in the election or removal of a party with investment discretion, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments), the instrument would be an ownership interest under the final rule.

In response to commenters and in order to provide clarity about the types of interests that would be considered within the scope of ownership interest, the Agencies have revised the definition of ''ownership interest'' to define the term more clearly. The Agencies are not explicitly excluding or including debt securities, instruments or interests with equity features as requested by some commenters, but are instead identifying certain specific characteristics that would cause a particular interest, regardless of the name or legal form of that interest, to be included within the definition of ownership interest. The Agencies believe that this elaboration on the characteristics of an ownership interest will enable parties, including securitization structures, to more easily analyze whether their interest is an ownership interest, regardless of the type of legal entity or the name of the particular interest.

As adopted, the final rule provides that an ownership interest would be any interest in or security issued by a covered fund that exhibits any of the following features or characteristics on a current, future, or contingent basis:[2097]

- has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund. For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or

[2090] *See* AFME *et al.;* AFR *et al.* (Feb. 2012); ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); Credit Suisse (Williams); Deutsche Bank (Repackaging Transactions); Occupy; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); TCW. For example, securitization structures generally provide that either the most senior or the most junior tranche notes have controlling voting rights. One commenter argued that under the proposed ownership interest definition, a banking entity could be deemed to have an ownership interest in an entity it does not own or sponsor simply due to its obtaining voting rights. *See* ASF (Feb. 2012). As a further example, one commenter alleged that securitization structures generally are not viewed as providing economic exposure to the profits and losses of the issuer in the same manner as equity interests in hedge funds and private equity funds. This commenter argued that the ownership interest definition should include only those interests that permit the banking entity to share without limit in the profits and losses or that earn a return that is based on the performance of the underlying assets. *See* SIFMA (Securitization) (Feb. 2012).

[2091] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2092] *See* AFME *et al.;* ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); RBC; SIFMA (Securitization) (Feb. 2012). These commenters argued that the ownership interest definition should not include tender option bond programs and other debt asset-backed securities. Two of these commenters argued that debt asset-backed securities should not be viewed as ownership interests because: (i) they are not typically viewed as having economic exposure to profits and losses of an ABS Issuer; (ii) they have a limited life, periodic fixed or fluctuating cumulative payments, and are senior to equity of the issuer should the issuer fail; (iii) they do not have perpetual life with broad voting rights, appreciation in the market value of the issuer and non-cumulative dividends, and subordination to the claims of debt holders if the issuer fails; and (iv) their limited voting rights (such as the rights to replace a servicer or manager) and such rights are protective in nature and similar to voting rights that accompany securities traditionally classified by the Agencies as debt securities (including securities formally structured as equity). *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012). One of these commenters argued that the ownership interest definition should be limited to those interests that share in the profits or losses of the relevant entity on an unlimited basis or that otherwise earn a return that is specifically based upon the performance of the underlying assets because the senior tranche in an asset-based securities transaction often has substantial voting rights and banking entities should not be penalized for requiring or otherwise obtaining voting rights that protect their interests. This commenter also expressed the view that banking entities should not be restricted from owning debt classes of new asset-backed securities because ''doing so would substantially constrict the market for asset-backed securities.'' *See* ASF (Feb. 2012).

[2093] *See* AFR *et al.* (Feb. 2012); Credit Suisse (Williams); Occupy. One of these commenters argued that any general statement about what instruments would be considered an ''ownership interest'' for purposes of securitization structures would be problematic and easy to evade because transaction documents underlying securitization structures are not standardized. This commenter suggested as an alternative using a safe harbor for standardized, pre-specified securitization structures. *See* AFR *et al.* (Feb. 2012). Another of these commenters argued that ''it is difficult to characterize holders of ABS securities in most securitization structures as having 'ownership interests' in any common understanding of the term'' and the concept of ownership interest is a ''poor fit for the securitization market, underscoring the benefits of excluding securitization issuers from the definition of covered fund entirely.'' *See* Credit Suisse (Williams).

[2094] *See* Credit Suisse (Williams).

[2095] *See* Credit Suisse (Williams) (arguing that such arrangements are a fundamental part of a bank's lending activities).

[2096] *See* final rule § 75.10(d)(6). The concept of a restricted profit share was referred to as ''carried interest'' in the proposed rule, a term that is often used as a generic reference to performance-based allocations or compensation. The Agencies have instead used the term ''restricted profit interest'' in the final rule to avoid any confusion that could result from using a term that is also used in other contexts. The final rule focuses only on whether a profit interest is excluded from the definition of ownership interest under section 13, and the final rule does not address in any way the treatment of such profit interests under other laws, including under Federal income tax law.

[2097] Each of these factors are designed to clarify the interests identified in the proposed definition of ownership interest as noted above.

similar rights arising due to an acceleration event;

• has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund. This would apply regardless of whether the right is pro rata with other owners or holders of interests; [2098]

• has the right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full (commonly known as the ''residual'' in securitizations). For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or similar rights arising due to an acceleration event;

• has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests); [2099]

• provides that the amounts payable by the covered fund with respect to the interest could, under the terms of the interest, be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; [2100]

• receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund.[2101] This provision would not include an interest that is entitled to receive dividend amounts calculated at a fixed or at a floating rate based on an index or interbank rate such as LIBOR; or

• any synthetic right to have, receive or be allocated any of the rights above. This provision would not permit banking entities to obtain synthetic or derivative exposure to any of the characteristics identified above in order to avoid being considered to have an ownership interest in the covered fund.

This definition of ''ownership interest'' is intended to address commenters' concerns regarding the applicability of the ownership interest definition to different types of interests. The Agencies believe defining ''ownership interest'' in this way will allow existing as well as potential holders of interests in covered funds, including securitizations, to effectively determine whether they have an ownership interest. As an example, this definition would include preferred stock, as well as a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. As a contrasting example, the Agencies believe that a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant would not generally be an ownership interest. Banking entities will be expected to evaluate the specific terms of their interests to determine whether any of the specified characteristics exist. In this manner, the Agencies believe that the definition of ownership interest in the final rule is clearer than under the proposal and thus should be less burdensome for banking entities in their determination of whether certain rights would cause an interest to be an ownership interest for purposes of compliance with the rule.

As indicated above, many commenters on securitizations under the proposed rule made arguments regarding the difficulty of applying the proposal's definition of ownership interest to securitization structures, contending that the definition should not include debt instruments with equity features, or that the final rule should provide a safe harbor under which the use of a standardized, pre-specified securitization structure would not give rise to an ownership interest.[2102] The Agencies are not adopting a separate definition of ownership interest for securitization transactions, providing for differing treatment of financial instruments, or providing a safe harbor as requested by some commenters. The revised definition of ownership interest will apply regardless of the type of legal entity or the name or legal form of the particular interest. The determination of whether an interest is an ownership interest under the final rule will depend on the features and characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights. While some commenters argued that securities issued in asset-backed securities transactions and by tender option bond issuers should not be viewed as ownership interests due to the nature of the securities issued or the possible lack of exposure to profits and losses,[2103] the Agencies do not believe that the type of covered fund involved or the type of security issued is an appropriate basis for determining whether there is an ownership interest for purposes of the restrictions contained in section 13(a)(1)(B) of the BHC Act. The Agencies believe that making distinctions in the definition of ownership interest based on the type of entity or the type of security, in which many of the same rights exist as for other types of ownership interests, would not be consistent with the statutory restrictions on ownership. Similarly, while some commenters argued that including a safe harbor for standardized securitization structures would be more effective in identifying an ownership interest in securitizations, the Agencies believe that the type of interest and the rights associated with the interest are more appropriate to determine whether an interest is an ownership interest and is necessary to avoid potential evasion of the ownership restrictions contained in section 13 of the BHC Act.

The Agencies understand that the definition of ownership interest in the final rule may include interests in a covered fund that might not be considered an ownership interest or equity interest in other contexts. For instance, it may include loans with an interest rate determined by reference to the performance of a covered fund or senior debt interests issued in a securitization. While the definition of ownership interest may affect the ability of a banking entity to hold such interests, whether existing or in the future, the Agencies believe that the definition of ownership interest as

[2098] This characteristic exists for both multi-class and single-class covered funds. In the context of an entity that issues shares, this right could cover, for example, common shares, as well as preferred shares the dividend payments of which are determined by reference to the performance of the covered fund.

[2099] The reference to ''all or a portion of excess spread'' is meant to include within the definition of ownership interest the right to receive any excess spread which remains after the excess spread is used to pay expenses, maintain credit enhancement such as overcollateralization or is otherwise reduced.

[2100] This characteristic does not refer to any reduction in the stated claim to principal or interest of a holder of an interest that occurs either as a result of a *bona fide* subsequent renegotiation of the terms of an interest or as a result of a bankruptcy, insolvency, or similar proceeding.

[2101] This provision is not intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities. However, the activities of banking entities are subject to the anti-evasion provisions.

[2102] *See supra* note 2090.

[2103] *See supra* note 2092.

adopted in the final rule is more effective in preventing possible evasion of section 13 by capturing interests that may be characterized as debt but confer benefits of ownership, including voting rights and/or the ability to participate in profits or losses of the covered fund.

The definition of ownership interest in the final rule, like the proposed rule, includes derivatives of the interests described above. Derivatives of ownership interests provide holders with economic exposure to the profits and losses of the covered fund or an ability to earn a return based on the performance of the fund's underlying holdings or investments in a manner substantially similar to an ownership interest. The Agencies believe the final rule's approach appropriately addresses the statutory purpose to limit a banking entity's economic exposure to covered funds, irrespective of the legal form, name, or issuer of that ownership interest.

As noted above, the proposed definition of ownership interest did not include carried interest (termed ''restricted profit interest'' in the final rule). The proposal recognized that many banking entities that serve as investment adviser or provide other services to a covered fund are routinely compensated for services they provide to the fund through receipt of carried interest. As a result, the proposed rule provided that an ownership interest with respect to a covered fund did not include an interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the banking entity (or an affiliate, subsidiary or employee thereof) served as investment manager, investment adviser, or commodity trading advisor, so long as certain enumerated conditions were met.[2104]

The enumerated conditions contained in the proposal were designed to narrow the scope of the exclusion of carried interest from the definition of ''ownership interest'' so as to distinguish between an investor's economic risks and a service provider's performance-based compensation. This was designed to limit the ability of a banking entity to structure carried interest in a manner that would evade section 13's restriction on the amount of ownership interests a banking entity may have as an investment in a covered fund.

Commenters disagreed over whether the definition of ownership interest should exclude carried interest. For instance, some commenters did not support excluding carried interest from the definition of ownership interest, arguing that such an exclusion was too permissive and inconsistent with the statute because, for instance, carried interest derives its value in part by tracking gains on price movements of investments by the fund.[2105] One commenter argued that, despite the fact that carried interest is typically provided as compensation for services provided to a fund, carried interest is a form of investment and therefore should be included as an ownership interest.[2106] Another commenter argued that permitting banking entities to hold an unrestricted amount of carried interest could create an indirect and undesirable link between prohibited proprietary trading and covered fund activities.[2107] These commenters also argued that treating carried interest as compensation for providing services would be inconsistent with the manner in which carried interest is treated for tax purposes.[2108]

Other commenters, however, supported excluding carried interest from the definition of an ownership interest and argued the exclusion was consistent with the words and purpose of section 13.[2109] One commenter argued that carried interest is readily distinguished from an investment in a covered fund because carried interest normally does not expose a banking entity to a covered fund's losses (other than in limited instances such as when a ''clawback'' provision is triggered).[2110] Another commenter argued that permitting a banking entity to receive carried interest without being subject to the requirements of section 13 regarding ownership interests better aligns the interest of the investment manager with that of the fund and its investors.[2111] Another commenter supported expanding the definition of carried interest to include an interest received by a banking entity in return for qualifying services (*e.g.,* lending, placement, distribution, or equity financing) provided to the investment manager of the fund, but not directly provided to the fund itself.[2112]

The proposal established four criteria that must be met in order for carried interest to be excluded from the definition of ownership interest. First, the proposal required that carried interest have the sole purpose and effect of permitting the banking entity or an employee thereof to share in the covered fund's profits as performance compensation for services provided to the fund. While most commenters did not object to this criterion, one commenter argued that the wording of this approach would appear to prohibit an employee of the banking entity from retaining a carried interest after the employee has changed employment.[2113] This commenter argued that the determination of the carried interest's purpose should be made only at the time the interest is granted, thereby enabling an employee to retain the carried interest if and when the employee no longer provides investment management, investment advisory, or similar services to the fund or is no longer employed at the banking entity.

Second, the proposal required that carried interest, once allocated, be distributed to the banking entity promptly after it is earned or, if not so distributed, not share in the subsequent profits and losses of the covered fund. One commenter urged the Agencies to allow the ''reserve'' portion of carried interest that for tax purposes is allocated to the investment manager or investment adviser, but invested alongside the fund and not formally allocated or distributed by the fund, also to qualify for the exclusion as carried interest.[2114] This commenter also suggested that this criterion should not affect the common European structure in which allocated carried interest may share in the subsequent losses, but not the profits, of the fund.

Third, under the proposal a banking entity (including its affiliates or employees) was not permitted to provide funds to the covered fund in connection with receiving a carried interest. The proposal specifically requested comment on whether the exemption for carried interest, including this requirement, was consistent with the current tax treatment and requirements of carried interest arrangements.[2115] Commenters urged the Agencies to relax or amend this criterion so that banking entities, including their affiliates and employees, whether directly or indirectly through a fund vehicle, would be permitted to make minimal capital contributions to the fund (typically less than 1 percent) in connection with the receipt of carried interest to the extent that such contributions provide the basis for

[2104] *See* proposed rule § 75.10(b)(3)(ii).

[2105] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012).

[2106] *See* Public Citizens; *see also* Occupy.

[2107] *See* AFR *et al.* (Feb. 2012).

[2108] *See* Occupy; Public Citizens; AFR *et al.* (Feb. 2012).

[2109] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Credit Suisse (Williams); SVB.

[2110] *See* Credit Suisse (Williams).

[2111] *See* TCW.

[2112] *See* Credit Suisse (Williams).

[2113] *See* TCW.

[2114] *See* Credit Suisse (Williams).

[2115] Joint Proposal, 76 FR at 68899.

treating the interest as carried interest for tax purposes.[2116] However, these commenters supported the proposal's requirement that any amount contributed by a banking entity in connection with receiving a carried interest should be aggregated with the banking entity's ownership interests for purposes of the 3 percent investment limits.

Fourth, the proposal provided that carried interest may not be transferable by the banking entity (or the affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary of the banking entity. Commenters generally urged removing the proposal's limitations on transferability and argued, among other things, that this criterion could prevent a banking entity (or its affiliate or employee) from transferring the carried interest in connection with selling or otherwise transferring the provision of advisory or other services that gave rise to the carried interest.[2117] Similarly, one commenter argued that the final rule should not require carried interest to be re-characterized as an ownership interest if it is transferred among employees, family members of employees or to estate planning vehicles upon an employee's death.[2118]

After considering carefully comments received on the proposal, the Agencies have determined to retain in the final rule the exclusion from the definition of ''ownership interest'' for a restricted profit interest (termed ''carried interest'' in the proposed rule [2119]) largely as provided in the proposed rule. The final rule, like the proposal, recognizes that banking entities that serve as investment adviser or provide other services to a covered fund are routinely compensated for such services through receipt of a restricted profit interest. The final rule, also like the proposal, generally excludes restricted profit interest from the definition of ownership interest subject to conditions designed to distinguish restricted profit interest, which serves as a form of compensation, from an investment in the fund prohibited (or limited) by section 13. As explained in detail below, the definition of restricted profit interest in the final rule has been modified from the proposal in several aspects to respond to commenters' concerns and to more effectively capture the types of compensation that is often granted in exchange for services provided to a fund. However, like the proposal, the final rule continues to contain a number of requirements designed to ensure that restricted profit interest functions as compensation for providing certain services to a covered fund and does not permit a banking entity to evade the investment limitations or other requirements of section 13.

Under the final rule, restricted profit interest is defined to include an interest held by an entity (or employee or former employee thereof) that serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as: (i) The sole purpose and effect of the interest is to allow the entity (or an employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received; (ii) all such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in subsequent investment gains of the covered fund; (iii) any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the investment limitations of § 75.12; and (iv) the interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.[2120] The final rule, like the proposal, permits any entity (or the affiliate or employee thereof) to receive or hold restricted profit interest if the entity (or the affiliate or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider to the covered fund. For example, an entity that provides services to the covered fund in a capacity as sub-adviser or placement agent would be eligible to receive or hold restricted profit interest.

As requested by commenters, the first condition in the final rule, in contrast to the proposal, permits an employee or former employee to retain a restricted profit interest after a change in employment status so long as the restricted profit interest was originally received as compensation for qualifying services provided to the covered fund.

Also in response to issues raised by commenters, the second condition in the final rule has been modified to permit so-called ''clawback'' features whereby restricted profit interest that has been provided to an investment manager, investment adviser, commodity trading advisor, or similar service provider may be taken back if certain subsequent events occur, such as if the fund fails to achieve a specified preferred rate of return or if liabilities or subsequent losses are incurred by the fund. Under these circumstances, the Agencies believe it is appropriate to allow the allocated but undistributed profits to be clawed back from the service provider's performance compensation, and the final rule has been amended to allow this practice. The final rule makes clear, however, that the undistributed profits may only be held in the fund in connection with such a clawback arrangement. Undistributed profits that remain in the covered fund after they have been allocated without connection to such an arrangement would be deemed to be an investment in the fund and would be an ownership interest under the final rule. Importantly, the final rule also retains the limitation in the proposal that undistributed profit may not share in subsequent investment gains of the covered fund. This limitation (together with the limited circumstances under which the undistributed profit may be retained in the fund) appears necessary in order to distinguish restricted profit interest, which functions as performance compensation and is not intended to be a form of investment, from an ownership interest, which is designed to be an investment. The Agencies believe that this approach achieves an appropriate balance between accommodating receipt of restricted profit interest, including such

[2116] *See* TCW; SIFMA (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2117] *See* ASF (Feb. 2012); *see also* Credit Suisse (Williams); SVB.

[2118] *See* TCW.

[2119] *See supra* note 2096 and accompanying text.

[2120] *See* final rule § 75.10(d)(6)(ii).

amounts held in ''reserve,''[2121] and limiting the ability of a banking entity to evade the investment limitations of section 13. The Agencies expect to review restricted profit interests to ensure banking entities do not use the exclusion for restricted profit interest in a manner that functions as an evasion of section 13.

As noted above, the Agencies understand that entities that provide investment management, investment advisory, commodity trading advisory or other services to a covered fund may, in connection with receiving restricted profit interest, be required to hold a small amount of ownership interests in a fund to provide the basis for desired tax treatment of restricted profit interest. Accordingly, the third condition of the final rule allows an entity that provides qualifying services to a fund to contribute funds to, and have an ownership interest in, the fund in connection with receiving restricted profit interest. As under the proposal, the amount of the contribution must be counted toward the investment limits under section 13(d)(4) and § 75.12 of the final rule. This would include attribution to the banking entity of sums invested by employees in connection with obtaining a restricted profit interest. Thus, the final rule permits a banking entity that provides investment management, investment advisory, or commodity trading advisory services to have both an ownership interest in, and receive restricted profit interest from, the covered fund, so long as the aggregate of the sums invested in all ownership interests acquired or retained by the banking entity (including a general partnership interest), either in connection with receiving the restricted profit interest or as an investment, are within the investment limitations in section 13(d)(4) and § 75.12 of the final rule. The Agencies believe this more appropriately implements the requirements of section 13 of the BHC Act by permitting banking entities to continue to provide customer-driven investment management services through organizing and offering covered funds, while also abiding by the investment limitations of section 13.

In response to comments, the fourth condition of the final rule permits the transfer of a restricted profit interest in connection with a sale to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund. In response to comments, the final rule also permits the transfer of a restricted profit interest to immediate family members of the banking entity's employees or former employees that provide investment management, investment advisory, commodity trading advisory, or other services to the covered fund, or in connection with the death of such employee. Also in response to comments, the final rule permits the transfer of a restricted profit interest to an affiliate or employee that provides investment management, investment advisory, commodity trading advisory, or other services to the covered fund. However, the final rule, like the proposed rule, would treat a restricted profit interest as an ownership interest if the restricted profit interest is otherwise transferable. This remaining restriction recognizes that a freely transferable restricted profit interest has the same economic benefits as an ownership interest and is essential to differentiating a restricted profit interest from an ownership interest.

f. Definition of ''Resident of the United States''

Section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' The statute does not define this term.

Under the proposed rule, the term ''resident of the United States'' was used in the context of the exemptions for covered trading and covered fund activities. As proposed, the definition of resident of the United States was similar, but not identical, to the SEC's definition of U.S. person in Regulation S, which governs offerings of securities outside of the United States.[2122] The Agencies proposed this approach in order to promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S.

Some commenters supported the proposed definition of resident of the United States.[2123] One commenter suggested that the proposed rule defined resident of the United States too broadly and inappropriately precluded investments in U.S. funds by foreign banking entities.[2124]

Other commenters generally argued that the final rule should adopt the definition of ''U.S. person'' under the SEC's Regulation S without the modifications in the proposed rule.[2125] According to many commenters, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S.[2126] They argued that, to the extent that the definitions of ''resident of the United States'' under section 13 and ''U.S. person'' under Regulation S differ, this would create unnecessary uncertainty and increase compliance burdens associated with monitoring multiple definitions.[2127] Other commenters urged the Agencies not to depart from the treatment of international parties and organizations (*e.g.,* the International Monetary Fund and the World Bank) under the SEC's Regulation S.[2128]

Many commenters contended that, because the definition of resident of the United States in the proposal was generally broader than the definition of U.S. person under Regulation S, many additional types of persons, entities and investors would be deemed residents of the United States for purposes of the foreign activity exemptions. Commenters argued that this would limit the potential for foreign banking entities to effectively use those statutorily provided exemptions. A few commenters noted that using a definition in the foreign fund exemption that differs from the definition in Regulation S loses the advantage of using a term that is already understood by market participants and that avoids confusion and limits compliance costs.[2129]

Other commenters suggested that defining resident of the United States as proposed presented problems for investment funds managed by U.S. investment advisers, even those without U.S. investors.[2130] Some commenters argued that, under the proposed

[2121] The Agencies believe that this addresses a commenter's concern regarding the ''reserve'' portion of carried interest discussed above; however such amounts may not share in subsequent investment gains of the covered fund for the reasons also discussed above.

[2122] *See* proposed rule § 75.2(t); 17 CFR 230.901—230.905.

[2123] *See, e.g.,* Occupy.

[2124] *See* Sens. Merkley & Levin (Feb. 2012) (citing 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[2125] *See, e.g.,* Union Asset; EFAMA; BVI; AFME *et al.;* IIB/EBF; Credit Suisse (Williams); Hong Kong Inv. Funds Ass'n.; PEGCC; UBS; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); AFG.

[2126] *See* PEGCC; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); ICI (Feb. 2012); Credit Suisse (Williams).

[2127] *See* IIB/EBF; Credit Suisse (Williams); ICI (Feb. 2012); ICI Global; PEGCC.

[2128] *See* IIB/EBF; ICI Global; Credit Suisse (Williams).

[2129] *See* Allen & Overy (on behalf of Foreign Bank Group); IIB/EBF; PEGCC; Union Asset.

[2130] *See, e.g.,* MFA; TCW.

definition, a foreign fund managed by a U.S. investment adviser or sub-adviser that is not otherwise subject to section 13 might be deemed a resident of the United States, thereby disqualifying the fund from relying on the foreign funds exemption, a result inconsistent with the purpose of section 13 and the statutory exemption in section 13(d)(1)(I).[2131]

Commenters also argued that the proposed definition raised issues for compensation plans of international organizations that are subject to section 13 of the BHC Act. Several commenters argued that U.S. employees of a foreign banking entity should not be considered residents of the United States if they invest in a non-U.S. covered fund pursuant to a *bona fide* employee investment, retirement or compensation program.[2132] The Agencies have carefully considered the comments received on the definition of resident of the United States, and have determined to modify the final rule as discussed below. The term ''resident of the United States'' is not defined in the statute and is used by the statute to clarify when foreign activity or investment of a foreign banking entity qualifies for the foreign funds exemption in section 13(d)(1)(I). The purpose of this exemption is to enable foreign banking entities to continue to engage in foreign funds activities and investments that do not have a sufficient nexus to the United States so as to present risk to U.S. investors or the U.S. financial system.[2133] The purpose of Regulation S is to provide a safe harbor from the registration provisions under the Securities Act for offerings that take place outside of the United States.[2134]

The Agencies believe that, because the covered funds provisions of the final rule involve sponsoring covered funds and offering and selling securities issued by funds (as compared to counterparty transactional relationships), the securities law framework reflected in Regulation S would most effectively achieve the purpose of the foreign funds exemption. As noted by commenters and discussed above, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S, and differing definitions under section 13 and Regulation S could create uncertainty and increase compliance burdens associated with monitoring multiple definitions. The Agencies therefore have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in Regulation S.[2135]

In addition, as explained in detail below in Part VI.B.4.b.3. of this **SUPPLEMENTARY INFORMATION**, the final rule provides that an ownership interest is offered for sale or sold to a resident of the United States if it is sold in an offering that ''targets'' residents of the United States.[2136] As explained in more detail in that section, this approach is consistent with Regulation S.

g. Definition of ''Sponsor''

Section 13(h)(5) of the BHC Act defines ''sponsor'' to mean: (i) serving as a general partner, managing member, or trustee of a covered fund; (ii) in any manner selecting or controlling (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) sharing with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2137] Sponsor is a key definition because it defines, in part, the scope of activities to which the prohibition in section 13(a)(1) applies.[2138]

Under the proposal, the term sponsor would have been defined largely as in the statute.[2139] Nearly all commenters who addressed the definition of sponsor argued that the definition was too broad and suggested various ways to narrow or limit the definition.[2140] Commenters generally expressed concerns that a sponsor to a covered fund became subject to the restrictions of section 13(f), limiting the relationships of the banking entity with the covered fund. Commenters argued this would prevent banking entities from providing many customary services to covered funds.[2141]

The proposal excluded from the definition of ''trustee'' as used in the term sponsor a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee's Retirement Income Security Act (''ERISA'') (29 U.S.C. 1103(a)(1)).[2142] On the other hand, the proposal provided that any banking entity that directs a directed trustee, or that possesses authority and discretion to manage and control the assets of a covered fund for which a directed trustee serves as trustee, would be considered a trustee of the covered fund.

Commenters generally supported the exception for directed trustees in the proposed rule but argued that the exception was too narrow because it only referred to directed trustees under section 403(a)(1) of the ERISA and did not include other similar custodial or administrative arrangements that may not meet those requirements or be subject to ERISA.[2143] These commenters argued that banking entities that serve as trustees or custodians of covered funds may provide a limited range of ministerial services or exercise limited fiduciary duties that, while not subject to ERISA or beyond those permitted for a directed trustee under ERISA, nevertheless do not involve the exercise of investment discretion or control over the operations of the covered fund in the same manner as a general partner or managing member. Some of these commenters advocated defining ''directed trustee'' more expansively to include any situation in which a banking entity serves solely in a directed, fiduciary, or administrative role where a third-party and not the banking entity exercises investment discretion.

In particular, some commenters also argued that a trustee should not be viewed as having investment discretion, and therefore should not be treated as a sponsor, if it possesses only the authority to terminate an investment adviser to a covered fund and to appoint another unaffiliated investment adviser

[2131] *See* AFG; BVI. *See also* MFA; TCW. Similarly, these commenters argued that although treated as a non-U.S. person under Regulation S, a non-U.S. fund organized as a trust in accordance with local law with a limited number of U.S. investors would have been a resident of the United States. Under the proposal, this foreign fund could not invest in another foreign covered fund seeking to rely on the exemption for covered fund activities or investments that occur solely outside of the United States.

[2132] *See* IIB/EBF; Credit Suisse (Williams); UBS; JPMC.

[2133] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2134] Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990) 55 FR 18306 (May 2, 1990).

[2135] *See* final rule § 75.10(d)(8).

[2136] *See infra* Part VI.B.4.b.3.

[2137] *See* 12 U.S.C. 1851(h)(5).

[2138] *See* 12 U.S.C. 1851(a)(1).

[2139] *See* proposed rule 75.10(b)(5).

[2140] A number of comments received regarding the definition of sponsor relate to securitization structures and are addressed below. There also were a few comments urging that insurance companies not be considered to sponsor their separate accounts. *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide. The Agencies believe these concerns should be addressed by the exclusion of separate accounts from the definition of covered fund, as discussed in Part VI.B.1.c.6. of this **SUPPLEMENTARY INFORMATION**.

[2141] *See, e.g.,* ASF (Feb. 2012); BNY Mellon *et al.;* Credit Suisse (Williams).

[2142] *See* proposed rule § 75.10(b)(6); *see also* 29 U.S.C. 1103(a)(1).

[2143] *See, e.g.,* Arnold & Porter; Ass'n. of Global Custodians; BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); *see also* Fin. Services Roundtable (June 14, 2011) (recommending the definition of directed trustee under the Board's Regulation R be used, which defines directed trustee to mean ''a trustee that does not exercise investment discretion with respect to the account'').

in order to fulfill a demonstrable legal or contractual obligation of the trustee, or the formal but unexercised power to make investment decisions for a covered fund in circumstances where one or more unaffiliated investment advisers have been appointed to manage fund assets. Some commenters argued in favor of excluding trustees serving under non-U.S. trust arrangements pursuant to which they may have legal or contractual authority to, but in fact do not, exercise investment discretion (*i.e.,* the entity has the formal authority to appoint an investment adviser to a trust but does so only in extraordinary circumstances such as appointing a successor investment adviser).[2144]

A few commenters requested confirmation that a banking entity acting as a custodian should not be considered a sponsor of a covered fund.[2145] One commenter argued that traditional client trust accounts for which a bank serves as discretionary trustee should not, by implication, themselves become ''covered funds'' that are ''sponsored'' by the bank.[2146]

One commenter argued that any person performing similar functions to a directed trustee (such as a fund management company established under Irish law), regardless of its formal title or position, also should be excluded if the person does not exercise investment discretion.[2147] Some commenters argued more generally for an exclusion from the definition of trustee (and therefore from the definition of sponsor) for entities that act as service providers (such as custodians, trustees, or administrators) to non-U.S. regulated funds, arguing that European laws already impose significant obligations on entities serving in these roles.[2148]

Under both section 13 of the BHC Act and the proposal, the definition of sponsor also included the ability to select or control (or to have employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of a covered fund. Some commenters argued that an entity should not be treated as a sponsor of a covered fund when it selects a majority of the initial directors, trustees or management of a covered fund that are independent of the banking entity, so long as the banking entity may not remove or replace the directors, trustees, or management and directors are subsequently either chosen by others or self-perpetuating.[2149] One of these commenters argued similarly that a banking entity should not be deemed to sponsor a covered fund if it selects an independent general partner, managing member or trustee of a new fund, so long as the general partner, managing member or trustee may not be terminated and replaced by the banking entity.[2150] Commenters argued that initial selection of these parties was inherently part of, and necessary to allow, the formation of a covered fund and would not provide a banking entity with ongoing control over the fund to a degree that the banking entity should be considered to be a sponsor.

The statute and proposed rule also defined the term sponsor to include an entity that shares, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name, with a covered fund. One commenter argued in favor of a narrower interpretation of this statutory provision.[2151] This commenter argued that a covered fund should be permitted to share the name of the asset manager that advises the fund without the asset manager becoming a sponsor so long as the asset manager does not share the same name as an affiliated insured depository institution or the ultimate parent of an affiliated insured depository institution.[2152] Another commenter argued that the proposal would put U.S. banking entities at a competitive disadvantage relative to non-banking entities and foreign banks.[2153] These commenters argued that the costs of rebranding covered funds or an asset manager would far outweigh any potential benefit in terms of reducing the risk that a banking entity may be pressured to ''bail out'' a covered fund with a name similar to its investment manager.[2154] One commenter also requested clarification that the name sharing prohibition does not apply in the context of offering documents that carry the names of the manager, sponsor, distributor, as well as the name of the fund itself.[2155] This commenter also advocated that, because of the costs associated with changing a fund name, the Agencies give specific guidance regarding how similar a name may be so as not to be a ''variation of the same name'' for purposes of the definition of sponsor and the activities permitted under section 13(d)(1)(G) and § 75.11 of the rule.

The Agencies have carefully considered comments received in light of the terms of the statute. Section 13(h)(5) of the BHC Act specifically defines the term ''sponsor'' for purposes of section 13. The Agencies recognize that the broad definition of sponsor in the statute will result in some of the effects commenters identified, as discussed above.

The final rule generally retains the definition of ''sponsor'' in the statute and the proposed rule, although with certain modifications and clarifications to respond to comments received regarding the exclusion for ''directed trustees.'' As in the proposed rule, the definition of sponsor in the final rule covers an entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund as defined in § 75.10(b)(1)(ii) of the final rule, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2156]

[2144] *See* BNY Mellon *et al.* (providing proposed rule text or suggesting in the alternative clarification regarding the phrase ''exercise investment discretion'' in the final rule preamble); Ass'n. of Global Custodians; ICI Global; State Street (Feb. 2012).

[2145] *See* Ass'n. of Global Custodians; SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); AFG; AFTI; BNY Mellon *et al.;* EFAMA; IMA; State Street (Feb. 2012).

[2146] *See* Arnold & Porter. To the extent that a client trust account would not be an investment company but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, such as the exclusion for common trust funds under section 3(c)(3) of that Act, it would not be a covered fund regardless of whether a banking entity acts as trustee.

[2147] *See* BNY Mellon *et al.*

[2148] *See* EFAMA; F&C; IRSG; Union Asset.

[2149] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012) (recommending the Agencies adopt independence guidelines similar to the FDIC's guidelines for determining whether audit committee members of insured depository institutions are ''independent'' of management); Credit Suisse (Williams).

[2150] *See* Credit Suisse (Williams) (arguing that such an approach would be consistent with the existing BHC Act concept of control with respect to funds).

[2151] A number of comments were also received regarding the restriction on name sharing that is one of the requirements of section 13(d)(1)(G) and § 75.11 of the proposed rule. These comments are discussed in Part VI.B.2.a.5. of this **SUPPLEMENTARY INFORMATION**.

[2152] *See* Credit Suisse (Williams); *see also* ABA (Keating); BlackRock; Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW (proposing similarly to limit the name-sharing restriction to the insured depository institution in context of section 13(d)(1)(G)).

[2153] *See* Goldman (Covered Funds).

[2154] *See* Credit Suisse (Williams); *see also* Goldman (Covered Funds).

[2155] *See* Credit Suisse (Williams).

[2156] *See* final rule § 75.10(d)(9). Some commenters asserted that custodians and service providers should not treated as sponsors under the final rule. The Agencies note, however, that a banking entity is not a sponsor under the final rule unless it serves in one or more of the capacities specified in the definition; controls or makes up the fund's board of directors or management as described in the final rule; or shares the same name or a variation of the same name with the fund as described in the final

While commenters urged the Agencies to provide an exemption from the definition of sponsor for a banking entity that selects the initial directors, trustees, or management of a fund,[2157] the final rule has not been modified in this manner because the initial selection of the directors, trustees or management of a fund is an action characteristic of a sponsor and is essential to the creation of a covered fund. The Agencies note, however, that the statute and the final rule allow banking entities to sponsor covered funds, including selecting the initial board of directors, trustees and management, so long as the banking entity observes certain requirements and conforms any initial investment in the covered fund to the limits in the statute and regulation during the relevant conformance period as discussed in Part VI.B.3.b. of this **SUPPLEMENTARY INFORMATION**.[2158] Moreover, a banking entity that does not continue to select or control a majority of the board of directors would not be considered to be a sponsor under this part of the definition once that role or control terminates. In the case of a covered fund that will have a self-perpetuating board of directors or a board selected by the fund's shareholders, this would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity.

As explained below, the Agencies believe that, in context, the term trustee in the definition of the term sponsor refers to a trustee with investment discretion. Consistent with this view, commenters urged the Agencies to exclude from the definition of sponsor certain trustees and parties commenters asserted acted in a similar capacity, as discussed above.[2159] The final rule therefore has been modified to exclude from the definition of trustee: (i) a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or (ii) a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (i).[2160] Under the final rule, a trustee would be excluded if the trustee does not have any investment discretion, but is required to ensure that the underlying assets are appropriately segregated for the benefit of the trust. Similarly, a trustee would be excluded if the trustee has no investment discretion but is authorized to replace an investment adviser with an unaffiliated party when the investment adviser resigns. With respect to an issuing entity of asset-backed securities and as explained below, a directed trustee excluded from the definition of sponsor would include a person that conducts their actions solely in accordance with directions prepared by an unaffiliated party.

The Agencies believe that this exclusion is appropriate because the relevant prong of the definition of sponsor (*i.e.,* serving as general partner, managing member, or trustee) specifies entities that have the ongoing ability to exercise control over a fund; directed trustees excluded from definition of sponsor in the final rule do not appear to have this ability and thus do not appear to be the type of entity that this prong of the definition of sponsor was intended to capture. If a trustee were itself to assume the role of investment adviser, or have the ability to exercise investment discretion with respect to the covered fund, the trustee would not qualify for this exclusion. The final rule does not include within the definition of sponsor custodians or administrators of covered funds unless they otherwise meet the definitional qualifications set forth in section 13 and the final rule.

The definition of sponsor will continue to cover entities that share the same name or variation of the same name of a covered fund for corporate, marketing, promotional, or other purposes, consistent with the definition of sponsor in section 13(h)(5). The Agencies recognize that some commenters urged the Agencies to modify this aspect of the definition of sponsor, and that the name-sharing prohibition included in the definition of sponsor (and in the conditions for the organize and offer exemption) will require some banking entities to rebrand their covered funds, which may prove expensive and will limit the extent to which banking entities may continue to benefit from brand equity they have developed.[2161] The costs a banking entity would incur to rebrand its covered funds would depend on the cost to rebrand the banking entity's current funds, as well as the banking entity's ability to attract new investor capital to its current and future covered funds. The total burden per banking entity, therefore, would depend on the brand equity as well as the number of covered funds that share a similar name.[2162] One commenter argued that, as a result, banking entities subject to section 13 may be at a competitive disadvantage to other firms that are not subject to these or similar restrictions.[2163] The Agencies believe that the final rule addresses some commenters' concerns to an extent by adopting a more tailored definition of covered, including a focused definition of foreign funds that will be covered funds and an exclusion for foreign public funds.[2164] In addition, to the extent that a banking entity would otherwise come under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that bears the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity this assistance could pose.

1. Definition of Sponsor With Respect to Securitizations

Commenters on the definition of sponsor in the context of securitization vehicles generally argued that the proposed definition of sponsor was too broad and requested clarification that various roles that banking entities might serve within a securitization structure would be excluded from the definition of sponsor, including servicers;[2165] backup servicers and master servicers;[2166] collateral agents and

rule. *See, e.g., supra* note 2156 and accompanying text. *See also infra* note 2160.

[2157] *See supra* note 2149 and accompanying text.

[2158] Similarly, a banking entity may share the same name or a variation of the same name with a covered fund so long as the banking entity does not organize and offer the covered fund in accordance with section 13(d)(1)(G) and § 75.11.

[2159] *See, e.g., supra* notes 2143–2144 and accompanying text. *See also supra* note 2156.

[2160] *See* final rule § 75.10(d)(10). With respect to the concept of a ''directed trustee'' under foreign law, commenters generally requested changes only if non-U.S. mutual fund equivalents were not excluded from the definition of covered fund. As discussed above, the final rule explicitly excludes foreign public funds from the definition of covered fund, which should address these commenters concerns. *See* final rule § 75.10(c)(1).

[2161] *See supra* notes 2151–2155 and accompanying text.

[2162] *See infra* note 2164.

[2163] *See supra* note 2153 and accompanying text.

[2164] For example, one commenter argued that it would need to rebrand approximately 500 established funds under the rule proposal if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2165] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commenters argued that servicers will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012). Another commenter stated that servicers do not have the authority to select assets or make investment decisions on behalf of investors. *See* PNC.

[2166] *See* ASF (Feb. 2012).

administrators;[2167] custodians;[2168] indenture trustees;[2169] underwriters, distributors, placement agents;[2170] arrangers, structuring agents;[2171] originators, depositors, securitizers;[2172] ''sponsors'' under the SEC's Regulation AB;[2173] administrative agents;[2174] and securities administrators and remarketing agents.[2175] Commenters argued that these parties should not be included in the definition of sponsor because such parties have clearly defined and extremely limited authority and discretion,[2176] do not have the right to control the decision-making and operational functions of the issuer,[2177] and would not have ''control'' under BHC Act control precedent.[2178] Conversely, one commentator supported defining sponsor under the proposed rule to include the Regulation AB sponsor, the servicer and the investment manager.[2179] Commenters also made arguments regarding the potential detrimental effects to securitization and credit markets if banking entities are prohibited from acting as sponsors of securitizations.[2180]

Commenters disagreed as to whether or not a sponsor under the final rule should include a party with any investment discretion, some investment discretion or complete investment discretion. Some commenters argued that certain parties should not be considered a sponsor because they were not an investment advisor or did not have investment discretion.[2181] Other commenters argued that an entity should not be considered a sponsor even though it has limited investment discretion,[2182] while others argued that investment advisers and parties with investment discretion should not be included in the definition of sponsor.[2183]

After considering comments received and the language and purpose of section 13, the Agencies have determined not to adopt a separate definition of sponsor for issuers of covered funds that are issuers of an asset-backed security. As described above and consistent with the statute, the definition of sponsor only includes parties that: (i) Serve as a general partner, managing member, or trustee (other than a directed trustee) of a covered fund; (ii) have the right to select or control a majority of the directors, trustees, or management of a covered fund; or (iii) share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. If the parties that commenters described do not serve in those capacities for a covered fund, do not have those rights with respect to a covered fund or do not share a name with a covered fund, such parties would not be a sponsor for purposes of the final rule, and, therefore, they would not be subject to the restrictions applicable to the sponsor of a covered fund, including the restrictions contained in section 13(f).[2184]

Additionally, the Agencies believe that the exclusion of loan securitizations from the definition of covered fund under the final rule addresses many of the commenters' concerns about the sponsor definition because this exclusion limits the types of securitizations that are covered funds and subject to the final rule. Similarly, the exclusion of certain ABCP conduits from the definition of covered fund will mean that the restrictions under section 13(f) will not apply to qualifying asset-backed commercial paper conduits.

As with any other covered fund under the final rule, the term sponsor would include a trustee that has the right to exercise any investment discretion for the securitization. For issuers of asset-backed securities, this would generally not include a trustee that executes decision-making, including investment of funds prior to the occurrence of an event of default, solely according to the provisions of a written contract or at the written direction of an unaffiliated party. In addition, under the rule as adopted a trustee with investment discretion may avoid characterization as a sponsor if it irrevocably delegates all of its investment discretion to another unaffiliated party with respect to the covered fund. The Agencies believe that these considerations regarding when a trustee is a sponsor responds to commenters' concerns regarding the roles of trustees in securitizations.[2185]

[2167] *Id.*

[2168] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012).

[2169] *Id.*

[2170] *See* Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commentators argued that placement agents and underwriters will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012).

[2171] *See* Cleary Gottlieb (''party that structures the asset-backed securities''); SIFMA (Securitization) (Feb. 2012).

[2172] *See* Credit Suisse (Williams); Wells Fargo (Covered Funds).

[2173] *See* SIFMA (Securitization) (Feb. 2012) (arguing that Regulation AB sponsors will not have the right to control the decision-making and operational functions of the issuer after they deposit the assets).

[2174] *See* Credit Suisse (Williams).

[2175] *See* ASF (Feb. 2012); Wells Fargo (Covered Funds).

[2176] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2177] *See* SIFMA (Securitization) (Feb. 2012).

[2178] *See* Credit Suisse (Williams).

[2179] *See* Occupy.

[2180] *See* ASF (Feb. 2012); Credit Suisse (Williams).

[2181] *See* ASF (Feb. 2012) (arguing that service providers, including trustees, custodians, collateral agents, servicers, master servicers, backup servicers, securities administrators, remarketing agents and collateral administrators, should not be considered the sponsor or investment manager of a fund under section 13 of the BHC Act because they have roles that are principally ministerial in nature and do not generally involve investment discretion or management and control activities); PNC (arguing that a banking entity should not be deemed a sponsor simply by serving as underwriter, distributor, placement agent, originator, depositor, investment adviser, servicer, administrative agent, securitizer or similar role because these parties do not have the authority to select assets or make investment decisions on behalf of investors).

[2182] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One commenter argued that the limited discretion that a servicer, trustee or custodian may have to either invest funds within certain parameters, liquidate assets following a default on the asset or the securitization default, or mitigate losses subject to a servicing standard, should not be considered a sponsor because these entities do not exercise the level of management and control exercised by the general partner or managing member of a hedge fund or private equity fund. Another commenter argued that to the extent that any of these parties exercises discretion, such discretion (A) involves decisions made after another party defaults (*e.g.,* post-event of default collateral sale), (B) prescribed by the transaction documents (*e.g.,* choosing among a limited number of eligible investments) and (C) governed by standards of care (*e.g.,* the servicing standards). *See* ASF (Feb. 2012). Another commenter requested clarification that the exclusion of trustees that do not exercise investment discretion would also cover trustees that (A) direct investment of amounts in accordance with the applicable transaction documents, (B) act as servicer pending the appointment of a successor or (C) liquidate collateral. *See* SIFMA (Securitization) (Feb. 2012). One commenter argued that the definition of sponsor should not include an investment manager unless the investment manager (A) serves in one of the capacities designated in the definition of sponsor and can be replaced at the discretion of one or more entities serving in such capacity or with or without cause by the security holders or (B) has the ''discretion to acquire or dispose of assets in the securitization for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.'' *Id.*

[2183] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); TCW (arguing that the investment manager is typically unaffiliated with the general partner or equivalent of such fund, does not control the board of directors, is not responsible for the operations or books and records of the fund and generally does not perform any other significant function for the fund, such as acting as transfer agent).

[2184] As discussed above, commenters argued that that various roles that banking entities might serve within a securitization structure should be excluded from the definition of sponsor. *See supra* notes 2165–2175 and accompanying text.

[2185] The Agencies also note that, while the entities commenters identified may not fall into the definition of sponsor, the ability of a banking entity to acquire and retain an interest in a securitization that is a covered fund will depend on whether it conducts its activity in a manner permitted under one of the exemptions contained in section 13(d)(1) of the BHC Act, such as the exemption for organizing and offering a covered fund.

2. Section 75.11: Activities Permitted in Connection With Organizing and Offering a Covered Fund

Section 13(d)(1)(G) of the BHC Act permits a banking entity to make investments in and sponsor covered funds within certain limits in connection with organizing and offering the covered fund.[2186] Section 75.11 of the final rule implements this statutory exemption, and includes several changes from the proposed rule in response to concerns raised by commenters as described in detail below.[2187]

a. Scope of Exemption

Section 75.11 of the proposed rule described the conditions that must be met in order to qualify for the exemption provided by section 13(d)(1)(G) for covered fund activities conducted in connection with organizing and offering a covered fund.[2188] These conditions generally mirrored section 13(d)(1)(G) of the statute, and included: (i) The banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;[2189] (ii) the covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except in accordance with the limitations on amounts and value of those interests as permitted under subpart C of the proposed rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under § 75.16 of the proposed rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and may not use the word ''bank'' in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; (viii) the banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in § 75.11(h) of the proposed rule; and (ix) the banking entity must comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[2190]

Commenters raised concern that the proposed rule could be read to extend the prohibition on covered fund activities beyond the scope intended by the statute.[2191] Because the proposed exemption was applicable to banking entities engaged in ''organizing and offering'' a covered fund, commenters were concerned that the proposed rule might be interpreted to prohibit a banking entity from engaging in activities that are part of organizing and offering a covered fund but that are not prohibited under the covered fund prohibition. In this regard, commenters contended that the activity of ''organizing and offering'' a covered fund would include serving as investment adviser, distributor, broker, and other activities not prohibited by section 13 of the BHC Act and not involving the acquisition or retention of an ownership interest in or sponsorship of a covered fund as those terms are defined in section 13.[2192]

The Agencies have modified the final rule to address this concern, which reflects a reading of the proposal not intended by the Agencies. Section 13(d)(1)(G) of the BHC Act by its terms provides an exemption from section 13(a) of the BHC Act, which prohibits a banking entity from acquiring or retaining an equity, partnership or other ownership interest in or sponsoring a covered fund. To the extent that an activity is not prohibited by section 13(a), no exemption to that statutory prohibition is needed to conduct that activity. However, it is common for prohibited and non-prohibited activities to be conducted together in connection with offering and organizing a covered fund. For example, an entity that provides investment advisory services to a covered fund (an activity not itself prohibited by section 13(a)(1)(B) of the BHC Act) often acquires an ownership interest in a covered fund and/or appoints a majority of management of the covered fund (which is included in the definition of sponsor under the statute), both of which are covered by the statutory prohibition in section 13(a)(1)(B). In that case, the banking entity may engage in the prohibited activity as part of organizing and offering a covered fund only if the prohibited activity is conducted in accordance with the requirements in the exemption in section 13(d)(1)(G) or some other exemption.

The final rule reflects this view in that it permits a banking entity to invest in or sponsor a covered fund in connection with organizing and offering the fund, which may involve activities that are not prohibited by section 13. Under the final rule, a banking entity that serves as an investment adviser to a covered fund (including a sub-adviser), for example, may permissibly invest in the covered fund to the extent the banking entity complies with the requirements of section 13(d)(1)(G) of the Act. An entity that serves only as investment adviser, without making any investment or conducting any activity covered by the prohibition in section 13(a), would not be covered by the prohibition in section 13(a) and thus would not need to rely on section 13(d)(1)(G) and § 75.11 of the final rule to conduct that investment advisory activity.

As described in more detail below, a number of commenters expressed concern about applying the requirements of section 13(d)(1)(G) and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of section 13 of the BHC Act and implementing regulations.[2193]

[2186] 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) (arguing that section 13 permits a banking entity to engage in a certain level of traditional asset management business).

[2187] *See* final rule § 75.11; proposed rule § 75.11.

[2188] *See* proposed rule §§ 75.11(a)—(h).

[2189] While section 13(d)(1)(G) of the BHC Act does not explicitly mention ''commodity trading advisory services,'' the Agencies proposed to treat commodity trading advisory services in the same way as investment advisory services because the proposed rule would have included commodity pools within the definition of ''covered fund.'' One commenter argued that a covered banking entity should not be permitted to qualify for the exemption in section 13(d)(1)(G) based on providing commodity trading advisory services. *See* Occupy. The Agencies believe that commodity trading advisors provide services to commodity pools that are similar to the services an investment adviser provides to a hedge fund or private equity fund. Because certain commodity pools are included within the definition of covered fund, banking entities may organize and offer these commodity pools as a means of providing these services to customers.

[2190] *See* proposed rule § 75.11(a)–(h).

[2191] *See, e.g.,* Arnold & Porter.

[2192] *See* Arnold & Porter; F&C.

[2193] *See, e.g.,* EFAMA; ICI Global; JPMC.

The Agencies believe that many of the concerns raised with respect to applying section 13(d)(1)(G) and the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State.[2194] Furthermore, foreign public funds are excluded from the definition of covered fund in the final rule.[2195] Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of section 13(d)(1)(G) and § 75.11 of the final rule, such as the name-sharing restriction or limitations on director and employee investments.

1. Fiduciary Services

In order to qualify for the exemption for activities related to organizing and offering a covered fund, section 13(d)(1)(G) generally requires that a banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, that the covered fund be organized and offered in connection with providing these services, and that the banking entity providing those services offer the covered fund only to persons that are customers of those services of the banking entity.[2196] These requirements were largely mirrored in the proposed rule. Requiring a customer relationship in connection with organizing and offering a covered fund helps to ensure that a banking entity is engaging in the covered fund activity for others and not on the banking entity's own behalf.[2197]

As noted in the proposal, section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the Agencies explained in the proposal that the customer relationship may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer. This application of the customer requirement is consistent with the manner in which these services are provided by banking entities. The proposed rule also required that a banking entity relying on the authority contained in § 75.11 adopt a credible plan or similar documentation outlining how the banking entity intended to provide advisory or similar services to its customers through organizing and offering such fund.

Several commenters indicated support for this customer requirement and, in particular, the Agencies' view that the customer relationship need not be a preexisting one.[2198] A few commenters contended that the statute required that a banking entity have a pre-existing customer relationship, and may not solicit investors outside of its existing asset management customers.[2199] One of these commenters argued that this would place banking entities at a competitive disadvantage compared to investment advisers that are not banking entities (and thus not subject to the requirements of section 13 and the final rule), but argued that this is a necessary result of section 13.[2200]

The final rule adopts the language largely as proposed, and the Agencies continue to believe that the customer relationship required under section 13(d)(1)(G) and the final rule may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer.[2201] The final rule requires that a covered fund be organized and offered pursuant to a written plan or similar documentation outlining how the banking entity (or an affiliate thereof) intends to provide advisory or similar services to its customers through organizing and offering the fund. As part of this requirement, the plan must be credible and indicate that the banking entity has conducted reasonable analysis to show that the fund is organized and offered for the purpose of providing *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to customers of the banking entity (or an affiliate thereof) and not to evade the restrictions of section 13 of the BHC Act.

The language of the final rule also adopts the statutory requirements (and modifications related to commodity pools as discussed above) that the banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and that the covered fund be organized and offered only in connection with the provision of those services. Banking entities provide a wide range of customer-oriented services which may qualify as *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.[2202] Historically, banking entities have used covered funds as a method of providing these services to customers in a manner that is both cost efficient for the customer and allows customers to benefit from access to advice and services that might not otherwise be available to them. These benefits apply to long-established customers as well as individuals or entities that have no pre-existing relationship with the banking entity but choose to obtain the benefit of trust, fiduciary, investment advisory, or commodity trading advisory services through participation in the covered fund. Covered funds also allow customers to gauge the historical record of the banking entity in providing these services by reviewing the funds' past performance.

The statute does not require that a covered fund be offered only to pre-existing customers of the banking entity, and the Agencies believe that imposing such a requirement would not improve the quality of the trust, fiduciary, investment advisory, or commodity trading advisory service, enhance the safety and soundness of the banking entity, or reduce the risks to the customers or the banking entity. In each case, the banking entity provides trust, fiduciary or advisory services to a covered fund for the benefit of the banking entity's customers, and the statute recognizes that organizing and offering a covered fund is a legitimate method for providing that service. In addition, the banking entity must abide by all the statutory and prudential

[2194] *See* final rule § 75.10(b)(1)(iii).

[2195] *See* final rule § 75.10(c)(1).

[2196] *See* 12 U.S.C. 1851(d)(1)(G)(i); proposed rule § 75.11(a).

[2197] *See* 156 Cong. Rec. at S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2198] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC.

[2199] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[2200] *See* Sens. Merkley & Levin.

[2201] *See* final rule § 75.11(a)(1)–(2). *See* Part VI.B.2.b. below for a discussion of these requirements in the context of a banking entity that organizes and offers a covered fund that is an issuing entity of asset-backed securities.

[2202] *See, e.g.,* 12 U.S.C. 1843(c)(4), (c)(8), (K), 12 CFR 225.28(b)(5) and (6), 12 CFR 225.86, 12 CFR 225.125 (with respect to a bank holding company); 12 U.S.C. 24(Seventh), 92a, 12 CFR Part 9 (with respect to a national bank); 12 U.S.C. Part 362 (with respect to a state non-member bank).

requirements imposed by section 13 and the entity's supervisors on the provision of those services. The Agencies do not believe that a pre-existing customer relationship requirement would be meaningful because it could easily be satisfied by a prospective customer seeking to invest in a covered fund by first establishing an account with a banking entity or purchasing another product (*e.g.,* a brokerage account or shares of a mutual fund).

2. Compliance With Investment Limitations

Section 13(d)(1)(G)(iii) of the BHC Act limits the ability of a banking entity that organizes and offers a covered fund to acquire or retain an ownership interest in that covered fund as an investment.[2203] Both the proposed rule and the final rule implement this provision by requiring that a banking entity limit its investments in a covered fund that the banking entity organizes and offers as provided in § 75.12.[2204] Comments received on investment limitations in the proposed rule, and modifications made to the final rule implementing these limitations, are described in Part VI.B.3. below.

3. Compliance With Section 13(f) of the BHC Act

Section 75.11(d) of the proposed rule required that the banking entity comply with the limitations on relationships with covered funds imposed by section 13(f) of the BHC Act.[2205] The final rule adopts this requirement and provides that the banking entity (and its affiliates) must comply with the requirements of § 75.14. Section 13(f) of the BHC Act prohibits certain transactions or relationships that would be covered by section 23A of the Federal Reserve Act, and provides that any permitted transaction is subject to section 23B of the Federal Reserve Act, in each instance as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2206] These limitations apply in several contexts, and are contained in § 75.14 of the final rule, discussed in detail below in Part VI.B.5.

4. No Guarantees or Insurance of Fund Performance

Section 75.11(e) of the proposed rule prohibited a banking entity that organizes and offers a covered fund from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which such covered fund invests.[2207] This prong implemented section 13(d)(1)(G)(iv) of the BHC Act and was intended to prevent a banking entity from engaging in bailouts of a covered fund in which the banking entity has an interest.[2208]

There were only a few comments received on this aspect of the proposal. One commenter supported the restriction on guarantees as effective and consistent with the statute.[2209]

One commenter argued that the final rule should not prohibit borrower default indemnification services (*i.e.,* the guarantee of collateral sufficiency upon a securities borrower's default) provided to lending clients by agent banks in connection with securities lending transactions involving a covered fund.[2210] This commenter argued that borrower default indemnification services guarantee only the deficit between the mark to market value of cash collateral received and the amount of any borrower default, and are therefore different from and more limited than the type of general investment performance or obligation guarantee that section 13 was designed to prevent.

The Agencies believe that the statute does not permit either full or partial guarantees of the obligations of a covered fund that the banking entity organizes and offers. Accordingly, the final rule, like the proposed rule, continues to mirror the statutory restriction on direct or indirect guarantees of the obligations or performance of a covered fund by a banking entity in connection with reliance on the exemption provided in section 13(d)(1)(G) of the BHC Act. However, in response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not prohibited. This type of indemnification is not a guarantee of the performance or obligations of a covered fund because it represents a guarantee to the customer or borrower of the obligation of the counterparty to perform and not a guarantee of the performance or underlying obligations of the covered fund. The requirement of the final rule that a banking entity and its affiliates not guarantee the obligations or performance of a covered fund that it organizes and offers therefore does not prohibit a banking entity from providing borrower default indemnifications to customers.

5. Limitation on Name Sharing With a Covered Fund

Section 75.11(f) of the proposed rule prohibited the covered fund from sharing the same name or a variation of the same name with the banking entity that relies on the exemption in section 13(d)(1)(G) of the BHC Act.[2211] The proposed rule also prohibited the covered fund from using the word ''bank'' in its name.[2212]

The name-sharing restriction was one of the most commented upon aspects of § 75.11. A number of commenters on this section expressed the view that the name-sharing restriction in section 13(d)(1)(G)(vi) of the BHC Act and the proposed rule was too strict. In particular, a number of commenters argued that the name-sharing restriction should allow an asset manager to share its name with a sponsored covered fund so long as the covered fund does not share the name of the insured depository institution or its affiliated holding company or use the word ''bank.''[2213]

Commenters argued that the name-sharing restriction as proposed would impose significant business and branding burdens on the industry without providing incremental benefit to the public.[2214] These commenters argued that it would be unduly burdensome and costly for funds currently affiliated with banking entities or managers that are themselves banking entities to change the name of their affiliated funds and that many of these funds have developed a reputation in the marketplace based on the current name of the fund and/or fund manager.

[2203] *See* 12 U.S.C. 1851(d)(1)(G)(iii).

[2204] *See* proposed rule and final rule § 75.12.

[2205] 12 U.S.C. 1851(d)(1)(G)(iv); proposed rule § 75.11(d).

[2206] *See* Part VI.B.5. below. The comments received on section 13(f) and § 75.16 of the proposed rule are described below.

[2207] 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § 75.11(e).

[2208] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2209] *See* Occupy.

[2210] *See* RMA.

[2211] 12 U.S.C. 1851(d)(1)(G)(vi); proposed rule § 75.11(f).

[2212] Similar restrictions on a fund sharing the same name, or variation of the same name, with an insured depository institution or company that controls an insured depository institution or having the word ''bank'' in its name, have been used previously in order to prevent customer confusion regarding the relationship between such companies and a fund. *See, e.g., Bank of Ireland,* 82 Fed. Res. Bull. 1129 (1996).

[2213] *See* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; EFAMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Katten (on behalf of Int'l Clients); Union Asset.

[2214] *See, e.g.,* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; *see also* SVB; Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012); UBS.

Some of these commenters argued that the name-sharing restriction would place asset managers and funds affiliated with banking entities at a competitive disadvantage to other asset managers and funds.[2215]

A few commenters argued that the rationale for the name-sharing restriction (*i.e.,* to discourage bailing out funds) was already addressed under other restrictions of section 13(d)(1)(G) and the proposed rule that prohibit a banking entity from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or of any covered fund in which such covered fund invested and that require disclosure that investments in the covered fund are not insured by the Federal Deposit Insurance Corporation.[2216] These commenters questioned the necessity for the name-sharing restriction when a prohibition on bailing out funds is already in place and where there is disclosure that investors bear the risk of loss in the fund. Some of these commenters contended it was unlikely that investors in a covered fund with an SEC-registered investment adviser that has a name unrelated to the name of an insured depository institution would be misled to believe that the fund would be backed in any way by a related insured depository institution or the Federal Deposit Insurance Corporation.[2217] One of these commenters argued that the name-sharing restriction should not apply to organizations where insured depository institutions represent a *de minimis* component of the organization's operations.[2218]

Other commenters recommended that the name-sharing restriction not be applied to covered funds that rely on the exemption for covered fund activities and investments that occur solely outside of the United States.[2219] A few commenters expressed concern that the name-sharing restriction could be incompatible with regulatory requirements in certain foreign jurisdictions that a covered fund's name must indicate the fund's connection with the fund sponsor.[2220] One commenter argued that it is common practice in Germany to disclose the designation of the sponsoring investment manager in the fund name in order to provide transparency to investors, while a few commenters contended that European jurisdictions, including the U.K., require an authorized fund to have a name representative of the authorized investment manager to avoid misleading fund investors.[2221] Commenters also argued that the name-sharing restriction was inconsistent with the laws of Ireland and Hong Kong.[2222] Certain commenters argued that the impact of the name-sharing restriction would be particularly unfair to non-U.S. retail funds like European UCITS if such funds are not allowed to use the name of the bank while U.S. mutual funds would not be subject to the same restriction.[2223]

By contrast, some commenters supported the name-sharing restriction. For example, one commenter indicated that the use of the word ''bank'' or a shared name in the fund's name was already strongly discouraged by prior guidance.[2224] Another commenter supported the name-sharing restriction but argued it did not go far enough because it did not apply to funds that a banking entity was permissibly allowed to sponsor and invest in under other provisions of section 13.[2225] According to this commenter, covered funds permitted under other exemptions should not be allowed to share the same name with the banking entity.[2226]

After carefully considering comments and the express terms of the statute, the final rule includes the name-sharing restriction as proposed.[2227] The name-sharing restriction is imposed by the statute and prohibits a banking entity from sharing the same name or variation of the same name with a covered fund. The statute also defines the scope of the prohibition by defining the term ''banking entity'' to generally include any affiliate or subsidiary of an insured depository institution or any company that controls an insured depository institution.[2228]

However, the Agencies believe that many of the concerns raised by commenters with respect to this provision should be addressed through the revised definition of covered fund in the final rule, and modifications to the exemption for covered fund activities and investments that occur solely outside of the United States.[2229] For example, as discussed in greater detail above in Part VI.B.1.c.1., foreign public funds sold outside the United States are excluded from the definition of covered fund.[2230] In addition, pursuant to the definition of covered fund in the final rule, a foreign fund only becomes a covered fund with respect to a U.S. banking entity (including a foreign affiliate of that U.S. banking entity) that acts as sponsor to, or has an ownership interest in, the fund. Moreover, numerous funds operate successfully with names that differ from the name of the fund sponsor or adviser.

The Agencies recognize, however, that the statutory name-sharing restriction may affect some entities that will be covered funds and that cannot rely on another permitted activity exemption under section 13(d)(1) and the final rule. The name-sharing restriction may result in certain costs and other economic burdens for banking entities that advise these funds, as discussed in greater detail in Part VI.B.1.g. above.[2231] However, as the Agencies also note above, to the extent that the restriction results in a banking entity not otherwise coming under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that shares the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity that this assistance might pose. The Agencies also expect that the conformance period, both for compliance with section 13 of the BHC Act generally and for funds that are illiquid funds, should be sufficient to allow covered funds to take the steps necessary to comply with the name-sharing restriction in the statute and final rule.

6. Limitation on Ownership by Directors and Employees

Section 75.11(g) of the proposed rule implemented section 13(d)(1)(G)(vii) of the BHC Act. That statutory provision prohibits any director or employee of

[2215] *See* Ass'n of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2216] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); T. Rowe Price; TCW.

[2217] *See* TCW; Union Asset.

[2218] *See* T. Rowe Price.

[2219] *See, e.g.,* UBS.

[2220] *See* Credit Suisse (Williams); EFAMA; JPMC; Katten (on behalf of Int'l Clients); Union Asset; IAA; ICI Global; UBS; SIFMA *et al.* (Covered Funds) (Feb. 2012) (*citing* Directive 2004/39/EC of the European Parliament and Council).

[2221] *See* BVI; EFAMA; JPMC; UBS; Union Asset; ICI Global; IAA.

[2222] *See* UBS; Union Asset; ICI Global.

[2223] *See, e.g.,* AFG; ICI Global; JPMC.

[2224] *See* Arnold & Porter (citing SEC Division of Investment Management, Letter to Registrants (May 13, 1993); Memorandum to SEC Chairman Breeden from Division of Investment Management (May 6, 1993); FDIC, Board, OCC, OTS, Interagency Statement on Retail Sales of Non-Deposit Investment Products (Feb. 14, 1994)).

[2225] *See* Occupy the SEC at 165.

[2226] *See id.*

[2227] *See* final rule § 75.11(f).

[2228] *See* 12 U.S.C. 1851(d)(1)(G)(vi) and (h)(1).

[2229] For example, one commenter alleged that it would need to rebrand approximately 500 established funds if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2230] *See* final rule § 75.10(b)(1)(ii) and (c)(1).

[2231] *See* Part VI.B.1.g.

the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[2232] This allows an individual employed by a banking entity, who also acts as fund manager or adviser (for example), to acquire or retain an ownership interest in a covered fund that aligns the manager or adviser's incentives with those of the banking entity's customers.[2233]

One commenter argued that only employees or directors who provide investment advisory services should be allowed to make an investment in the fund and that the rule should not allow employees or directors who provide other, unspecified services to invest in a fund.[2234] This commenter argued that the proposed rule would allow non-adviser banking entity employees who have no need to maintain ''skin in the game'' to earn profit on the fund's performance. According to another commenter, fiduciary clients of banking organizations often are less interested in whether the fund manager or other service providers have money in the fund than whether the client's own account manager, and those individuals above him/her who are responsible for investment decisions, have allocated his or her own assets in the same way and into the same general asset classes and funds as the client's fiduciary account is being allocated.[2235]

The more prevalent view among commenters was that the proposed rule should be revised and expanded to permit investments in a sponsored fund by a broader group of banking entity directors, officers, and employees, directly or indirectly through employee benefit programs or trust and fiduciary accounts, regardless of whether the individual provides services to the covered fund.[2236] Some commenters argued that narrowly limiting permissible director and employee investments could put asset managers affiliated with an insured depository institution at a competitive disadvantage relative to managers that are not affiliated with an insured depository institution,[2237] as well as make it more difficult for banking entities to offer their U.S. and non-U.S. employees similar choices in retirement plans.[2238]

Two commenters urged that the supervisors of a fund's portfolio managers or investment advisers should be permitted to invest.[2239] These commenters also argued that individuals who provide support services to the fund, including administrative, oversight and risk management, legal compliance, regulatory, product structuring, deal sourcing and origination, deal evaluation and diligence, investor relations, sales and marketing, tax, accounting, valuation and other operational support services, should be permitted to invest in the fund. These commenters also requested confirmation that any director, including an individual serving on the board or investment committee of a fund or its manager, should be permitted to invest.[2240] Another commenter argued that employees and directors should be permitted to make their own individual investment decisions independently without regard to whether they provide services to the covered fund.[2241] One commenter contended that a grandfathering approach is necessary to address situations where a pre-existing covered fund already has investments from directors and employees who do not directly provide services to the fund because the fund may be unable to force those individuals out of the fund.[2242]

A number of commenters argued that, if defined too narrowly, this restriction may conflict with the laws of other jurisdictions that require advisers and/or their directors and employees to invest in the funds they manage.[2243] For example, several commenters argued that this requirement will directly conflict with the European Alternative Investment Fund Managers Directive.[2244] Two commenters contended that certain jurisdictions, including the Netherlands, require directors and other personnel of fund managers to hold fund units or shares of funds managed by the fund manager as part of their pensions.[2245]

The final rule retains the requirement limiting the ownership of a covered fund by directors and employees of a banking entity (or an affiliate thereof) relying on the exemption in section 13(d)(1)(G) of the BHC Act.[2246] This limitation is imposed by statute on banking entities that rely on this exemption. If a director or employee does not provide services to the fund, they may not invest in that fund. As in the statute, the final rule allows employees who provide services to the fund other than investment advisory services to invest in the fund. Under the final rule, directors or employees who provide investment advice or investment management services to the fund may invest in that fund. Similarly, directors or employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services, may also invest in the fund. In response to comments, the final rule has been modified to make clear that a former director or employee may retain an interest in a covered fund if the director or employee acquired the interest while serving as a director or employee of the banking entity and providing investment advisory or other services to the covered fund.

The Agencies believe that many of the concerns raised by commenters regarding the effects of this limitation on foreign funds are addressed through the scope of foreign funds that will be covered funds, and revisions to the exemption provided for covered fund activities and investments that occur solely outside of the United States. Moreover, the final rule excludes foreign public funds and broad-based foreign pension funds from the definition of covered fund and they are thus not subject to the restrictions of section 13 or the final rule.[2247]

Section 13 clearly contemplates investments by certain employees and directors of the banking entity.[2248] However, the Agencies continue to believe that certain director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in section 13(d)(4) of the BHC Act and the final rule. In order to address this concern, the final rule attributes an ownership interest in a

[2232] *See* 12 U.S.C. 1851(d)(1)(G)(vii); proposed rule § 75.11(g).

[2233] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2234] *See* Occupy.

[2235] *See* Arnold & Porter.

[2236] *See* Arnold & Porter; BOK, Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011); PEGCC; T. Rowe Price.

[2237] *See* Credit Suisse (Williams).

[2238] *See* T. Rowe Price.

[2239] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2240] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2241] *See* BOK (citing proposed rule at § 75.17); Arnold & Porter.

[2242] *See* SVB.

[2243] *See* EFAMA; BVI; IAA; ICI Global; JPMC; Union Asset.

[2244] *See* Annex II para. 1(m). Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers.

[2245] *See* EFAMA; Union Asset.

[2246] *See* final rule § 75.11(g).

[2247] *See* final rule §§ 75.10(c)(1) and 75.10(c)(5).

[2248] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

covered fund acquired or retained by a director or employee to a banking entity for purposes of the investment limits in section 13(d)(4) under certain circumstances. This attribution is discussed in detail below in Part VI.B.3.f.

7. Disclosure Requirements

Section 75.11(h) of the proposed rule required that, in connection with organizing and offering a covered fund, the banking entity clearly and conspicuously disclose, in writing, to prospective and actual investors in the covered fund that any losses in the covered fund will be borne solely by investors in the covered fund and not by the banking entity and its affiliates or subsidiaries; and that the banking entity's and its affiliates' or subsidiaries' losses in the covered fund will be limited to losses attributable to the ownership interests in the covered fund held by the banking entity and its affiliates or subsidiaries in their capacity as investors in the covered fund. In addition, the proposed rule required that a banking entity disclose, in writing: (i) that each investor should read the fund offering documents before investing in the covered fund; (ii) that the ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case); and (iii) the role of the banking entity and its affiliates, subsidiaries, and employees in sponsoring or providing any services to the covered fund. The proposed rule also required banking entities to comply with any additional rules of the appropriate Agency designed to ensure that losses in any covered fund are borne solely by the investors in the covered fund and not by the banking entity.[2249] In proposing the rule, the Agencies indicated that a banking entity may satisfy these disclosure requirements by making the required disclosures in the covered fund's offering documents.[2250]

A few commenters supported the disclosure requirement as effective and consistent with the statute.[2251] One commenter stated that the disclosures required in section 13(d)(1)(G)(viii) of the Act and the proposed rule are consistent with disclosures in the banking agencies' February 1994 ''Interagency Statement on Retail Sales of Non-deposit Investment Products'' and other FINRA and SEC guidance.[2252] One commenter suggested that the rule include a requirement that the disclosures be issued in plain English.[2253]

Another commenter argued that the Agencies should revise the disclosure requirements under the proposal so that offering materials of non-U.S. funds provided to non-U.S. investors outside the United States need not include the specified disclosures nor refer to the FDIC or other specific U.S. agencies.[2254] This commenter argued that a non-U.S. person investing in a non-U.S. fund offered or sponsored by a non-U.S. banking entity has no expectation that the fund or its interests would be insured by the FDIC. The Agencies believe this concern is addressed through the revised definition of covered fund, which generally provides that a foreign fund offered outside of the United States will only be a covered fund with respect to a U.S. banking entity (including a foreign affiliate of the U.S. banking entity) that acts as sponsor to, or invests in, the fund.[2255]

The final rule adopts the proposed disclosure requirements substantially as proposed. As explained above, these disclosures are largely required by the statute.[2256] The proposed requirement to disclose that ownership interests in a covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case) is not expressly required by the statute. However, section 13(d)(1)(G)(iii) permits the Agencies to impose additional rules designed to ensure that losses in a covered fund are borne solely by investors in the fund and not by a banking entity. The Agencies believe that requiring a banking entity to make this disclosure as part of organizing and offering a covered fund furthers this purpose by removing the potential for misperception that a covered fund sponsored by a banking entity (which by definition must be affiliated with a depository institution insured by the FDIC) is guaranteed by that insured institution or the FDIC. Moreover, as noted above, this disclosure is already commonly provided by banking entities.

b. Organizing and Offering an Issuing Entity of Asset-Backed Securities

To the extent that an issuing entity of asset-backed securities is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o–11) which requires a banking entity to retain and maintain a certain minimum interest in certain asset-backed securities.[2257] In order to give effect to this separate requirement under the Dodd-Frank Act, § 75.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under the provisions of that Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2258] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2259] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2260]

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides an exemption that permits a banking entity to organize and offer a

[2249] 12 U.S.C. 1851(d)(1)(G)(viii); proposed rule § 75.11(h).

[2250] To the extent that any additional rules are issued to ensure that losses in a covered fund are borne solely by the investors in the covered fund and not by the banking entity, a banking entity would be required to comply with those as well in order to satisfy the requirements of section 13(d)(1)(G)(viii) of the BHC Act.

[2251] *See, e.g.,* Occupy.

[2252] *See* Arnold & Porter.

[2253] *See* Occupy.

[2254] *See* Katten (on behalf of Int'l Clients).

[2255] *See* final rule § 75.10(b)(1)(iii).

[2256] *See* 12 U.S.C. 1851(d)(1)(G)(viii).

[2257] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. *See* Credit Risk Retention, 78 FR 57928 (Sept. 20, 2013).

[2258] *See* proposed rule § 75.14(a)(2)(iii).

[2259] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2260] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

covered fund that is an issuing entity of asset-backed securities.[2261] The Agencies have determined to provide this exemption in order to address the unique circumstances and ownership structures presented by securitizations.[2262] Under the final rule, a banking entity may permissibly organize and offer a covered fund that is an issuing entity of asset-backed securities so long as the banking entity (and its affiliates) comply with all of the requirements of § 75.11(a)(3) through (a)(8).[2263] As discussed above, the requirements of § 75.11(a)(3) through 75.11(a)(8) are that: (i) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § 75.12 of the final rule;[2264] (ii) the banking entity and its affiliates comply with the requirements of § 75.14 of the final rule; (iii) the banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (iv) the covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or variation of the same name with the banking entity (or an affiliate thereof) and does not use the word ''bank'' in its name; (v) no director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund except under the limited circumstances noted in the final rule; and (vi) the banking entity complies with the disclosure requirements regarding covered funds in the final rule.

The Agencies believe that the requirements of the exemption for organizing and offering a covered fund that is an issuing entity of asset-backed securities, which are in most aspects consistent with the exemption for organizing and offering a covered fund in section 13(d)(1)(G), provide limitations on a banking entity's securitization activities involving covered funds that are consistent with the limitations imposed with respect to organizing and offering a covered fund that is not an issuing entity of asset-backed securities. For instance, a banking entity may not share the same name as a covered fund that is an issuing entity of asset-backed securities and is prohibited from guaranteeing or otherwise ''bailing out'' a covered fund that is an issuing entity of asset-backed securities, including being required to comply with section 13(f) of the BHC Act regarding covered transactions with the covered fund. Furthermore, like a banking entity's investment in any covered fund, the final rule limits the ability of a banking entity to invest in a covered fund that is an issuing entity of asset-backed securities unless it meets the requirements of § 75.12.

Unlike many other covered funds, the Agencies understand that banking entities might not act in a fiduciary capacity when they organize and offer a covered fund that is a securitization vehicle. For instance, as part of organizing and offering a securitization vehicle, one or more parties may typically organize and initiate the securitization by selling or transferring assets, either directly or indirectly, to an issuing entity of asset-backed securities. An entity that provides these services typically does so as a service to provide investors and the entity's customers with the ability to invest in the assets in a manner and to a degree that they may otherwise be unable to do. In order to identify certain activities that would be included as organizing and offering a securitization, the final rule provides that organizing and offering an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, for the issuer, or acquiring or retaining an ownership interest in the issuer in compliance with the implementing regulations issued under section 15G of that Act.

The final rule reflects, as discussed above, that one or more parties that organize and offer an issuing entity of asset-backed securities may not provide any of the services identified in § 75.11(a)(1). In this case the banking entity is not required to comply with § 75.11(a)(1) or (a)(2). Section 75.11(b) of the final rule is designed to address situations where, as discussed above, a banking entity does not act in a fiduciary capacity when it organizes and offers a covered fund that is a securitization vehicle. With respect to any securitization vehicle that retains a collateral manager for investment advice regarding the assets of the securitization vehicle, such a collateral manager would be required to comply with all of the provisions of § 75.11(a) to acquire and retain an ownership interest in such securitization vehicle.

The final rule therefore both identifies certain activities that would be included as organizing and offering a securitization and modifies the requirements of § 75.11 to reflect differences between securitizations and other types of covered funds, as discussed above. The Agencies believe, therefore, that the final rule appropriately addresses the type of activity that is usually associated with organizing and offering a securitization and also comports with the manner in which Congress chose to define the type of parties engaged in activities that merit special attention related to issuing entities of asset-backed securities in another part of the Dodd-Frank Act.

The Agencies have determined to provide this exemption by using their authority in section 13(d)(1)(J) of the BHC Act and believe that this exemption promotes and protects the safety and soundness of banking entities and the financial stability of the United States. Many companies and other entities utilize securitization transactions to efficiently manage, allocate and distribute risks throughout the markets in a manner consistent with meeting the demands of their investors. Companies also utilize securitizations in order to help provide liquidity to certain asset classes or portions of the market that, absent this liquidity, may experience decreased liquidity and increased costs of funding. For instance, if banking entities were not permitted to organize and offer a securitization, the Agencies believe this would result in increased costs of funding or credit for many businesses of all sizes that are engaged in activities that section 13 of the BHC Act was not designed to address. Additionally, this exemption enables banking entities to acquire and retain ownership interests in a covered fund to comply with section 15G of the Exchange Act, which requires certain parties to a securitization transaction to retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. The Agencies therefore have determined that this exemption will promote and protect the safety and soundness of banking entities and the financial stability of the United States by facilitating the benefits securitizations can provide as discussed above, and also by enabling banking

[2261] *See* final rule § 75.11(b).

[2262] As used in this **SUPPLEMENTARY INFORMATION**, the term ''securitization'' means a transaction or series of transactions that result in the issuance of asset-backed securities.

[2263] *See* final rule § 75.11(b) (providing the requirements for a banking entity that is organizing and offering a covered fund that is an issuing entity of asset-backed securities by reference to the requirements of § 75.11(a), as discussed above).

[2264] As explained in detail below in Part VI.B.3. addressing the limitations on investments in covered funds by a banking entity, the final rule permits a banking entity to acquire and retain ownership interests in a covered fund in order to comply with section 15G of the Exchange Act (15 U.S.C.78o–11) in an amount that does not exceed the amount required to comply with the banking entity's chosen method of compliance under section 15G and the implementing regulations issued thereunder.

entities to comply with section 15G of the Exchange Act.

The Agencies believe it would not be consistent with the safety and soundness of banking entities or the financial stability of the United States to prevent banking entities from acquiring or retaining ownership interests in securitizations as part of the permitted activity of organizing and offering securitizations or from meeting any applicable requirements related to securitizations, including those imposed under section 15G of the Exchange Act. The Agencies note that the exemption for organizing and offering a securitization does not relieve banking entities of any requirements that they may be subject to with respect to their investments in or relationships with a securitization, such as any applicable requirements regarding conflicts of interest relating to certain securitizations under section 27B of the Securities Act of 1933.

c. Underwriting and Market Making for a Covered Fund

Section 13(d)(1)(B) permits a banking entity to purchase and sell securities and other instruments described in 13(h)(4) in connection with certain underwriting or market making-related activities.[2265] The proposal did not discuss how this exemption applied in the context of underwriting or market making of ownership interests in covered funds.

Commenters argued that the scope of the permitted activities under sections 13(d)(1)(B), (D) and (F), which respectively set out permitted activities of underwriting and market making-related activities, activities on behalf of customers, and activities by a regulated insurance company, apply to all of the activities prohibited under section 13(a), whether those activities would involve proprietary trading or ownership of or acting as a sponsor to covered funds.[2266] Commenters argued that the statutory exemption for underwriting and market making-related activities is applicable to both proprietary trading and covered fund activities, and recommended that the final rule allow banking entities to hold ownership interests and other securities of covered funds for the purpose of underwriting and engaging in market making-related activities.[2267] Commenters noted that many structured finance vehicles rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and argued that, without a market making exemption for securities of covered funds, banking entities would be unable to engage in customer-driven underwriting and market making activity with respect to securities issued by entities such as collateralized loan obligation issuers and non-U.S. exchange-traded funds.[2268]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to provide a covered fund specific provision for underwriting and market making-related activities of ownership interests in covered funds. These underwriting and market making activities are within the scope of permitted activities under the final rule so long as:

- The banking entity conducts the activities in accordance with the requirements of § 75.4(a) or § 75.4(b), respectively;
- With respect to any banking entity (or an affiliate thereof) that: acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on § 75.11(a); acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § 75.11(b); or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § 75.12(a)(2)(ii) and § 75.12(d); and
- With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § 75.11, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities under § 75.11(c), are included in the calculation of all ownership interests under § 75.12(a)(2)(iii) and § 75.12(d).[2269]

The Agencies believe that providing a separate provision relating to permitted underwriting and market making-related activities for ownership interests in covered funds is supported by section 13(d)(1)(B) of the BHC Act.[2270] The exemption for underwriting and market making-related activities under section 13(d)(1)(B), by its terms, is a statutorily permitted activity and exemption from the prohibitions in section 13(a), whether on proprietary trading or on covered fund activities. Applying the statutory exemption in this manner accommodates the capital raising activities of covered funds and other issuers in accordance with the underwriting and market making provisions under the statute.

The final rule provides that a banking entity must include any ownership interests that it acquires or retains in connection with underwriting and market making-related activities for a particular covered fund for purposes of the per-fund limitation under § 75.12(a)(2)(ii) if the banking entity: (i) Acts as a sponsor, investment adviser or commodity trading advisor to the covered fund; (ii) otherwise acquires and retains an ownership interest in the covered fund as permitted under § 75.11(a); (iii) acquires and retains an ownership interest in the covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in the covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § 75.11(b); or (iv) directly or indirectly guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests. This is designed to prevent any unintended

[2265] *See* 12 U.S.C. 1851(d)(1)(B).

[2266] *See* Cleary Gottlieb *et al.;* JPMC; Credit Suisse (Williams).

[2267] *See* BoA; Cleary Gottlieb; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Deutsche Bank (Fund-Linked Products); SIFMA (Securitization) (Feb. 2012). Other commenters argued that application of Section 13(f) of the BHC Act would prohibit the underwriting and market making by a banking entity of the securities of a covered fund that such banking entity sponsors, organizes and offers or provides investment management advice or services because Section 13(f) of the BHC Act prohibits the purchase of securities by a banking entity from such a covered fund. *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); FSA (Feb. 2012).

[2268] *See* JPMC; Cleary Gottlieb.

[2269] *See* final rule § 75.11(c).

[2270] A discussion of the implementation of section 13(d)(1)(D) and (F) with regard to the final rule's limitations on covered fund investments and activities is provided in the section that relates to permitted covered fund interests and activities by a regulated insurance company and § 75.13(c) of the final rule.

expansion of ownership of covered funds by banking entities that are subject to the per fund limitations under § 75.12.

These banking entities will have a limited ability to engage in underwriting or market making-related activities for a covered fund for which the banking entity's investments are subject to the per-fund limitations in § 75.12 as discussed above. Such a banking entity will have more flexibility to underwrite and make a market in the ownership interests of such a covered fund in connection with organizing and offering the covered fund during the fund's seeding period, since during the seeding period a banking entity may own in excess of three percent of the covered fund, subject to the other requirements in § 75.12.

The final rule also provides that all banking entities that engage in underwriting and market-making related activities in covered funds are required to include the aggregate value of all ownership interests of the banking entity in all covered funds acquired and retained under § 75.11, including in connection with underwriting and market making-related activities under § 75.11(c), in the calculation of the aggregate covered fund ownership interest limitations under § 75.12(a)(2)(iii) (and make the associated deduction from tier one capital for purposes of calculating compliance with applicable regulatory capital requirements).[2271]

Some commenters asked that the Agencies permit banking entities to engage in market making and underwriting in non-sponsored covered fund interests.[2272] The final rule permits a banking entity that does not hold an ownership interest in the covered fund in reliance on §§ 75.11(a) or 75.11(b) of the final rule, is not a sponsor of the covered fund, is not an investment adviser or commodity trading advisor to the covered fund, and does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests to rely on the market-making and underwriting exemption in § 75.11(c) provided that the banking entity meets all of the requirements of that exemption. These conditions include the aggregate funds limitation and the capital deduction contained in § 75.12 after including all ownership interest held by the banking entity and its affiliates under § 75.11, including ownership interests acquired or retained under the exemption for underwriting and market making-related activities in § 75.11(c). In accordance with section 13(d)(1) of the BHC Act, the Agencies have determined that these restrictions on reliance on the market-making and underwriting exemption provided by section 13(d)(1)(B) are appropriate to address the purposes of section 13 of the BHC Act, which is aimed at assuring that banking entities do not bail-out a covered fund and maintain sufficient capital against the risks of ownership of covered funds. The Agencies note, however, that the guarantee restriction is not intended to prevent a banking entity from entering into arrangements with a covered fund that are not entered into for the purpose of guaranteeing the obligations or performance of the covered fund. For example, this restriction is not intended to prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity. The determination of whether an arrangement would fall within this guarantee restriction would depend on the facts and circumstances.

The Agencies emphasize that any banking entity that engages in underwriting or market making-related activities in covered funds must comply with all of the conditions applicable to such activity as set forth in section §§ 75.4(a) and 75.4(b).[2273] Thus, holdings of a single covered fund would be subject to limitations on risk as well as length of holding period, among other applicable limitations and requirements. These requirements are designed specifically to address a banking entity's underwriting and market making-related activities and to prohibit holding exposures in excess of reasonably expected near term demand of clients, customers and counterparties.

3. Section 75.12: Permitted Investment in a Covered Fund

a. Proposed Rule

Section 75.12 of the proposed rule implemented section 13(d)(4) of the BHC Act and described the limited circumstances under which a banking entity may acquire or retain an ownership interest in a covered fund that the banking entity (which includes its subsidiaries and affiliates) organizes and offers.[2274] Section 13(d)(4)(A) of the BHC Act permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers for the purpose of: (i) Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or (ii) making a *de minimis* investment in the fund, subject to several limitations. Section 13(d)(4)(B) of the BHC Act requires that investments by a banking entity in a covered fund must, not later than one year after the date of establishment of the fund, be reduced to an amount that is not more than three percent of the total outstanding ownership interests of the fund. Consistent with the statute, § 75.12 of the proposal provided that, after expiration of the seeding period, a banking entity's investment in a single covered fund may not represent more than three percent of the total outstanding ownership interests in the covered fund (the ''per-fund limitation'').[2275] In addition, as provided in the statute, the proposal provided that the total amount invested by a banking entity in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (the ''aggregate funds limitation'').[2276]

b. Duration of Seeding Period for New Covered Funds

Commenters argued that it is essential to serving their customers efficiently that a banking entity be permitted to acquire and retain an ownership interest in a covered fund that it organizes and offers as a *de minimis* investment or for the purpose of establishing the fund. A number of commenters contended that a banking entity typically invests a limited amount of its own capital in a fund (''seed capital'') as part of organizing the fund to produce investment performance as a record of the fund's investment strategy (''track record'').[2277] Once a track record for the fund is established, the banking entity markets the fund to unaffiliated investors.

Commenters argued that the one-year seeding period provided in the proposed rule would be too short to establish a track record for many types of covered funds. Commenters argued that the duration of the track record investors typically demand before investing in a new fund depends on a number of factors (*e.g.,* the type of fund,

[2271] *See* final rule § 75.11(c)(3).

[2272] *See* Cleary Gottlieb; Credit Suisse (Williams).

[2273] *See* final rule § 75.11(c)(1).

[2274] 12 U.S.C. 1851(d)(4); proposed rule § 75.12.

[2275] *See* proposed rule §§ 75.12(a)(1)(i); 75.12(a)(2)(i)(A) and (B); 75.12(b).

[2276] *See id.* at §§ 75.12(a)(1)(ii); 75.12(a)(2)(ii); 75.12(c).

[2277] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); T. Rowe Price; Credit Suisse (Williams); Allen & Overy (on behalf of Canadian Banks);TCW.

investment strategy, and potential investors). According to commenters, an inability to demonstrate a track record over multiple years may reduce the allocation of capital by investors who are unable to gain an understanding of the investment strategy, risk profile, and potential performance of the fund.[2278]

Commenters provided alternative suggestions regarding how to define the start of the seeding period for purposes of applying the statutory exception for investments during the seeding period. For example, two commenters recommended that the Agencies treat a private equity fund as being established on the date on which the fund begins its asset-acquisition phase and is closed to new investors, and a hedge fund as established on the date on which the fund has reached its target amount of funding and begins investing according to the fund's stated investment objectives.[2279] Another commenter suggested that the permitted seeding period begin on the date on which third-party investors are first admitted to the fund.[2280]

Several commenters expressed concern that the per-fund limitation could be subject to evasion unless the Agencies require that the seeding period begin at the time funds are first invested by the banking entity in the fund.[2281] Some of these commenters suggested the Agencies impose a dollar cap of $10 million on the seed capital that a banking entity may provide to a newly organized covered fund in addition to the statutory limits based on the amount of the fund's shares and the amount of the banking entity's tier 1 capital.[2282] These commenters argued that an explicit quantitative limit better accounted for the size of some banking entities, which otherwise made the potential amount of capital placed in covered funds quite large.[2283]

The Agencies have considered carefully the comments on the proposal and have made several modifications to the final rule to more clearly explain how the limitations apply during the seeding period. The final rule continues to provide that a banking entity may invest in a covered fund that it organizes and offers either in connection with establishing the fund, or as a *de minimis* investment.[2284] Importantly, the statute does not permit a banking entity to invest in a covered fund unless the banking entity organizes or offers the covered fund or qualifies for another exemption. As explained more fully in the discussion of § 75.11 above, a wide variety of activities are encompassed in organizing and offering a covered fund. Under the statute, which generally prohibits investments in covered funds, a banking entity may invest in a covered fund under the exemptions provided in section 13(d)(1) of the BHC Act, including section 13(d)(1)(G) and the provisions of section 13(d)(4), only if the banking entity engages in one or more of these permitted activities with regard to that covered fund and complies with all applicable limitations under the final rule regarding investments in a covered fund.

As noted above, the statute allows a banking entity to acquire and hold all of the ownership interests in a covered fund for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors.[2285] However, the statute also imposes a limit on the duration of an investment made in connection with seeding a covered fund. At the end of that period, the investment must conform to the limits on *de minimis* investments set by the statute. In keeping with the terms of the statute, the final rule, like the proposal, allows banking entities a seeding period of one-year for all covered funds. The statute also allows the Board to extend that period, upon an application by a banking entity, for two additional years if the Board finds an extension to be consistent with safety and soundness and in the public interest.[2286] As explained below, the final rule, like the proposal, incorporates this process and sets forth the factors the Board will consider when determining whether to allow an extended seeding period. The Board and the Agencies will monitor these extension requests to ensure that banking entities do not seek extensions for the purpose of evading the restrictions on covered funds or to engage in prohibited proprietary trading.

As noted above, the proposal did not specify ''date of establishment,'' and commenters suggested a variety of dates that could serve as the date of establishment for purposes of determining the duration of the seeding period and the per-fund limitations on ownership interests in a covered fund.[2287] After considering comments received on the proposal, the Agencies have modified the final rule to include a definition of ''date of establishment'' for a covered fund. In general, the date of establishment is the date on which an investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund. The Agencies perceive the act of making investments to execute an investment or trading strategy as demonstrating that the fund has begun its existence and is no longer simply a plan or proposal. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuing entity of asset-backed securities, the date of establishment under the final rule is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. This is the date that the entity is formed and the securities are generally sold around this time. The Agencies believe this is the appropriate time for the date of establishment for securitizations because this is the date that the securitization risks are transferred to the owners of the securitization vehicle. Once the assets have been transferred, the securitization has been established and securities of the issuer may typically be priced in support of organizing and offering the issuer. Setting a later time, such as when the fund becomes fully subscribed or the assets have been fully assembled, could permit a banking entity to engage in prohibited proprietary trading under the guise of waiting for investors that may never materialize.[2288]

The statute also requires a banking entity to actively seek unaffiliated investors to reduce or dilute the entity's ownership interest to the amount permitted under the statute. This requirement is included in the final

[2278] *See et al.* (Covered Funds) (Feb. 2012); *see also* Ass'n of Institutional Investors (Feb. 2012); Bank of Montreal et al. (Jan. 2012); Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Japanese Bankers Ass'n; SSgA (Feb. 2012); T. Rowe Price; Union Asset. One commenter argued that this limitation would constrain portfolio composition of a covered fund due to an inability of a fund to raise sufficient capital to make larger investments. *See* Credit Suisse (Williams).

[2279] *See* AFG; Union Asset.

[2280] *See* SIFMA (Mar. 2012); *see also* Credit Suisse (Williams).

[2281] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2282] *See* Occupy; Sens. Merkley & Levin (Feb. 2012); *see also* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2283] *See, e.g.,* Public Citizen.

[2284] *See* final rule § 75.12(a)(1).

[2285] 12 U.S.C. 1851(d)(4).

[2286] *See id.* at 1851(d)(4)(C).

[2287] *See* SIFMA *et al.* (Mar. 2012); Credit Suisse (Williams); EFAMA: Hong Kong Inv. Funds Ass'n; AFG; Union Asset.

[2288] Importantly, the statute recognizes that a banking entity may need more than the automatic one-year seeding period to build a track record and/or market its interests to unaffiliated investors; therefore, a banking entity may apply for an extension of the seeding period as provided in 75.12(e) of the final rule as discussed below in Part VI.B.3.h.

rule, and underscores the nature of covered fund activities under section 13(d)(1)(G) as a method to provide investment advisory, trust and fiduciary services to customers rather than allow the banking entity to engage in prohibited proprietary trading. To effectuate the requirements of the statute, under the final rule, banking entities that organize and offer a covered fund must develop and document a plan for offering shares in the covered fund to other investors and conforming the banking entity's investments to the *de minimis* limits to help monitor and ensure compliance with this requirement.

While certain commenters requested that the final rule include a quantitative dollar limit on the amount of funds a banking entity may use to organize and offer a covered fund, the Agencies have declined to add this limitation in the final rule. This type of limit is not required by statute. Moreover, the Agencies believe that imposing a strict dollar limit may not adequately permit banking entities to employ trading or investment strategies that will attract unaffiliated investors, thereby precluding banking entities from meeting the demands of customers contrary to the purpose of section 13.

c. Limitations on Investments in a Single Covered Fund (''Per-Fund Limitation'')

Section 13(d)(4)(B) imposes limits on the amount of ownership interest a banking entity may have in any single covered fund at the end of the one year period (subject to limited extension) after the date of establishment of the fund (the ''seeding period''). In recognition of the fact that a covered fund may have multiple classes or types of ownership interests with different characteristics or values, the proposal required that a banking entity apply the limits to both the total value of and total amount of the banking entity's ownership interest in a covered fund.

The proposed rule required a banking entity to calculate the per-fund limitation using two methods. First, a banking entity was required to calculate the value of its investments and capital contributions made with respect to any ownership interest in a single covered fund as a percentage of the value of all investments and capital contributions made by all persons in that covered fund. Second, a banking entity was required to determine the total number of ownership interests held by the banking entity in a single covered fund as a percentage of the total number of ownership interests held by all persons in that covered fund.[2289] Both calculations were required to be done without regard to committed funds not yet called for investment. The proposed rule also required the banking entity to calculate the value and amount of its ownership interest in each covered fund in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests.[2290] These calculations were designed to ensure that the banking entity's investment in a covered fund could not result in more than three percent of the losses of the covered fund being allocated to the banking entity's investment.[2291]

Commenters did not generally object to calculating the per-fund limitation based on both number and value of ownership interests. Several commenters urged the Agencies to allow a banking entity to value its investment in a covered fund based on the acquisition cost of the investment, instead of fair market value, notwithstanding the manner in which the covered fund accounts for or values investments for its shareholders generally.[2292] One commenter suggested that the Agencies allow a banking entity to choose between acquisition cost and fair value so long as the chosen valuation method is applied consistently to both the numerator and denominator when calculating the per-fund limitation.[2293]

To the extent that an issuer of an asset-backed security is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o-11) which requires certain parties to a securitization transaction, including banking entities, to retain and maintain a certain minimum interest in certain issuers or asset-backed securities.[2294] In order to give effect to this separate requirement under the Dodd-Frank Act, § 75.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under that provisions of the Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2295] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2296] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2297] Some commenters argued that the exemption should be broadened to permit a banking entity to hold in excess of the minimum amount required under section 15G of the Exchange Act instead of allowing only the minimum amount required by that section.[2298] One commenter requested that the final rule permit a banking entity to hold an amount of risk in a securitization that is commensurate with what investors demand rather than the minimum required by section 15G.[2299] Some commenters argued that banking entities may be subject to similar generally applicable requirements to hold risk in securitizations under foreign law, such as Article 122a of the Capital Requirements Directive issued by the European Union, and that the final rule should permit banking entities to comply with these foreign legal requirements.[2300]

Conversely, a few commenters objected to the proposed rule's exemption for risk-retention as unclear and argued that if the exemption was

[2289] *See* proposed rule § 75.12(b)(2).

[2290] *See* proposed rule § 75.12(b)(4).

[2291] *See* Joint Proposal, 76 FR at 68904.

[2292] *See* ABA (Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2293] *See* ABA (Keating) (alleging that this is similar to the SEC's approach to the definition of venture capital fund for the purposes of being exempt from investment advisor registration).

[2294] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. See *Credit Risk Retention,* 78 FR 57928 (Sept. 20, 2013).

[2295] *See* proposed rule § 75.14(a)(2)(iii).

[2296] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2297] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2298] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2299] *See* BoA.

[2300] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); SIFMA (Securitization) (Feb. 2012); BoA.

retained, the Agencies should provide that any amounts held by a banking entity in a securitization that exceed the minimum required to satisfy section 15G of the Exchange Act should count towards the aggregate funds limitation of the banking entity.[2301] One commenter argued that the final rule should impose higher capital charges for interests held in these securitizations due to concerns that securitizations involve heightened risks due to the complexity of their ownership structure.[2302]

The Agencies have carefully considered the comments received and are adopting the calculation requirements for the per-fund limitation as proposed with several modifications, including modifications designed to address the unique characteristics and ownership structure of securitizations. The final rule, like the proposal, requires that a banking entity calculate its per-fund investment limit in covered funds that are not issuing entities of asset-backed securities based on both the value of its investments and capital contributions in and to each covered fund and the total number of ownership interests it has in each covered fund. A banking entity's investment (including investments by its affiliates) may not exceed either three percent of the value of the covered fund or three percent of the number of ownership interests in the covered fund at the end of the seeding period. The Agencies continue to believe that requiring the per-fund limitation to be calculated based on these two measures best effectuates the terms and purpose of the per-fund limitation in the statute. Together, these measures ensure that a banking entity's exposure to and ownership of each covered fund is limited. Each measure alone could provide a distorted view of the banking entity's ownership interest and could be more easily manipulated, for example by issuing ownership interests with high value or special governance provisions. As discussed in more detail below, the final rule contains a separate method for calculating the value of investments in issuing entities of asset-backed securities due to the fact that these entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

The per-fund limitation on ownership interests must be measured against the total ownership interests of the covered fund, as defined in § 75.10 of the final rule and as discussed above in Part VI.B.1.e. In determining the amount of ownership interests held by the banking entity and its affiliates, the banking entity must include an ownership interest permitted under §§ 75.4 and 75.11 of the final rule.[2303] Additionally, any banking entity that acts as underwriter or market-maker for ownership interests of a covered fund must do so in compliance with the limitations of §§ 75.4(a) and 75.4(b) of the final rule, including the limits on the amount, types, and risk of the underwriting position or market-maker inventory as well as in compliance with the per-fund limitation, as applicable, and the aggregate funds limitations and capital deduction in the final rule. The Agencies expect to monitor these activities to ensure that a banking entity does not engage in underwriting or market making-related activity in a manner that is inconsistent with the limitations of the statute and the final rule.[2304]

The final rule requires that the value of the ownership interests and contributions made by a banking entity in each covered fund (that is not an issuing entity of an asset-backed security) be the fair market value of the interest or contribution. The Agencies have determined to use fair market value as the measurement of value for the per-fund value limitation in order to ensure comparability with the investments made in the covered fund by others and limit the potential that the valuation measure can be manipulated (for example by altering the percentage of gains and losses that are associated with a particular ownership interest). A banking entity should determine fair market value for purposes of the final rule, including the calculation of both the per-fund and aggregate funds limitations, in a manner that is consistent with its determination of the fair market value of its assets for financial statement purposes and that fair market value would be determined in a manner consistent with the valuations reported by the relevant covered fund unless the banking entity determines otherwise for purposes of its financial statements and documents the reason for any disparity. If fair market value cannot be determined, then the value shall be the historical cost basis of all investments and capital contributions made by the banking entity to the covered fund. The final rule also requires that, once a valuation method is chosen, the banking entity calculate the value of its investments and the investments of all others in the covered fund for purposes of the per-fund limitation in the same manner and according to the same standards.[2305] This approach is intended to ensure that, for purposes of calculating the per-fund limitation, a banking entity does not calculate its investment in a covered fund in a manner more favorable to the banking entity than the method used by the covered fund for valuing the investments made by others. Under the final rule and as explained in more detail below, any ownership interest acquired or retained by an employee or director of the banking entity is attributed to the banking entity for purposes of the per-fund limitation if the banking entity financed the purchase of the ownership interest. Additionally, any amount contributed or paid by a banking entity or its employee to obtain an ownership interest in connection with obtaining the restricted profit interest must be included in calculating compliance with the per-fund and aggregate funds limitations (*See* Part VI.B.1.e. above).[2306]

In determining the per-fund limitation for purposes of § 75.12 of the final rule, the banking entity should use the same methodology for valuing its investments and capital contributions as the banking entity uses to prepare its financial statements and regulatory reports.[2307] In particular, the fair market value of a

[2301] *See* Occupy.

[2302] *See* Sens. Merkley & Levin (Feb. 2012).

[2303] As discussed above in Part VI.B.2.c., the per-fund limitation does not apply to ownership interests held by a banking entity that acts as market maker or underwriter in accordance with § 75.11(c) of the final rule, so long as the banking entity does not also organize and offer, or act as sponsor, investment adviser or commodity trading advisor to, the fund, or, with respect to ownership interests in issuing entities of asset-backed securities, is not a securitizer who continues to own ownership interests or is not an entity that holds ownership interests in compliance with Section 15G of the Exchange Act and the implementing regulations adopted thereunder; however, the banking entity that is acting as market maker or underwriter that is not subject to the per-fund limitation must still comply with the other requirements set forth in §§ 75.4(a) and 75.4(b), respectively, and any other applicable requirements set out in § 75.11(c).

[2304] The Agencies note that if a banking entity acts as investment adviser or commodity trading advisor to a covered fund and shares the same name or variation of the same name with the fund, then that banking entity would be a sponsor and therefore subject to the limitations of section 13(f).

[2305] In the context of securitizations, the final rule similarly provides that the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all other investors in the covered fund in the same manner and according to the same standards.

[2306] *See* Part VI.B.1.e.

[2307] For example, a depository institution or bank holding company should use the same methodology as used in the Report of Condition and Income (Call Report) for depository institutions and the Consolidated Financial Statements for Holding Companies (FR Y–9C) for bank holding companies, respectively.

banking entity's investments and any capital contributions made to a covered fund should be the same for purposes of § 75.12 of the final rule as reported on the banking entity's financial statements and regulatory reports. Similarly, if fair market value of all investments in and capital contributions cannot be determined for purposes of § 75.12 of the final rule, then the banking entity should use the same methodology to calculate the historical cost basis of the investments and any capital contributions as the banking entity uses to prepare its financial statements and regulatory reports. The Agencies will review carefully the methodology that a banking entity uses to calculate the value of its investments in and capital contributions made to covered funds as part of the process to monitor compliance with the final rule.

The Agencies expect that for the majority of covered funds, the party that organizes and offers the fund or otherwise exercises control over the fund will provide a standard methodology for valuing interests in the fund. However, the Agencies understand that for some covered funds, including issuing entities of asset backed securities, there may be multiple parties that organize and offer the fund that each utilize a different methodology or standard for calculating the value of ownership interests of the fund. Going forward, the Agencies expect that in these circumstances the parties that organize and offer the covered fund will work together or select a responsible party to determine a single standard by which all ownership interests in the covered fund will be valued.

One commenter suggested the Agencies count both invested funds and committed funds not yet called for investment towards the per-fund limitation.[2308] This commenter argued that a banking entity has already contractually allocated committed-yet-uncalled funds to the covered fund and that depositors face a risk of loss for such funds if the covered fund fails.

The final rule, like the proposal, does not count committed-yet-uncalled funds towards the per-fund limitation; instead, it counts funds once they are invested. This approach reflects the fact that these funds may never be called while at the same time ensuring that the banking entity must comply with the per-fund limitation once the funds are called. The Agencies note that a banking entity is prohibited from guaranteeing or bailing out a covered fund that the banking entity or one of its affiliates organizes and offers by the terms of the statute and the final rule and, accordingly, would not be permitted to provide committed funds to a covered fund in a manner inconsistent with the limitations in the statute and final rule.

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides that, for purposes of applying the per-fund limitation to an investment in a covered fund that is an issuing entity of an asset-backed security, the ownership interest held by the banking entity and its affiliates generally may not exceed three percent of the fair market value of the ownership interests of the fund as measured in accordance with § 75.12(b)(3), unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder. A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of section 13 of the BHC Act and this rule, the amount held by the banking entity may not exceed the amount required under the chosen option. Under the final rule, if a banking entity's investment in a covered fund is held pursuant to the requirements of section 15G of the Exchange Act, the banking entity must calculate the amount and value of its ownership interest for purposes of the per-fund limitation as of the date and according to the same valuation methodology applicable pursuant to the requirements of that section and the implementing regulations issued thereunder.

While the amount retained in compliance with section 15G of the Exchange Act and the implementing regulations issued thereunder may permit a banking entity to own more than three percent of the ownership interests in a securitization that is a covered fund, this approach is appropriate to reconcile the competing policies of section 13 of the BHC Act and section 15G of the Exchange Act which requires that a securitizer of certain securitizations retain a minimum of five percent of the risk of the securitization. Congress enacted these two apparently conflicting provisions in the same Act, and the Agencies believe the more specific section regarding risk retention in securitizations was intended to prevail over the more general restriction on ownership of covered funds (which applies to a broader range of entities). The Agencies believe that the risk limitation goals of section 13 of the BHC Act are met by satisfying the minimum requirement of an applicable option under section 15G of the Exchange Act as the maximum initial investment limit, and applying the other limitations discussed in this section governing aggregate investment in covered funds and capital deductions.

As under the proposal, if a banking entity does not have a minimum risk retention requirement, that banking entity would remain subject to the limitations of section 13(d)(4) of the BHC Act and § 75.12 on the amount of ownership interests it may hold in an issuing entity of asset-backed securities. A banking entity may not combine the amounts under these provisions to acquire or retain ownership interests in a securitization that exceed the aggregate permissible amounts.

Some commenters requested that the Agencies coordinate implementation of any exemption for risk-retention requirements under section 13 of the BHC Act with the issuance of rules implementing section 15G of the Exchange Act. The Agencies note that rules implementing section 15G have been proposed but not yet finalized, but the Agencies will review the interaction between the rules promulgated under section 13 of the BHC Act and section 15G of the Exchange Act once the rules under section 15G are finalized. Regardless of any action that may be taken regarding rules implementing section 15G, the final rule permits banking entities to own ownership interests in and sponsor covered funds as discussed above.

Some commenters also requested that the final rule provide an exemption to permit banking entities to comply with any risk retention requirement imposed under foreign law that is similar to section 15G of the Exchange Act. The Agencies are not revising the rule to permit banking entities to own ownership interests required to be retained pursuant to risk retention-type requirements under foreign law. The Agencies are providing the exemption for the required ownership arising from the risk retention provisions under section 15G of the Exchange Act in order to reconcile the requirements under the Dodd-Frank Act applicable to ownership of securitization interests; however, the Agencies do not believe at this time that such reconciliation is appropriate with respect to foreign law

[2308] *See* Occupy.

risk retention-type requirements and those requirements should not prevail over the purpose of section 13 of the BHC Act to reduce banking entities' exposure to risks from investments in covered funds.

The Agencies also note that the definition of covered fund has been modified to exclude certain foreign public funds and also any foreign fund that is not owned or sponsored by a U.S. banking entity. Moreover, the final rule permits foreign banking entities to engage in covered fund activities and investments that occur solely outside of the United States without regard to the investment limitations of section 13(d)(4) of the BHC Act and § 75.12 of the final rule, which may include retaining risk in a securitization to the extent required under foreign law. In these manners, the final rule permits foreign banking entities to comply with requirements under foreign law that govern their securitization activities or investments abroad. However, as noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities and, as such, U.S. banking entities' investments in foreign securitizations that are covered funds would remain subject to the investment limitations of section 13(d)(4) and § 75.12 of the final rule.

The proposed rule provided that a banking entity must comply with both measures of the per-fund limitation at all times. The preamble to the proposal explained that the Agencies expected a banking entity to calculate its per-fund limitation no less frequently than the frequency with which the fund performs such calculation or issues or redeems interests, and in no case less frequently than quarterly.[2309]

Several commenters requested that the Agencies modify the frequency of this calculation and monitoring requirement to a standard quarterly basis.[2310] These commenters argued that, although some covered funds may provide daily liquidation and redemption rights to investors, monitoring the per-fund limitation on a continuous basis would be costly and burdensome and would not provide a significant offsetting benefit.

The Agencies continue to believe that for covered funds other than issuing entities of asset-backed securities the per-fund limitations apply to investments in covered funds at all times following the end of the seeding period. However, to relieve burden and costs, while also setting a minimum recordkeeping standard, the final rule has been modified to require that a banking entity calculate the amount and value of its ownership interests in covered funds other than issuing entities of asset-backed securities quarterly.[2311] The Agencies believe that this change will assist in reducing unnecessary costs and burdens in connection with calculating the per-fund limitation, particularly for smaller banking entities, and will also facilitate consistency with the calculation for the aggregate funds limitation (which is also determined on a quarterly basis). Nevertheless, should a banking entity become aware that it has exceeded the per-fund limitation for a given fund at any time, the Agencies expect the banking entity to take steps to ensure that the banking entity complies promptly with the per-fund limitation.[2312]

The Agencies have also modified the timing and methodology of the per-fund limitation as it applies to securitizations to address the unique circumstances and ownership structure presented by securitizations, which typically wind down over time. Unlike many other covered funds, securitizations do not generally experience increases in the amount of investors or value of ownership interests during the life of the securitization; rather, they generally experience only a contraction of the investor base and reduction in the total outstanding value of ownership interests on an aggregate basis, and may do so at different rates under the terms of the transaction agreements, meaning that the percentage of ownership represented by a particular ownership interest may increase as the fund amortizes but without the banking entity adding any funds. The manner in which securitizations are organized and offered, as well as the amortization of securitizations, differs from many other covered funds; section 15G of the Exchange Act also requires that certain parties to securitization transactions, which may include banking entities, retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. Therefore, for purposes of calculating a banking entity's per-fund limitation with respect to a securitization, the calculation of the per-fund limitation shall be based on whether section 15G applies and the implementing regulations are effective. In the case of an ownership interest in an issuing entity of an asset-backed security that is subject to section 15G of the Exchange Act and for which effective implementing regulations have been issued, the calculation of the per-fund limitation shall be made as of the date and pursuant to the methodology applicable pursuant to the requirements of section 15G of the Exchange Act and the implementing regulations issued. For securitizations executed after the effective date of the final rule and prior to the adoption and implementation of the rules promulgated under section 15G of the Exchange Act and for securitizations for which a fair valuation calculation is not required by the implementing rules promulgated under section 15G of the Exchange Act, the per fund limitation is calculated as of the date on which the assets are initially transferred into the issuing entity of the asset-backed securities or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund.[2313] This calculation for issuers of asset backed securities is only required to be performed once on the date noted above, and thereafter only upon the date on which the price of additional securities of the covered fund to be sold to third parties is determined.

As noted above, the per-fund limitations for ownership interests in issuing entities of asset-backed securities are calculated based only on the value of the ownership interest in relation to the value of all ownership interests in the issuing entity of the asset-backed security and are not calculated on a class by class, or tranche by tranche basis. For purposes of the valuation, the aggregate value of all the assets that are transferred to the issuing entity of the asset-backed securities, and any assets otherwise held by the issuing entity, are determined based on the valuation methodology used for determining the value of the assets for financial statement purposes. This valuation will be the value of the ownership interests in the issuing entity for purposes of the calculation. A banking entity will need to determine

[2309] *See* proposed rule § 75.12(b); Joint Proposal, 76 FR at 68904.

[2310] *See, e.g.,* ABA (Keating); Credit Suisse (Williams); JPMC.

[2311] *See* final rule § 75.12(b)(2)(i) and (ii). For covered funds that are an issuing entity of asset-backed securities, recalculation of the banking entity's permitted ownership for purposes of the per-fund limitation is not required unless the covered fund sells additional securities.

[2312] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(I).

[2313] In addition, although some commenters requested that banking entities be able to hold more than the minimum required by section 15G, the Agencies are not revising the per fund limitation in that manner. One of the purposes of section 13 of the BHC Act is to reduce banking entities' exposure to risks from investments in covered funds, and the Agencies believe at this time that permitting banking entities to retain risk exposure to the covered fund in excess of the minimum required to be retained would contradict the purposes of section 13 of the BHC Act.

its percentage ownership in the issuing entity based on the its contributions to the entity in relation to the contributions of all parties and after taking into account the value of any residual interest in the issuing entity. In addition, for purposes of the final rule, the asset valuation is as of the date of establishment (the date of the asset transfer to the issuing entity of the asset-backed securities).

d. Limitation on Aggregate Permitted Investments in All Covered funds (''Aggregate Funds Limitation'')

In addition to the per-fund limitation, section 13(d)(4) of the BHC Act provides that the aggregate of a banking entity's investments in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (referred to above as the ''aggregate funds limitation'').[2314] To implement this limitation, the proposed rule required a banking entity to determine the aggregate value of the banking entity's investments in covered funds by calculating the sum of the value of each investment in a covered fund, as determined in accordance with applicable accounting standards. This amount was then measured as a percentage of the tier 1 capital of the banking entity for purposes of determining compliance with the aggregate funds limitation. For purposes of applying the limit, a banking entity that is subject to regulatory capital requirements was required under the proposed rule to measure tier 1 capital in accordance with those regulatory capital requirements; a banking entity that is not a subsidiary of a reporting banking entity and that is not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency was required by the proposed rule to calculate its tier 1 capital based on the total amount of shareholders' equity of the top-tier entity as of the last day of the most recent calendar quarter, as determined under applicable accounting standards.

Commenters expressed a variety of views regarding the aggregate funds limitation. One commenter argued that basing the aggregate funds limitation on the size of tier 1 capital of a banking entity provides an advantage to the largest institutions with large absolute capital bases and disadvantages smaller banks that are well capitalized but have a smaller absolute capital base.[2315] This commenter urged the Agencies to permit all banking entities to invest in covered funds in an amount that is, in the aggregate, the greater of $1 billion (subject to prudential investment limitations and safety and soundness concerns), or three percent of tier 1 capital.[2316]

In contrast, other commenters urged the Agencies to decrease the statutory limit in order to prevent the largest banking entities from investing amounts that, while within the statutory limit, could be very large in absolute terms.[2317] One commenter argued that a loss of three percent of tier 1 capital would be a material loss reflected in a change in stock price.[2318] Another commenter suggested the Agencies consider whether the investment supports a large flow of management fees linked to market volatility or has significant embedded leverage.[2319]

Some commenters argued that the final rule should calculate the value of covered fund investments based on acquisition cost instead of fair market value.[2320] These commenters argued that using fair value to calculate the aggregate funds limitation penalizes banking entities for organizing and investing in successful funds and, conversely, would allow banking entities to increase investments in unsuccessful funds (the value of which would decline relative to the capital of the banking entity).

In contrast, another commenter argued that valuation of a covered fund investment should include any mark-to-market increase in a banking entity's aggregate investments in order to keep pace with increases in the capital of the banking entity.[2321]

Some commenters discussing the frequency of the calculation of the aggregate funds limitation supported determining the aggregate funds limitation on the last day of each calendar quarter as required in the proposal.[2322] Other commenters argued that the statute requires compliance at all times rather than periodic calculations of compliance.[2323]

After consideration of the comments in light of the statutory provisions, the Agencies have adopted the requirements for calculating the aggregate funds limitation as proposed with several modifications as explained below. Under the final rule, the aggregate value is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in each covered fund (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), as measured on a historical cost basis. This aggregate value is measured against the total applicable tier 1 capital for the banking entity as explained below.

For purposes of determining the aggregate funds limitation, the final rule requires that the value of investments made by a banking entity be calculated on a historical cost basis. This approach limits the aggregate amount of funds a banking entity may provide to covered funds as a percentage of the banking entity's capital as required by statute. At the same time, this approach does not permit a banking entity to increase its exposure to covered funds in the event any investment in a particular covered fund declines in value as a result of the fund's investment activities. Permitting a banking entity to increase its aggregate investments as covered funds lose value would permit the banking entity both to increase its exposure to covered funds at the same time the covered funds it already owns are losing value and to effectively bail-out investors by providing additional capital to troubled covered funds. Neither of these actions is consistent with the purposes of section 13 of the BHC Act. Moreover and as explained below, because the final rule requires that the banking entity deduct from the entity's capital the greater of historical cost (plus earnings) or fair market value of its investments in covered funds, the deduction accounts for any profits resulting from investments in covered funds.

Historical cost basis means, with respect to a banking entity's ownership interest in a covered fund, the sum of all amounts paid or contributed by the banking entity to a covered fund in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest)), less any amounts received as a redemption, sale or distribution of such ownership interest or restricted profit interest. Under the final rule, any reduction of the historical cost would not generally include gains or losses, fees, income, expenses or similar items. However, as noted above, the final rule also requires that a banking entity deduct any earnings from its tier 1 capital even if it values its ownership interests in a covered fund pursuant to historical cost.

The concern expressed by commenters that the aggregate funds

[2314] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(II).

[2315] *See* ABA (Abernathy).

[2316] *See, e.g.,* ABA (Abernathy).

[2317] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2318] *See* Public Citizen.

[2319] *See* AFR *et al.* (Feb. 2012).

[2320] *See* ABA(Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2321] *See* Occupy.

[2322] *See* ABA (Keating).

[2323] *See* AFR *et al.* (Feb. 2012); Occupy.

limitation should account for increases in the fair market value of covered funds is addressed in other ways under the final rule. In particular, the final rule requires that for purposes of calculating compliance with regulatory capital requirements the banking entity deduct from the entity's capital the greater of fair market value (or historical cost plus earnings) of its investment in each covered fund; thus, profits resulting from investments in covered funds will not inflate the capital of the banking entity for regulatory compliance purposes. Moreover, as explained above, the per-fund limitation is generally based on fair market value, which maintains the relative level of a banking entity's investment in each covered fund.

As noted above, the aggregate funds limitation applies to all investments by a banking entity in a covered fund that the banking entity or an affiliate thereof holds under §§ 75.4 and 75.11 of the final rule. The limitation would also apply to investments by a banking entity made or held during the seeding period as part of organizing and offering a covered fund, including ownership interests held in order to satisfy the requirements of section 15G of the Exchange Act, as well as ownership interests held by a banking entity in the capacity of acting as underwriter or market-maker.

As under the proposal, this calculation must be made as of the last day of each calendar quarter, consistent with when tier 1 capital is reported by banking entities to the Agencies. Because compliance with the aggregate funds limitations is calculated based on tier 1 capital, the Agencies believe it is more appropriate to require the calculation to be performed on the same schedule as tier 1 capital is reported. While the aggregate funds limitation must be calculated on a quarterly basis, the Agencies expect banking entities to monitor investments in covered funds regularly and remain in compliance with the limitations on covered fund investments throughout the quarter. The Agencies intend, through their respective supervisory processes, to monitor covered fund investment activity to ensure that a banking entity is not attempting to evade the requirements of section 13.

The Agencies recognize that banks with large absolute capital bases will be able to place a greater amount of capital in covered funds compared to banks with small absolute capital bases. However, the amount of risk exposure to a covered fund, despite their different investment strategies, will be relatively similar across banking entities, which is consistent with the language and risk-limiting purpose of section 13.

e. Capital Treatment of an Investment in a Covered Fund

Section 13(d)(4)(B)(iii) of the BHC Act provides that, for purposes of determining compliance with applicable capital standards under section 13(d)(3) of that Act, the aggregate amount of outstanding investments by a banking entity under section 13(d)(4), including retained earnings, must be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate with the leverage of the covered fund.[2324] Section 13(d)(3) authorizes the Agencies, by rule, to impose additional capital requirements and quantitative limitations, including diversification requirements on any of the activities permitted under section 13 of the BHC Act if the Agencies determine that such additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.[2325]

The proposed rule implemented the capital deduction provided for under section 13(d)(4)(B)(iii) of the BHC Act by requiring a banking entity to deduct the aggregate fair value of its investments in covered funds, including any attributed profits, from tier 1 capital. As in the statute, the proposed rule applied the capital deduction to ownership interests in covered funds held as an investment by a banking entity pursuant to the provisions of section 13(d)(4) of the BHC Act, and not to ownership interests acquired under other permitted authorities, such as a risk-mitigating hedge under section 13 of the BHC Act. The proposed rule required the deduction to be calculated consistent with the method for calculating other deductions under the applicable risk-based capital rules. The proposed rule did not otherwise adopt additional capital requirements and quantitative limitations under section 13(d)(3) of the BHC Act.

Some commenters supported the proposed dollar-for-dollar deduction from tier 1 capital of a banking entity's aggregate investments in covered funds and asserted it is consistent with the statute.[2326] One of these commenters urged the Agencies to rely on their authority under section 13(d)(3) of the BHC Act to apply the capital deduction to other permitted ownership interests in covered funds to protect the safety and soundness of the banking entity.[2327] In contrast, other commenters urged the Agencies to eliminate the capital deduction for investments in covered funds and questioned the Agencies' statutory authority to impose the capital deduction.[2328] These commenters argued that the statute does not authorize or require the Agencies to require banking entities to deduct their investments in covered funds for purposes of calculating capital pursuant to the applicable capital rules. According to these commenters, section 13 only requires deductions for purposes of determining compliance with applicable capital standards under section 13 and argued the Agencies did not make the necessary safety and soundness findings under section 13(d)(3) to impose additional capital requirements on any activities permitted under section 13(d)(1).[2329] One commenter urged the Agencies to make any capital adjustment as part of the banking agencies' broader efforts to implement the Basel III capital framework.[2330] Another commenter urged the Agencies to apply the capital deduction only for purposes of determining a banking entity's compliance with the aggregate funds limitation and not for other regulatory capital purposes.[2331] This commenter also argued that a capital deduction is normally not required for assets reflected on a bank's consolidated balance sheet, and that the Agencies should not require a deduction for a covered fund investment that is not consolidated with the banking entity for financial reporting purposes under GAAP.[2332] Some commenters urged the Agencies to apply the capital deduction only to a banking entity's investment in a covered fund that the banking entity organizes and offers and not to ownership interests otherwise permitted to be held under section 13 of the BHC Act.[2333]

Several commenters addressed the manner for valuing an investment subject to the deduction. One commenter urged the Agencies to permit a banking entity to calculate the deduction based on the acquisition cost, instead of the fair market value, of the banking entity's ownership interest in

[2324] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[2325] *Id.* at 1851(d)(3).

[2326] *See* Occupy.

[2327] *See* Occupy.

[2328] *See* ABA (Keating); BNY Mellon *et al.;* PNC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2329] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2330] *Id.*

[2331] *See* ABA (Keating).

[2332] *See* ABA (Keating); *see also* letter from PNC.

[2333] *See* Arnold & Porter; SVB.

the covered fund.[2334] This commenter emphasized that valuing the investment at fair market value would penalize a banking entity if the covered fund performs well by reducing the amount of capital available for additional covered fund investments but reduce the capital charge against troubled investments. One commenter argued that the Agencies did not perform an appropriate cost-benefit analysis of the deduction in the proposed rules.[2335]

Other commenters sought clarification on how the capital deduction would apply to a foreign banking organization. Several commenters argued that the capital deduction should not apply to a foreign banking entity that calculates its tier 1 capital under the standards of its home country.[2336] These commenters argued that imposing a capital deduction requirement on foreign banks would not be consistent with past practices on the application of U.S. risk-based capital requirements to foreign banking organizations.

The Agencies have carefully considered the comments in light of the statutory provisions requiring a capital deduction. The statute requires that the aggregate amount of outstanding investments by a banking entity, including retained earnings, be deducted from the assets and tangible equity of the banking entity.[2337] This requirement is independent of the minimum regulatory capital requirements in the final capital rule published by the Federal Banking agencies in 2013 (''regulatory capital rule'').[2338]

The Federal Banking agencies recognize that the regulatory capital rule imposes risk weights and deductions that do not correspond to the deduction for covered fund investments imposed by section 13 of the BHC Act. The Federal Banking agencies intend to review the interaction between the requirements of this rule and the requirements of the regulatory capital rule and expect to propose steps to reconcile the two rules.

At the same time, the Agencies believe that the dollar-for-dollar deduction of the fair market value of a banking entity's investment in a covered fund is appropriate to protect the safety and soundness of the banking entity, as provided in section 13(d) of the BHC Act. This approach ensures that a banking entity can withstand the failure of a covered fund without causing the banking entity to breach the minimum regulatory capital requirements. Consistent with the language and purpose of section 13 of the BHC Act, this deduction will help provide that a banking entity has sufficient capital to absorb losses that may occur from covered fund investments without endangering the safety and soundness of the banking entity or the financial stability of the United States.

Accordingly, under the final rule, a banking entity must, for purposes of determining compliance with applicable regulatory capital requirements, deduct the greater of (i) the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(b)(6)(ii)), on a historical cost basis, including earnings or (ii) the fair market value of the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(b)(6)(ii)), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.[2339] This deduction must be made whenever the banking entity calculates its tier 1 capital, either quarterly or at such other time at which the appropriate Federal banking agency may request such a calculation. Requiring a banking entity to deduct the greater of historical cost or fair market value of all covered fund investments made by a banking entity from the entity's tier 1 capital should result in an appropriate deduction that is consistent with the manner in which the banking entity accounts for its covered fund investments. For instance, if a banking entity accounts for its investments in covered funds using fair market value, then any changes in the fair market value of the banking entity's investment in a covered fund should similarly be reflected in the banking entity's tier 1 capital. Thus, this deduction should not unduly penalize banking entities for making successful investments or allow more investments in troubled covered funds.

The final rule does not require a foreign banking entity that makes a covered fund investment in the United States, either directly or through a branch or agency, to deduct the aggregate value of the investment from the foreign bank's tier 1 capital calculated under applicable home country standards. However, any U.S. subsidiary of a foreign banking entity that is required to calculate tier 1 capital under U.S. risk based capital regulations must deduct the aggregate value of investment held through that subsidiary from its tier 1 capital.

While some commenters requested that additional capital charges be imposed on banking entity's interests in securitizations, the Agencies have declined to do so at this time. Under the final rule, the banking entity must deduct the value of its investment in a securitization that is a covered fund from its tier 1 capital for purposes of determining compliance with the applicable regulatory capital requirements. This requirement already requires the banking entity to adjust its capital for the possibility of losses on the full amount of its investment. The Agencies do not believe that it is appropriate to impose additional capital charges on these securitizations because it would act as a disincentive to retain risk in securitizations for which the banking entity acts as issuer or sponsor, a result that would contradict the purpose of section 15G of the Exchange Act. Additionally and as noted in the proposal, permitting a banking entity to retain the minimum level of economic interest and risk in a securitization will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

The Agencies have also declined to impose additional quantitative limitations or diversification requirements on covered fund investments at this time. The Agencies believe that the per-fund and aggregate funds limitations, as well as the capital deduction required by the rule, acting together with the other limitations on covered fund activities, establish an appropriate framework for ensuring that the covered fund investments and activities of banking entities are conducted in a manner that is safe and sound and consistent with financial stability. The Agencies will continue to monitor these activities and investments

[2334] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2335] *Id.*

[2336] *See* IIB/EBF.

[2337] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[2338] *See* 78 FR 62018, 62072 (Oct. 11, 2013) (Board/OCC/FDIC Basel III Final Rule); 78 FR 55340, 55391 (Sept. 10, 2013) (FDIC Basel III interim final rule).

[2339] *See* 12 CFR part 208, subpart D and appendixes A, B, E, and F; 12 CFR part 217 (to be codified), and 12 CFR part 225, appendixes A, D, E, and G; *see also* 12 CFR 240.15c3–1 (net capital requirements for brokers or dealers).

to determine whether other limitations are appropriate over time.

f. Attribution of Ownership Interests to a Banking Entity

The proposed rule attributed an ownership interest to a banking entity based on whether or not the banking entity held the interest through a controlled entity. The proposed rule required that any ownership interest held by any entity that is controlled, directly or indirectly, by a banking entity be included in the amount and value of the banking entity's permitted investments in a single covered fund. The proposed rule required that the *pro rata* share of any ownership interest held by any covered fund that is not controlled by the banking entity, but in which the banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares, be included in the amount and value of the banking entity's permitted investments in a single covered fund.

Many commenters expressed concerns regarding the proposed attribution requirements.[2340] These commenters argued that the proposed *pro rata* attribution requirements are not required or permitted by the statute, have unintended and inconsistent consequences for covered fund investments, impose heavy compliance costs on banking entities, and would impede the ability of funds sponsored by banking entities to invest in third-party funds for the benefit of clients. Some commenters argued that the costs and complexity of determining whether a banking entity ''controls'' another banking entity under the BHC Act and the Board's precedent are high and urged the Agencies to adopt a simpler test.[2341] For example, some commenters urged that shares of a company be attributed to a banking entity only when the banking entity maintains ownership of 25 percent or more of voting shares of the company.[2342]

Several commenters maintained that applying the attribution requirements to fund-of-funds structures and parallel or master-feeder structures would be unworkable.[2343] Commenters contended that the proposed attribution rules could result in a banking entity calculating the per-fund limitation in a way that exceeds the banking entity's actual loss exposure if the attribution rule for controlled investments is interpreted to require that 100 percent of all investments made by controlled entities be attributed to the banking entity.[2344]

In addition, several commenters argued that the *pro rata* attribution of investments held through non-controlled structures is not consistent with the Board's rules and practices for purposes of the activity and investment limits in other sections of the BHC Act. Commenters also maintained that this *pro rata* attribution for non-controlled entities would be impracticable because a banking entity has only a limited ability to monitor, direct, or restrain investments of a covered fund that it does not control.[2345]

Conversely, one commenter supported the *pro rata* attribution requirement in the proposal. This commenter argued that this requirement reduced opportunities for evasion through subsidiaries, affiliates or related entities.[2346]

The final rule has been modified in light of the comments. Under the final rule, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations only if the investment is made by the banking entity or another entity controlled by the banking entity. Accordingly, the final rule does not generally require that a banking entity include the *pro rata* share of any ownership interest held by any entity that is not controlled by the banking entity, and thus reduces the potential compliance costs of the final rule. The Agencies believe that this concept of attribution is more consistent with how the Board has historically applied the concept of ''control'' under the BHC Act for purposes of determining whether a company subject to that Act is engaged in an activity or whether to attribute an investment to that company. Furthermore, because a banking entity does not control a non-affiliate and typically has less access to information about the holdings of a non-affiliate, this change is unlikely to present opportunity for circumvention of the per-fund and aggregate funds limitations. The Agencies will monitor these limitations for practices that appear to be attempts to circumvent them.[2347]

Whether a banking entity controls another entity under the BHC Act may vary depending on the type of entity in question. As noted above in Part VI.B.1.b.3., the Board's regulations and orders have long recognized that the concept of control is different for funds than for operating companies.[2348] In contrast to the proposal, the final rule incorporates these different concepts of control in part by providing that, for purposes of section 13 of the BHC Act and the final rule, a registered investment company, SEC-regulated business development company, and a foreign public fund as described in § 75.10(c)(1) of the final rule will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.[2349]

In response to commenter concerns regarding the workability of the proposed rule, the final rule has been modified to address how ownership interests would be attributed to a banking entity when those interests are held in a fund-of-funds or multi-tiered fund structures. For instance, banking entities may use a variety of structures to satisfy operational needs or meet the investment needs of customers of their trust, fiduciary, investment advisory or commodity trading advisory services.

First, except as explained for purposes of calculating a banking entity's permitted investment in multi-tier fund structures, the final rule does not generally attribute to a banking entity ownership interests held by a covered fund so long as the banking

[2340] *See* ABA (Keating); Arnold & Porter; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012).

[2341] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Arnold & Porter.

[2342] *See* ABA (Keating); Arnold & Porter.

[2343] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012). These commenters argued that banking entities traditionally utilize a fund-of-funds structure to offer customers the opportunity to invest indirectly in a portfolio of other funds (including some funds sponsored and managed by one or more third parties) and that these structures provide customers with certain risk-mitigating benefits and allow customers to gain exposure to a diverse portfolio without having to satisfy the minimum investment requirements of each fund directly. They also argued that parallel and feeder entities are established for a variety of client-driven reasons, including to accommodate tax needs of clients and that these entities should be viewed as a single investment program in which the master fund holds and manages investments in portfolio assets and the feeder fund typically makes no investments other than in the master fund.

[2344] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Arnold & Porter; SSgA (Feb. 2012).

[2345] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2346] *See* Occupy.

[2347] The Agencies note that other provisions of the BHC Act and Savings and Loan Holding Company Act would prohibit a banking entity that is a bank holding company or savings and loan holding company from acquiring 5 percent or more of a covered fund that is itself a bank holding company or a savings and loan holding company, respectively, without regulatory approval. *See* 12 U.S.C. 1842(a); 12 U.S.C. 1467a(e).

[2348] *See, e.g.,* First Union Letter.

[2349] *Id. See* final rule § 75.12(b)(1)(ii).

entity's investment in the covered fund meets the per-fund limitation in the final rule.[2350] Absent unusual circumstances or structures, a banking entity would not control a covered fund in which the banking entity has an ownership interest that conforms to the per-fund and aggregate funds limitations contained in the final rule. Thus, the interests held by that covered fund would not be attributed to the banking entity for the reasons discussed above.

The final rule also explains how the investment limitations apply to investments of a banking entity in multi-tier fund structures. The Agencies believe that master-feeder fund structures typically constitute a single investment program in which the master fund holds and manages investments and the feeder funds typically make no investments other than in the master fund and exist as a convenience for customers of the trust, fiduciary, investment advisory, or commodity trading advisory services of the banking entity. Similarly, trust, fiduciary, or advisory customers of a banking entity may desire to obtain diversified exposure to a variety of funds or investments through investing in a fund-of-funds structure that the banking entity organizes and offers.

In order to meet the demands of these customers, the final rule provides that if the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the per-fund limitation the banking entity's permitted investment shall be measured only at the master fund. However, in order to appropriately capture the banking entity's amount of investment in the master fund, a banking entity must include in this calculation any investment held by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund.[2351]

Similarly, regarding fund-of-funds structures, the final rule provides that if a banking entity organizes and offers a covered fund pursuant to § 75.11 for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity organizes and offers, then the banking entity's permitted investment in that other covered fund shall include any investment held by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the other fund that is held through the fund of funds. The banking entity's investment in the fund of funds must also meet the investment limitations contained in § 75.12. In these manners, the final rule permit a banking entity to meet the demands of customers of their trust, fiduciary, or advisory services while also limiting the ability of a banking entity to be exposed to more than the amount of risk of a covered fund contemplated by section 13.

As described above in the discussion of organizing and offering a covered fund, other provisions of section 13 contemplate investments by employees and directors of the banking entity that provide qualifying services to a covered fund.[2352] The Agencies recognized in the proposal that employee and director investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire in a covered fund.[2353] In order to address this concern, the proposal attributed an ownership interest in a covered fund acquired or retained by a director or employee to the person's employing banking entity if the banking entity either extends credit for the purposes of allowing the director or employee to acquire the ownership interest, guaranteed the director or employee's purchase, or guarantees the director or employee against loss on the investment.

One commenter supported the way the proposal addressed evasion concerns by attributing an ownership interest in a covered fund acquired or retained by a director or employee to a banking entity.[2354] A different commenter urged the Agencies to attribute any employee investments in a covered fund to the banking entity itself, regardless of the source of funds.[2355] Another commenter argued that the statute prohibits a banking entity from guaranteeing an investment by an employee or director.[2356]

After considering the comments and the language of the statute, the Agencies have determined to retain the requirement that all director or employee investments in a covered fund be attributed to the banking entity for purposes of the per-fund limitation and the aggregate funds limitation whenever the banking entity provides the employee or director funding for the purpose of acquiring the ownership interest. Specifically, under the final rule, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.[2357] It is also important to note that the statute prohibits a banking entity from guaranteeing the obligations or performance of a covered fund in which it acts as investment adviser, investment manager or sponsor, or organizes and offers.[2358]

As discussed above in the definition of ownership interest, the final rule also attributes to the banking entity any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity. This approach ensures that all funding provided by the banking entity—whether directly or through its employees or directors—and all exposures of the banking entity—whether directly or through a guarantee provided to or on behalf of an employee or director—is counted against the limits on exposure contained in the statute and final rule. At the same time, this approach recognizes that employees and directors may use their own resources, not protected by the banking entity, to invest in a covered fund. Employees of investment advisers in particular often invest their own resources in covered funds they advise, both by choice and as a method to align their personal financial interests with those of other investors in the covered fund. So long as these investments are truly with personal resources, and are not funded by the banking entity, these personal investments would not expose the banking entity to loss and would not be attributed by the final rule to the banking entity. This approach is also consistent with the terms of the statute, which expressly contemplates investments by directors or employees of a banking entity in their individual capacity.[2359]

The Agencies intend to monitor investments by directors and employees of a banking entity to ensure that employee ownership interests are not

[2350] *See* final rule § 75.12(b)(1)(iii).

[2351] *See* final rule § 75.12(b)(34).

[2352] *See* 12 U.S.C. 1851(d)(1)(G)(vii); final rule § 75.11(g).

[2353] *See* Joint Proposal, 76 FR at 68902.

[2354] *See* Ass'n. of Institutional Investors (Feb. 2012).

[2355] *See* Occupy.

[2356] *See* Arnold & Porter.

[2357] *See* final rule § 75.12(b)(1)(iv).

[2358] *See* 12 U.S.C. 1851(f)(1).

[2359] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

used to circumvent the per-fund and aggregate funds limitations in section 13. Among the factors the Agencies will consider, in addition to financing and guarantee arrangements, are whether the benefits of the acquisition and retention, such as dividends, inure to the benefit of the director or employee and not the banking entity; the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity; and the employee or director, rather than the banking entity, determines whether the employee or director should make the investment.

The proposed rule contained a provision intended to curb potential evasion of the per-fund limitation and aggregate limitation through parallel investments by banking entities that were not otherwise subject to section 13 of the BHC Act. Specifically, the proposed rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation.

Several commenters objected to this requirement and argued that it was not consistent with the statute. These commenters argued that section 13 of the BHC Act restricts a banking entity's investments in covered funds, and not direct investments by a banking entity in individual companies under other authorities, such as the merchant banking investment authority in section 4(k)(4)(H) of the BHC Act.[2360] Some commenters argued that prohibiting or limiting direct investments could cause a conflict between a banking entity's fiduciary duty to its clients to manage their covered fund investments and the banking entity's duty to its shareholders to pursue legitimate merchant banking investments.[2361] Some commenters urged the Agencies not to attribute any parallel co-investment alongside a covered fund to a banking entity unless there is a pattern of evasion, and some requested that there be prior notice and an opportunity for a hearing to determine whether such a pattern has occurred.[2362] Another commenter recommended the Agencies provide a safe harbor for situations where a bank trustee is acting on behalf of customers.[2363]

In contrast, other commenters contended that the risks of direct investments, such as those made under merchant banking authority, are similar to those of many investments in covered funds. These commenters urged the Agencies to restrict direct investments in the underlying holdings or assets of a covered fund in the same manner as direct investments in covered funds.[2364]

After carefully considering the comments and the language of the statute, the Agencies have determined not to adopt the proposed prohibition on parallel investments in the final rule. As illustrated by commenters, banking entities rely on a number of investment authorities and structures to meet the needs of their clients and make investments under a variety of authorities that are not coordinated with investments made by covered funds owned or advised by the banking entity. The Agencies believe that many investments made by banking entities are made for the purpose of serving the legitimate needs of customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate funds limitations in section 13.

Nevertheless, the Agencies continue to believe that the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors. For instance, the Agencies understand that it is relatively common for the sponsor of a covered fund in connection with a privately negotiated investment to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment. Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a ''co-investment fund''), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund. Finally, the Agencies note that if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund.

g. Calculation of Tier 1 Capital

The proposal explained that tier 1 capital is a banking law concept that, in the United States, is calculated and reported by certain depository institutions and bank holding companies in order to determine their compliance with regulatory capital standards. Accordingly, the proposed rule clarified that for purposes of the aggregate funds limitation in § 75.12, a banking entity that is a bank, a bank holding company, a company that controls an insured depository institution that reports tier 1 capital, or uninsured trust company that reports tier 1 capital (each a ''reporting banking entity'') needed to use the reporting banking entity's tier 1 capital as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.

The proposal also recognizes that not all entities subject to section 13 of the BHC Act calculate and report tier 1 capital. In order to provide a measure of equality related to the aggregate funds limitation contained in section 13(d)(4)(B)(ii)(II) of the BHC Act and § 75.12(c) of the proposed rule, the proposed rule clarified how the aggregate funds limitation should be calculated for entities that are not required to calculate and report tier 1 capital in order to determine compliance with regulatory capital standards. Under the proposed rule, with respect to any banking entity that is not affiliated with a reporting banking entity and not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency, the banking entity's tier 1 capital for purposes of the aggregate funds limitation was the total amount of shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting

[2360] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq. See* ABA (Keating); BoA; BOK; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2361] *See* ABA (Keating).

[2362] *See* BOK; SVB; ABA (Keating); BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2363] *See* BOK.

[2364] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012).

standards.[2365] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank), the aggregate funds limitation was the amount of tier 1 capital reported by such depository institution.[2366] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is not a depository institution (*e.g.,* a nonbank subsidiary of a bank holding company), the aggregate funds limitation was the amount of tier 1 capital reported by the top-tier affiliate of such banking entity that holds and reports tier 1 capital under the proposal.[2367]

Commenters did not generally object to the proposed approach for determining the applicable tier 1 capital for banking entities. One commenter advocated calculating the aggregate funds limitation based on the tier 1 capital of the banking entity making the covered fund investment instead of the tier 1 capital of the consolidated banking entity.[2368] In addition, the commenter urged the Agencies to require banking entities to divest any portions of the investment that exceeds 3 percent of that entity's tier 1 capital.

The final rule provides that any banking entity that is required to calculate and report tier 1 capital (a ''reporting banking entity'') must calculate the aggregate funds limitation using the tier 1 capital amount reported by the entity as of the last day of the most recent calendar quarter as reported to the relevant Federal banking agency. A non-depository institution subsidiary of a reporting banking entity may rely on the consolidated tier 1 capital of the reporting banking entity for purposes of calculating compliance with the aggregate funds limitation. In the case of a depository institution that is itself a reporting banking entity and that is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in covered funds held by the depository institution (including the investments by its subsidiaries) may not exceed three percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution. The final rule also provides that any banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank) may compute compliance with the aggregate funds limitations using the amount of tier 1 capital reported by such depository institution.

Several commenters argued that foreign banking organizations should be permitted to use the consolidated tier 1 capital at the top-tier foreign banking organization level, as calculated under applicable home country capital standards, to calculate compliance with the aggregate funds limitation.[2369] One commenter noted that the tier 1 capital of a banking entity may fluctuate based on specific conditions relevant only to the banking entity, and urged the Agencies to consider an alternative measure of capital, although this commenter did not suggest any alternative.[2370]

After considering the comments received and that purpose and language of section 13 of the BHC Act, the Agencies have determined that for foreign banking organizations, the aggregate funds limitation would be based on the consolidated tier 1 capital of the foreign banking organization, as calculated under applicable home country standards. However, a U.S. bank holding company or U.S. savings and loan holding company that is controlled by a foreign banking entity must separately meet the per-fund and aggregate funds limitations for each and all (respectively) covered fund investments made by the U.S. holding company, based on the tier 1 capital of the U.S. bank holding company or U.S. savings and loan holding company. The Federal banking agencies may revisit this approach in light of the manner in which the Board implements the enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies, including the proposed U.S. intermediate holding company requirements under that rule.[2371]

h. Extension of Time To Divest Ownership Interest in a Single Fund

The proposed rule provided that the Board may, upon application by a banking entity, extend the period of time that a banking entity may have to conform an investment to the 3 percent per-fund limitation. As in the statute, the proposed rule permitted the Board to grant up to an additional two years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. The proposal required a banking entity to submit an application for extension to the Board, and set forth the factors that the Board would consider in reviewing an application for extension, including a requirement that the Board consult with the primary Federal supervisory agency for the banking entity prior to acting on an application.

Some commenters argued that the final rule should be modified to extend automatically the one-year statutory period for complying with the per-fund limitation by an additional two years without application or approval on a case-by-case basis and to apply the extended conformance period to the aggregate funds limitations.[2372] Some of these commenters suggested that Congress explicitly recognized the need for a banking entity to have a sufficient seeding period following establishment of a fund, and that funds often require more than one year to attract enough unaffiliated investors to enable the sponsoring banking entity to reduce its ownership interests in the fund to the level required by section 13(d)(4).

Other commenters argued that the amount of a banking entity's own capital involved in seeding a fund is typically ''small'' and suggested that, in order to prevent banking entities from engaging in prohibited proprietary trading through a fund, the Board should condition the ability of a banking entity to qualify for an extension of the one-year statutory period on several requirements, including a requirement that the banking entity not have provided more than $10 million in seed capital as part of establishing the covered fund.[2373]

The Agencies have carefully considered comments received on the proposal and have determined instead to adopt the process and standards governing requests for extensions of time to divest an ownership interest in a single covered fund largely as proposed. The Agencies believe that this approach is consistent with the process and standards set out under the statute.

As under the proposal, the final rule requires any banking entity that seeks an extension of the conformance period provided for the per-funds limitation to submit a written request to the Board. Any such request must be submitted to the Board at least 90 days prior to the

[2365] *See* proposed rule § 75.12(c)(2)(ii)(B)(2).

[2366] *See* proposed rule § 75.12(c)(2)(ii)(A).

[2367] *See* proposed rule § 75.12(c)(1)(B(2)(ii)(B)(1).

[2368] *See* Occupy.

[2369] *See* Credit Suisse (Williams); IIB/EBF.

[2370] *See* Japanese Bankers Ass'n.

[2371] *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 FR 76628, 76637 (Dec. 28, 2012).

[2372] *See, e.g.,* SIFMA et al. (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); TCW; Credit Suisse (Williams).

[2373] *See, e.g.,* Occupy; Sens. Merkley & Levin (Feb. 2012).

expiration of the applicable time period and provide the reasons why the banking entity believes the extension should be granted. In addition, the request must explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods to the limits imposed by the final rule. To allow the Board to assess the factors provided in the statute, the final rule provides that any extension request by a banking entity must address: (i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (ii) the contractual terms governing the banking entity's interest in the covered fund; (iii) the total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States; (iv) the cost to the banking entity of divesting or disposing of the investment within the applicable period; (v) whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty; (vi) the banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund; (vii) market conditions; and (viii) any other factor that the Board believes appropriate. In contrast to the proposal, the final rule does not require information on whether the extension would pose a threat to safety and soundness of the covered banking entity or to financial stability of the United States. The categories of information in final rule have been modified in order to eliminate redundancies.

The final rule continues to permit the Board to impose conditions on granting any extension granted if the Board determines conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or otherwise unsound practices, or to otherwise further the purposes of section 13 of the BHC Act and the final rule. In cases where the banking entity is primarily supervised by another Agency, the Board will consult with such Agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period. While some commenters requested that the Board modify the final rule to permit a banking entity to have covered fund investments in excess of the aggregate funds limitation,[2374] the final rule does not contain such a provision. As noted in the release for the proposed rule, the statutory grant of authority to provide extensions of time to comply with the investment limits refers specifically and only to the period for conforming a seeding investment to the per-fund limitation.[2375]

As noted in the proposed rule, the Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through misuse of requests for extension of the seeding period for covered funds. Therefore, the Board and the Agencies will monitor requests for extensions of the seeding period for activity in covered funds that is inconsistent with the requirements of section 13 of the BHC Act.

4. Section 75.13: Other Permitted Covered Fund Activities

a. Permitted Risk-Mitigating Hedging Activities

Section 13(d)(1)(C) of the BHC Act provides an exemption for certain risk-mitigating hedging activities.[2376] In the context of covered fund activities, the proposed rule implemented this authority narrowly and permitted a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge only in two situations: (i) When acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund; and (ii) with respect to a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.[2377] The proposed rule imposed specific requirements on a banking entity seeking to rely on this exemption.[2378]

The Agencies received a range of comments on the proposed risk-mitigating hedging exemption for ownership interests in covered funds. Some commenters objected to the limited applicability of the statutory risk-mitigating hedging exemption in the covered funds context and urged the Agencies to allow ownership interests in covered funds to be used in any appropriate risk-mitigating hedging.[2379] In contrast, other commenters urged the Agencies to delete one or both of the risk-mitigating hedging exemptions as the commenters argued they were inconsistent with the statute or otherwise inappropriate.[2380] Commenters also argued that a separate risk-mitigating hedging exemption for covered funds is unnecessary because the statute provides a single risk-mitigating hedging exemption.[2381]

Some commenters argued that the proposed rule would impede banking entities from offering covered-fund linked products to customers, including hedging these products, and would, in particular, impair the ability of banking entities to hedge the risks of fund-linked derivatives with fund-linked swaps or shares of covered funds referenced in fund-linked products.[2382] These commenters argued this limitation would increase risks at banking entities and was inconsistent with the purpose of the risk-mitigating hedging exemption. Commenters also proposed modifying the proposal to permit risk-mitigating hedging activities that facilitate a customer's exposure to profits and/or losses of the covered fund, to permit portfolio or dynamic hedging strategies involving covered fund interests, and to eliminate the proposed condition that a customer would not itself be a banking entity.[2383] Some commenters also urged the Agencies to grandfather existing risk-mitigating hedging activities with respect to any covered-fund linked products that comply with the hedging

[2374] *See* ABA (Keating).

[2375] *See* 12 U.S.C. 1851(d)(4)(C).

[2376] *See* 12 U.S.C. 1851(d)(1)(C).

[2377] *See* proposed rule § 75.13(b)(1)(i)(A) and (B).

[2378] These requirements were substantially similar to the requirements for the risk-mitigating hedging exemption for trading activities contained in proposed § 75.5. In addition, proposed § 75.13(b) also required that: (i) The hedge represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund arising out of the transaction to accommodate a specific customer request or directly connected to the banking entity's compensation arrangement with an employee; and (ii) the banking entity document, at the time the transaction is executed, the hedging rationale for all hedging transactions involving an ownership interest in a covered fund.

[2379] *See* BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2380] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2381] *See* BoA.

[2382] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2383] *See, e.g.,* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Deutsche Bank (Fund-Linked Products).

requirements for proprietary trading under § 75.5 of the proposed rule.[2384]

In contrast, other commenters objected to the exemption for hedging covered fund-linked products sold to customers. These commenters asserted that this activity would authorize investment in covered funds in a manner that would not be subject to the three percent per-fund limitation;[2385] or would be inconsistent with the statutory requirement that a banking entity actively seek additional investors for a fund.[2386]

Some commenters urged the Agencies to expand the hedging exemption to allow banking entities to invest in covered funds in order to hedge obligations relating to deferred compensation plans for employees who do not directly provide services to the covered fund for which the hedge relates.[2387] Another commenter argued that banking entities should be permitted to hedge compensation investment accounts for executive officers who are not involved in the management of the investment accounts.[2388] In contrast, other commenters objected to the hedging exemption for compensation arrangements, arguing that it may increase risk to banking entities,[2389] is unnecessary,[2390] or may provide banking entities with an opportunity to evade the limitations on the amount of ownership interests they may have as an investment in a covered fund.[2391]

After review of the comments, the Agencies believe at this time that permitting only limited risk-mitigating hedging activities involving ownership interests in covered funds is consistent with the safe and sound conduct of banking entities, and that increased use of ownership interests in covered funds could result in exposure to higher risks.[2392]

In particular, the Agencies have determined that transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity. These transactions expose the banking entity to the risk that the customer will fail to perform, thereby effectively exposing the banking entity to the risks of the covered fund. Furthermore, a customer's failure to perform may be concurrent with a decline in value of the covered fund, which could expose the banking entity to additional losses. Accordingly, the Agencies believe that these transactions pose a significant potential to expose banking entities to the same or similar economic risks that section 13 of the BHC Act sought to eliminate, and have not adopted the proposed exemption for using ownership interests in covered funds to hedge these types of transactions in the final rule.

As argued by some commenters, modifying the proposal to eliminate the exemption for permitting banking entities to acquire covered fund interests in connection with customer facilitation may impact banking entities ability to hedge the risks of fund-linked derivatives through the use of fund-linked swaps or shares of covered funds referenced by fund-linked products.[2393] Some commenters on the proposal argued that innovation of financial products may potentially be reduced if the final rule does not permit this type of activity related to fund-linked products.[2394] The Agencies recognize that U.S. banking entities may no longer be able to participate in offering certain customer facilitation products relating to covered funds, but believe it is consistent with the purposes of section 13 to restrict these activities.

The final rule maintains the proposed exemption for hedging employee compensation arrangements with several changes. To ensure that exempt hedging activities are designed to reduce one or more specific risks, as required by section 13(d)(1)(C) of the BHC Act, the proposed rule required that permitted hedging activity be designed to reduce the specific risks to the banking entity in connection with and related to its obligations or liabilities. The final rule permits a banking entity to acquire or retain an ownership interest in a covered fund provided that the ownership interest is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund. Under the final rule, a banking entity may not use as a hedge ownership interests of a covered fund for which the employee does not provide services. The requirement under the final rule that the hedging activity be designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity is consistent with the requirement in § 75.5 of the final rule, as discussed above in Part VI.A.4. The final rule permits a banking entity to hedge its exposures to price and other risks based on fund performance that arise from restricted profit interest and other performance based compensation arrangements with its investment managers.

Section 13(a)(2) of the final rule describes the criteria a banking entity must meet in order to rely on the risk-mitigating hedging exemption for covered funds. These requirements, which are based on the requirements for the risk-mitigating hedging exemption for trading activities under § 75.5 of the final rule and which are discussed in detail above in Part VI.A.4, have been modified from the proposal to reflect the more limited scope of this section.[2395] In particular, the final rule permits a banking entity to engage in risk-mitigating hedging activities involving ownership interests in a covered fund only if the banking entity has established and implements, maintains and enforces an internal compliance program that is reasonably designed to ensure the covered banking entity's compliance with the requirements of the hedging exemption, including reasonably designed written policies and procedures and internal controls and ongoing monitoring and authorization procedures, and has acquired or retained the ownership interest in accordance with these written policies, procedures and internal controls. Furthermore, the acquisition or retention of an ownership interest must demonstrably reduce or otherwise significantly mitigate, at the inception of the hedge, one or more specific, identifiable risks arising in connection with the compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund. The acquisition or retention also may not, at the inception of the hedge, result in any significant new or additional risk that is not itself hedged contemporaneously in accordance with the hedging exemption, and the hedge must be subject to continuing review, monitoring and management by the banking entity.

[2384] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA.

[2385] *See* Sens. Merkley & Levin (Feb. 2012).

[2386] *See* AFR *et al.* (Feb. 2012).

[2387] *See* Arnold & Porter.

[2388] *See* BOK.

[2389] *See* Occupy.

[2390] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2391] *See* Occupy.

[2392] *See* 12 U.S.C. 1851(d)(2).

[2393] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2394] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2395] *See* final rule § 75.13(a)(2).

The final rule also permits a banking entity to engage in risk-mitigating hedging activities in connection with a compensation arrangement, subject to the conditions noted above, only if the compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate thereof has acquired an ownership interest and the losses on such ownership interest are offset by corresponding decreases in the amounts payable in connection with the related employee compensation arrangement.[2396]

b. Permitted Covered Fund Activities and Investments Outside of the United States

Section 13(d)(1)(I) of the BHC Act[2397] permits foreign banking entities to acquire or retain an ownership interest in, or act as sponsor to, covered funds, so long as those activities and investments occur solely outside the United States and certain other conditions are met (the ''foreign fund exemption'').[2398] As described in the proposal, the purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities and investments, while preserving national treatment and competitive equality among U.S. and foreign banking entities within the United States.[2399] The statute does not explicitly define what is meant by ''solely outside of the United States.''

The proposed rule allowed foreign banking entities that met certain qualifications to engage in covered fund activities, including owning, organizing and offering, and sponsoring funds outside the United States. The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and when an activity or investment would occur ''solely outside of the United States.'' The proposed rule allowed a qualifying foreign banking entity to acquire or retain an ownership interest in, or act as sponsor to, a covered fund under the exemption only if no subsidiary, affiliate or employee of the banking entity that's incorporated or physically located in the United States engaged in offering or selling the covered fund. The proposed rule also implemented the statutory requirement that prohibited an ownership interest in the covered fund from being offered for sale or sold to a resident of the United States.

Commenters generally expressed support for an exemption to allow foreign banking entities to conduct foreign covered fund activities and make investments outside the United States.[2400] A number of commenters also expressed concerns that the proposed foreign fund exemption was too narrow and would not be effective in permitting foreign banking entities to engage in covered fund activities and investments outside of the United States. For instance, many commenters argued that several of the proposal's restrictions on the exemption were not required by statute and were inconsistent with congressional intent to limit the extraterritorial impact of section 13 of the BHC Act.[2401] These commenters argued that the foreign funds exemption should focus on whether a prohibited activity, such as sponsoring or investing in a covered fund, involves principal risk taken or held by the foreign banking entity that poses risk to U.S. banking entities or the financial stability of the United States.[2402] Commenters also argued that a broader exemption would better recognize the regulation and supervision of the home country supervisor of the foreign banking entity and of its covered fund activities.[2403]

Some commenters contended that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[2404] Commenters also alleged that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities conducting activity pursuant to this exemption.[2405] These commenters argued that foreign banking entities relying on the foreign fund exemption should not be subject to the compliance program requirements contained in Appendix C with respect to their non-U.S. operations.[2406]

Several commenters argued that the restrictions of section 13(f), which limits transactions between a banking entity and certain covered funds, would not apply to activities and investments made in reliance on the foreign fund exemption.[2407] Some commenters argued that the Agencies should grandfather all existing foreign covered funds and argued that failure to provide relief for existing relationships could cause substantial disruption to foreign covered funds and significantly harm investors in existing funds without producing a clear offsetting benefit.[2408]

[2396] *See* final rule § 75.13(a)(2)(iii).

[2397] Section 13(d)(1)(I) of the BHC Act permits a banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund notwithstanding the restrictions on investments in, and relationships with, a covered fund, if: (i) Such activity or investment is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (ii) the activity occurs solely outside of the United States; (iii) no ownership interest in such fund is offered for sale or sold to a resident of the United States; and (iv) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(I).

[2398] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the final rule's implementation of section 13(d)(1)(I) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[2399] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (''Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs seek to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.'').

[2400] *See, e.g.,* IIB/EBF; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Occupy.

[2401] *See* Ass'n. of German Banks; BVI; Allen & Overy (on behalf of Canadian Banks); EFAMA; F&C; HSBC; IIB/EBF; ICSA; PEGCC; Société Générale; Union Asset; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Williams); Cadwalader (on behalf of Thai Banks).

[2402] *See* IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Katten (on behalf of Int'l Clients).

[2403] *See* Credit Suisse (Williams); PEGCC; *see also* Commissioner Barnier.

[2404] *See e.g.,* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Ass'n. of German Banks; Société Générale; Chamber (Feb. 2012).

[2405] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA. As discussed below in Part VI.C.1, other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[2406] *See* AFG; Ass'n. of German Banks; BVI; Comm. on Capital Markets Regulation; IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; Union Asset. As discussed in greater detail below in Part VI.C.1, activities and investments of a foreign bank that are conducted under the foreign funds exemption are generally not subject to the specific requirements of § 75.20 and Appendices A and B. The U.S. operations of foreign banking entities are expected to have policies and procedures in place to ensure that they conduct activities under this part in full compliance with this part.

[2407] *See* Australian Bankers Ass'n.; AFMA; Allen & Overy (on behalf of Foreign Bank Group); British Bankers' Ass'n.; F&C; French Banking Fed'n.; IIB/EBF; Japanese Bankers Ass'n; Katten (on behalf of Int'l Clients); Union Asset. *See also infra* Part VI.B.5.

[2408] *See* BVI; Credit Suisse (Williams); EFAMA; IIB/EBF; PEGCC; Union Asset. *See supra* Part II for a discussion regarding the conformance period.

In response to comments received on the proposal, the final rule contains a number of modifications to more effectively implement the foreign fund exemption in light of the language and purpose of the statute. Importantly, as explained in the section defining covered funds, the Agencies also believe that the more circumscribed definition of covered fund, including the exclusion for foreign public funds, should alleviate many of the concerns raised and potential burdens identified by commenters with respect to the funds activities of foreign banking entities.[2409]

1. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(I) provides that, in order to be eligible for the foreign funds exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. Consistent with this statutory language, the proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

The Agencies did not receive substantive comment on this aspect of the proposal related to the foreign fund exemption, though some commenters offered suggestions to clarify various parts of the wording of the scope of the definition of banking entities that may qualify for the exemption. The final rule makes only minor, technical changes to more fully carry out the purposes of the statute.

Consistent with the statutory language and purpose of section 13(d)(1)(I) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under[2410] or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. As noted above, section 13(d)(1)(I) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[2411] Because of this express statutory requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its sponsorship or investment activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act. The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule also provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[2412]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[2413] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[2414] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[2415] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[2416] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the foreign fund exemption.[2417]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not subject to the

[2409] For instance, many commenters raised concerns regarding the treatment of foreign public funds such as UCITS. As discussed in greater detail above in Part VI.B.1, the definition of covered fund under the final rule has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute (*e.g.,* certain foreign funds that are established by U.S. banking entities). Foreign public funds are also excluded from the definition of covered fund under the final rule. The modifications in the final rule in part address commenters' request that foreign funds be grandfathered. To the extent that an entity qualifies for one or more of the exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Moreover, any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

[2410] The final rule clarifies the eligibility requirements for banking entities seeking to rely on the foreign fund exemption. Section 13(d)(1)(I) of the BHC Act and § 75.13(c)(1)(i) of the proposal require that a banking entity seeking to rely on the foreign fund exemption not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states. For clarification purposes, in addition to the eligibility requirement in Section 13(d)(1)(I) of the BHC Act and the proposal, the final rule also expressly requires that the banking entity not itself be organized under the laws of the United States.

[2411] *See* 12 U.S.C. 1851(d)(1)(I).

[2412] Section 75.13(b)(2) only addresses when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(I) of the BHC Act, are unable to rely on the foreign funds exemption.

[2413] *See* 12 U.S.C. 1843(c)(9).

[2414] *See* 12 CFR 211.20 *et seq.*

[2415] Some commenters argued that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign fund exemption. For example, subpart B of the Board's Regulation K includes various approval requirements and interstate office location restrictions. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. The final rule does not retain the proposal's requirement that the activity be conducted in compliance with all of subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the foreign fund exemption in section 13(d)(1)(I) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[2416] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule only referenced the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[2417] This modification to the definition of foreign banking organization from the proposed definition is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of the foreign fund exemption [2418] if the entity, on a fully-consolidated basis,[2419] meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[2420] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and § 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States.[2421] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the restrictions on covered fund activities and investments, a result that the Agencies do not believe was intended.

2. Activities or Investments Solely Outside of the United States

As noted above, the proposed rule adopted a transaction-based approach to implementing the foreign fund exemption and focused on the extent to which the foreign fund transactions occur within, or are carried out by personnel, subsidiaries or affiliates within, the United States. In particular, § 75.13(c)(3) of the proposed rule provided that a transaction or activity be considered to have occurred solely outside of the United States only if: (i) The transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; (ii) no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

Commenters suggested that, like the foreign trading exemption, the foreign fund exemption should focus on the location of activities that a banking entity engages in as principal.[2422] These commenters argued that the location of sales activities of a fund should not determine whether a banking entity has sponsored or acquired an ownership interest in a covered fund solely outside of the United States. Commenters also argued that foreign banking entities typically locate marketing and sales personnel for foreign funds in the United States in order to serve customers, including those that are not residents of the United States, and that the proposal would needlessly force all covered fund sales activities to shift outside of the United States. These commenters alleged that the restrictions under the proposal would cause foreign banking entities to relocate their personnel from the United States to overseas, diminishing U.S. jobs with no concomitant benefit.[2423]

Many commenters requested removal of the proposal's prohibition on a U.S. subsidiary, affiliate, or employee of the foreign banking entity offering or selling fund interests in order to qualify for the foreign fund exemption.[2424] Commenters argued that this limitation was not included in the statute and that the limited involvement of persons located in the U.S. in the distribution of ownership interests in a foreign covered fund should not, by itself, disqualify the banking entity from relying on the foreign fund exemption so long as the fund is offered only outside the United States.[2425] These commenters argued that organizing and offering a fund is not a prohibited activity so long as it is not accompanied by ownership or sponsorship of the covered fund. One commenter urged that the final rule permit U.S. personnel of a foreign banking entity to engage in non-selling activities related to a covered fund, including acting as investment advisor, establishing fund vehicles, conducting back-office functions such as day-to-day management and deal sourcing tax structuring, obtaining licenses, interfacing with regulators, and other related activities that do not involve U.S. sales activity.[2426]

Instead of the proposal's transaction-based approach to implementing the foreign fund exemption, many commenters suggested the final rule adopt a risk-based approach.[2427] These commenters argued that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign activity of foreign banking entities in line with the purpose of the statue.[2428] Commenters also contended that foreign activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[2429]

In response to commenters' concerns and in order to more effectively implement both the statutory prohibition as well as the foreign fund exemption, the final rule has been modified to better reflect the purpose of the statute by ensuring that the principal risks of covered fund investments and sponsorship by foreign banking entities permitted under the foreign funds exemption occur and remain solely outside of the United States. One of the principal purposes of section 13 is to limit the risks that covered fund investments and activities pose to the safety and soundness of U.S. banking entities and the U.S. financial

[2418] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[2419] For clarification purposes, the final rule has been modified from the proposal to provide that the requirements for this provision must be met on a fully-consolidated basis.

[2420] *See* final rule § 75.13(b)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § 75.13(b)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

[2421] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § 75.13(b)(2)(ii)(B).

[2422] *See* Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2423] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Société Générale; Union Asset.

[2424] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients); TCW; Union Asset.

[2425] *See* IIB/EBF; Société Générale; TCW; Union Asset; Credit Suisse (Williams); *see also* Katten (on behalf of Int'l Clients) (recommending that, similar to the SEC's Regulation S (17 CFR 230.901 through 230.905), the final rule provide that involvement of persons located in the United States in the distribution of a non-U.S. covered fund's securities to potential purchasers outside of the United States not affect the analysis of whether a non-U.S. banking entity's investment or sponsorship occurs outside the United States).

[2426] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2427] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); George Osborne.

[2428] *See* IIB/EBF.

[2429] *See* IIB/EBF.

system. Another purpose of the foreign fund exemption was to limit the extraterritorial application of section 13 as it applies to foreign banking entities subject to section 13.

To accomplish these purposes in light of the structure and purpose of the statute and in response to commenters, the final rule adopts a risk-based approach rather than a transaction approach to the foreign fund exemption. In order to ensure these risks remain solely outside of the United States, the final rule also includes several conditions on the availability of the foreign fund exemption. Specifically, the final rule provides that an activity or investment occurs solely outside the United States for purposes of the foreign fund exemption only if:

- The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and it not controlled directly or indirectly by, a banking entity that is located in the United States or established under the laws of the United States or of any State;
- The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;
- The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and
- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.[2430]

These requirements are designed to ensure that any foreign banking entity engaging in activity under the foreign fund exemption does so in a manner that ensures the risk and sponsorship of the activity or investment occurs and resides solely outside of the United States.

The final rule has been modified from the proposal to specifically recognize that, for purposes of the foreign fund exemption, a U.S. branch, agency, or subsidiary of a foreign bank, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[2431] A subsidiary (wherever located) of a U.S. branch, agency, or subsidiary of a foreign bank is also considered itself to be located in the United States. This provision helps give effect to the statutory language limiting the foreign fund exemption to activities of foreign banking entities that occur ''solely outside of the United States'' by clarifying that the U.S. operations of foreign banking entities may not sponsor or acquire or retain an ownership interest in a covered fund as principal based on this exemption.

Because so-called ''back office'' activities do not involve sponsoring or acquiring or retaining an ownership interest in a covered fund, the final rule does not impose restrictions on U.S. personnel of a foreign banking entity engaging in these activities in connection with one or more covered funds. This allows providing administrative services or similar functions to the covered fund as an incident to the activity conducted under the foreign fund exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund).

The foreign fund exemption in the final rule also permits the U.S. personnel and operations of a foreign banking entity to act as investment adviser to a covered fund in certain circumstances. For instance, the U.S. personnel of a foreign banking entity may provide investment advice and recommend investment selections to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States. As explained above, the final rule also explicitly provides that acquiring or retaining an ownership interest does not include acquiring or retaining an ownership interest in a covered fund by a banking entity acting solely as agent, broker, or custodian, subject to certain conditions, or acting on behalf of customers as a trustee, or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of the customer and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest.[2432] The final rule would thus allow a foreign bank to engage in any of these capacities in the U.S. without the need to rely on the foreign fund exemption.

3. Offered for Sale or Sold to a Resident of the United States

The proposed rule provided that no ownership interest in the covered fund be offered for sale or sold to a resident of the United States, a requirement of the statute.[2433] Numerous commenters focused on the definition of ''resident of the United States'' in the proposed rule and the manner in which the restriction on offers and sales to such persons would interrelate with Regulation S under the Securities Act of 1933. Commenters asserted that, since market participants have long conducted offerings of foreign funds in reliance on Regulation S [2434] in order to comply with U.S. securities law obligations, these same securities law principles should be applied to determine whether a person is a resident of the United States for purposes of section 13 and the final rule to determine whether an offer or sale is made to residents of the United States.[2435]

Certain commenters argued that because of the way the restriction in the statute and proposed rule was written, it was unclear whether the restriction on offering for sale to a resident of the United States applied to the foreign banking entity or to any third party that establishes a fund.[2436] Commenters argued the prohibition against offers or sales of ownership interests to residents of the United States should apply only to offers and sales of covered funds organized and offered by the foreign banking entity but not to covered funds established by unaffiliated third parties.[2437] These commenters reasoned that a foreign banking entity should be permitted to make a passive investment in a covered fund sponsored and controlled by an unaffiliated third party that has U.S. investors as long as the foreign banking entity does not itself offer or sell ownership interest in the covered fund to residents of the United

[2430] *See* final rule § 75.13(b)(4).

[2431] *See* final rule § 75.13(b)(5).

[2432] *See* final rule § 75.10(a)(2).

[2433] *See* proposed rule § 75.13(c)(1)(iii).

[2434] *See* 17 CFR 230.901–905.

[2435] *See* IIB/EBF; EFAMA; ICI Global.

[2436] *See* Cadwalader (on behalf of Thai Banks); Grosvenor; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2437] *See* Ass'n. of German Banks; BAROC; Cadwalader (on behalf of Thai Banks); Comm. on Capital Markets Regulation; Credit Suisse (Williams); IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); PEGCC.

States.[2438] Commenters contended that this interpretation would be consistent with section 13's purpose to prevent foreign banks from using the foreign fund exemption to market and sell covered funds to U.S. investors, while simultaneously limiting the extraterritorial impact of section 13.[2439] Commenters argued that the proposal's foreign fund exemption would negatively impact U.S. asset managers unaffiliated with any banking entity because they would either be forced to exclude foreign banking entities from investing in their funds or would need to ensure that no residents of the United States hold ownership interests in funds offered to these entities.[2440] Commenters also contended that foreign banking entities, including sovereign wealth funds that own or control foreign banking organizations, invest tens of billions of dollars in U.S. covered funds and that if these types of investments were not permitted under the foreign fund exemption an important source of foreign investment in the U.S. could be eliminated.[2441]

Commenters argued that an investment by a foreign banking entity in a third-party unaffiliated fund does not pose any risk to a U.S. banking entity or to the U.S. financial system. Moreover, commenters argued that a foreign banking entity that has invested in a fund sponsored and advised by a third party has no control over whether—and may have no knowledge—that the third party has determined to offer or sell the fund to U.S. residents.[2442]

As noted above, one of the purposes of section 13 is to limit the risk to banking entities and the financial system of the United States. Another purpose of the statute appears to be to permit foreign banking entities to engage in foreign activities without being subject to the restrictions of section 13 while also ensuring that these foreign entities do not receive a competitive advantage over U.S. banking entities with respect to offering and selling their covered fund services in the United States.[2443] As such, the final rule does not prohibit a foreign banking entity from making an investment in or sponsoring a foreign fund. However, a foreign banking entity would not be permitted under the foreign fund exemption to invest in, or engage in the sponsorship of, a U.S. or foreign covered fund that offers ownership interests to residents in the United States unless it does so pursuant to and subject to the limitations of the permitted activity exemption for organizing and offering a covered fund, for example, which has the same effect for U.S. banking entities. The final rule ensures that the risk of the sponsoring and investing in non-U.S. covered funds by foreign banking entities remains outside of the United States and that the foreign fund exemption does not advantage foreign banking entities relative to U.S. banking entities with respect to providing their covered fund services in the United States by prohibiting the offer or sale of ownership interests in related covered funds to residents of the United States.

Commenters also argued that foreign investors in a foreign covered fund should not be treated as residents of the United States for purposes of the final rule if, after purchasing their interest in the covered fund, they relocate to the U.S.,[2444] or travel to the U.S. on a temporary basis.[2445] Commenters also argued that non-U.S. investors in a fund offered by a foreign banking entity should not be prohibited from transferring their interests to residents of the United States in the secondary market.[2446] One commenter alleged that, notwithstanding the reasonable efforts of foreign banking entities to prevent residents of the United States from investing in their foreign covered funds, investors may find ways to circumvent and invest in covered funds without knowledge or assistance from the foreign banking entity.[2447]

Certain commenters argued that there was a substantial risk that foreign funds offered by foreign banking entities would not be able to rely on the exemption due to the presence of a limited number of investors who are residents of the United States.[2448] A few commenters suggested that the final rule should require that, for both related and unrelated covered funds, a banking entity need only have a reasonable belief that an ownership interest in a covered fund is not offered or sold to residents of the United States in order to qualify for the foreign fund exemption. Commenters argued that only active targeting or marketing towards a resident of the United States by the foreign banking entity should be prohibited by the final rule, and that the incidental presence of a limited number of investors that are residents of the United States in a foreign covered fund offered by a foreign banking entity should not prohibit the foreign banking entity from relying on the foreign fund exemption.[2449] One commenter argued that, for certain complex fund structures (*e.g.,* a structure with a master fund and multiple feeder funds that investors invest in or a parallel fund structure both managed by the same fund manager), eligibility for the foreign fund exemption should not be precluded for a fund with no ownership interests offered for sale or sold to U.S. residents even if a related covered fund is offered to residents of the United States.[2450]

After considering comments received on the proposal, the final rule retains the statutory requirement that no ownership interest in the covered fund be offered for sale to a resident of the United States.[2451] The final rule provides that an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold or has been sold pursuant to an offering that targets residents of the United States.[2452]

Absent circumstances otherwise indicating a nexus with residents of the United States, the sponsor of a foreign fund would not be viewed as targeting U.S. residents for purposes of the foreign fund exemption if it conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States.[2453] If ownership interests

[2438] *See* Grosvenor; IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); Sens. Merkley & Levin (Feb.2012); Norinchukin; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2439] *See* BAROC; Credit Suisse (Williams); Grosvenor; IIB/EBF.

[2440] *See* Comm. on Capital Markets Regulation; Credit Suisse (Williams); PEGCC.

[2441] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Grosvenor; PEGCC.

[2442] *See* AFG; BAROC; Cadwalader (on behalf of Thai Banks); Japanese Bankers Ass'n.

[2443] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2444] *See* IIB/EBF; Katten (on behalf of Int'l Clients); Union Asset.

[2445] *See* IFIC; *see also* Allen & Overy (on behalf of Canadian Banks).

[2446] *See* Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2447] *See* Credit Suisse (Williams).

[2448] *See* BVI; EFAMA; Union Asset.

[2449] *See* AFG; Union Asset; *see also* BVI; Allen & Overy (on behalf of Canadian Banks); Katten (on behalf of Int'l Clients).

[2450] *See* Japanese Bankers Ass'n.

[2451] *See* final rule § 75.13(b)(1)(iii).

[2452] *See* final rule § 75.13(b)(3).

[2453] *See* Statement of the Commission Regarding Use of Internet Web sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Securities Act Release No. 7516 (Mar. 23, 1998). Reliance on these principles only applies with respect to whether an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of

that are issued in a foreign offering are listed on a foreign exchange, secondary market transactions could be undertaken by the banking entity outside the United States in accordance with Regulation S under the foreign fund exemption.[2454] Foreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a discretionary account or similar account for a person who is not a resident of the United States).[2455] In order to comply with the rule as adopted, sponsors of covered funds established outside of the United States must examine the facts and circumstances of their particular offerings and confirm that the offering does not target residents of the United States.

With respect to the treatment of multi-tiered fund structures under the foreign fund exemption, the Agencies expect that activities related to certain complex fund structures should be integrated in order to determine whether an ownership interest in a covered fund is offered for sale to a resident of the United States. For example, a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity.

4. Definition of ''Resident of the United States''

As discussed in greater detail above in Part VI.B.1, section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' As noted above in Part VI.B.1.f describing the definition of ''resident of the United States,'' the statute does not define this term.

After carefully considering comments received, the Agencies have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in the SEC's Regulation S.[2456] The Agencies note, however, that it would not be permissible under the foreign fund exemption for a foreign banking entity to facilitate or participate in the formation of a non-U.S. investment vehicle for a person or entity that is itself a U.S. person for the specific purpose of investing in a foreign fund. The Agencies believe that this type of activity would constitute an evasion of the requirements of section 13 of the BHC Act.

c. Permitted Covered Fund Interests and Activities by a Regulated Insurance Company

As discussed above, section 13(d)(1)(F) of the BHC Act permits a banking entity that is a regulated insurance company acting for its general account, or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions.[2457] Section 13(d)(1)(D) of the Act permits a banking entity to purchase or sell a financial instrument on behalf of customers.[2458] The proposal implemented these exemptions with respect to the proprietary trading activities of insurance companies by permitting a banking entity that is an insurance company to purchase or sell a financial instrument for the general account of the insurance company or for a separate account, in each case subject to certain restrictions.[2459] The proposal did not apply these exemptions to covered fund activities or investments.

A number of commenters argued that section 13 was designed to accommodate the business of insurance by exempting both the proprietary trading and covered fund activities of insurance companies.[2460] These commenters argued that providing an exemption for covered fund activities and investments through both the general account and separate accounts of an insurance company was integral to the business of insurance and that, absent an exemption from the covered fund provisions, insurance companies would lack an effective means to diversify their holdings and obtain adequate rates of return in order to maintain affordable premiums for customers.[2461]

Some commenters argued that section 13 of the BHC Act specifically provides exemptions from both the covered fund prohibition of section 13(a)(1), and the prohibition on proprietary trading.[2462] Commenters contended that the exemptions in section 13(d)(1)(F) (referencing activity in general accounts of insurance companies) and 13(d)(1)(D) (referencing activities on behalf of customers) cross-reference the instruments described in section 13(h)(4) and not activity described in section 13(h)(4). On this basis, commenters argued the statute exempts both proprietary trading in these instruments described in section 13(h)(4) and investments in those instruments (including when those instruments are ownership interests in covered funds).[2463]

Alternatively, commenters argued that the Agencies should use their authority in section 13(d)(1)(J) of the BHC Act to provide an exemption for the covered fund activities and investments of insurance companies.[2464] These commenters argued that exempting covered funds activities and investments of insurance companies would promote and protect the safety and soundness of the banking entity and financial stability of the United States and provide certain benefits to the U.S. financial system by allowing insurance companies to access important asset classes (for better investment diversity and returns), provide more diverse product offerings to customers, better manage their investment risks through diversification and more closely matching the maturity of their assets

section 13 of the BHC Act. In addition, reliance would not be appropriate if a foreign fund engages in a private placement of ownership interests in the United States in reliance on Section 4(a)(2) of the Securities Act of 1933 or Regulation D (17 CFR 230.501–230.506).

[2454] An offer or sale is made in an ''offshore transaction'' under Regulation S if, among other conditions, the transaction is executed in, on or through the facilities of a ''designated offshore securities market'' as described in Regulation S, which includes a number of foreign stock exchanges and markets and any others the SEC designates. *See* Securities Act rule 902(h).

[2455] *See* Securities Act rule 902(k)(2).

[2456] *See* final rule § 75.10(d)(8).

[2457] *See* 12 U.S.C. 1851(d)(1)(F).

[2458] *See* 12 U.S.C. 1851(d)(1)(D).

[2459] *See* proposed rule §§ 75.6(b)(2)(iii); 75.6(c).

[2460] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers); ACLI (Jan. 2012); Country Fin. *et al.;* Nationwide; NAMIC; Fin. Services Roundtable (Feb. 3, 2012) (citing FSOC study at 71); HSBC Life; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; *see also* Rep. McCarthy *et al.;* Sen. Nelson; Sen. Hagan; Sens. Brown & Harkin.

[2461] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); USAA (citing FSOC study at 71); HSBC Life; ACLI; NAMIC; Nationwide.

[2462] *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide; *see also* Rep. McCarthy *et al.;* Sens. Brown & Harkin.

[2463] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); USAA; HSBC Life; Country Fin. *et al.;* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide (discussing the exemption for the general account of an insurance company); ACLI; Nationwide (discussing the exemption for separate accounts).

[2464] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers).

and liabilities, contribute liquidity to capital markets, and support economic growth through the provision of capital to entrepreneurs and businesses.[2465] Commenters also argued that an exemption for insurance companies from the covered fund prohibitions was necessary to permit insurance companies that are banking entities to effectively compete with insurance companies not affiliated with an insured depository institution.[2466] Commenters alleged that insurance companies are already subject to extensive regulation under state insurance laws that specifically include provisions designed to diversify risk among investment categories, limit exposure to particular types of asset classes including covered fund investments, and protect the safety and soundness of the insurance company.[2467]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to permit an insurance company or its affiliate[2468] to acquire or retain an ownership interest in, or act as sponsor to, a covered fund for either the general account of the insurance company or one or more separate accounts established by the insurance company.[2469]

These activities are only permitted under the final rule so long as: (1) The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company; (2) the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which the insurance company is domiciled; and (3) the appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in § 75.13(c)(2) of the final rule is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[2470]

The Agencies believe that exempting insurance activities and investments from the covered fund restrictions is supported by the language of sections 13(d)(1)(D) and (F) of the BHC Act,[2471] and more fully carries out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2472] Section 13(d)(1)(F) of the statute specifically exempts general accounts of insurance companies, and, as explained above in Part VI.A.7, separate accounts are managed and maintained on behalf of customers, an activity exempt under section 13(d)(1)(D) of the statute. By their terms, these are statutory exemptions from the prohibitions in section 13(a), which includes both the prohibition on proprietary trading and the prohibition on covered fund investments and sponsorship. Moreover, the statutory language of sections 13(d)(1)(D) and 13(d)(1)(F), both cross-reference the instruments described in section 13(h)(4) and not activity described in section 13(h)(4). These instruments are ''any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract or any other security or financial instrument that [the Agencies determine by rule.]'' This reference covers an ownership interest in a covered fund. The Agencies believe these exemptions as modified more fully carry out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2473] Insurance companies are already subject to a robust regulatory regime including limitations on their investment activities.

5. Section 75.14: Limitations on Relationships With a Covered Fund

Section 13(f) of the BHC Act generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section 13(d)(1)(G) of the BHC Act) from entering into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act (''FR Act'').[2474] The statute also provides an exemption for prime brokerage transactions between a banking entity and a covered fund in which a covered fund managed, sponsored, or advised by that banking entity has taken an ownership interest. Section 13(f) subjects any transaction permitted under section 13(f) of the BHC Act (including a permitted prime brokerage transaction) between the banking entity and covered fund to section 23B of the FR Act.[2475] In general, section 23B of the FR Act requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party. Section 75.16 of the proposed rule implemented these provisions.[2476]

a. Scope of Application

Section 13(f) of the BHC Act and the related provisions of the proposal were among the most commented upon aspects of the covered funds section. The majority of commenters argued that the broad definition of ''covered fund'' under the proposal made the proposed implementation of section 13(f) unworkable and disruptive to existing market practices because it would

[2465] *See* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); USAA; HSBC Life; ACLI (Jan. 2012); NAMIC; Nationwide.

[2466] *See, e.g.,* Nationwide.

[2467] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); USAA; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; NAMIC; Nationwide; Rep. McCarthy *et al. See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that activities of insurance companies ''are heavily regulated by State insurance regulators, and in most cases do not pose the same level of risk as other proprietary trading'').

[2468] Some commenters urged the Agencies to provide that an affiliate or subsidiary of an insurance company could purchase covered funds for the insurance company's general account or a separate account. *See e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012). The Agencies note that the final rule provides (as does the statute) an exemption that permits an insurance company or its affiliate to acquire and retain an ownership interest in a covered fund solely for the insurance's company general account (or one or more of its separate account); such an affiliate or subsidiary also may be a wholly-owned subsidiary, as defined in the final rule.

[2469] The final rule defines the terms ''general account'' and ''separate account'' largely as proposed, and includes the new defined term ''insurance company,'' defined as a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act. *Cf.* section 2(a)(17) of the Investment Company Act (defining the term insurance company).

[2470] *See* final rule § 75.13(c).

[2471] *See* 12 U.S.C. 1851(d)(1)(D), (F).

[2472] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2473] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2474] 12 U.S.C. 371c. The Agencies note that this does not alter the applicability of section 23A of the FR Act and the Board's Regulation W to covered transactions between insured depository institutions and their affiliates.

[2475] 12 U.S.C. 371c–1.

[2476] *See* proposed rule § 75.16.

prohibit corporate funding transactions with ordinary corporate entities that do not engage in hedge fund or private equity activities.[2477] Commenters also argued that activities that the proposal appeared to permit as a permitted activity exemption (*e.g.,* investments in public welfare funds) would be prohibited by the restrictions in 13(f)[2478] and that the Agencies should construe section 13(d)(1)(J) of the BHC Act as allowing them to permit banking entities to enter into covered transactions with a covered fund, if those activities would promote and protect the safety and soundness of banking entities and the financial stability of the United States.[2479] However, many of the comments discussed above and some of the economic burdens noted by these commenters have been addressed by revisions discussed above in Part VI.B.1 to the definition of covered fund.[2480] A number of these and related comments are also addressed by portions of the final rule that provide that the prohibitions of section 13 do not apply to interests acquired, for example, as agent, broker, custodian, in satisfaction of a debt previously contracted, through a pension fund, or as trustee or fiduciary (all within the limits defined in the final rule).

Several commenters argued that applying the restrictions in section 13(f) to foreign activities of foreign banking entities would be inconsistent with the presumption against extraterritorial application of U.S. law and principles of international comity, including deference to home-country regulation.[2481] For example, one commenter expressed concern that rules being developed around custody obligations in the European Union may require a prime broker or custodian to indirectly guarantee assets of a fund, which would directly conflict with the prohibition on guarantees in section 13(f) of the BHC Act.[2482] As explained above, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds.[2483] These changes substantially address the issues raised by commenters regarding the applicability of section 13(f) of the BHC Act to foreign funds.

Commenters also raised a number of other issues. For instance, some commenters argued that applying section 13(f) to securitization entities would in some instances run counter to the rule of construction contained in section 13(g)(2) regarding the sale and securitization of loans.[2484] These commenters recommended that the final rule, at a minimum, grandfather pre-existing relationships between banking entities and existing securitization vehicles to reduce the potential effects of the final rule on agreements and positions entered into before the enactment of the statute.[2485]

One commenter argued that a banking entity that delegates its responsibility for acting as sponsor, investment manager, or investment adviser to an unaffiliated entity should no longer be subject to the restrictions of section 13(f).[2486] By its terms, section 13(f) of the BHC Act applies to a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that relies on section 13(d)(1)(G) of the BHC Act in connection with organizing and offering a covered fund). The Agencies believe that a banking entity that delegates its responsibility to act as sponsor, investment manager, or investment adviser to an unaffiliated party would still be subject to the limitations of section 13(f) if the banking entity retains the ability to select, remove, direct, or otherwise exert control over the sponsor, investment manager, or investment adviser designee. In addition, the unaffiliated party designated as sponsor, investment manager, or investment adviser would be subject to the restrictions of section 13(f) if the third party is a banking entity.

b. Transactions That Would Be a ''Covered Transaction''

Section 13(f) of the BHC Act prohibits covered transactions as defined in section 23A of the FR Act between a banking entity that serves as investment manager, investment advisor or sponsor to a covered fund or that relies on the exemption in section 13(d)(1)(G) and a covered fund.[2487] A number of commenters contended that the definition of ''covered transaction'' in section 13(f) of the BHC Act should incorporate the exemptions available under section 23A and the Board's Regulation W.[2488] These commenters alleged that the statute's general reference to section 23A suggests that the term ''covered transaction'' should be construed in light of section 23A as a whole, including the exemptions in subsection (d) of that Act and as implemented in the Board's Regulation W.[2489] These commenters also argued that the Board's authority to interpret and issue rules pursuant to section 23A of the FR Act and section 5(b) of the BHC Act, the general rule-making authority contained in section 13(b) of the BHC Act, and the exemptive authority in section 13(d)(1)(J) all

[2477] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); BoA; Barclays; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI Global; ISDA (Feb. 2012); RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2478] *See* SunTrust; AHIC; SBIA.

[2479] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2480] *See* final rule § 75.10(b). *See supra* Part VI.B.1.

[2481] *See* IIB/EBF; Katten (on behalf of Int'l Clients); EBF; EFAMA; French Banking Fed'n.; Japanese Bankers Ass'n.

[2482] *See* AIMA.

[2483] *See* final rule § 75.10(b)(1)(ii) and (c)(1). *See supra* Part VI.B.1.

[2484] Section 75.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. As discussed in greater detail above in Part VI.B.2.b, a banking entity that continues to hold interests in a securitization in reliance on this exemption must comply with certain requirements, including the requirements of § 75.14. Accordingly, § 75.14 of the final rule has also been modified from the proposal to prohibit a banking entity that continues to hold an ownership interest in accordance with § 75.11(b), and its affiliates, from entering into a covered transaction with a covered fund, subject to certain exceptions.

[2485] *See* AFME *et al.:* ASF (Feb. 2012); Ashurst; BoA; Barclays; Cadwalader (Municipal Securities); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Deutsche Bank (Fund-Linked Products); Fidelity; GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI (Feb. 2012); IIB/EBF; ISDA (Feb. 2012); JPMC; PNC *et al.;* PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Chamber (Feb. 2012). These comments are addressed above in Part II regarding availability of the conformance period provisions of section 13 of the BHC Act.

[2486] *See* Katten (on behalf of Int'l Clients).

[2487] The term ''covered transaction'' is defined in section 23A of the FR Act to mean, with respect to an affiliate of a member bank: (i) A loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase; (ii) a purchase of or an investment in securities issued by the affiliate; (iii) a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation; (iv) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company; (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; (vi) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate; or (vii) a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7), as amended by section 608 of the Dodd-Frank Act.

[2488] *See* 12 U.S.C. 371c(d); 12 CFR 223.42; ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Allen & Overy (on behalf of Foreign Bank Group).

[2489] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012).

provide a basis for providing such exemptions.[2490]

In particular, commenters argued that intraday extensions of credit;[2491] transactions fully secured by cash or U.S. government securities;[2492] purchases of liquid assets and marketable securities from covered funds;[2493] and riskless principal transactions with covered funds all should be exempt from the restrictions in section 13(f) of the BHC Act.[2494] These commenters argued that providing an exemption for intraday extensions of credit in particular was necessary to allow a banking entity to continue to provide affiliated covered funds with standard custody, clearing, and settlement services that include intra-day or overnight overdrafts necessary to facilitate securities settlement, contractual settlement, pre-determined income, or similar custody-related transactions. Some commenters argued that transactions fully secured by cash or U.S. government securities do not expose banking entities to inappropriate risks, are permitted in unlimited amounts under section 23A, and should not be entirely prohibited under the rule.[2495] A few commenters argued that the proposal would prohibit securities lending transactions and argued that borrower default indemnifications by a banking entity in agency securities lending arrangements should not be prohibited under section 13(f).[2496] Some commenters argued that a banking entity should be allowed to accept the shares of a sponsored covered fund as collateral for a loan to any person or entity, in particular where the loan is not for the purpose of purchasing interests in the covered fund.[2497]

One commenter argued that no exceptions should be granted to the definition of covered transaction, and financing of covered funds would relate to greater fund risk.[2498] In addition, that commenter contended that the Agencies should prohibit a sale of securities by a banking entity to a covered fund even though these transactions are not within the definition of covered transaction for purposes of section 23A of the FR Act.[2499]

The final rule continues to apply the same definition of covered transaction as the proposal. Section 13(f) refers to a covered transaction, as defined in section 23A of the FR Act. Section 13(f) of the BHC Act does not incorporate or reference the exemptions contained in section 23A of the FR Act or the Board's Regulation W. Indeed, the exemptions for these transactions are not included in the definition of covered transactions in section 23A; the exemptions are instead in a different subsection of section 23A and provide an exemption from only some (but not all) of the provisions of section 23A governing covered transactions.[2500] Therefore, the final rule does not incorporate the exemptions in section 23A.

Similarly, the final rule incorporates the statutory restriction as written, which provides that a banking entity that serves in certain specified roles may not enter into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the FR Act as if the banking entity were a member bank and the covered fund were an affiliate thereof. There are certain occasions when the restrictions of section 23A apply to transactions that involve a third party other than an affiliate of a member bank. For example, section 23A would apply to an extension of credit by a member bank to a customer where the extension of credit is secured by shares of an affiliate. The Agencies believe that these transactions between a banking entity and a third party that is not a covered fund are not covered by the terms of section 13(f), which (as discussed above) make specific reference to transactions by the banking entity *with* the covered fund. A contrary reading would prohibit securities margin lending, which Congress has specifically addressed (and permitted) in other statutes. There is no indication in the legislative history that Congress intended section 13(f) to prohibit margin lending that occurs in accordance with other specific statutes. Thus, section 13(f) does not prohibit a banking entity from extending credit to a customer secured by shares of a covered fund (as well as, perhaps, other securities) held in a margin account. However, the Agencies expect banking entities not to structure transactions with third parties in an attempt to evade the restrictions on transactions with covered funds, and the Agencies will use their supervisory authority to monitor and restrict transactions that appear to be evasions of section 13(f).

c. Certain Transactions and Relationships Permitted

While section 13(f)(1) of the BHC Act generally prohibits a banking entity from entering into a transaction with a related covered fund that would be a covered transaction as defined under section 23A of the FR Act, other specific portions of the statute permit a banking entity to engage in certain transactions or relationships with such funds.

1. Permitted Investments and Ownerships Interests

The proposed rule permitted a banking entity to acquire or retain an ownership interest in a covered fund in accordance with the requirements of section 13.[2501] This was consistent with the text of section 13(f), which by its terms is triggered by the presence of certain ownership interests. This view also resolved an apparent conflict between the text of section 13(f) and the reference in section 13(f) prohibiting covered transactions under section 23A of the FR Act, which includes acquiring or retaining an interest in securities issued by an affiliate.

Several commenters supported this aspect of the proposal.[2502] There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section. Moreover, a contrary reading would make these more specific sections that permit covered transactions between a banking entity and a covered fund mere surplusage. Therefore, the final rule adopts this provision as proposed.[2503]

2. Prime Brokerage Transactions

Section 13(f) provides an exception from the prohibition on covered transactions with a covered fund for any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored, or advised by a banking entity has taken an ownership interest (a ''second-tier fund''). However, the statute does not define

[2490] *See* BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Credit Suisse (Williams).

[2491] *See* ABA (Keating); AFG; Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* Credit Suisse (Williams); EFAMA; French Treasury *et al.;* JPMC; IMA; RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); SSgA (Feb. 2012); Vanguard.

[2492] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2493] *See* Credit Suisse (Williams).

[2494] *See, e.g.,* Credit Suisse (Williams).

[2495] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2496] *See* State Street (Feb. 2012); RMA.

[2497] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Katten (on behalf of Int'l Clients).

[2498] *See* Occupy.

[2499] *See* 12 U.S.C. 371c(b)(7); *see also* 12 U.S.C. 371c–1(a)(2)(B) (including the sale of securities or other assets to an affiliate as a transaction subject to section 23B).

[2500] *See* 12 U.S.C. 371c(d).

[2501] *See* proposed rule § 75.16(a)(2)(i).

[2502] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2503] The final rule modifies the proposal to clarify that a banking entity may acquire and retain an ownership interest in a covered fund by express reference to the permitted activities described in §§ 75.11, 75.12 and 75.13.

prime brokerage transaction. The proposed rule defined prime brokerage transaction to include providing one or more products or services, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.[2504]

A few commenters argued that the proposed definition of prime brokerage transaction was overly broad and should not permit securities lending or borrowing services. These commenters argued that securities lending and borrowing (and certain other services) could increase leverage by covered funds and the risk that a banking entity would bailout these funds.[2505]

Other commenters argued that the proposed definition of prime brokerage transaction was confusing because it included transactions (such as data or portfolio management support) that were not ''covered transactions'' under section 23A of the FR Act and thus not prohibited as an initial matter by section 13(f). These commenters argued that including otherwise permissible transactions within the definition of prime brokerage transaction created uncertainty about the permissibility of other transactions or services that are not expressly covered transactions under section 23A of the FR Act and thus not prohibited under section 13(f). One commenter proposed defining prime brokerage transaction as any ''covered transaction'' entered into by a banking entity with a covered fund ''for purposes of custody, clearance, securities borrowing or lending services, trade execution and settlement, financing and related hedging, intermediation, or a similar purpose.'' [2506]

A few commenters supported expanding the definition of prime brokerage transaction to include any service or transaction ''related to'' a specific list of permissible transactions. For instance, one commenter argued that acting as agent in providing contractual income and settlement services and intraday and overnight overdraft protection should expressly be included within the definition of prime brokerage transaction.[2507] This commenter also urged that borrower default indemnification should be included as a prime brokerage transaction to the extent it would be a covered transaction that is prohibited by section 13(f).[2508] Another commenter recommended that the definition of prime brokerage transaction expressly include transactions in commodities, futures and foreign exchange, as well as securities, and transactions effected through OTC derivatives, including, without limitation, contracts for differences, various swaps and security-based swaps, foreign exchange swaps and forwards and ''FX prime brokerage''.[2509]

Based on review of the comments, the definition of prime brokerage transaction has been modified in several ways. For purposes of the final rule, prime brokerage transaction is defined to mean any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the FR Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support. The definition of prime brokerage transaction under the final rule generally recognizes the same relationships that were considered when defining prime brokerage transaction under the proposal,[2510] without certain of the modifications suggested by some commenters that are discussed above. The Agencies carefully considered comments received on the definition of prime brokerage transaction. As noted above, certain commenters requested that various types of transactions be included in or omitted from the definition. The Agencies believe it appropriate to include within the definition of prime brokerage transaction those transactions that the Agencies believe generally constitute the typical type of prime brokerage transactions provided in the market. Including this list of relationships provides clarity and certainty for transactions that are commonly considered to be prime brokerage transactions.

The final rule incorporates within the definition of prime brokerage transaction a reference to covered transactions under section 23A(b)(7) of the FR Act. This change aligns the final rules with section 13(f) of the BHC Act and is designed to eliminate confusion and provide certainty regarding both the breath of the prohibition on covered transactions in section 13(f) and the scope of the exception for prime brokerage transactions. Thus, a transaction or relationship that is not a covered transaction under section 13(f) of the BHC Act is not prohibited in the first instance (unless prohibited elsewhere in section 13). Within the category of transactions prohibited by section 13(f), transactions within the definition of prime brokerage transaction are permitted.

Some commenters argued that the Agencies should provide an exemption for prime brokerage transactions with a broader array of funds than the proposal permitted. For instance, some commenters argued that the Agencies should permit a banking entity to enter into a prime brokerage transaction with any covered fund or fund structure that the banking entity organizes and offers or for which it directly serves as investment manager, investment adviser, or sponsor, and should not limit the exception for prime brokerage transactions to only a second-tier covered fund.[2511] Conversely, a few commenters argued that the prime brokerage exemption should only permit a banking entity to provide these services to a third-party fund in order to ensure that the provision of prime brokerage services does not give rise to the same risks that section 13 was designed more generally to limit.[2512]

The Agencies note that the statute by its terms does not restrict prime brokerage transactions generally. As noted above, section 13(f)(3)(A) of the BHC Act provides that a banking entity may enter into any prime brokerage transaction with a second-tier fund. The statute by its terms permits a banking entity with a relationship to a covered fund described in section 13(f) to engage in prime brokerage transactions (that are covered transactions) only with second-tier funds and does not extend to covered funds more generally. Neither the statute nor the final rule limit covered transactions between a banking entity and a covered fund for which the banking entity does not serve as investment manager, investment adviser, or sponsor (as defined in section 13 of the BHC Act) or have an interest in reliance on section 13(d)(1)(G) of the BHC Act. Under the statute, the exemption for prime brokerage transactions is available only so long as certain enumerated conditions are satisfied.[2513] The conditions are that (i) the chief executive officer (or equivalent officer) of the banking entity certifies in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the

[2504] *See* proposed rule § 75.10(b)(4).

[2505] *See, e.g.,* Occupy; Public Citizen.

[2506] *See* SIFMA *et al.* (Mar. 2012).

[2507] *See* RMA.

[2508] *See* RMA.

[2509] *See* Katten (on behalf of Int'l Clients).

[2510] *See* final rule § 75.10(d)(5).

[2511] *See* RMA; Katten (on behalf of Int'l Clients); EFAMA; *see also* Hong Kong Inv. Funds Ass'n.; IMA; Union Asset.

[2512] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2513] *See* 12 U.S.C. 1851(f)(3).

covered fund or of any covered fund in which such covered fund invests, and (ii) the Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity. The proposed rule incorporated each of these provisions. The final rule provides that this certification be made to the appropriate Federal supervisor for the banking entity.

A few commenters argued that the proposal did not adequately address how the CEO attestation requirement in section 13(f) would apply to foreign banking organizations. They argued that a senior officer with authority for the U.S. operations of the foreign bank should be permitted to make the required attestation.[2514]

The statute allows the attestation for purposes of the prime brokerage exception in section 13(f) of the BHC Act to be from the chief executive officer or ''equivalent officer.'' [2515] In the case of the U.S. operations of foreign banking entities, the senior officer of the foreign banking entity's U.S. operations or the chief executive officer of the U.S. banking entity may provide the required attestation.

d. Restrictions on Transactions With Any Permitted Covered Fund

Sections 13(f)(2) and 13(f)(3)(B) of the BHC Act apply section 23B of the FR Act [2516] to certain transactions and investments between a banking entity and a covered fund as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2517] Section 23B provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.[2518]

Mirroring the statute, the proposal applied this requirement to transactions between a banking entity that serves as investment manager, investment adviser, or sponsor to a covered fund and that fund and any other fund controlled by that fund. It also applied this condition to a permissible prime brokerage transaction in which a banking entity may engage under the proposal.

Commenters generally did not raise any issues regarding the proposal's implementation of section 13(f)(2) and 13(f)(3)(B). The final rule generally implements these requirements in the same manner as the proposal.[2519]

6. Section 75.15: Other Limitations on Permitted Covered Fund Activities

Like § 75.8, § 75.17 of the proposed rule implemented section 13(d)(2) of the BHC Act, which places certain limitations on the permitted covered fund activities and investments in which a banking entity may engage. Consistent with the statute and § 75.8 of the proposed rule, § 75.17 provided that no transaction, class of transactions, or activity was permissible under §§ 75.11 through 75.14 and § 75.16 of the proposed rule if the transaction, class of transactions, or activity would: (i) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Section 75.17 of the proposed rule defined ''material conflict of interest,'' ''high-risk assets,'' and ''high-risk trading strategies'' for these purposes in a fashion identical to the definitions of the same terms for purposes of § 75.8 of the proposed rule related to proprietary trading. In the final rule, other than the permitted activities to which §§ 75.7 and 75.15 apply, §§ 75.7 and 75.15 are also identical. Comments received on the definitions in these sections, as well as the treatment of these concepts under the final rule, are described in detail in Part VI.A.9 above.

The Agencies also note that some concerns identified by commenters regarding the rule's extraterritorial application are addressed by modifications in the final rule to the definition of a covered fund under § 75.10. As noted above, commenters requested that the Agencies clarify that the limitations in §§ 75.8 or 75.17 of the proposed rule apply only to a foreign banking entity's U.S. activities and affiliates.[2520] As discussed in greater detail above in Part VI.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in § 75.10(b)(1), a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States. Foreign public funds, as defined in § 75.10(c)(1) of the final rule, are also excluded from the definition of a covered fund. By excluding foreign public funds from the definition of covered fund and by narrowing the scope of the definition of a covered fund with respect to foreign funds, the Agencies have addressed some commenters' concerns regarding the burdens imposed by proposed rule § 75.17.

C. Subpart D and Appendices A and B—Compliance Program, Reporting, and Violations

Subpart D of the proposed rule implemented section 13(e)(1) of the BHC Act and required certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on activities and investments set forth in section 13 and the proposed rule.[2521]

As explained in detail below, in response to comments on the compliance program requirements and Appendix C (Minimum Standards for Programmatic Compliance) and to conform to modifications to other sections of the proposed rule, the Agencies are adopting a variety of modifications to Subpart D of the proposed rule, which requires certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and

[2514] *See* proposed rule § 75.16(a)(2)(ii); IIB/EBF; Credit Suisse (Williams).

[2515] *See* 12 U.S.C. 1851(f)(3)(A)(ii).

[2516] 12 U.S.C. 371c–1.

[2517] *See* proposed rule § 75.16(b).

[2518] 12 U.S.C. 371c–1(a); 12 CFR 223.51.

[2519] *See* final rule § 75.14(b). As discussed above, § 75.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. A banking entity that continues to own interests in a securitization in reliance on this exemption must comply, among other things, with the requirements of § 75.14. Accordingly, § 75.14(b) of the final rule has been modified to require that a banking entity that continues to hold an ownership interest in accordance with § 75.11(b) is subject to section 23B of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate.

[2520] *See* EBF; Ass'n. of German Banks.

[2521] For Commission registrants that are swap dealers and to which this rule applies, it is noted that the compliance requirements of subpart D are included in the Commission's regulations that are to be addressed as part of the chief compliance officer duties and requirements under CFTC regulation 3.3.

covered fund activities and investments set forth in section 13 of the BHC Act and the final rule. As described above, this compliance program requirement forms a key part of the multi-faceted approach to implementing section 13 of the BHC Act, and is intended to ensure that banking entities establish, maintain and enforce compliance procedures and controls to prevent violation or evasion of the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments.

The proposal adopted a tiered approach to implementing the compliance program mandate, requiring a banking entity engaged in proprietary trading activities or covered fund activities and investments to establish a compliance program that contained specific elements and, if the banking entity's activities were significant, meet a number of more detailed minimum standards. If a banking entity did not engage in proprietary trading activities and covered fund activities and investments, it was required to ensure that its existing compliance policies and procedures included measures that were designed to prevent the banking entity from becoming engaged in such activities and making such investments and to develop and provide for the required program under § 75.20(a) of the proposed rule prior to engaging in such activities or making such investments, but was not otherwise required to meet the requirements of subpart D of the proposed rule.

1. Section 75.20: Compliance Program Mandate

a. Program Requirement

A number of commenters argued that the compliance program requirements of the proposal were overly specific, too prescriptive and complex to be workable, and not justified by the costs and benefits of having a compliance program.[2522] For instance, one commenter expressed concern that the complexity of the proposed compliance regime would undermine compliance efforts because the requirements were overlapping, imprecise, and did not provide sufficient clarity to traders or banking entities as to what types or levels of activities would be viewed as permissible trading.[2523] Some commenters argued that the compliance program would be challenging to enforce or administer with any consistency across different banking entities and jurisdictions.[2524] A few commenters objected to any attempt to identify every possible instance of prohibited proprietary trading in otherwise permitted activity.[2525] By contrast, some commenters supported the proposed compliance program as effective and consistent with the statute but also suggested a number of ways that the proposal's compliance program could be improved.[2526]

A few commenters argued that the proposed compliance program should be replaced with a more principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the structure and activities of their organizations.[2527] A few commenters argued that building on compliance regimes that already exist at banking entities, including risk limits, risk management systems, board-level governance protocols, and the level at which compliance is monitored, would reduce the costs and complexity of the proposal while also enabling a robust compliance mechanism for section 13.[2528]

Another commenter suggested that the focus of the compliance program be on the key goal of reducing risk at banking entities by requiring each banking entity to establish a risk architecture that prescribes a customer-focused business model for market making-related activities including a comprehensive set of risk limits that focuses on servicing customers and ensuring safety and soundness.[2529] This commenter suggested the proposal's compliance requirements be replaced by a simpler compliance framework that could be harmonized with the broader systemic capital and risk management framework under the Basel accord. This commenter argued such a framework would increase transparency as well as reduce overall complexity and costs of regulation, and that information relevant to the compliance infrastructure, including customer orientation policies and procedures, target customer and product lists, trade histories, and risk limit calibration methodology and analyses, should all be made available to examiners.[2530] Another commenter urged that the compliance program could be generally improved by having a greater focus on the compensation incentives within the compliance program of banking entities.[2531]

A number of other commenters requested certain types of banking entities be specifically excluded from having to implement the requirements of the compliance program. For example, some commenters urged that the details required in proposed Appendix C apply only to those banking entities and business lines within a banking group that have ''significant'' covered funds or trading activities and not apply to an affiliate of a banking entity that does not engage in the types of activities section 13 is designed to address (*e.g.,* an industrial affiliate that manufactures machinery).[2532] One commenter argued that the final rule should not impose a compliance program requirement on a banking entity that owns 50 percent or less of another banking entity in order to ensure the compliance program did not discourage joint ventures or other arrangements where a banking entity does not have actual control over an affiliate.[2533] As discussed in Part VI.B.4.c. above,[2534] other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities because insurance companies are already subject to comprehensive regulation of the kinds

[2522] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading); *see also* Barclays; BlackRock; Chamber (Dec. 2011); Comm. on Capital Markets Regulation; Credit Suisse (Williams); FIA; Goldman (Covered Funds); Investure; NYSE Euronext; RBC; STANY; Wedbush; *see also* Northern Trust; Chamber (Feb. 2012).

[2523] *See* Citigroup (Feb. 2012).

[2524] *See* ABA (Abernathy); IIB/EBF; ICFR. While the Agencies recognize these issues, the Agencies believe the final rule's modifications to the proposal—for example, providing for simplified programs for smaller, less active banking entities and increasing the asset threshold that triggers enhanced compliance requirements—helps balance enforceability and consistency concerns with implementing a program that helps to ensure compliance consistent with section 13(e)(1) of the BHC Act. *See* 12 U.S.C. 1851(e)(1).

[2525] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; STANY; *see also* Barclays.

[2526] *See* AFR (Nov. 2012); Occupy; Sens. Merkley & Levin (Feb. 2012)

[2527] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); *see also* NYSE Euronext; Stephen Roach.

[2528] *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ABA (Abernathy); Paul Volcker.

[2529] *See* Citigroup (Feb. 2012); *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2530] *See* Citigroup (Feb. 2012).

[2531] *See* Occupy.

[2532] *See, e.g.,* Credit Suisse (Williams); GE (Feb. 2012); *see also* NAIB *et al.;* Chamber (Feb. 2012).

[2533] *See* GE (Feb. 2012). Under the BHC Act, an entity would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution. Pursuant to the BHC Act, a company controls another company if, for instance, the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company. *See* 12 U.S.C. 1841(a)(2). The compliance program requirement applies to all banking entities in order to ensure their compliance with the final rule.

[2534] *See* Part VI.B.4.c.

and amounts of investments they can make under State or foreign insurance laws and regulations.[2535] However, another commenter suggested that insurance company affiliates of banking entities expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[2536]

A few commenters argued that requiring securitization vehicles to establish even the minimal requirements set forth in § 75.20(d) would impose unnecessary costs and burdens on these entities.[2537] By contrast, another commenter argued that, because of the perceived risks of these entities, securitization vehicles related to a banking entity should be required to comply fully with the proposed rule regardless of how such compliance procedures are funded by the banking entity.[2538]

Several commenters urged that foreign activities of foreign banking entities, which are already subject to their own prudential regulation under applicable home country regulation, be excluded from the compliance program and argued that to do otherwise would be an extraterritorial expansion of U.S. law.[2539] These commenters contended that the compliance program requirements for foreign banking entities should, in any event, be narrowly circumscribed.[2540] One commenter proposed that the foreign activity of foreign banking entities be excluded from compliance, reporting and other obligations where the risk of the activity is outside of the United States because those risks do not pose a threat to U.S. taxpayers.[2541] Another commenter argued that only U.S. affiliates of foreign banking entities engaged in proprietary trading and covered fund activities as principal in the United States should be required to institute the compliance and reporting systems required in the proposal, and that all foreign affiliates only be required to have policies and procedures designed to prevent the banking entity from engaging in relevant trading and covered fund activities in the United States.[2542] This commenter also expressed concern that the reporting and recordkeeping requirements could be interpreted to apply to an entire trading unit, even trading activities with no U.S. nexus, if any portion of a trading unit's activities, even a single trade, would be required to rely on the market-making, hedging, underwriting or U.S. government security exemptions.[2543]

Commenters also offered thoughts on the timeframe within which banking entities must establish a compliance program. One commenter urged that reporting begin immediately,[2544] while another commenter contended that the effective date provided banking entities with sufficient time to implement the proposal's compliance program.[2545] Other commenters, however, argued that banking entities should have additional time to establish compliance programs.[2546] Some commenters argued banking entities should have one-year from the date of publication of the final rule to implement their compliance programs,[2547] while others urged that banking entities have a two-year period to build compliance systems.[2548] One commenter suggested the Board amend its conformance rule to provide U.S. banking entities with an additional year for implementing the compliance requirements with respect to their foreign operations.[2549]

After considering comments on the proposal, the final rule retains the compliance program requirement with a variety of modifications. In particular, the modifications are designed to make the compliance program requirements clearer and more tailored to the size, complexity and type of activity conducted by each banking entity.[2550] The Agencies also believe that the revisions build on the limits, procedures and elements of risk management programs that many banking entities have already developed to monitor and control the risk of existing trading and investment activities.[2551]

The final rule builds on the proposed rule's tiered approach by adjusting asset thresholds and by adding a new provision allowing a banking entity with modest covered activities to customize its compliance program. Specifically, the final rule allows banking entities with total assets below $10 billion to fold compliance measures into their existing compliance program in a manner that addresses the types and amounts of activities the entity conducts.[2552] The proposal did not contain such a provision. Similar to the proposal, the final rule requires that a banking entity that conducts no activity subject to section 13 of the BHC Act is not required to develop any compliance program until it begins conducting activities subject to section 13.[2553] The final rule further modifies the proposal by requiring that a banking entity with total assets greater than $10 billion but less than $50 billion is generally required to establish a compliance program suited to its activities which includes the six elements described in the final rule.[2554] Additionally, the final

[2535] *See, e.g.,* ACLI (Jan. 2012); Country Fin. *et al.;* NAMIC.

[2536] *See* Sens. Merkley & Levin (Feb. 2012). As noted above, the compliance program requirement applies to all banking entities, including insurance companies that are considered banking entities, in order to ensure their compliance with the final rule.

[2537] *See* ASF (Feb. 2012); AFME *et al.;* SIFMA (Securitization) (Feb. 2012); Commercial Real Estate Fin. Council.

[2538] *See* Occupy.

[2539] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *see also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2540] *See, e.g.,* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Williams); HSBC.

[2541] *See* Australian Bankers Ass'n. (Feb. 2012); *see also* RBC.

[2542] *See* IIB/EBF.

[2543] *See* IIB/EBF.

[2544] *See* Occupy.

[2545] *See* Alfred Brock.

[2546] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *see also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012).

[2547] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Credit Suisse (Seidel); *see also* BDA (Mar. 2012).

[2548] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* GE; Credit Suisse (Williams); Goldman (Prop. Trading); Morgan Stanley; RBC; SVB.

[2549] *See* Morgan Stanley.

[2550] The Agencies believe these modifications, such as increasing the threshold that triggers enhanced compliance standards and allowing smaller banking entities to customize their compliance programs, help address concerns that the proposed requirement was too complex and unworkable. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading).

[2551] Some commenters argued that the requirement should build on banking entities' existing compliance regimes. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ABA (Abernathy); Paul Volcker.

[2552] *See* final rule § 75.20(f)(2).

[2553] *See* final rule § 75.20(f)(1). In response to a few commenters, the final rule, unlike § 75.20(d) of the proposed rule, no longer requires a banking entity include measures that are designed to prevent such entity from becoming engaged in covered trading activities or covered fund investments and activities.

[2554] Under the proposal, each banking entity was required to have a compliance program that addressed the elements described in the rule, unless the banking entity did not engage in prohibited activities or investments, in which case it need only have existing policies and procedures requiring the banking entity to develop a compliance program

rule requires that the largest and most active banking entities, with total assets above $50 billion, or that are subject to the quantitative measurements requirement due to the size of their trading assets and liabilities, adopt an enhanced compliance program that addresses the six elements described in the rule plus a number of more detailed requirements described in Appendix B.[2555]

In response to commenters' concerns regarding compliance program burdens in connection with covered fund activities and investments, the final rule is further modified with respect to thresholds for covered fund activities and investments. As noted above, this and the other modifications are designed to make the compliance program requirement clearer and more tailored to the size, complexity and type of activity conducted by each banking entity. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invests in the aggregate more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total asset thresholds discussed above, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies have also modified the compliance program reporting obligations of foreign banking entities with respect to their covered trading and covered fund activities that are conducted pursuant to the exemptions contained in §§ 75.6(e) and 75.13(b).[2556]

The final rule also responds to commenters' concerns regarding the timeframe within which a banking entity must establish and implement the compliance program required for that entity under § 75.20. Under the final rule, each banking entity must establish the compliance program required for that entity under § 75.20 as soon as practicable and in no case later than the end of the conformance period.[2557] The Agencies expect that during this period a banking entity will develop and implement the compliance program requirements of the final rule as part of its good-faith efforts to fully conform its activities and investments to the requirements of section 13 and the final rule. As explained below in the discussion of the enhanced minimum standards for compliance programs under Appendix B, the final rule also requires larger and more active banking entities to report certain data regarding their trading activities. These requirements have been phased-in to provide banking entities an opportunity to develop the necessary systems to capture and report the relevant data.[2558] In addition, as explained below, the Agencies will consider, after a period to gain experience with the data, revisiting these data collections to determine their usefulness in monitoring the risk and types of activities conducted by banking entities.

b. Compliance Program Elements

Section 75.20 of the final rule specifies six elements that each compliance program required under that section must at a minimum contain. With some minor modifications, these are the same six elements that were included in the proposed rule. The changes reflect modifications made in requirements and limits in the other provisions of the rule and, in particular, acknowledge the importance of trading and hedging limits, appropriate setting, monitoring and management review of trading and hedging limits, strategies, and activities and investments, incentive compensation and other matters.

The six elements specified in § 75.20(b) are:

- Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities and covered fund activities and investments conducted by the banking entity to ensure that all activities and investments that are subject to section 13 of the BHC Act and the rule comply with section 13 of the BHC Act and the rule;[2559]
- A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and the rule and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and the rule;[2560]
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the rule or by management as requiring attention;[2561]
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;[2562]
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and

before engaging in such activities. Further, a banking entity that has trading assets and liabilities equal to or greater than $1 billion, or equal to 10% or more of total assets, would have been subject to additional standards under the proposed rule. *See* proposed rule § 75.20(a), (c), (d).

[2555] Because the Agencies have determined not to retain proposed Appendix B in the final rule, proposed Appendix C is now Appendix B under the final rule.

[2556] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *see also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2557] As discussed in Part II., the Board is extending the conformance period by one year. Extension of the conformance period will, among other things, provide banking entities with additional time to establish the required compliance program. The Agencies believe the extension of the conformance period, as well as the phased-in approach to implementing the enhanced compliance program in Appendix B, address certain commenters' requests for additional time to establish a compliance program. *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA et al. (Covered Funds) (Feb. 2012); SIFMA et al. (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *see also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012); Morgan Stanley.

[2558] Commenters provided a wide range of feedback regarding the timeframe for establishing a compliance program, from requesting that reporting begin immediately to requesting two years from the date of publication of the final rule. *See, e.g.,* Occupy; Alfred Brock; Wells Fargo (Prop. Trading); PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies believe that the final rule's approach appropriately balances the desire for effective regulation with requests for additional time to establish a compliance program.

[2559] This requirement is substantially the same as the proposed written policies and procedures requirement. *See* proposed rule § 75.20(b)(1).

[2560] This requirement is substantially the same as the proposed internal controls requirement. *See* proposed rule § 75.20(b)(2).

[2561] The final rule modifies the proposed management framework requirement by adding that the management framework element must include appropriate management review of trading limits, strategies, hedging activities, incentive compensation, and other matters. *See* final rule § 75.20(b)(3). *See also* proposed rule § 75.20(b)(3). One commenter suggested that the compliance program requirement have a greater focus on compensation incentives. *See* Citigroup (Feb. 2012).

[2562] The final rule modifies the proposed independent testing requirement by specifying that such testing must be done ''periodically.'' *See* final rule § 75.20(b)(4). *See also* proposed rule § 75.20(b)(4). The meaning of ''independent testing'' is discussed in more detail below in Part VI.C.2.e. The reference to ''audit'' does not mean that the independent testing must be performed by a designated auditor, whether internal or external.

enforce the compliance program;[2563] and

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

Under the final rule, these six elements must be part of the compliance program of each banking entity with total consolidated assets greater than $10 billion that engages in activities covered by section 13 of the BHC Act.

As discussed above, the Agencies have moved particular elements with respect to the required compliance program for the exemptions contained in § 75.4(a), § 75.4(b), and § 75.5 into the specific requirements of these exemptions. The Agencies believe this structure more effectively conveys that satisfying the requirements of these exemptions involves specific compliance measures or, with respect to underwriting and market making, a customer-focused business model, as requested by some commenters.[2564]

In addition to the generally required compliance program elements specified in § 75.20(b), a banking entity relying on any of these exemptions should employ the specific compliance tools specified within the relevant section of this rule to facilitate compliance with the applicable exemption and should appropriately tailor the required compliance program elements to the individual trading activities and strategies of each trading desk on an ongoing basis. By specifying particular compliance program-related requirements in the exemptions, the Agencies have sought to provide additional guidance and clarity as to how a compliance program should be structured,[2565] while at the same time providing the banking entity with sufficient discretion to consider the type, size, scope and complexity of its activities and business structure in designing a compliance program to meet the requirements set forth in § 75.20(b).[2566]

For a banking entity with more than $10 billion in total consolidated assets, the compliance program requires additional documentation with respect to funds. For example, the banking entity is required to maintain records that include documentation of exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliate) in determining that such fund is not a covered fund.[2567] The banking entity is also required to maintain, with respect to each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions provided by §§ 75.10(c)(1), 75.10(c)(5), 75.10(c)(8), 75.10(c)(9), or 75.10(c)(10) of subpart C, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions.[2568] If the banking entity operates a seeding vehicle described in §§ 75.10(c)(12)(i) or 75.10(c)(12)(iii) of subpart C that will become a registered investment company or SEC-regulated business development company, the compliance program must also include a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § 75.12(a)(2)(i)(B) of subpart C.[2569] Furthermore, for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interest in foreign public funds as described in § 75.10(c)(1) of subpart C owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, such banking entity must include in its compliance program documentation the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized. Such calculation must be done at the end of each calendar quarter and must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters.[2570]

c. Simplified Programs for Less Active Banking Entities

The proposed rule provided that the six elements of the compliance program required by § 75.20 would apply to all banking entities engaged in covered trading activities or covered fund activities and investments and that the minimum detailed standards of Appendix C would apply to only those banking entities above specified thresholds. The application of detailed minimum standards was intended to reflect the heightened compliance risks of significant covered trading and

[2563] The final rule retains the proposed training requirement. *See* final rule § 75.20(b)(5). *See also* proposed rule § 75.20(b)(5).

[2564] One of these commenters suggested the Agencies adopt a simpler compliance framework that could be harmonized with the Basel accord. *See* Citigroup (Feb. 2012). The Agencies believe the final framework described above helps address concerns about streamlining the compliance program requirement while meeting the statutory requirement to issue regulations ''in order to insure compliance'' with section 13. 12 U.S.C. 1851(e)(1).

[2565] One commenter stated that the proposed rule did not provide sufficient clarity as to what types or levels of activities would be permissible. *See* Citigroup (Feb. 2012).

[2566] Some commenters requested a more principles-based framework that allows banking entities to customize compliance programs to the structure and activities of their organizations. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); NYSE Euronext; Stephen Roach.

[2567] *See* final rule § 75.20(e)(1). As discussed under § 75.10 regarding entities excluded from the definition of covered fund, the Agencies recognize that the final rule's definition of covered fund does not include certain pooled investment vehicles. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule. The Agencies are adopting this additional documentation requirement to facilitate such monitoring activities.

[2568] *See* final rule § 75.20(e)(2). The Agencies are adopting this additional documentation requirement for the same reasons discussed above with respect to § 75.20(e)(1).

[2569] *See* final rule § 75.20(e)(3). The rationale for this additional documentation requirement is provided under the discussion regarding registered investment companies and business development companies in § 75.10.

[2570] *See* final rule § 75.20(e)(4). The rationale for this additional documentation requirement is provided under the discussion regarding foreign public funds in § 75.10. For purposes of this requirement, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. *See* final rule § 75.20(e)(5).

significant covered fund activities and investments.

The proposed rule provided that a banking entity with no covered activities or investments could satisfy the requirements of § 75.20 if its existing compliance policies and procedures were amended to include measures that were designed to prevent the banking entity from becoming engaged in such activities or making such investments and required the banking entity to develop and provide for the required compliance program prior to engaging in covered activities or making covered investments.

Several commenters expressed concern over the requirement in § 75.20(d) of the proposed rule that a banking entity that did not engage in any covered trading activities or covered fund activities or investments must ensure that its existing compliance policies and procedures include measures designed to prevent the banking entity from becoming engaged in such activities and making such investments.[2571] In particular, some commenters expressed concern that the proposal would have a burdensome impact on community banks and force community banks to hire specialists to amend their policies and procedures to ensure compliance with section 13 and the final regulations. These commenters argued that a banking entity should not be required to amend its compliance policies and procedures and set up a monitoring program if the banking entity does not engage in prohibited activities.[2572]

A few commenters argued that the Agencies should more carefully consider the burden of the compliance program on smaller institutions that engage in a modest level of permissible trading or covered fund activity.[2573] One commenter recommended that smaller banks be given the benefit of the doubt regarding compliance.[2574] For instance, one commenter recommended that banking entities with consolidated assets of $10 billion or less be permitted to engage in a limited amount of interest rate swaps and certain other traditional banking activities without being required to establish a compliance program.[2575]

The Agencies have considered carefully the comments received and, as noted above, have modified the rule in order to limit the implementation, operational or other burdens or expenses associated with the compliance requirements for a banking entity that engages in no covered activities or investments. The final rule permits banking entities that have no covered activities or investments (other than covered transactions in obligations of or guaranteed by the United States or an agency of the United States and municipal securities) to satisfy the compliance program requirements by establishing the required compliance program prior to becoming engaged in such activities or making such investments. This eliminates the burden on banking entities that do not engage in covered activities or investments.

Similarly, § 75.20(f)(2) of the final rule provides that a banking entity with total consolidated assets of $10 billion or less as measured on December 31 of the previous two years that does engage in covered activities and investments may satisfy the requirements of § 75.20 by including in its existing compliance policies and procedures references to the requirements of section 13 and subpart D as appropriate given the activities, size, scope and complexity of the banking entity.[2576] This could include appropriate references to the limits on trading activities permitted in reliance upon any of the exemptions contained in § 75.4(a), § 75.4(b) or § 75.5.

d. Threshold for Application of Enhanced Minimum Standards

Under the proposed rule, banking entities with significant covered trading activities or covered fund activities and investments were required to establish an enhanced compliance program in accordance with Appendix C, which contained detailed compliance program requirements. The proposed rule required a banking entity to implement the enhanced compliance program under Appendix C if the banking entity engaged in covered activities and investments and either: (i) Has, on a consolidated basis, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion or equals 10 percent or more of its total assets; or (ii) has, on a consolidated basis, aggregate investments in covered funds the average value of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion, or sponsors and advises one or more covered funds the total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

In general, commenters argued that the activities and investments subject to section 13 are conducted by only a small number of the nation's largest financial firms and that the compliance program requirements should be tailored to target these firms.[2577] Some commenters urged the Agencies to raise substantially the proposed $1 billion threshold for trading assets and liabilities in § 75.20(c)(2) of the proposal to $10 billion or higher due to the high costs of implementing the enhanced compliance program. A few commenters argued that even if the threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements included in Appendix C.[2578] Some of these commenters recommended the threshold for trading assets for compliance should be increased to no less than $10 billion to mitigate the costs and impact on regional banking organizations that do not engage proprietary trading subject to the prohibition of section 13. These commenters argued that the compliance requirements of § 75.20(a)–(b) are sufficient to ensure that regional banking organizations have appropriate compliance programs.[2579] One commenter suggested the threshold for the enhanced compliance requirement be increased to $50 billion in combined

[2571] *See, e.g.,* ICBA; ABA (Keating); Conf. of State Bank Supervisors; NAIB; Ryan Kamphuis; Wisconsin Bankers Ass'n.

[2572] *See, e.g.,* ICBA; ABA (Keating).

[2573] *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB.

[2574] *See* Sens. Merkley & Levin (Feb. 2012).

[2575] *See* ICBA.

[2576] Some commenters asked the Agencies to consider the burden of the compliance program requirement on smaller institutions and recommended that small banks be given the benefit of the doubt regarding compliance. *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB. The Agencies decline to follow the approach suggested by another commenter to allow banking entities with assets of $10 billion or less be permitted to engage in certain limited activities without having to establish a compliance program. *See* ICBA. The Agencies believe that requiring a banking entity engaged in covered trading or covered fund activity to establish a compliance program is a fundamental part of the multi-faceted approach to implementing section 13 of the BHC Act, which requires the Agencies to implement rules ''to insure compliance with this section.'' 12 U.S.C. 1851(e)(1). Further, the Agencies believe that the final rule's modification of the proposal to allow banking entities with total assets under $10 billion to customize their compliance programs helps ease the burden of this requirement on smaller institutions.

[2577] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); PNC *et al.*

[2578] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2579] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy).

trading assets and liabilities.[2580] One commenter also argued that banking entities required to establish enhanced compliance programs should no longer be required to do so if they fall below the threshold.[2581]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which compliance program requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold triggering the enhanced compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering Appendix C.[2582] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2583] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2584] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be included in the $1 billion standard for becoming subject to any reporting and recordkeeping requirements under the final rule.[2585]

A few commenters argued that the $1 billion threshold for establishing an enhanced compliance program should not include the amount of investments in, or assets of, funds that are SBICs or similar funds that contain, SBICs or other investments specified under section 13(d)(1)(E) of the BHC Act, such as investments in and funds that qualify for low-income housing tax credits, or New Markets Tax Credits or that qualify for Federal historic tax credits or similar state programs.[2586] These commenters argued that each of these types of funds is expressly permitted by the statute and that including these investments and funds in the dollar thresholds that trigger the programmatic compliance requirements of Appendix C would provide a disincentive to banking entities investing in or sponsoring these funds, a result inconsistent with permitting these types of investments. Similarly, one commenter urged that investments by a banking entity in, and assets held by, loan securitizations not be included in these thresholds because these activities and investments are expressly excluded from coverage under the rule of construction contained in section 13(g)(2) of the BHC Act regarding the securitization of loans.[2587] Another commenter urged that this threshold not include investments in, or assets of, any securitization vehicle that would be considered a covered fund because many smaller and regional banking entities that were not intended to be subject to Appendix C likely would exceed the $1 billion threshold if these assets are included.[2588] A few commenters also argued that, during the conformance period, investments in, and relationships with, a covered fund that a banking entity is required to terminate or otherwise divest in order to comply with section 13 should not be included for purposes of calculating the compliance thresholds.[2589]

After considering comments received on the proposal and in order to implement a compliance program requirement that is consistent with the purpose and language of the statute and rule while at the same time appropriately calibrating the associated resource burden on banking entities, the final rule applies the enhanced minimum standards contained in Appendix B to only those banking entities with the most significant covered trading activities or those that meet a specified threshold of total consolidated assets. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invest in the aggregate more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total consolidated asset thresholds, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies believe that commenters' concerns about whether certain types of covered fund investments or activities (e.g., amounts or relationships held during the conformance period) are included for purposes of calculating the enhanced compliance thresholds are addressed because under the final rule, the enhanced compliance thresholds are based on total consolidated assets and not the amount of covered fund investments and activities. Similar to the proposed rule, which provided that a banking entity could be subject to the enhanced compliance program if the Agency deemed it appropriate, the final rule's enhanced compliance program also could apply if the Agency notifies the banking entity in writing that it must satisfy the requirements.[2590]

Section 75.20 provides that three categories of banking entities will be subject to the enhanced minimum standards contained in Appendix B. The first category is any banking entity that engages in proprietary trading and is required to report metrics regarding its trading activities to its primary Federal supervisory agency under the final rule.[2591] This category includes a banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities that equal or exceed $50 billion based on the average gross sum of trading assets and liabilities (on a worldwide consolidated basis and after excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters. A foreign banking entity with U.S. operations is required to adopt an enhanced compliance program if its total trading assets and liabilities across all its U.S. operations equal or exceed $50 billion (after excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. or any agency of the U.S.). While these banking entities will be required to begin to report and record quantitative measurements by June 30, 2014, they will not be required to implement an enhanced compliance program by this date. Instead, as discussed above, a banking entity must establish a compliance program as soon as practicable and in no event later than the end of the conformance period. As explained more fully in Part VI.C.3., this category expands over time to include

[2580] *See* State Street (Feb. 2012).

[2581] *See* ABA (Keating).

[2582] *See* PNC *et al.*

[2583] *See* PNC *et al.*

[2584] *See* Northern Trust.

[2585] *See* Occupy.

[2586] *See* ABA (Keating); PNC *et al.*

[2587] *See* PNC *et al.*

[2588] *See* ASF (Feb. 2012).

[2589] *See* PNC *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2590] *See* proposed rule § 75.20(c)(2)(iii); final rule § 75.20(c)(3).

[2591] Issues related to the threshold for reporting quantitative measurements are discussed in detail in Part VI.C.3., below.

any banking entity with trading assets and liabilities that equal or exceed $10 billion (as measured in the manner described above). For banking entities below the $50 billion threshold that become subject to the quantitative measurements requirement through the phased-in approach, they will not become subject to the enhanced compliance program until the date they are required to comply with the quantitative measurements requirement. However, these banking entities will be required to have a compliance program that meets the requirements of § 75.20(b) by the end of the conformance period. Thus, banking entities with between $25 billion and $50 billion trading assets and liabilities (as described in § 75.20(d)) will be required to implement an enhanced compliance program under Appendix B by April 30, 2016. Similarly, banking entities with between $10 billion and $25 billion trading assets and liabilities will be subject to the requirements of Appendix B by December 31, 2016.

After considering comments, the Agencies have increased the trading asset and liability thresholds triggering the enhanced compliance program requirements. The Agencies believe that banking entities with a significant amount of trading assets should have the most detailed programs for ensuring compliance with the trading and other requirements of section 13 of the BHC Act and the final rule. Specifically, consistent with the thresholds for reporting and recording quantitative measurements, the threshold will initially be $50 billion trading assets and liabilities and, over time, will be reduced to $10 billion.[2592] As noted by commenters, these thresholds will continue to capture a significant percentage of the total trading assets and liabilities in the banking system, but will reduce the burdens to smaller, less complex banking entities.[2593] With respect to this first category, the Agencies determined, in response to comments,[2594] that the threshold for proprietary trading should not include trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States. This approach reduces the burdens associated with the enhanced minimum compliance program on banking entities whose trading operations consist primarily of trading U.S. government or agency obligations, which are generally exempt from the proprietary trading prohibition under § 75.6(a)(1)(i). While some commenters argued that additional assets or liabilities, such as securitizations or investments in SBICs, should be excluded from the calculation,[2595] the Agencies believe that trading in other assets involves more complex trading activity and warrants being included in the threshold calculation for applying the enhanced compliance program requirement.

To balance the increased trading asset and liability threshold with the goal of requiring appropriate specificity and rigor for large and complex banking organizations' compliance programs, the Agencies have determined to also require an enhanced compliance program for any banking entity that has reported total consolidated assets, as of the previous calendar year-end, of $50 billion or more. Banking entities with total assets of $50 billion or more are among the most complex banking entities and have been found by Congress to pose sufficient risk to the financial stability of the United States to warrant being generally subject to enhanced prudential standards under section 165 of the Dodd-Frank Act. With respect to foreign banking entities, this threshold is calculated by reference solely to the aggregate assets of the foreign banking entity's U.S. operations, including its U.S. branches and agencies. This approach is consistent with the statute's focus on the risks posed by covered trading activities and investments within the United States and also responds to commenters' concerns regarding the level of burden placed on foreign banking entities with respect to their foreign operations.[2596]

The third category includes any banking entity that is notified by its primary Federal supervisory Agency in writing that it must satisfy the requirements and other standards contained in Appendix B. By retaining the flexibility to impose enhanced compliance requirements on a given banking entity upon specific notice to the firm, the Agencies have the ability to apply additional standards to any banking entity with a mix, level, complexity or risk of activities that, in the judgment of the relevant supervisory Agency, indicates that the firm should appropriately have in place an enhanced compliance program.

Some commenters argued that the final rule should not require a banking entity to establish the type of detailed compliance regime dictated by Appendix C for both trading and covered fund activities and investments simply because the banking entity engages in one but not the other activity.[2597]

To comply with the applicable compliance program requirements under § 75.20 and Appendix B of the final rule, banking entities should appropriately take into account the type, size, scope and complexity of their activities and business structure in determining the terms, scope and detail of the compliance program to be instituted.[2598] For example, if all of a banking entity's activities subject to the rule involve covered fund activities or investments, it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the proprietary trading provision of the rule. Similarly, if a banking entity engages only in activities that are subject to the proprietary trading provisions of the rule and does not engage in any covered fund activities or investments, it would not be expected that the banking entity would implement the same detailed compliance program under the covered funds section as would be required for its proprietary trading activities. In each of these situations, the banking entity would be expected to put in place sufficient controls to ensure that an appropriate compliance program is established before the banking entity commences a new covered activity. The

[2592] Some commenters requested raising this dollar threshold to at least $10 billion. *See* PNC *et al.;* PNC; ABA (Keating). One commenter suggested the threshold be increased to $50 billion. *See* State Street (Feb. 2012).

[2593] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy); ABA (Keating). The Agencies recognize that, at the $10 billion threshold, a significant percentage of the trading assets and liabilities in the banking industry will remain subject to the enhanced compliance program requirement. *See* PNC.

[2594] *See* PNC *et al.*

[2595] *See, e.g.,* ABA (Keating) (suggesting the threshold should not include the amount of investments in or assets of SBICs, or those that qualify for low-income housing tax credits (LIHTC) New Markets Tax Credits (NMTC), or Federal historic tax credits (HTC)); PNC *et al.* (loans); Northern Trust.

[2596] Several commenters requested that foreign activities of foreign banking entities be excluded from the compliance program requirement. *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de Mexico; Norinchukin. One commenter stated the only U.S. affiliates of foreign banking entities should be required to institute the proposed reporting and compliance requirements. *See* IIB/EBF.

[2597] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2598] This is generally consistent with the proposed rule's compliance program requirement. *See* proposed rule § 75.20(a) (requiring that the banking entity's compliance program be appropriate for the size, scope and complexity of activities and business structure of the banking entity).

Agencies believe that this treatment is consistent with the statutory language regarding internal controls and recordkeeping to ensure compliance with section 13 and also reduces unnecessary costs and burdens associated with requiring banking entities to implement compliance requirements that are not appropriate to the size, scope and risk of their relevant activities.

2. Appendix B: Enhanced Minimum Standards for Compliance Programs

The proposed rule contained an appendix (Appendix C) which specified a variety of minimum standards applicable to the compliance program of a banking entity with significant covered trading activities or covered fund activities and investments. The Agencies proposed to include these minimum standards as part of the regulation itself, rather than as accompanying guidance, reflecting the compliance program's importance within the general implementation framework for the rule.

As explained above, the Agencies continue to believe that the inclusion of specified minimum standards for the compliance program within the regulation itself rather than as accompanying guidance serves to reinforce the importance of the compliance program in the implementation framework for section 13 of the BHC Act. As explained above, the Agencies believe that large banking entities and banking entities engaged in significant trading activities should establish, maintain and enforce an enhanced compliance program. The requirements for an enhanced compliance program have been consolidated in Appendix B of the final rule.

Similar to the proposed rule, section I of Appendix B provides that the enhanced compliance program must:

- Be reasonably designed to identify, document, monitor and report the covered trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and the rule;
- Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and the rule;
- Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;
- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program; and
- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

The proposed rule included several definitions within the appendix. In the final rule, all definitions have been moved to other sections of the rule or into Appendix A (governing metrics). Any banking entity subject to the enhanced minimum standards contained in Appendix B may incorporate existing policies, procedures and internal controls into the compliance program required by Appendix B to the extent that such existing policies, procedures and internal controls assist in satisfying the requirements of Appendix B.

Section II of Appendix B contains two parts: One that sets forth the enhanced minimum compliance program standards applicable to covered trading activities of a banking entity and one that sets forth the corresponding enhanced minimum compliance program standards with respect to covered fund activities and investments. As noted above, if all of a banking entity's activities subject to the final rule involve only covered trading activities (or only covered fund activities and investments), it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the covered funds (or proprietary trading) provisions of the rule. As discussed below, the Agencies have determined not to include the provisions regarding enterprise-wide compliance programs.

a. Proprietary Trading Activities

Like the proposed compliance appendix, section II.a of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities.[2599] This portion of Appendix B requires a banking entity to devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its covered trading activities, and to promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program and changes in legal, regulatory or other requirements.

Similar to the proposed rule, section II.a of Appendix B requires a banking entity subject to the Appendix to: (i) Have written policies and procedures governing each trading desk that include a description of certain information specific to each trading desk that will delineate its processes, mission and strategy, risks, limits, types of clients, customers and counterparties and its compensation arrangements; (ii) include a comprehensive description of the risk management program for the trading activity of the banking entity, as well as a description of the governance, approval, reporting, escalation, review and other processes that the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and subpart B; (iii) implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and subpart B and with the banking entity's policies and procedures, and establish and enforce risk limits appropriate for the activity of each trading desk; and (iv) for any hedging activities that are conducted in reliance on the exemption contained in § 75.5, establish, maintain and enforce policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that describe the positions, techniques and strategies that each trading desk may use, the manner in which the banking entity will determine that the risks generated by each trading desk have been properly and effectively hedged, the level of the organization at which

[2599] *See* Joint Proposal, 76 FR at 68963.

hedging activity and management will occur, the management in which such hedging strategies will be monitored and the personnel responsible for such monitoring, the risk management processes used to control unhedged or residual risks, and a description of the process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § 75.5.

To the extent that any of the standards contained in Appendix B may be appropriately met by policies and procedures, internal controls and other requirements that are common to more than one trading desk, a banking entity may satisfy the requirements for the enhanced minimum standards of the compliance program by implementing such common requirements with respect to any such desks as to which they are appropriately applicable.[2600] To the extent the required elements of the compliance program apply differently to different trading desks that conduct trading in the same financial instruments, a banking entity must document the differences and adopt policies and procedures and implement internal controls specific to each of the different trading desks. Overall, the policies and procedures should provide the Agencies with a clear, comprehensive picture of a banking entity's covered trading activities that can be effectively reviewed.

Appendix B also requires that the banking entity perform robust analysis and quantitative measurement of its covered trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. In particular, the banking entity must incorporate into its compliance program any quantitative measure reported by the banking entity pursuant to Appendix A where applicable, and include at a minimum: (i) Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of the quantitative measures employed; (ii) ongoing timely monitoring and review of calculated quantitative measurements; (iii) the establishment of thresholds and trading measures for each trading desk and heightened review of any trading activity that is inconsistent with those thresholds; and (iv) review, investigation and escalation with respect to matters that suggest a reasonable likelihood that a trading desk has violated any part of section 13 of the BHC Act or the rule.[2601]

Where a banking entity is subject to the reporting requirements of Appendix A, any additional quantitative measurements developed and implemented by the banking entity under the compliance program requirement are not required to be routinely submitted to the relevant Agency as provided in Appendix A, but are subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request. Where a banking entity is not subject to the requirements of Appendix A, that banking entity would likewise not be required by this rule to routinely submit these additional quantitative measurements to the relevant Agency, but would be subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request.

In addition to the other requirements that are specific to proprietary trading, the banking entity's compliance program must identify the activities of each trading desk that will be conducted in reliance on the exemptions contained in §§ 75.4 through 75.6, including an explanation of (i) how and where in the organization such activity occurs, and (ii) which exemption is being relied on and how the activity meets the specific requirements of such exemption. For trading activities that rely on an exemption contained in §§ 75.4 through 75.6, the banking entity's compliance program should include an explanation of how, and its policies, procedures and internal controls that demonstrate that, such trading activities satisfy such exemption and any other requirements of section 13 of the BHC Act and the final rule that are applicable to such activities. A foreign banking entity that engages in proprietary trading in reliance on the exemption contained in § 75.6(e) will be expected to provide information regarding the compliance program implemented to ensure compliance with the requirements of that section, including compliance by the U.S. operations of the foreign banking firm, but will only be expected to provide trading information regarding activity conducted within the United States (absent an indication of activity conducted or designed to evade the requirements of section 13 of the BHC Act of the final rule).[2602]

In addition, the compliance program must describe the process for ensuring that liquidity management activities are conducted in conformance with the limits and policies contained in § 75.3(d)(3). This includes processes for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any proprietary trading activity that may indicate potential violations of section 13 of the BHC Act and subpart B and to prevent violations of section 13 of the BHC Act and subpart B. The standards set forth in subpart D direct the banking entity to include requirements in its compliance program for documenting remediation efforts, assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the implementation of the compliance program.

b. Covered Fund Activities or Investments

Section II.b of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

The enhanced compliance program requirements for covered funds and investments focus on: (i) Ensuring that the compliance program provides a process for identifying all covered funds that the banking entity sponsors, organizes or offers, and covered funds in which the banking entity invests; (ii) ensuring that the compliance program provides a method for identifying all funds and pools that the banking entity sponsors or has an interest in and the type of exemption from the Investment Company Act or Commodity Exchange Act (whether or not the fund relies on section 3(c)(1) or 3(c)(7) of the

[2600] This is consistent with proposed Appendix C, except that the term ''trading unit'' from the proposal has been replaced with the term ''trading desk.'' *See* Joint Proposal, 76 FR at 68965.

[2601] *See* Joint Proposal, 76 FR at 68965.

[2602] *See* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Seidel); HSBC.

Investment Company Act or section 4.7 of the regulations under the Commodity Exchange Act), and the amount of ownership interest the banking entity has in those funds or pools; (iii) identifying, documenting, and mapping where any covered fund activities are permitted to be conducted within the banking entity; and (iv) including an explanation of compliance; (v) describing sponsorship activities related to covered funds; and (vi) establishing, maintaining and enforcing internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and subpart C, and (vii) monitoring of the banking entity's investments in and transactions with any covered funds.

In addition, the banking entity's compliance program must document the banking entity's plan for seeking unaffiliated investors to ensure that any investment by the banking entity in a covered fund conforms to the limits contained in the final rule or that the covered fund is registered in compliance with the securities laws within the conformance period provided in the final rule. Similarly, the compliance program must ensure that the banking entity complies with any limits on transactions or relationships with the covered fund contained in the final rule, including in situations in which the banking entity is designated as a sponsor, investment manager, investment adviser or commodity trading adviser by another banking entity.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity that may indicate potential violations of section 13 of the BHC Act and subpart C. The standards set forth in subpart D require the banking entity to include requirements in its compliance program for documenting remediation efforts, assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the design or implementation of the compliance program.

c. Enterprise-Wide Programs

Appendix C in the proposed rule contained a provision that permitted a banking entity to establish a compliance program on an enterprise-wide basis. Some commenters argued that a less specific and more flexible compliance regime would be essential to make the enterprise-wide compliance structures contemplated in Appendix C effective because requiring individualized policies and procedures for each business line would diminish the benefits of enterprise-wide compliance and prevent consistency of these policies and procedures within the banking entity.[2603] One of these commenters recommended the Agencies provide greater options for developing a compliance program and not limit a banking entity to a choice between a single enterprise-wide program or a separate program for each subsidiary engaged in activities covered by the proposed rule.[2604]

In contrast, one commenter argued that any enterprise-wide compliance program would only be effective if combined with additional programs at the trading unit or subsidiary level to train all employees at a banking entity.[2605] This commenter argued that each trading unit is different and suggested that it would be more efficient to mandate enterprise-wide default internal controls, but provide each individual trading unit the flexibility to tailor these requirements to its own specific business.[2606] This commenter also urged that Appendix C's elements III (internal controls), IV (responsibility and accountability) and VII (recordkeeping) should not be imposed solely at the enterprise-wide level.[2607]

After considering carefully the comments on the proposal, the Agencies have removed the reference to an enterprise-wide compliance program from the final rule; however, the Agencies acknowledge that a banking entity may establish a compliance program on an enterprise-wide basis, as long as the program satisfies the requirements of § 75.20 and, where applicable, Appendix B. A banking entity may employ common policies and procedures that are established at the enterprise-wide level or at a business-unit level to the extent that such policies and procedures are appropriately applicable to more than one trading desk or activity, as long as the required elements of Appendix B and all of the other applicable compliance-related provisions of the rule are incorporated in the compliance program and effectively administered across trading desks and banking entities within the consolidated enterprise or designated business. If a banking entity establishes an enterprise-wide program, like a non-enterprise wide program, that program will be subject to supervisory review and examination by any Agency vested with rule writing authority under section 13 of the BHC Act with respect to the compliance program and the activities or investments of each banking entity for which the Agency has such authority.[2608] The banking organization would be expected to provide each appropriate Agency with access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rule writing authority.

For similar reasons, the Agencies have determined not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13.[2609] At this time the Agencies do not believe such an approach would be consistent with the statute, which requires each Agency to adopt a rule for the types of banking entities under its jurisdiction,[2610] or effective given the different authorities and expertise of each Agency. The Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.[2611]

d. Responsibility and Accountability

Section III of Appendix B includes the enhanced minimum standards for responsibility and accountability. Section III contains many of the provisions contained in the proposed rule relating to responsibility and accountability, with certain modifications.[2612] Section III requires a banking entity to establish, maintain and enforce both a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and the rule. The standards in Section III focus on four key constituencies—the board of directors,

[2603] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2604] *See* Wells Fargo (Prop. Trading).

[2605] *See* Occupy.

[2606] *See* Occupy.

[2607] *See* Occupy.

[2608] *See* 12 U.S.C. 1851(b)(2)(B)(i).

[2609] *See* Barclays; Goldman (Prop. Trading); BoA; SIFMA Funds *et al.* (Prop. Trading) (Feb. 2012); Comm. on Capital Markets Regulation.

[2610] *See* 12 U.S.C. 1851(b)(2)(B).

[2611] Accordingly, the SEC's and the CFTC's final rules, unlike the applicable proposals, do not incorporate by reference the rules and interpretations of the Federal banking agencies with respect to covered fund activities or investments. *See* SEC proposed rule § 255.10(a)(2), Joint Proposal, 76 FR at 68942–68943, and CFTC Proposal, 77 FR at 8421–8423.

[2612] *See* Joint Proposal, 76 FR at 68966.

the CEO, senior management, and business line managers. Certain of the standards contained in the proposed rule relating to business management are separately covered by specific requirements contained in sections II.a and II.b of Appendix B. Section III makes it clear that the board of directors, or similar corporate body, and the CEO and senior management are responsible for creating an appropriate ''tone at the top'' by setting an appropriate culture of compliance and establishing clear policies regarding the management of the firm's trading activities and its fund activities and investments. Senior management must be made responsible for communicating and reinforcing the culture of compliance established by it and the board of directors, for the actual implementation and enforcement of the approved compliance program, and for taking corrective action where appropriate.

In response to a question in the preamble to the proposed rule regarding whether the chief executive officer or similar officer of a banking entity should be required to provide a certification regarding the compliance program requirements, a few commenters urged that the final rule should not require that the board of directors or CEO of a banking entity review or certify the effectiveness of the compliance program.[2613] These commenters argued that existing processes developed by large, complex banking entities for board of director reporting and governance processes ensure that compliance programs work appropriately, and argued that these protocols would establish appropriate management and board of directors' oversight of the section 13 compliance program.[2614] By contrast, several commenters advocated requiring CEO attestation regarding compliance with section 13.[2615] One commenter suggested that the rule require an annual assessment by management of the effectiveness of internal controls and policies and require a public accounting firm to attest to the accuracy of those annual assessments.[2616]

After considering comments received on the proposal, the Agencies have determined to include a requirement in the final rule that a banking entity's CEO annually attest in writing to the appropriate Agency for the banking entity that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix B and § 75.20 of the rule in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this rule. Although some commenters stated that existing protocols of certain banking entities would establish appropriate oversight of the rule's compliance program,[2617] the Agencies believe this requirement will better help to ensure that a strong governance framework is implemented with respect to compliance with section 13 of the BHC Act, and that it more directly underscores the importance of CEO engagement in the governance and management framework supporting compliance with the rule. In the case of the U.S. operations of a foreign banking entity, including a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations of the foreign banking entity who is located in the United States.

e. Independent Testing

Section IV of the Appendix B includes the enhanced minimum standards for independent testing, which are substantially similar to the proposed independent testing standards.[2618] A banking entity subject to Appendix B must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the trading desk or other organizational unit being tested, outside auditors, consultants, or other qualified independent parties. If a banking entity uses internal personnel to conduct the independent testing, the Agencies would expect that the banking entity ensure that the personnel responsible for the testing are separate from the unit and functions being tested (*e.g.,* the personnel do not report to a person who is directly responsible for the unit or involved in the functions being tested) and have knowledge of the requirements of section 13 and its implementing rules. Although an external audit is not required to meet the independent testing requirement, the Agencies would expect that, when external auditors are engaged to review compliance by a banking entity with laws and regulations, the banking entity would give appropriate consideration to the need to review the compliance program required under this rule.

While one commenter suggested the final rule prescribe the precise manner in which a banking entity must conduct its compliance testing,[2619] the Agencies believe such a requirement is unnecessary because the standards in the final rule will ensure that independent testing of the effectiveness of a banking entity's compliance program is objective and robust. The independent testing must examine both the banking entity's compliance program and its actual compliance with the rule. This testing must include not only testing of the overall adequacy and effectiveness of the compliance program and compliance efforts, but also the effectiveness of each element of the compliance program and the banking entity's compliance with each provision of the rule. This requirement is intended to ensure that a banking entity continually reviews and assesses, in an objective manner, the strength of its compliance efforts and promptly identifies and remedies any weaknesses or matters requiring attention within the compliance framework.

f. Training

Like the proposed compliance appendix, Section V of Appendix B includes the enhanced minimum standards for training.[2620] It requires that a banking entity provide adequate training to its trading personnel and managers, as well as other appropriate personnel, in order to effectively implement and enforce the compliance program. In particular, personnel engaged in covered trading activities and investments should be educated with respect to applicable prohibitions and restrictions, exemptions, and compliance program elements to an extent sufficient to permit them to make informed, day-to-day decisions that

[2613] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2614] *See* SIFMA *et al.* (Prop. Trading); *see also* Wells Fargo (Prop. Trading).

[2615] *See* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Ralph Saul (Oct. 2011); John Reed; *see also* BEC *et al.* (Oct. 2011); Matthew Richardson.

[2616] *See* Merkley & Levin (Feb. 2012).

[2617] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Wells Fargo (Prop. Trading).

[2618] *See* Joint Proposal, 76 FR at 68967.

[2619] One commenter suggested that any compliance testing under the final rule be monitored by the Agencies and initially tested by internal audit personnel of the banking entity who are subject to a specific licensing and registration process for section 13 of the BHC Act and supplemented by an annual independent external review. *See* Occupy; *see also* proposed rule § 75.20(b)(4). The Agencies believe it would be unnecessarily burdensome to require particular licensing and registration processes for internal auditors that are specific to section 13 of the BHC Act.

[2620] *See* Joint Proposal, 76 FR at 68967.

support the banking entity's compliance with section 13 of the BHC Act and the rule. In particular, any personnel with discretionary authority to trade, in any amount, should be appropriately trained regarding the differentiation of prohibited proprietary trading and permitted trading activities and given detailed guidance regarding what types of trading activities are prohibited. Similarly, personnel providing investment management or advisory services, or acting as general partner, managing member, or trustee of a covered fund, should be appropriately trained regarding what covered fund activities and investments are permitted and prohibited.

g. Recordkeeping

Section VI of Appendix B contains the enhanced minimum standards for recordkeeping which are consistent with the proposed recordkeeping standards.[2621] Generally, a banking entity must create records sufficient to demonstrate compliance and support the operation and effectiveness of its compliance program (*i.e.,* records demonstrating the banking entity's compliance with the requirements of section 13 of the BHC Act and the rule, any scrutiny or investigation by compliance personnel or risk managers, and any remedies taken in the event of a violation or non-compliance), and retain these records for no less than five years in a form that allows the banking entity to promptly produce these records to any relevant Agency upon request. Records created and retained under the compliance program must include trading records of the trading units, including trades and positions of each such unit. Records created and retained under the enhanced compliance program must also include documentation of any exemption in the final rule relied on by the banking entity to invest in or sponsor a covered fund.

While one commenter requested that the period for retaining records be extended from 5 years to 6 years, the final rule does not make this change.[2622] The Agencies believe that 5 years is an appropriate minimum period for requiring retention of records to demonstrate compliance with the final rule. The final rule allows the Agencies to require a banking entity to retain records for a longer period if appropriate.

3. Section 75.20(d) and Appendix A: Reporting and Recordkeeping Requirements Applicable to Trading Activities

Section 75.7 of the proposed rule, which the Agencies proposed to implement in part section 13(e)(1) of the BHC Act,[2623] required certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, § 75.7 required banking entities to comply with the recordkeeping requirements in § 75.20 of the proposed rule, related to the banking entity's compliance program,[2624] as well as any other reporting or recordkeeping requirements that the relevant Agency may impose to evaluate the banking entity's compliance with the proposed rule.[2625]

Proposed Appendix A required a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The measurements varied depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contained a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of a banking entity's market-making operations, would constitute prohibited proprietary trading.[2626] Under the proposal, a banking entity was required to comply with proposed Appendix A's reporting and recordkeeping requirements only if it had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) was, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.[2627] The Agencies did not propose to extend the reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appeared that the more limited benefits of applying these requirements to such banking entities, whose trading activities are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements.

a. Approach to Reporting and Recordkeeping Requirements Under the Proposal

The proposal explained that the reporting and recordkeeping requirements of § 75.7 and Appendix A of the proposed rule were an important part of the proposed rule's multi-faceted approach to implementing the prohibition on proprietary trading. These requirements were intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading, and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. To do so, the proposed rule required certain banking entities to calculate and report detailed quantitative measurements of their trading activity, by trading unit. These measurements were meant to help banking entities and the Agencies in assessing whether such trading activity is consistent with permitted trading activities in scope, type and profile. The quantitative measurements required to be reported under the proposed rule were generally designed to reflect, and to provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful in differentiating permitted market making-related activities from prohibited proprietary trading. For example, the proposed quantitative measurements measured the size and type of revenues generated, and the types of risks taken, by a trading unit. Each of these measurements appeared to be useful in assessing whether a trading unit was (i) engaged in permitted market making-related activity or (ii) materially exposed to high-risk assets or high-risk trading strategies. Similarly, the proposed quantitative measurements also measured how much revenue was generated per such unit of risk, the volatility of a trading unit's profitability, and the extent to which a trading unit trades with customers. Each of those characteristics appeared to be useful in assessing whether a trading unit is

[2621] *See* Joint Proposal, 76 FR at 68967.

[2622] One commenter specifically urged that records for any type of compliance program be required to be kept on all hedges, rather than only those placed at a different level or trading unit as under the proposal, and that the retention period for all compliance records be changed from 5 years to 6 years in line with the statute of limitations on civil suits for fraud, contracts and collection of debt in accounts in New York State. *See* Occupy.

[2623] Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. *See* 12 U.S.C. 1851(e)(1). Section 75.20 and Appendix C of the proposed rule also implemented section 13(e)(1) of the BHC Act.

[2624] *See* Part III.D. of this **SUPPLEMENTARY INFORMATION**.

[2625] *See* proposed rule § 75.7.

[2626] *See supra* Part VI.A.3.c.8 (explaining why Appendix B was removed from the final rule).

[2627] *See* proposed rule § 75.7(a).

engaged in permitted market making-related activity.

However, as noted in the proposal, the Agencies recognize that no single quantitative measurement or combination of measurements can accurately identify prohibited proprietary trading without further analysis of the context, facts, and circumstances of the trading activity. In addition, certain quantitative measurements may be useful for assessing one type of trading activity, but not helpful in assessing another type of trading activity. As a result, the Agencies proposed to use a variety of quantitative measurements to help identify transactions or activities that warrant more in-depth analysis or review.

To be effective, this approach requires identification of useful quantitative measurements as well as judgment regarding the type of measurement results that suggest a further review of the trading unit's activity is warranted. The Agencies proposed to take a heuristic approach to implementation in this area that recognized that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision. In particular, the Agencies noted that, although a variety of quantitative measurements have traditionally been used by market participants and others to manage the risks associated with trading activities, these quantitative tools have not been developed, nor have they previously been utilized, for the explicit purpose of identifying trading activity that warrants additional scrutiny in differentiating prohibited proprietary trading from permitted market making-related activities.[2628]

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

In addition to the proposed quantitative measurements, the proposal explained that a banking entity may itself develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and the proposed rule and to establish, maintain, and enforce an effective compliance program, as required by § 75.20 of the proposed rule and Appendix C. The Agencies noted that the proposed quantitative measurements in Appendix A were intended to assist banking entities and Agencies in monitoring compliance with the proprietary trading restrictions and would not necessarily provide all the data necessary for the banking entity to establish an effective compliance program. The Agencies also recognized that appropriate and effective quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading unit, including types of instruments traded, trading activities and strategies, and history and experience (*e.g.,* whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities needed to ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within risk tolerances established by the banking entity, and to monitor for compliance with the proprietary trading restrictions in the proposed rule.

To the extent that data regarding measurements, as set forth in the proposed rule, are collected, the Agencies proposed to utilize the conformance period provided in section 13 of the BHC Act to carefully review that data, further study the design and utility of these measurements, and if necessary, propose changes to the reporting requirements as the Agencies believe are needed to ensure that these measurements are as effective as possible.[2629] This heuristic, gradual approach to implementing reporting requirements for quantitative measurements was intended to ensure that the requirements are formulated in a manner that maximizes their utility for identifying trading activity that warrants additional scrutiny in assessing compliance with the prohibition on proprietary trading, while limiting the risk that the use of quantitative measurements could inadvertently curtail permissible market making-related activities that provide an important service to market participants and the capital markets at large.

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

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

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $5 billion would be required the banking entity to furnish quantitative measurements for all trading units of the banking entity engaged in trading activity subject to §§ 75.4, 75.5, or 75.6(a) of the proposed

[2628] Joint Proposal, 76 FR at 68883.

[2629] *See* 12 U.S.C. 1851(c)(2); Joint Proposal, 76 FR at 68883.

rule (*i.e.,* permitted underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations). The scope of data to be furnished depended on the activity in which the trading unit was engaged. First, for the trading units of such a banking entity that are engaged in market making-related activity pursuant to § 75.4(b) of the proposed rule, proposed Appendix A required that a banking entity furnish seventeen quantitative measurements.[2630] Second, all trading units of such a banking entity engaged in trading activity subject to §§ 75.4(a), 75.5, or 75.6(a) of the proposed rule were required to report five quantitative measurements designed to measure the general risk and profitability of the trading unit.[2631] The Agencies expected that each of these general types of measurements would be useful in assessing the extent to which any permitted trading activity involves exposure to high-risk assets or high-risk trading strategies. These requirements would apply to all type of trading units engaged in underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations. These additional measurements applicable only to trading units engaged in market making-related activities were designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $1 billion but is less than $5 billion would be required to provide quantitative measurements to be furnished for trading units that engaged in market making-related activity subject to § 75.4(b) of the proposed rule. Trading units of such banking entities that engaged in market making-related activities needed to report eight quantitative measurements designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.[2632] The proposal applied a smaller number of measurements to a smaller universe of trading units for this class of banking entities because they are likely to pose lesser compliance risk and fewer supervisory and examination challenges. The Agencies noted in the proposal that a less burdensome reporting regime, coupled with other elements of the proposal (*e.g.,* the compliance program requirement), was likely to be equally as effective in ensuring compliance with section 13 of the BHC Act and the proposed rule for banking entities with smaller trading operations.

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

b. General Comments on the Proposed Metrics

A number of commenters were supportive of metrics. A few commenters argued that the metrics could reveal prohibited proprietary trading activity and be an appropriate and valuable tool in analyzing positions.[2633] One commenter argued that metrics are the single most valuable tool available to the Agencies for distinguishing between prohibited and permitted activities and recommended the compliance program be structured around metrics.[2634] Another commenter stated that the identification of metrics is one of the strengths of the proposed rule and offered great promise for successful implementation of the rule.[2635] One commenter expressed support for the metrics and argued that there would be substantial evasion of the rule without reporting of these measurements.[2636] Some commenters proposed a presumption of compliance so long as trading activity is conducted in a manner consistent with tailored quantitative metrics and related specific thresholds as coordinated and agreed with the relevant Agency.[2637] A few of commenters suggested that metrics not be used as a bright-line trigger and recommended flexibility in the application of metrics for assessing market-making activities.[2638] Two commenters supported metrics as part of a bright lines approach.[2639]

A number of commenters felt that some metrics might be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity.[2640] These commenters advocated an approach where banking entities and examiners would determine over time the usefulness and relevance of particular metrics.[2641] One commenter expressed support for the 5 metrics required for trading in U.S. government obligations.[2642] A number of commenters recommended that metrics be tailored to different asset classes and markets, to avoid the drawbacks of a one-size-fits-all approach.[2643] One commenter argued that application of metrics to market-making activities at different firms may produce very different results, all of which might reflect legitimate market-making.[2644] Commenters also indicated that not all metrics are meaningful and calculable

[2630] *See* proposed rule Appendix A.III.A. These seventeen quantitative measurements are discussed further below.

[2631] *See* proposed rule Appendix A.III.A. These five quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) VaR and Stress VaR; (iv) Risk Factor Sensitivities; and (v) Risk and Position Limits. Each of these and other quantitative measurements discussed in proposed Appendix A are discussed in detail below.

[2632] *See* proposed rule Appendix A.III.A. These eight quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) Portfolio Profit and Loss; (iv) Fee Income and Expense; (v) Spread Profit and Loss; (vi) VaR; (vii) Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and (viii) Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

[2633] *See, e.g.,* Paul Volcker; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Invesco; Comm. on Capital Markets Regulation.

[2634] *See* Goldman (Prop. Trading).

[2635] *See* Sens. Merkley & Levin (Feb. 2012).

[2636] *See* Occupy.

[2637] *See* Barclays; see also BoA; Invesco; ISDA (Feb. 2012); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2638] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Oliver Wyman (Feb. 2012); UBS; Western Asset Mgmt.; Goldman (Prop. Trading); Northern Trust.

[2639] *See* John Reed; Public Citizen.

[2640] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Stephen Roach.

[2641] *See* Wells Fargo (Prop. Trading); Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Stephen Roach.

[2642] *See* UBS.

[2643] *See* Goldman (Prop. Trading); Northern Trust; *see also* UBS.

[2644] *See* Comm. on Capital Markets Regulation.

for all trading units and some would be unnecessarily burdensome.[2645]

Other commenters did not support the use of metrics. These commenters argued that metrics reporting was one aspect of the complexity of the proposal that increased the cost and difficulty of distinguishing market-making from prohibited proprietary trading.[2646] One commenter argued that banking entities may avoid legitimate market making activities that would produce ''worse'' metrics results.[2647]

Several commenters expressed concern that the costs exceeded the benefits of the required quantitative metrics in the proposal. In particular, commenters argued that the 17 metrics in the proposal calculated at each trading unit was excessive, would generate an unmanageable amount of data, would yield numerous false positives, and would require the construction and programming of highly sophisticated systems that are not currently employed.[2648] A few commenters suggested that a more limited set of metrics would reduce compliance complexity.[2649] Some commenters noted that many of these metrics have not been historically reported by banking entities and some of the metrics would require substantial resources and investment infrastructure to produce some of the metrics without a clear functional purpose.[2650] According to other commenters, however, banking entities currently use all or nearly all of the proposed metrics.[2651] One commenter urged that it would be good to make metrics consistent with the banking entities' internal reporting and control systems.[2652] Some commenters argued it was critical for the Agencies to get the metrics right,[2653] while others indicated it was unclear how the Agencies could analyze such information to draw useful conclusions.[2654]

Some commenters expressed concern that metrics were vulnerable to manipulation and arbitrage.[2655] These commenters generally felt that the quantitative measurements were only appropriate for certain liquid and transparent trading activities but not meaningful for illiquid markets, including opaque securities and derivatives.[2656] These commenters also argued that the vast majority of proprietary trading would not be differentiable through analysis of the data.[2657] Other commenters expressed concern that the use of metrics not replace regulatory review of actual specific trading positions held by banking entities.[2658] One commenter argued that in relying on metrics to be elaborated upon and discussed in the examination process, the proposed rule did not meet the fundamental fair notice goal of regulation.[2659]

A few commenters also recommended creation of a central data repository or data sharing protocol that would promote consistency and accountability in oversight and regulation and suggested the Office of Financial Research (''OFR'') be given access to this data so that it can provide centralized analysis and monitoring to identify any trends that give rise to systemic risk.[2660] These commenters generally supported compliance benefits that would result from increased public disclosure of banking entities' trading and funds activities, including all of their trading positions, their valuation models, and their compliance metrics.[2661]

Some commenters expressed support for the reporting thresholds contained in Appendix A.[2662] One commenter suggested that all banking entities that engage in any trading (regardless of threshold) report certain metrics.[2663] Other commenters supported metrics reporting, but recommended the threshold for trading assets and liabilities be increased from $1 billion to $10 billion to mitigate any cost and burden impact on smaller banking entities.[2664] These commenters pointed out that even if the minimum dollar threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements including Appendix A.[2665] One commenter suggested the threshold be raised to $50 billion in combined trading assets and liabilities.[2666]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which reporting requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold for compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering metrics reporting.[2667] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2668] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2669] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be included in the $1 billion standard for becoming subject to any reporting and record-keeping requirements under the final rule.[2670]

A number of commenters argued that monthly reporting was too frequent because of the complexity of the process that surrounds generation of regulatory

[2645] *See* Morgan Stanley; *see also* ISDA (Feb. 2012).

[2646] *See* ABA (Keating); Barclays; Citigroup (Feb. 2012); ISDA (Feb. 2012); UBS; Oliver Wyman (Feb. 2012); Prof. Duffie; Wellington.

[2647] *See* Oliver Wyman (Feb. 2012).

[2648] *See* BoA (expressing concern about the need for new systems to distinguish bid-ask spreads from price appreciation); UBS; Wellington.

[2649] *See* BoA; Barclays; Citigroup (Feb. 2012).

[2650] *See* Credit Suisse (Seidel); Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale (arguing that many calculation questions need to be resolved before banking entities can create necessary systems to measure metrics).

[2651] *See* Occupy; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen. For example, one commenter cited a study finding that 14 out of 17 of the proposed metrics are either in wide use today or are possible to implement fairly easily using data already collected for internal risk management and profit and loss purposes. *See* AFR *et al.* (Feb. 2012) (citing John Lester and Dylan Walsh, ''The Volcker Rule Ban On Prop Trading: A Step Closer to Reality, Point of View,'' Oliver Wyman Company (Oct. 2011)).

[2652] *See* Paul Volcker.

[2653] *See, e.g.,* UBS.

[2654] *See* BoA; UBS; Wellington.

[2655] *See* AFR (Nov. 2012); *see also* Occupy; Public Citizen.

[2656] *See* Occupy; AFR (Nov. 2012); Wells Fargo (Prop. Trading).

[2657] *See* Occupy.

[2658] *See* Sens. Merkley & Levin (Feb. 2012).

[2659] *See* ISDA (Feb. 2012) (citing *Mason v. Florida Bar,* 208 F.3d 952, 958–59 (11th Cir. 2000)).

[2660] *See* Sens. Merkley & Levin (Feb. 2012); *see also* Occupy; Public Citizen.

[2661] *See* Sens. Merkley & Levin (Feb. 2012); *see also* Public Citizen; John Reed.

[2662] *See* ICBA; Occupy.

[2663] *See* Occupy (suggesting all banking entities that engage in trading be required to provide VaR Exceedance, Risk Factor Sensitivities and Risk and Position Limits).

[2664] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy).

[2665] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2666] *See* State Street (Feb. 2012).

[2667] *See* PNC *et al.*

[2668] *See* PNC *et al.*

[2669] *See* Northern Trust.

[2670] *See* Occupy at 60.

reports and suggested that the frequency of reporting should be quarterly.[2671] One commenter supported the reporting frequency as extremely effective and said it should not be reduced in any way.[2672]

A number of comments were received on the implementation timeframe for metrics reporting. Several commenters urged allowing banking entities the use of the full conformance period for creating the systems and processes to capture and report the quantitative metrics.[2673] Some commenters suggested that metrics should not be required to be reported until one year after adoption of final regulations.[2674] A different commenter suggested that the Agencies provide a one-year period during which they determine which metrics will be employed for different asset classes and an additional one-year period during which such metrics could be reviewed so metrics would be a required component of a banking entity's compliance program no sooner than 2 years after issuance of the final rule.[2675] Another commenter suggested that banking entities and regulators use the first year of the conformance period to consult with one another and determine the usefulness and relevance of individual metrics for different activities, asset classes, and markets and the second year of the conformance period to test the metrics systems to validate the accuracy and relevance of metrics that are agreed upon the first year.[2676] One commenter suggested a subset of metrics be rolled out gradually across trading units before implementing the full suite of metrics that are ultimately adopted or metrics could be rolled out one trading unit at a time.[2677] Another commenter said the Agencies should identify key metrics that are clearly workable across all ranges of trading activity and most likely to provide useful data and require those metrics be implemented first and require other metrics to be phased in over time in consultation with the banking entity's primary Federal regulator.[2678] One commenter supported the heuristic approach of the proposal and suggested the Agencies should draw on resources and comment from the public and the industry in continuing the process of developing and building out metrics.[2679]

Another commenter requested that the final rule specify how trading assets and liabilities should be reported for savings and loan holding companies.[2680] This commenter requested clarification that positions held for hedging or liquidity management purposes should not count as trading assets or liabilities for the $5 billion threshold in Appendix A. Another commenter expressed concern that derivatives valuation may value derivatives substantially lower than their notional exposure and thereby make high reporting thresholds not meaningful or reflective of inherent risk.[2681]

Many commenters expressed concern that the smallest trading unit level was too low a level for collecting metrics data and suggested the final rule provide a higher reporting level.[2682] These commenters stated that calculating at too low of a level would be more likely to generate false positives[2683] and would be burdensome, particularly for firms with large trading operations.[2684] In addition, some commenters indicated that it would be problematic if the definition of ''trading unit'' is applied at a legal entity level and cannot be applied across multiple legal entities within the same affiliate group.[2685] By contrast, two commenters supported the collection of metrics at the trading desk level and appropriate levels above the trading desk.[2686] One of these commenters expressed concern that the rule allowed for an inappropriately large trading desk unit that could combine significantly unrelated trading desks, which would impede detection of proprietary trading and supported measurements at multiple levels of organization to combat evasion concerns.

In response to questions in the proposal about whether the Agencies should establish numerical thresholds for some or all of the proposed quantitative measurements, a number of commenters expressed opposition to establishing numerical thresholds for purposes of the rule,[2687] while others stated that thresholds should be established over time.[2688] In opposition of thresholds, one commenter expressed concern that numerical thresholds could be easily abused and evaded and may need to be constantly revised and updated as financial markets evolve.[2689] In addition, another commenter stated that numerical thresholds should not be imposed because metric levels will differ by asset class and type of activity.[2690] A few commenters suggested that numerical thresholds, based on the specific asset class or market, would be useful to provide clarity or consistency about the types of activity that are permitted under the rule.[2691] Two commenters expressed support for banking entities establishing numerical thresholds, in consultation with the relevant regulator, for different trading units based on differences between markets and asset classes.[2692]

c. Approach of the Final Rule

As explained below, the Agencies have reduced the number of metrics that banking entities must report under Appendix A from the 17 metrics in the proposal to 7 metrics in the final rule. The final rule also increases the level of activity that is required to trigger mandatory reporting of metrics data and phases in the reporting requirement over time.

Under the final rule, a banking entity engaged in significant trading activity as defined by § 75.20 must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

In response to comments, the final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in

[2671] *See* JPMC; *see also* Stephen Roach.

[2672] *See* Occupy.

[2673] *See* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); UBS; Stephen Roach.

[2674] *See* Credit Suisse (Seidel); JPMC; Wells Fargo (Prop. Trading).

[2675] *See* BoA.

[2676] *See* Morgan Stanley; *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2677] *See* Goldman (Prop. Trading).

[2678] *See* Wells Fargo (Prop. Trading).

[2679] *See* AFR *et al.* (Feb. 2012).

[2680] *See* GE (Feb. 2012).

[2681] *See* Occupy.

[2682] *See, e.g.,* BoA; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; RBC.

[2683] *See* JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA. *See also* Sen. Gillibrand.

[2684] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[2685] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2686] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2687] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Occupy; Alfred Brock.

[2688] *See* Wellington; Barclays; Goldman (Prop. Trading); CalPERS; John Reed.

[2689] *See* Occupy.

[2690] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2691] *See* Wellington; CalPERS; John Reed.

[2692] *See* Goldman (Prop. Trading); Barclays.

approach based on the size of trading assets and liabilities.[2693] Banking entities that meet the relevant thresholds must collect and report metrics for all trading desks engaged in covered trading activity beginning on the dates established in § 75.20 of the final rule. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States). Banking entities with less than $50 billion and greater than or equal to $25 billion in trading assets and liabilities and banking entities with less than $25 billion and greater than or equal to $10 billion in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively. The Agencies believe that these delayed dates for reporting metrics should allow firms adequate time to develop systems to calculate and report the quantitative metrics. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in § 75.20 unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion or greater in trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis.[2694] All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by § 75.20, unless another time is requested by the primary supervisory Agency for the entity except for a preliminary period when reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[2695]

The Agencies believe that together the reduced number of metrics, the higher thresholds for reporting metrics, delayed reporting dates, and modified reporting frequency reduce the costs and burden from the proposal while allowing collection of data to permit better monitoring of compliance with section 13 of the BHC Act. The Agencies also believe that the delayed dates for reporting quantitative metrics will provide banking entities with the time to develop systems to calculate and report these metrics. The Agencies are not applying these reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appears that the more limited benefits of applying these requirements to banking entities with lower levels of trading activities, which represent entities that are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements of Appendix A.

The final rule defines ''trading desk'' to replace the concept of ''trading unit'' in the proposal.[2696] Under the final rule, trading desk means the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies believe that applying quantitative measurements to a level that aggregates a variety of distinct trading activities may obscure or ''smooth'' differences between distinct lines of business, asset categories and risk management processes in a way that renders the measurement relatively uninformative because it does not adequately reflect the specific characteristics of the trading activities being conducted.

While the Agencies recognize that applying quantitative measurements at the trading desk level may result in some ''noise'' in the data and false positives, the Agencies believe it is necessary to apply the quantitative measurements at the trading desk level to enhance consistency with other provisions of the final rule. For example, because the requirements of the market-making exemption apply at the trading desk level of organization, the Agencies believe quantitative measurements used to monitor a banking entity's market making-related activities should also calculated, reported, and recorded at the trading desk level. In response to commenters' concerns that trading desk level measurements are more likely to generate false positives, the Agencies emphasize that quantitative measurements will not be used as a dispositive tool for determining compliance and, rather, will be used to monitor patterns and identify activity that may warrant further review.

Like the proposal, the final rule does not include specific numerical thresholds. Commenters did not suggest specific thresholds for particular metrics or provide data and analysis that would support particular thresholds.[2697] Given the range of financial instruments and trading activity covered by the final rule, as well as potential differences among banking entities' organizational structures, trading strategies, and level of presence in a particular market, the Agencies are concerned that numerical thresholds for specific metrics would not account for these differences and could inappropriately constrain

[2693] As noted above, a number of commenters suggested setting a higher threshold than the proposed $1 billion and $5 billion trading asset and liability thresholds because even thresholds of $10 billion to $50 billion would capture a significant percentage of the total trading assets and liabilities in the banking system. *See* ABA (Keating); M&T Bank; PNC *et al.;* State Street (Feb. 2012). The Agencies believe that the phase-in approach to the metrics requirement established in the final rule should generally address commenters' concerns about the implementation timeframe by providing time for analysis, development of systems (if needed), and implementation of the quantitative measurements requirement. *See, e.g.,* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); UBS; Stephen Roach; Credit Suisse (Seidel); Wells Fargo (Prop. Trading). The Agencies are establishing a phase-in approach, rather than requiring all banking entities above the $10 billion threshold to report metrics within the same timeframe, to strike a balance between the benefits of receiving data to help monitor compliance with the rule against the need for time to assess the effectiveness and usefulness of the quantitative measurements in practice and for some firms to develop additional systems for purposes of this requirement.

[2694] Consistent with certain commenters' requests, the final rule generally requires less frequent reporting than was proposed. However, the Agencies continue to believe that monthly reporting is appropriate for the largest banking entities above the $50 billion threshold. More frequent reporting for these firms is appropriate to allow for more effective supervision of their large-scale trading operations. *See* JPMC; Stephen Roach.

[2695] *See* final rule § 75.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements after the end of the relevant period than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

[2696] *See* final rule § 75.3(e)(13); *see also supra* Parts VI.A.2.c.1.c.ii. and VI.A.3.c.1.c.i.

[2697] *See* Wellington; CalPERS; John Reed.

legitimate activity.[2698] Further, mandated thresholds for the metrics would not recognize the impact changing market conditions may have on a given trading desk's quantitative measurements. Consistent with two commenters' suggested approach, banking entities will be required to establish their own numerical thresholds for quantitative measurements under the enhanced compliance program requirement in Appendix B.[2699]

d. Proposed Quantitative Measurements and Comments on Specific Metrics

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

- *Risk-management measurements*—VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;
- *Source-of-revenue measurements*—Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;
- *Revenues-relative-to-risk measurements*—Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;
- *Customer-facing activity measurements*—Inventory Turnover, Inventory Aging, and Customer-facing Trade Ratio; and
- *Payment of fees, commissions, and spreads measurements*—Pay-to-Receive Spread Ratio.

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

Under the proposal, the first set of quantitative measurements related to risk management, and included VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits. Commenters generally supported the use of risk-management metrics as the most important measure of compliance, indicating that these metrics could potentially provide useful supervisory information.[2700]

In general, commenters supported the use of the VaR metric.[2701] One of these commenters argued that VaR was not particularly indicative of proprietary trading, but could be helpful to reveal a trading unit's overall size and risk profile.[2702] Another commenter indicated that significant, abrupt or inconsistent changes to VaR may need to be absorbed by market makers who absorb large demand and supply shocks into their inventories.[2703] This commenter contended that the six largest bank holding companies had proprietary trading losses that frequently exceeded their VaR estimates and the design and supervision of such risk measures should be revisited.

One commenter argued that the definition of VaR was not made clear in the proposal and was missing some important information regarding methodology as VaR methodologies tend to vary among banking entities.[2704] This commenter recommended the development of a standard methodology by the OFR including a central repository for historical calculation data for each asset for the purpose of ensuring standard calculation across the industry. This commenter also expressed concern that VaR calculations are heavily reliant on the quality of input data and stated that many markets are unable to provide sufficient information such that VaR calculations are meaningful, including markets for illiquid products for which accurate historical price and market information is sparse and could severely under represent true potential losses under VaR calculations.[2705]

A few commenters expressed concern about the applicability of VaR when applied to ALM activities.[2706] These commenters argued that risk management metrics such as VaR would not help to distinguish ALM and valid risk mitigating hedging activities from prohibited proprietary trading. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not marked to market but the corresponding hedge may be.

One commenter argued that the use of stress VaR would be important to guard against excessive risk taking.[2707] A few commenters suggested that additional guidance be provided for Stress VaR including linking it to the broader stress testing regime and based on extreme conditions that are not based on historic precedent.[2708] These commenters also argued that a one-day holding period assumption is inadequate, especially for less liquid asset classes, and recommended that stress be measured over a longer period. One commenter argued that Stress VaR should be removed from the list of required metrics as it is not in regular use for day-to-day risk management and provides little relevant information about the intent or proportionality

[2698] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2699] *See* Goldman (Prop. Trading); Barclays. *See also* final rule Appendix B.

[2700] *See, e.g.,* AFR et al. (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *see also* BNY Mellon *et al.* (suggesting the use of VaR measures for foreign exchange trading activity).

[2701] *See, e.g.,* Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; Public Citizen.

[2702] *See* Goldman (Prop. Trading).

[2703] *See* Prof. Duffie.

[2704] *See* Occupy.

[2705] *See* Occupy.

[2706] *See* JPMC; State Street (Feb. 2012); *see also* BoA; CH/ABASA. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not mark-to-market but the corresponding hedge may be. *See* State Street (Feb. 2012).

[2707] *See* Public Citizen.

[2708] *See* AFR *et al.* (Feb. 2012); Public Citizen.

between risk assumed and client demands.[2709]

A number of commenters requested that VaR Exceedance be removed from the list of metrics. These commenters argued that the primary function of VaR Exceedance is to analyze the quality of a VaR model and that VaR backtesting is already reported to regulators as part of the supervisory process. These commenters argued that VaR Exceedance does not reveal trading intent or actual risk taken.[2710] One commenter argued that VaR Exceedance may be useful to the Agencies as an indicator of the quality of the VaR measure relative to the profit and loss of the trading unit but that a more rigorous back-testing process would serve as a better analytical tool than VaR Exceedance to evaluate the quality of the VaR model result and should be included as an additional metric.[2711] One commenter suggested that risk-based metrics should measure risk as a function of capital.[2712] Another commenter warned that risk metrics could be significantly higher during times of market stress and volatility than during normal times.[2713]

A few commenters expressed support for risk factor sensitivities as useful, supervisory information.[2714] One of these commenters suggested that risk factor sensitivities could orient regulators to a trading unit's overall size and risk profile,[2715] while another commenter stated that risk factor sensitivities would be the most useful tool for identifying the accumulation of market risk in different areas of a banking entity.[2716] One commenter suggested that several risk factor sensitivity snapshots be taken throughout the day with an average value reported at the end of day.[2717] This commenter also recommended that trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios), should trigger additional disclosures in risk factor sensitivity reporting.[2718]

Commenters also supported risk and position limits as providing useful, supervisory information. Several commenters indicated that these limits could be helpful to orient regulators to a trading unit's overall size and risk profile.[2719] Another commenter expressed the view risk and position limits are the most comprehensive measures of risk taking and incorporate VaR, Stress VaR, and Risk Factor Sensitivities.[2720] A different commenter argued it was unclear how position limits are in fact a quantitative metric and not a description of a banking entity's internal risk policies.[2721]

After carefully considering the comments received, the final rule retains the risk-management metrics other than VaR Exceedance. The collection of information regarding Risk and Position Limits, VaR, Stress VaR, and Risk Factor Sensitivities is consistent with the aim of providing a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible activities. Moreover, a number of commenters indicated that the risk management measures would be effective at achieving these goals.[2722] The risk management measure that was not retained in the final rule, VaR Exceedance, was considered, in light of the comments, as not offering significant additional information on the overall risk profile and activities of the trading desk relative to the burden associated with computing, auditing and reporting it on an ongoing basis.[2723]

The risk-management measurements included in the final rule are widely used by banking entities to measure and manage trading risks and activities.[2724] VaR, Stress VaR, and Risk Factor Sensitivities provide internal, model-based assessments of overall risk, stated in terms of large but plausible losses that may occur or changes in revenue that would be expected to result from movements in underlying risk factors. The provided description and calculation guidance for each of these measures is consistent with both current market practice and regulatory capital requirements for banks. The final rule does not provide a prescriptive definition of each of these measurements as these measures must be flexible enough to be tailored to the specific trading activities of each trading desk. Supervisory guidance and comparisons of these measures across similarly situated trading desks at a given entity as well as across entities will be used to ensure that the provided measurements conform to the description and calculation guidance provided in Appendix A. Risk and Position Limits and Usage provide an explicit assessment of management's expectation of how much risk is required to perform permitted market-making, underwriting and hedging activities. The final rule requires that the usage of each risk and position limit be reported so that the risk taking by each trading desk can be monitored and assessed on an ongoing basis.[2725]

With the exception of Stress VaR, each of these measurements are routinely used to manage and control risk taking activities, and are also used by some banking entities for purposes of calculating regulatory capital and allocating capital internally.[2726] In the context of permitted market making-related activities, these risk management measures are useful in assessing whether the actual risk taken is consistent with the level of principal risk that a banking entity must retain in order to service the near-term demands of customers. Significant, abrupt or inconsistent changes to key risk management measures, such as VaR, that are inconsistent with prior experience, the experience of similarly situated trading desks and management's stated expectations for such measures may indicate impermissible proprietary trading, and may warrant further review. In addition, indicators of unanticipated or unusual levels of risk taken, such as breaches of internal Risk and Position Limits, may suggest behavior that is inconsistent with appropriate levels of risk and may warrant further scrutiny. The limits required under § 75.4(b)(2)(iii) and § 75.5(b)(1)(i) must meet the applicable requirements under § 75.4(b)(2)(iii) and § 75.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a

[2709] *See* JPMC.

[2710] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2711] *See* Occupy.

[2712] *See* Citigroup (Feb. 2012).

[2713] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2714] *See* Citigroup (Feb. 2012); Prof. Duffie; Occupy.

[2715] *See* Goldman (Prop. Trading).

[2716] *See* Occupy.

[2717] *See* Occupy.

[2718] *See* Occupy.

[2719] *See, e.g.,* Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading).

[2720] *See* Barclays.

[2721] *See* Occupy.

[2722] *See, e.g.,* AFR *et al.* (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *see also* Northern Trust; State Street (Feb. 2012).

[2723] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2724] *See* Joint Proposal, 76 FR at 68887.

[2725] The Agencies believe this clarification responds to one commenter's question regarding how risk and position limits will be used and assessed for purposes of the rule. *See* Occupy.

[2726] *See* Joint Proposal, 76 FR at 68887.

trading desk based on the types of positions traded by, and risk exposures of, that desk.

Under the proposal, the second set of quantitative measurements related to the source of revenues, and included Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution. A few commenters expressed support for Comprehensive Profit and Loss as a reasonable contextual metric and contended that the metric could inform the analysis of whether market-making revenues are from customer transactions.[2727]

As described above, a number of commenters expressed concern about a focus on revenues as part of evaluating market-making.[2728] For instance, one commenter argued that the rule should not require, even in guidance, that market making-related permitted activities be ''designed to generate revenues from fees, commissions, bid-asks spreads or other income,'' arguing that this prejudges appropriate results for revenue metrics and implies that a *bona fide* market maker is not permitted to benefit from revenues from market movements.[2729] One commenter expressed concern that the source-of-revenue metrics are subject to manipulation as these metrics depend on correctly classifying revenue into market bid-ask spreads as opposed to other sources of revenue.[2730] One commenter stated that this metric should serve as a secondary indication of risk levels because it could be subject to manipulation.[2731] Another commenter recommended use of the sub-metric in Comprehensive P&L Attribution.[2732] A different commenter recommended the adoption of clearer metrics to distinguish customer revenues from revenues from price movements.[2733] One commenter indicated that after-the-fact application of quantitative measurements such as Comprehensive Profit and Loss may cause firms to reconsider their commitment to market making and recommended that, to the extent this metric is used, it should be applied flexibly in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2734]

A few commenters supported Portfolio Profit and Loss as a reasonable contextual metric to inform whether revenues from market-making transactions are from customer transactions.[2735] However, one of these commenters argued that this metric would not necessarily be indicative of prohibited proprietary trading and profits may reflect *bona fide* market making-related, underwriting, and hedging activities.[2736] Another commenter argued that this metric should serve as a secondary indication of risk levels and may be subject to manipulation.[2737]

Some commenters felt that Fee Income and Expense was a useful metric.[2738] One of these commenters argued this metric has the potential to help distinguish permitted activities from prohibited proprietary trading.[2739] Another commenter felt this metric would be useful in liquid markets that trade with the convention of fees and commissions but less useful, but still indicative, in other markets that use inter-dealer brokers to conduct client-related activities.[2740] One commenter argued that it would be impracticable to produce Fee Income and Expense data for foreign exchange trading, which is predominantly based on bid/offer spread.[2741]

A few commenters thought that Spread P&L could be useful.[2742] One of these commenters argued that Spread P&L has the potential to help distinguish permitted activities from prohibited proprietary trading.[2743] This commenter suggested that the final rule remove the proposal's revenue requirement as part of market-making and instead rely on revenue metrics such as Spread P&L.[2744] This commenter argued, however, that it will not always be clear how to best calculate Spread P&L and it would be critical for the Agencies to be flexible and work with banking entities to determine the appropriate proxies for spreads on an asset-class-by-asset class and trading desk-by-trading-desk basis. One commenter contended that the proposed implementation in the proposal was more difficult than necessary and suggested End of Day Spread Proxy is sufficient. Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to calculate Spread P&L.[2745]

However, the majority of commenters recommended removal of Spread P&L as a metric.[2746] These commenters argued that a meaningful measure for Spread P&L cannot be calculated in the absence of a continuous bid-ask spread, making this metric misleading especially for illiquid positions and shallow markets.

A few commenters generally expressed support for the inclusion of Comprehensive Profit and Loss Attribution.[2747] One of these commenters stated that this metric was the most comprehensive metric for measuring sources of revenue and included other metrics as sub-metrics, such as Comprehensive Profit and Loss, Portfolio Profit and Loss, and Fee Income and Expense. Another commenter contended the mention of ''customer spreads'' and ''bid-ask spreads'' was unclear and that both of these terms should be removed from the calculation guidance. Other commenters argued that the benefits of this metric do not justify the costs of generating a report of Comprehensive P&L Attribution on a daily basis.[2748] One commenter urged the Agencies to ensure that each institution be permitted to calculate this metric in a way that reflects the institution's unique characteristics.[2749]

After carefully considering the comments received, the final rule maintains only a modified version of Comprehensive P&L Attribution metric and does not retain the proposed Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, or Spread Profit and Loss metrics. The final rule also requires volatility of comprehensive profit and loss to be reported. As pointed out by a number of

[2727] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy; *see also* Barclays.

[2728] *See supra* Part VI.A.3.c.7.b.

[2729] *See* SIFMA (May 2012).

[2730] *See* AFR (Nov. 2012).

[2731] *See* Occupy.

[2732] *See* Barclays.

[2733] *See* Public Citizen.

[2734] *See* NYSE Euronext.

[2735] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2736] *See* Goldman (Prop. Trading).

[2737] *See* Occupy.

[2738] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2739] *See* Goldman (Prop. Trading). This commenter urged that fee income and expense should be considered together with Spread P&L arguing that these two both measures of customer revenues and, in practice, may function as substitutes for each other.

[2740] *See* Occupy.

[2741] *See* Northern Trust.

[2742] *See, e.g.,* Goldman (Prop. Trading); JPMC; UBS.

[2743] *See* Goldman (Prop. Trading).

[2744] *See* Goldman (Prop. Trading); *see also* Paul Volcker (supporting a metric considering the extent to which earnings are generated by pricing spreads rather than changes in price).

[2745] *See* JPMC; UBS; *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2746] *See* ABA *et al.;* BoA; Barclays; Credit Suisse (Seidel); Japanese Bankers Ass'n; Northern Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* AFR *et al.* (Feb. 2012); Occupy.

[2747] *See* Barclays; Occupy.

[2748] *See* BOK; Goldman (Prop. Trading); SIFMA *et al.* (Prop Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2749] *See* SIFMA *et al.* (Prop Trading) (Feb. 2012).

commenters, Comprehensive Profit and Loss Attribution provides a holistic attribution of each trading desk's profit and loss and contains much of the information content that is provided by many of the other metrics, such as Fee Income and Expense.[2750] Accordingly, the use of Comprehensive Profit and Loss Attribution in the final rule greatly simplifies the metric reporting requirement and reduces burden while retaining much of the information and analysis that was provided in the full set of five metrics that were contained in the proposal. In addition, in response to commenters' concerns about the burdens of separately identifying specific revenue sources (*e.g.,* revenues from bid-ask spreads, revenues from price appreciation), the Agencies have modified the focus of the proposed source of revenue metrics to focus on when revenues are generated, rather than the specific sources of revenue.[2751] This approach should also help address one commenter's concern about the need for new, sophisticated systems to differentiate bid-ask spreads from price appreciation.[2752] The utility of this modified approach is discussed in more detail in the discussion of the market-making exemption.[2753] Finally, the Comprehensive Profit and Loss Attribution metric will ensure that all components of a trading desk's profit and loss are measured in a consistent and comprehensive fashion so that each individual component can be reliably compared against other components of a trading desk's profit and loss without being considered in isolation or taken out of context.

This measurement is intended to capture the extent, scope, and type of profits and losses generated by trading activities and provide important context for understanding how revenue is generated by trading activities. Because permitted market making-related activities seek to generate profits by providing customers with intermediation and related services while managing, and to the extent practicable minimizing, the risks associated with any asset or risk inventory required to meet customer demands, these revenue measurements would appear to provide helpful information to banking entities and the Agencies regarding whether actual revenues are consistent with these expectations.

Under the proposal, the third set of measurements related to realized risks and revenue relative to realized risks, and includes Volatility of Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss, and Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss.

A few commenters indicated support for these metrics as appropriate, contextual metrics.[2754] These commenters indicated that these metrics may serve to highlight areas requiring further investigation, since high P&L volatility may indicate a deviation from traditional client related activities and that a well-structured trading operation should be able to obtain relatively high ratios of revenue-to-risk (as measured by various metrics), low volatility, and relatively high turnover.[2755] One commenter recommended that New Trades P&L be substituted for Portfolio P&L for purposes of computing Volatility of P&L because New Trades P&L captures customer revenues more completely and is therefore more useful for distinguishing market making from proprietary trading.[2756] Another commenter indicated that Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss incorporates (and therefore obviates the need for a separate calculation of) the metric Volatility of Portfolio Profit and Loss.[2757]

One commenter urged that after-the-fact application of Comprehensive Profit and Loss to Volatility Ratio may cause firms to reconsider their commitment to market making and argued that this metric should be applied flexibly in light of market conditions prevailing during the relevant time period and as one of many factors relevant to an assessment of overall bona fide market making.[2758] One commenter supported monitoring Portfolio Profit and Loss to Volatility Ratio and argued that the Agencies should establish a clear pattern of profit and loss results of individual trading units through iterative application of the metrics.[2759]

One commenter expressed support for Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss indicating that these metrics may serve to highlight areas requiring further investigation, since a significant number of unprofitable trading days may indicate a deviation from traditional client-related activities.[2760] Another commenter suggested that these metrics be removed as they would result in market makers being less likely to take client-facing positions due to reluctance to incur unprofitable trading days that could indicate the presence of impermissible activity despite the utility of such trades in providing liquidity to customers.[2761]

One commenter requested including Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss in the metrics set as the most comprehensive metric in the revenue-relative-to-risk category making other metrics unnecessary in this area.[2762] Another commenter argued that this metric would produce inconsistent results within and across trading units and would generally not support any meaningful conclusions regarding the permissibility or risk of trading activities.[2763]

After carefully considering the comments received, the final rule does not include any of the proposed revenue-relative-to-risk measurements. Each of these measures provides information that may generally be useful for characterizing the overall risk profile of the trading activities of each trading unit and evaluating the extent to which the quantitative profile of a trading unit's activities is consistent with permissible trading activities. The broad information content of these measures, however, can largely be reproduced from transformations of information that will be provided in the Comprehensive Profit and Loss Attribution and, as noted above, volatility of comprehensive profit and loss must be reported. Analogs to the other metrics such as Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss can be computed similarly from information that will be provided in the Comprehensive Profit and Loss Attribution. Accordingly, the information contained in these metrics

[2750] *See* Barclays.

[2751] *See* JPMC; UBS; SIFMA *et al.* (Prop Trading) (Feb. 2012); ABA (Keating); BoA; Barclays; Credit Suisse (Seidel).

[2752] *See* BoA.

[2753] *See supra* Part VI.A.3.c.7.c.

[2754] *See, e.g.,* Goldman (Prop. Trading); Volcker; John S. Reed; *see also* AFR *et al.* (Feb. 2012); Sen. Merkley; Occupy; Public Citizen.

[2755] *See* Occupy; Public Citizen; Sen. Merkley.

[2756] *See* Goldman (Prop. Trading) (also suggesting that New Trades P&L be substituted for Portfolio P&L in Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio and Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss).

[2757] *See* Barclays.

[2758] *See* NYSE Euronext.

[2759] *See* AFR *et al.* (Feb. 2012).

[2760] *See* Occupy.

[2761] *See* Barclays.

[2762] *See* Barclays.

[2763] *See* Goldman (Prop. Trading).

is retained in the final rule while the burden associated with computing, auditing and reporting these additional metrics on an ongoing basis has been eliminated.

Under the proposal, the fourth set of quantitative measurements related to customer-facing activity measurements. These metrics include Inventory Risk Turnover, Inventory Aging, and Customer-facing Trade Ratio.

A few commenters supported the proposal's Inventory Risk Turnover metric though some of these commenters suggested modifications to the metric.[2764] One commenter argued that this metric could indicate whether a given trading unit holds risk and inventory consistently with the asset class in which such trading unit deals, the types of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading unit serves.[2765] Another commenter argued that the final rule should explicitly state that a trading unit's inventory management practices will be evaluated using this metric.[2766] Some commenters expressed the view that this metric might be useful in the case of liquid positions but not in the case of illiquid or difficult-to-hedge products, which naturally have lower risk turnover. Others noted support for this metric tailored on an asset-by-asset basis.[2767]

A few commenters requested that the final rule clarify that this metric will not be required to be calculated for every possible Risk Factor Sensitivity measurement for the applicable portfolio and that a banking entity and its regulator should determine one or two core risk factors per asset classes with respect to which this metric that will be calculated to strike a reasonable balance between costs of calculations and benefits of this metric.[2768] Other commenters argued the Inventory Risk Turnover Metric was difficult to measure, burdensome, and would create uncertainty for derivatives counterparties.[2769]

A few commenters supported the Inventory Aging metric. One commenter argued it should be included in the metrics set to indicate whether a given trading desk holds risk and inventory consistently within the asset class in which such trading desk deals, the type of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading desk serves.[2770] This commenter suggested tailoring the metric based on the market for a particular asset class and market conditions because aging levels may be higher in less liquid markets. A number of commenters argued that application of the Inventory Aging metric is only appropriate for cash products and should not be used for trading units engaged in transactions in financial instruments such as derivatives.[2771] Another commenter argued that the Inventory Aging metric is generally not useful for derivatives, and for non-derivatives it provides essentially similar information to Inventory Risk Turnover.[2772] One commenter requested additional guidance on how to calculate this metric.[2773]

A few commenters indicated that the Customer-Facing Trade Ratio could be helpful in distinguishing prohibited proprietary trading from market making and would be more effective than the proposal's negative presumption against interdealer trading to evaluate the amount of interdealer trading that is consistent with market making-related or hedging activity in a particular business.[2774] Some commenters suggested that the metric could be improved and argued that the number of transactions executed over a calculation period does not provide an adequate measure for the level of customer-facing trading because it does not reflect the size of transactions or the amount of risk. These commenters suggested replacing the metric with a more risk-sensitive metric or defining the ratio so that it measures notional principal risk associated with customer transactions and is appropriately tailored to the relevant asset class or market.[2775]

A number of commenters raised concerns about the definition of customer for purposes of this metric. One commenter argued that a failure to define ''customer'' to differentiate between customers and non-customers would render this metric meaningless.[2776] Another commenter contended that the metric would be appropriate as long as banking entities have the flexibility to determine who is a customer.[2777] One commenter argued that using a definition of ''customer'' that is different between the market making-related activity and the reported metric could make legitimate market making-related activity with customers appear to be prohibited proprietary trading.[2778] This commenter argued that other dealers and other registered market participants should be recognized as customers of the banking entity. A few commenters contended that this metric would be burdensome if it required a banking entity to tag individual trades as customer or non-customer.[2779] A few commenters argued that interdealer trading should be allowed as part of market making and argued this metric would not provide a useful measure of customer-facing activity.[2780] Some commenters also expressed concern about the implications of such a metric for hedging activity, which may involve relatively less customer-facing activity.[2781]

After carefully considering the comments received, the final rule retains all three of the customer-facing activity measurements from the proposal, though each measure has been modified. A number of commenters raised issues regarding the complexities associated with computing the Inventory Risk Turnover metric. In particular, as noted above, some commenters argued that computing the metric for every reported risk factor sensitivity would be burdensome and would not be informative.[2782] The inventory metric required in the final rule, Inventory Turnover, is applied at the transaction level and not at the risk factor sensitivity level. Accordingly, for a given trading desk and calculation period, *e.g.,* 30 days, there is only one value of the Inventory Turnover metric rather than one value for each risk factor sensitivity that is managed and reported by the trading desk. In this sense, the turnover metric required in the final rule is similar to more traditional and common measures of inventory turnover. Moreover, the required turnover metric is simpler and less costly to track and record while still

[2764] *See* Goldman (Prop. Trading); Barclays; John Reed; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2765] *See* Barclays.

[2766] *See* Goldman (Prop. Trading).

[2767] *See, e.g.,* Barclays; Goldman (Prop. Trading); JPMC; John Reed.

[2768] *See* Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Morgan Stanley.

[2769] *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2770] *See* Barclays; *see also* Invesco.

[2771] *See* Barclays; Goldman (Prop. Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

[2772] *See* Goldman (Prop. Trading).

[2773] *See* Société Générale.

[2774] *See* Goldman (Prop. Trading); *see also* Invesco.

[2775] *See* Barclays; Goldman (Prop. Trading) ; JPMC; SIFMA (Prop. Trading) (Feb. 2012); UBS.

[2776] *See* Occupy.

[2777] *See* Wells Fargo (Prop. Trading).

[2778] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2779] *See* SIFMA (Prop. Trading) (Feb. 2012); *see also* Goldman (Prop Trading).

[2780] *See* Barclays; Japanese Bankers Ass'n; Oliver Wyman (Dec. 2011); SIFMA (Prop. Trading) (Feb. 2012).

[2781] *See* Barclays; Wells Fargo (Prop. Trading).

[2782] *See* Goldman (Prop. Trading); JPMC; SIFMA (Prop. Trading) (Feb. 2012).

providing banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In addition, the description of Inventory Turnover in the final rule provides explicit guidance on how to apply the metric to derivative positions.[2783]

Inventory Aging provides banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In the case of Inventory Aging, the proposal required that the aging schedule be organized according to a specific set of age ranges (*i.e.,* 0–30 days, 30–60 days, 60–90 days, 90–180 days, 180–360 days, and more than 360 days). This requirement has not been adopted in the final rule in order to provide greater flexibility and to recognize that specific age ranges that may be relevant for one asset class may be less relevant for another asset class. Also, to address commenters' uncertainty about how this metric would apply to derivatives, the final rule's description of the Inventory Aging metric provides guidance on how to apply the metric to derivative positions.[2784]

The Customer Facing Trade Ratio provides directionally useful information regarding the extent to which trading transactions are conducted with customers. In the case of the Customer Facing Trade Ratio, the proposal required that customer trades be measured on a trade count basis. The final rule requires that the Customer Facing Trade Ratio be computed in two ways. As in the proposal, the metric must be computed by measuring trades on a trade count basis. Additionally, as suggested by some commenters, the final rule requires that the metric be computed by measuring trades on a notional value basis. The value based approach is required to reflect the fact noted by some commenters, that a trade count based measure may not accurately represent the amount of customer facing activity if customer trade sizes systematically differ from the sizes of non-customer trades. In addition, the term ''customer'' for purposes of the Customer-Facing Trade Ratio is defined in the same manner as the terms client, customer, and counterparty used for purposes of the market-making exemption. This will ensure that the information provided by this metric is useful for purposes of monitoring compliance with the market-making exemption.[2785]

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

One commenter expressed concern that after-the-fact application of the Pay-to-Receive Spread Ratio could cause firms to reconsider their commitment to market making. This commenter suggested that if this measure is used, it be applied flexibly, in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2786] Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to the entire process of calculating Pay-to-Receive Spread Ratio.[2787] A number of commenters argued for removing this metric because its calculation incorporates the Spread P&L metric.[2788] Some of these commenters argued that the metric requires a trade-by-trade analysis which would be expensive to compute and would not provide any additional information that is not available from other metrics. One commenter alleged that this metric was not calculable by any methodology.[2789]

The Pay-to-Receive Spread Ratio has not been retained in the final rule. As noted by some commenters, the broad information content of this metric will largely be captured in the Comprehensive Profit and Loss Attribution measurement. In addition, the Comprehensive Profit and Loss Attribution will place such factors that are related to the proposed Pay-to-Receive Spread Ratio in context with other factors that determine total profitability. Accordingly, factors relating to the payment of fees, commissions and spreads will not be considered in isolation but will be viewed in a context that is appropriate to the entirety of the trading desk's activities. Finally, using the information contained in the Comprehensive Profit and Loss Attribution to holistically assess the range of factors that determine overall profitability, rather than requiring a large number of separate and distinct measurements, will reduce the resulting compliance burden while ensuring an integrated and holistic approach to assessing the activities of each trading desk.

Commenters also suggested a number of additional metrics be added to the final rule that were not contained in the proposal. One commenter, who advocated for an alternative framework for market making supported by structural and transactional metrics, suggested that structural metrics could include the ratio of salespeople to traders and the level of resources devoted to client research and trading content.[2790] Two commenters supported the use of a counterparty risk exposure measure, not only to the risk of counterparty default but also to potential gains and losses to major counterparties for each of a list of systemically important scenarios.[2791] One of these commenters suggested that entity-wide inflation risk assessments be produced on a daily basis.[2792] This commenter also argued that an important metric that is missing is a Liquidity Gap Risk metric that estimates

[2783] The Agencies believe that this should address commenters' uncertainty with respect to how the Inventory Risk Turnover metric would work for derivatives. *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2784] *See* Barclays; Goldman (Prop. Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

[2785] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2786] *See* NYSE Euronext.

[2787] *See* UBS.

[2788] *See* CH/ABASA; Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy; SIFMA (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2789] *See* Morgan Stanley.

[2790] *See* Morgan Stanley.

[2791] *See* Prof. Duffie; Occupy.

[2792] *See* Occupy.

the price change that occurs following a sudden disruption in liquidity for a product, arguing that there needs to be an industry-wide effort to more accurately measure and account for the significant effect that liquidity and changes in its prevailing level have on the valuation of each asset.

One commenter argued that the metrics regime was well-designed for market-making but lacking in other areas like hedging. This commenter recommended the addition of additional metrics more applicable to other non-market making activities like a net profit metric for hedging.[2793] Two commenters argued that quantitative measurement for underwriting was not included in the proposal and stated that in a bona fide underwriting, unsold balances should be relatively small so a marker for potential non-bona fide underwriting should be recognized if VaR (unhedged and uncovered) of the unsold balance that is allocated to a banking entity is large relative to the expected revenue measured by the pro rata underwriting spread.[2794]

After carefully considering the comments received, these and other proposed metrics have not been included as part of the final rule. One major concern raised by a range of commenters was the degree of complexity and burden that would be required by the metrics reporting regime. In light of these comments, the final rule includes a number of quantitative measurements that are expected to provide a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible trading activities in a cost effective and efficient manner while being appropriate for a range of different trading activities. Moreover, while many commenters suggested a number of different alternative metrics, many of these alternatives are consistent with the broad themes, risk management, sources of revenues, customer facing activity, that inform the quantitative measurements that are retained in the final rule. Finally, banking entities will be expected to develop their own metrics, as appropriate, to further inform and improve their own monitoring and understanding of their trading activities. Many of the alternative metrics that were suggested by commenters, especially those that relate to a specific market or type of instrument, may be used by banking entities as they develop their own quantitative measurements.

For each individual quantitative measurement in the final rule, Appendix A describes the measurement, provides general guidance regarding how the measurement should be calculated and specifies the period over which each calculation should be made. The proposed quantitative measurements attempt to incorporate, wherever possible, measurements already used by banking entities to manage risks associated with their trading activities. Of the measurements proposed, the Agencies expect that a large majority of measurements proposed are either (i) already routinely calculated by banking entities or (ii) based solely on underlying data that are already routinely calculated by banking entities. However, calculating these measurements according to the specifications described in Appendix A and at the trading desk level mandated by the final rule may require banking entities to implement new processes to calculate and furnish the required data.[2795]

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

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

The Agencies expect to evaluate the data collected during the compliance period both for its usefulness as a barometer of impermissible trading activity and excessive risk-taking and for its costs. This evaluation will consider, among other things, whether all of the quantitative measurements are useful for all asset classes and markets, as well as for all the trading activities subject to the metrics requirement, or if further tailoring is warranted.[2796] The Agencies propose to revisit the metrics and determine, based on a review of the data collected by September 30, 2015, whether to modify, retain or replace the metrics. To allow firms to develop systems to calculate and report these metrics, the Agencies have delayed all reporting of the metrics until July 2014, phased in the reporting requirements over a multi-year period, and reduced the category of banking entities that must report the metrics to a smaller number of firms that engage in significant trading activity. These steps, combined with the reduction in the number of metrics required to be reported, are designed to reduce the cost and burden associated with compiling and reporting the metrics while retaining the usefulness of this data collection in helping to ensure that trading activities are conducted in compliance with section 13 of the BHC Act and the final rule and in a manner that monitors, assesses and controls the risks associated with these activities.

4. Section 75.21: Termination of Activities or Investments; Authorities for Violations

Section 75.21 implements section 13(e)(2) of the BHC Act, which authorizes an Agency to order a banking entity subject to its jurisdiction to terminate activities or investments that violate or function as an evasion of section 13 of the Act.[2797] Section 13(e)(2) further provides that this paragraph shall not be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.[2798]

The proposed rule implemented section 13(e)(2) in two parts. First, § 75.21(a) of the proposal required any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the proposed rule, or in a manner that functions as an evasion of the

[2793] *See* AFR *et al.* (Feb. 2012).

[2794] *See* AFR *et al.* (Feb. 2012); *see also* Public Citizen.

[2795] *See* Credit Suisse (Seidel); Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale; Occupy; Paul Volcker; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen.

[2796] The Agencies believe this review, along with the fact that quantitative measurements will not be used as a dispositive tool for determining compliance and the removal of many of the proposed metrics, should help address commenters' concerns that some of the proposed quantitative measurements will not be as relevant for certain asset classes, markets, and activities. *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading); Stephen Roach.

[2797] *See* 12 U.S.C. 1851(e)(2).

[2798] *Id.*

requirements of section 13 of the BHC Act or the proposed rule, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the proposed rule, to terminate the activity and, as relevant, dispose of the investment.[2799] Second, § 75.21(b) of the proposal provided that if, after due notice and an opportunity for hearing, the respective Agency finds reasonable cause to believe that any banking entity has engaged in an activity or made an investment described in paragraph (a), the Agency may, by order, direct the entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.[2800]

Several commenters urged the Agencies to strengthen the authorities provided for under § 75.21,[2801] with some commenters expressing concern that the proposed rule does not establish sufficient enforcement mechanisms and penalties for violations of the rule's requirements.[2802] Some commenters suggested the Agencies add language in § 75.21 authorizing the imposition of automatic and significant financial penalties—as significant as the potential gains from illegal proprietary trading—on traders, supervisors, executives, and firms for violating section 13 of the BHC Act and the final rule.[2803] These commenters suggested the Agencies incorporate reference to the Board's authority under section 8 of the BHC Act into the rule,[2804] and others encouraged the Agencies to rely on their inherent authority to impose automatic penalties and fines.[2805] A few commenters stated that traders, management, and banking entities should be held responsible for violations under certain circumstances.[2806] Finally, another commenter recommended that officers and directors of a banking entity be removed from office, be prohibited from being affiliated with a banking entity, and be subject to salary clawbacks for violations of section 13 of the BHC Act and the final rule.[2807]

The Agencies note that the authorities provided for in § 75.21 are not exclusive. The Agencies have a number of enforcement tools at their disposal to carry out their obligations to ensure compliance with section 13 of the BHC Act and the final rule, and need not reference them expressly in § 75.21 in order to exercise them. Specifically, the Agencies may rely on their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law.[2808] For example, a banking entity that violates section 13 of the BHC Act and the final rule may be subject to criminal and civil penalties under section 8 of the BHC Act. Banking entities may also be subject to formal enforcement actions under section 8 of the Federal Deposit Insurance Act (FDIA), such as cease and desist orders or civil money penalty actions,[2809] or safety and soundness orders under section 39 of the FDIA which may be enforceable through assessment of civil money penalties and through the Federal court system. In addition, officers, directors, and other institution-affiliated parties [2810] may be subject to civil money penalties, prohibition or removal actions, and personal cease and desist orders under section 8 of the FDIA. Submission of late, false, or misleading reports, including false statements on compliance with section 13 of the BHC Act or the final rule, may also result in actions under applicable securities, commodities, banking, and criminal laws, including imposition of civil money and criminal penalties.[2811] Therefore, the final rule is consistent with the proposal and does not mention other enforcement actions available to address violations of section 13 of the BHC Act and this final rule.

Section 13 of the BHC Act and the final rule do not limit the reach or applicability of the antifraud and other provisions of the Federal laws to banking entities, including, for example, section 17(a) of the Securities Act of 1933 or section 10(b) and 15(c) of the Exchange Act and the rules promulgated thereunder.

One commenter also suggested that the Agencies use their authority under section 13(d)(3) of the BHC Act to impose additional capital requirements and quantitative limitations on banking entities for repeat violations of the prohibition on proprietary trading.[2812] The Agencies believe they can rely on other inherent enforcement authorities to address repeat violations. The Agencies note that several other commenters also requested the Agencies to exercise their authority under section 13(d)(3).[2813] The Agencies do not believe that it is appropriate to exercise their authority under this section at this time, primarily because the capital treatment of banking entities' trading activities is currently being addressed through the Agencies' risk-based capital rulemakings.[2814] Additionally, the Agencies believe Congress intended section 13(d)(3) to serve the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider U.S. financial system. To the extent commenters

[2799] *See* proposed rule § 75.21(a). The proposal noted that the Agencies included § 75.21(a), in addition to the provisions of § 75.21(b) of the proposed rule, to clarify that the requirement to terminate an activity or, as relevant, dispose of an investment would be triggered when a banking entity discovers the violation or evasion, regardless of whether an Agency order has been issued.

[2800] *See* proposed rule § 75.21(b).

[2801] *See* Sen. Merkley; Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[2802] *See, e.g.,* BEC *et al.* (Jan. 2012); John Reed; Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Sen. Merkley; Public Citizen.

[2803] *See, e.g.,* Form Letter Type A; Form Letter Type B; Sarah McKee; David R. Wilkes; Ben Leet; Karen Michaelis; Barry Rein; Allan Richardson; Ronald Gedrim; Susan Pashkoff; Joan Budd; Frances Vreman; Lisa Kazmier; Michael Wenger; Dyanne DiRosario; Alexander Clayton; James Ofsink; Richard Leining (arguing that violators should face penalties such as seizure and discharge of the board and executives); Lee Smith; *see also* Occupy; Public Citizen.

[2804] *See* Better Markets (Feb. 2012) (contending that penalties should include specific administrative penalties, including monetary penalties, bars, cease and desist orders, strengthened penalties for recurring violations, and sanctioning of employees involved in the violation and public reporting of such sanctions); AFR *et al.* (arguing that section 8 of the BHC Act provides civil penalties for violations by a company or individual and criminal penalties for willful violations of the BHC Act). *See also* Occupy (requesting the Agencies provide penalties that are specific to this rule in addition to the general framework for criminal and civil penalties in section 8 of the BHC Act).

[2805] *See* Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

[2806] *See* John Reed; Better Markets (Feb. 2012). *See also* BEC *et al.* (Jan. 2012) (arguing that CEOs and CFOs should be held fully responsible for any violations of the rule by any employees above the clerical level); Occupy (recommending that traders relying on an exemption in the proposed rule be held personally liable for any losses on trading positions).

[2807] *See* Occupy.

[2808] *See* 12 U.S.C. 1851(g)(3).

[2809] *See, e.g.,* 12 U.S.C. 1818(i) (authorizing imposition of civil money penalties up to the maximum daily amount of $1,000,000 for, among other things, knowing violations of law or regulation).

[2810] *See* 12 U.S.C. 1813(u) (defining ''institution-affiliated party'').

[2811] *See, e.g.,* 12 U.S.C. 164 (authorizing imposition of civil money penalties for, among other things, submitting false or misleading reports or information to the OCC); 18 U.S.C. 1005 (authorizing imposition of fines of not more than $1,000,000 or imprisonment not more than 30 years, or both, for, among other things, making a false entry in the books, reports or statements of a bank with intent to injure, defraud or deceive).

[2812] *See* Better Markets (Feb. 2012).

[2813] *See* Sen. Merkley; Public Citizen; Better Markets (Feb. 2012); Profs. Admati & Pfleiderer.

[2814] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule, 78 FR 62017 (Friday, October 11, 2013).

suggested section 13(d)(3) be employed for a punitive purpose, the Agencies do not believe the provision was designed to serve such a purpose nor do the Agencies believe that would be an appropriate use of the provision. Thus, the Agencies believe section 13(d)(3) is more appropriately employed for the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider financial stability of the U.S. financial system.

Commenters also urged the Agencies to clearly delineate in the final rule the jurisdictional authority of each of the Agencies to enforce compliance with section 13 of the BHC Act and the implementing final rule. A number of commenters recommended approaches to coordinating examinations and enforcement among the Agencies, as well as to providing interpretive guidance.[2815] For example, some commenters observed that more than one Agency would have jurisdiction over a given banking entity, and recommended that supervision and enforcement of the final rule for all entities within a banking enterprise remain completely with one Agency.[2816] Further, some commenters recommended that a single Agency be appointed to provide interpretations, supervision, and enforcement of section 13 and the rules thereunder for all banking entities.[2817] Similarly, one commenter suggested that the Board be given initial authority to supervise the implementation of the rule because it is the primary enforcer of the BHC Act and the single regulator that can currently look across a banking group's entire global businesses, regardless of legal entity. This commenter stated that the Board could then determine whether an activity should be delegated to one of the other Agencies for further examination or enforcement.[2818] In addition, with respect to interpretive authority, some commenters indicated that the Board should be given sole interpretive authority of the statute and the rules thereunder.[2819] Other commenters urged the Agencies to supervise and enforce the rule on a coordinated basis so as to minimize duplicative enforcement efforts, reduce costs, and promote certainty.[2820]

Section 13(e)(2) mandates that each Agency enforce compliance of section 13 with respect to a banking entity ''under the respective [A]gency's jurisdiction.'' [2821] This section provides the Agencies with the authority to order a banking entity to terminate activities or investments that violate or function as an evasion of section 13 of the BHC Act.[2822] Decisions about whether to issue such orders could be made after examinations or otherwise. Nothing in the final rule limits an Agency's inherent authority to conduct examinations or otherwise inspect banking entities to ensure compliance with the final rule. Section 75.1 of each Agency's proposed rule described the specific types of banking entities to which that Agency's rule applies. The Agencies acknowledge commenters' concerns about overlapping jurisdictional authority. The Agencies recognize that, on occasion, a banking entity may be subject to jurisdiction by more than one Agency. As is customary, the Agencies plan to coordinate their examination and enforcement proceedings under section 13, to the extent possible and practicable, so as to limit duplicative actions and undue costs and burdens for banking entities.[2823]

The Agencies are adopting § 75.21 substantially as proposed. Accordingly, § 75.21(a) of the final rule provides that any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the final rule or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the final rule, including through an abuse of any activity or investment permitted or expressly excluded by the terms of the final rule, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the final rule, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment. This provision allows the Agencies to enforce the rule's prohibitions against proprietary trading and sponsoring or owning interests in covered funds regardless of how banking entities classify their actions, while also providing banking entities the freedom to legitimately engage in those banking activities which are outside the scope of the statute.

VII. Administrative Law Matters

A. Paperwork Reduction Act Analysis

The Paperwork Reduction Act (''PRA'') provides that a Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget (''OMB'').[2824] This final rulemaking contains several collections of information for which the three Federal banking agencies—the Board, the OCC, and FDIC—sought control numbers at the time they proposed the same substantive requirements that the Commission later proposed.[2825]

To avoid double accounting of information collections for which control numbers were sought, the Commission did not propose and is not finalizing an information collection request for this rulemaking. Rather, as indicated in its proposed rulemaking, the Board provided that it would submit its information collection to OMB once its final rule is published, and that the submission would include burden for Federal Reserve-supervised institutions, as well as burden for OCC-, FDIC-, SEC-, and CFTC-supervised institutions under a holding company.[2826] The Board, OCC, and FDIC, as well as the SEC, are expected to adopt equivalent final rulemakings on or about the same date as the CFTC adopts its final rule. The Board, OCC, and FDIC included in

[2815] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); Comm. on Capital Market Regulation; BEC *et al.;* ISDA (Apr. 2012).

[2816] *See* Barclays (arguing that ideally the umbrella Federal regulator of the enterprise should take this role); Goldman (Prop. Trading).

[2817] *See* BoA; BEC *et al.*

[2818] *See* Comm. on Capital Market Regulation.

[2819] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (recommending that the Board be responsible for resolving potentially conflicting supervisory recommendations or matters requiring attention arising from examinations as well); ISDA (Apr. 2012). *See also* ABA (Keating) (arguing that the Agencies should defer to the Board's sole authority to interpret provisions of Volcker that intersect with other statutory provisions subject to the Board's jurisdictional authority, such as Super 23A); JPMC (contending that the Agencies should adopt and seek comment on a protocol for supervision and enforcement that will ensure a given banking entity will face one set of rules and different banking entities will face the same set of rules). The Agencies decline to adopt the commenter's suggested approach of deferring to the Board's sole interpretive authority with respect to the provisions of the final rule. The Agencies believe at this time that such an approach would be neither appropriate nor effective given the different authorities and expertise of each Agency. *See* Part VI.C (discussing the Agencies' decision not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13).

[2820] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (stating that the Agencies should issue one set of exam findings under these circumstances); ISDA (Apr. 2012).

[2821] *See* 12 U.S.C. 1851(c)(2).

[2822] *See* 12 U.S.C. 1851(e)(2) (requiring ''due notice and opportunity for hearing'').

[2823] *See* 12 U.S.C. 1844 (establishing jurisdictional boundaries for regulation of bank holding companies); *see also* 12 U.S.C. 1828a (antievasion statute empowering OCC, FDIC, and the Board to impose restrictions on relationships or transactions between banks and their subsidiaries and affiliates).

[2824] 44 U.S.C. 3501 et seq.

[2825] *See* 76 FR 68846, 68936, Nov. 7, 2011 (joint release of the Board, OCC, FDIC, and the SEC), and 77 FR 8332, 8420, Feb. 14, 2012.

[2826] 76 FR at 68936.

the Supplementary Information of their final rulemakings an overview of their PRA analyses including burden cost estimates, with further analyses to be provided in the supporting statements required to be submitted to OMB according to their regulations implementing the PRA.

In particular, section 619 of the Dodd-Frank Act provides that the banking agencies, the SEC, and the Commission engage in ''coordinated rulemaking,'' which includes all entities for which the Commission ''is the primary financial regulatory agency, as defined in section 2'' of the Dodd-Frank Act. Section 2 defines ''primary financial regulatory agency'' as a Federal banking agency with respect to certain depository institutions except as provided in other subsections of section 2. In subsection (12)(C), the Commission is designated as the primary financial regulatory agency for, among other things, ''any . . . swap dealer . . . registered with the [Commission] . . ..'' Section 4s(c)(1) of the CEA, as adopted in section 731 of the Dodd-Frank Act, provides that ''any person that is required to be registered as a swap dealer shall register with the Commission regardless of whether the person is also a depository institution.''

Accordingly, banking entities, including domestic depository institutions and branches and agencies of foreign banks subject to supervision by OCC or the Board, have registered with the Commission. It is presently not known how many additionally may register. To ensure that the Commission has access to fulfill its statutory obligations and not unduly burden its registrants with duplicative information collection requirements, and pursuant to its proposed rulemaking, the Commission will request, pursuant to 44 U.S.C. 3509, that the director of the OMB designate the banking agencies as the respective collection agencies for PRA purposes for all banking entities for which the Commission is the primary financial regulatory agency with respect to this rulemaking.

B. Regulatory Flexibility Act Analysis

In general, section 4 of the Regulatory Flexibility Act (5 U.S.C. 604) (RFA) requires an agency to prepare a final regulatory flexibility analysis (FRFA) for a final rule unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined as of July 22, 2013, to include banking entities with total assets of $500 million or less (''small banking entities'').[2827] Pursuant to section 605(b) of the RFA, a FRFA is not required if an agency certifies that the final rule will not have a significant economic impact on a substantial number of small entities. The Agencies have considered the potential economic impact of the final rule on small banking entities in accordance with the RFA. The Agencies believe that the final rule will not have a significant economic impact on a substantial number of small banking entities for the reasons described below.

The Agencies previously considered the impact of the proposed rule for purposes of the RFA and concluded that the proposed rule would not appear to have a significant economic impact on a substantial number of small banking entities. In support of this conclusion, the proposed rule, among other things, noted that the thresholds for the metrics reporting requirements under § 75.7 and Appendix A and for the enhanced and core compliance program requirements under § 75.20 and Appendix C of the proposed rule would not capture small banking entities.[2828]

The Agencies received several comments on the impact of the proposed rule on small entities. Commenters argued that the Agencies incorrectly concluded that the proposed rule would not have a significant economic impact on a substantial number of small entities.[2829] Commenters asserted that the proposed rule would have a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services, including covered fund-linked products for investment and hedging purposes and underwriting and market-making related services.[2830]

The Agencies have carefully considered these comments in developing a final rule. To minimize burden on small banking entities, section 75.20(f)(1) of the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments. In addition, to minimize the burden on small banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity. Only those banking entities with total assets of greater than $10 billion will need to adopt more detailed or enhanced compliance requirements under the final rule. (For purposes of the enhanced compliance program in Appendix B of the final rule, the threshold for banking entities is total consolidated assets of $50 billion or more.) Accordingly, the compliance requirements under the final rule do not have a significant economic impact on a substantial number of small banking entities.

Likewise, the final rule raises the threshold for metrics reporting from the proposed rule to capture only firms that engage in significant trading activities. Specifically, the metrics reporting requirements under § 75.20 and Appendix A of the final rule apply only to banking entities with average trading assets and liabilities on a consolidated, worldwide basis for the preceding year equal to or greater than $10 billion. Accordingly, the metrics reporting requirements under the final rule do not impact small banking entities.

Moreover, the Agencies have revised the definition of covered fund in the final rule to address many of the concerns raised by commenters regarding the unintended consequences of the proposed definition.[2831] The definition of covered fund under the final rule contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, acquisition vehicles, insurance company separate accounts, registered investments companies, and public welfare investment funds. The Agencies believe that these changes will

[2827] *See* 13 CFR 121.201; *see also* 13 CFR 121.103(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

[2828] *See* Joint Proposal, 76 FR at 68938–68939.

[2829] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012); ABA (Keating).

[2830] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

[2831] *See* Part VI.B.1. of this **SUPPLEMENTARY INFORMATION.**

further minimize the burden for small banking entities such as those that may use wholly owned subsidiaries for organizational convenience or make public welfare investments to achieve their financial and Community Reinvestment Act goals.

Finally, in response to commenters' assertion that the proposed rule would have had a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services,[2832] the Agencies note that the RFA does not require the Agencies to consider the impact of the final rule, including its indirect economic effects, on small entities that are not subject to the requirements of the final rule.[2833]

For the reasons stated above, the OCC, FDIC, SEC, and CFTC certify, for the banking entities subject to each such Agency's jurisdiction, that the final rule will not result in a significant economic impact on a substantial number of small entities. In light of the foregoing, the Board does not believe, for the banking entities subject to the Board's jurisdiction, that the final rule would have a significant economic impact on a substantial number of small entities.

List of Subjects in 17 CFR Part 75

Banks, Banking, Compensation, Credit, Derivatives, Federal branches and agencies, Federal savings associations, Government securities, Hedge funds, Insurance, Investments, National banks, Penalties, Proprietary trading, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Swap dealers, Trusts and trustees, Volcker rule.

For the reasons discussed in the preamble, the Commodity Futures Trading Commission adds part 75 to 17 CFR Chapter I to read as follows:

[2832] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

[2833] *See e.g.,* In Mid-Tex Electric Cooperative v. FERC, 773 F.2d 327 (D.C. Cir. 1985); *United Distribution Cos.* v. *FERC,* 88 F.3d 1105, 1170 (D.C. Cir. 1996); *Cement Kiln Recycling Coalition* v. *EPA,* 255 F.3d 855 (D.C. Cir. 2001). Commenters relied on Aeronautical Repair Station Association v. Federal Aviation Administration, 494 F.3d 161 (DC Cir 2007) to argue that the Agencies must consider the indirect economic effects of the final rule on small non-banking entities. This case is inapposite, however, because there the agency's own rulemaking release expressly stated that the rule imposed responsibilities directly on certain small business contractors. The court reaffirmed its prior holdings that the RFA limits its application to small entities ''which will be subject to the proposed regulation—that is, those small entities to which the proposed rule will apply.'' *Id.* at 176 (emphasis and internal quotations omitted).

PART 75—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

Subpart A—Authority and Definitions

Sec.
75.1 Authority, purpose, scope, and relationship to other authorities.
75.2 Definitions.

Subpart B—Proprietary Trading

75.3 Prohibition on proprietary trading.
75.4 Permitted underwriting and market making-related activities.
75.5 Permitted risk-mitigating hedging activities.
75.6 Other permitted proprietary trading activities.
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75.8–75.9 [Reserved]

Subpart C—Covered Fund Activities and Investments

75.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.
75.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.
75.12 Permitted investment in a covered fund.
75.13 Other permitted covered fund activities and investments.
75.14 Limitations on relationships with a covered fund.
75.15 Other limitations on permitted covered fund activities.
75.16–75.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

75.20 Program for compliance; reporting.
75.21 Termination of activities or investments; penalties for violations.
Appendix A to Part 75—Reporting and Recordkeeping Requirements for Covered Trading Activities
Appendix B to Part 75—Enhanced Minimum Standards for Compliance Programs

Authority: 12 U.S.C. 1851.

Subpart A—Authority and Definitions

§ 75.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the Commission under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading by, and investments in or relationships with covered funds by, certain banking entities. This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds, and further explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to banking entities for which the CFTC is the primary financial regulatory agency, as defined in section 2(12) of the Dodd-Frank Act.

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the BHC Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of the BHC Act shall apply to the activities of an applicable banking entity, even if such activities are authorized for the applicable banking entity under other applicable provisions of law.

§ 75.2 Definitions.

Unless otherwise specified, for purposes of this part:

(a) *Affiliate* has the same meaning as in section 2(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(k)).

(b) *Bank holding company* has the same meaning as in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

(c) *Banking entity.* (1) Except as provided in paragraph (c)(2) of this section, *banking entity* means:

(i) Any insured depository institution;

(ii) Any company that controls an insured depository institution;

(iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and

(iv) Any affiliate or subsidiary of any entity described in paragraphs (c)(1)(i), (ii), or (iii) of this section.

(2) Banking entity does not include:

(i) A covered fund that is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section;

(ii) A portfolio company held under the authority contained in section 4(k)(4)(H) or (I) of the BHC Act (12 U.S.C. 1843(k)(4)(H), (I)), or any portfolio concern, as defined under 13 CFR 107.50, that is controlled by a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), so long as the portfolio company or portfolio concern is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section; or

(iii) The FDIC acting in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(d) *Board* means the Board of Governors of the Federal Reserve System.

(e) *CFTC* or *Commission* means the Commodity Futures Trading Commission.

(f) *Dealer* has the same meaning as in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)).

(g) *Depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

(h) *Derivative.* (1) Except as provided in paragraph (h)(2) of this section, *derivative* means:

(i) Any swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68));

(ii) Any purchase or sale of a commodity, that is not an excluded commodity, for deferred shipment or delivery that is intended to be physically settled;

(iii) Any foreign exchange forward (as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)) or foreign exchange swap (as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25));

(iv) Any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(C)(i));

(v) Any agreement, contract, or transaction in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and

(vi) Any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b));

(2) A derivative does not include:

(i) Any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)); or

(ii) Any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

(i) *Employee* includes a member of the immediate family of the employee.

(j) *Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(k) *Excluded commodity* has the same meaning as in section 1a(19) of the Commodity Exchange Act (7 U.S.C. 1a(19)).

(l) *FDIC* means the Federal Deposit Insurance Corporation.

(m) *Federal banking agencies* means the Board, the Office of the Comptroller of the Currency, and the FDIC.

(n) *Foreign banking organization* has the same meaning as in section 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)), but does not include a foreign bank, as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)), that is organized under the laws of the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, or the Commonwealth of the Northern Mariana Islands.

(o) *Foreign insurance regulator* means the insurance commissioner, or a similar official or agency, of any country other than the United States that is engaged in the supervision of insurance companies under foreign insurance law.

(p) *General account* means all of the assets of an insurance company except those allocated to one or more separate accounts.

(q) *Insurance company* means a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act (12 U.S.C. 1851).

(r) *Insured depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)), but does not include an insured depository institution that is described in section 2(c)(2)(D) of the BHC Act (12 U.S.C. 1841(c)(2)(D)).

(s) *Loan* means any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.

(t) *Primary financial regulatory agency* has the same meaning as in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)).

(u) *Purchase* includes any contract to buy, purchase, or otherwise acquire. For security futures products, purchase includes any contract, agreement, or transaction for future delivery. With respect to a commodity future, purchase includes any contract, agreement, or transaction for future delivery. With respect to a derivative, purchase includes the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(v) *Qualifying foreign banking organization* means a foreign banking organization that qualifies as such under § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c), or (e)).

(w) *SEC* means the Securities and Exchange Commission.

(x) *Sale* and *sell* each include any contract to sell or otherwise dispose of. For security futures products, such terms include any contract, agreement, or transaction for future delivery. With respect to a commodity future, such terms include any contract, agreement, or transaction for future delivery. With respect to a derivative, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(y) *Security* has the meaning specified in section 3(a)(10) of the Exchange Act (15 U.S.C. 78c(a)(10)).

(z) *Security-based swap dealer* has the same meaning as in section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)).

(aa) *Security future* has the meaning specified in section 3(a)(55) of the Exchange Act (15 U.S.C. 78c(a)(55)).

(bb) *Separate account* means an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(cc) *State* means any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

(dd) *Subsidiary* has the same meaning as in section 2(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(d)).

(ee) *State insurance regulator* means the insurance commissioner, or a similar official or agency, of a State that is engaged in the supervision of insurance companies under State insurance law.

(ff) *Swap dealer* has the same meaning as in section 1(a)(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)).

Subpart B—Proprietary Trading

§ 75.3 Prohibition on proprietary trading.

(a) *Prohibition.* Except as otherwise provided in this subpart, a banking entity may not engage in proprietary trading. *Proprietary trading* means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.

(b) *Definition of trading account.* (1) Trading account means any account that is used by a banking entity to:

(i) Purchase or sell one or more financial instruments principally for the purpose of:

(A) Short-term resale;

(B) Benefitting from actual or expected short-term price movements;

(C) Realizing short-term arbitrage profits; or

(D) Hedging one or more positions resulting from the purchases or sales of financial instruments described in paragraphs (b)(1)(i)(A), (B), or (C) of this section;

(ii) Purchase or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule; or

(iii) Purchase or sell one or more financial instruments for any purpose, if the banking entity:

(A) Is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

(B) Is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.

(2) *Rebuttable presumption for certain purchases and sales.* The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section.

(c) *Financial instrument*—(1) *Financial instrument* means:

(i) A security, including an option on a security;

(ii) A derivative, including an option on a derivative; or

(iii) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

(2) A financial instrument does not include:

(i) A loan;

(ii) A commodity that is not:

(A) An excluded commodity (other than foreign exchange or currency);

(B) A derivative;

(C) A contract of sale of a commodity for future delivery; or

(D) An option on a contract of sale of a commodity for future delivery; or

(iii) Foreign exchange or currency.

(d) *Proprietary trading does not include:*—(1) Any purchase or sale of one or more financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;

(2) Any purchase or sale of one or more financial instruments by a banking entity that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties;

(3) Any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan of the banking entity that:

(i) Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used;

(ii) Requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

(iii) Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit, and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;

(iv) Limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis, and independent testing to ensure that the purchase and sale of securities that are not permitted under § 75.6(a) or (b) are for the purpose of liquidity management and in accordance with the liquidity management plan described in paragraph (d)(3) of this section; and

(vi) Is consistent with the Commission's supervisory requirements, guidance, and expectations regarding liquidity management;

(4) Any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency in connection with clearing financial instruments;

(5) Any excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(6) Any purchase or sale of one or more financial instruments by a banking entity, so long as:

(i) The purchase (or sale) satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity; or

(ii) The purchase (or sale) satisfies an obligation of the banking entity in connection with a judicial,

administrative, self-regulatory organization, or arbitration proceeding;

(7) Any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker, or custodian;

(8) Any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity; or

(9) Any purchase or sale of one or more financial instruments by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the Commission.

(e) *Definition of other terms related to proprietary trading.* For purposes of this subpart:

(1) *Anonymous* means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale.

(2) *Clearing agency* has the same meaning as in section 3(a)(23) of the Exchange Act (15 U.S.C. 78c(a)(23)).

(3) *Commodity* has the same meaning as in section 1a(9) of the Commodity Exchange Act (7 U.S.C. 1a(9)), except that a commodity does not include any security;

(4) *Contract of sale of a commodity for future delivery* means a contract of sale (as that term is defined in section 1a(13) of the Commodity Exchange Act (7 U.S.C. 1a(13)) for future delivery (as that term is defined in section 1a(27) of the Commodity Exchange Act (7 U.S.C. 1a(27))).

(5) *Derivatives clearing organization* means:

(i) A derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1);

(ii) A derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1); or

(iii) A foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

(6) *Exchange,* unless the context otherwise requires, means any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, or, for purposes of securities or security-based swaps, an exchange, as defined under section 3(a)(1) of the Exchange Act (15 U.S.C. 78c(a)(1)), or security-based swap execution facility, as defined under section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)).

(7) *Excluded clearing activities* means:

(i) With respect to customer transactions cleared on a derivatives clearing organization, a clearing agency, or a designated financial market utility, any purchase or sale necessary to correct trading errors made by or on behalf of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(ii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(iii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(iv) Any purchase or sale in connection with and related to the management of the default or threatened default of a clearing agency, a derivatives clearing organization, or a designated financial market utility; and

(v) Any purchase or sale that is required by the rules or procedures of a clearing agency, a derivatives clearing organization, or a designated financial market utility to mitigate the risk to the clearing agency, derivatives clearing organization, or designated financial market utility that would result from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

(8) *Designated financial market utility* has the same meaning as in section 803(4) of the Dodd-Frank Act (12 U.S.C. 5462(4)).

(9) *Issuer* has the same meaning as in section 2(a)(4) of the Securities Act of 1933 (15 U.S.C. 77b(a)(4)).

(10) *Market risk capital rule covered position and trading position* means a financial instrument that is both a covered position and a trading position, as those terms are respectively defined:

(i) In the case of a banking entity that is a bank holding company, savings and loan holding company, or insured depository institution, under the market risk capital rule that is applicable to the banking entity; and

(ii) In the case of a banking entity that is affiliated with a bank holding company or savings and loan holding company, other than a banking entity to which a market risk capital rule is applicable, under the market risk capital rule that is applicable to the affiliated bank holding company or savings and loan holding company.

(11) *Market risk capital rule* means the market risk capital rule that is contained in subpart F of 12 CFR part 3, 12 CFR parts 208 and 225, or 12 CFR part 324, as applicable.

(12) *Municipal security* means a security that is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.

(13) *Trading desk* means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

§ 75.4 Permitted underwriting and market making-related activities.

(a) *Underwriting activities*—(1) *Permitted underwriting activities.* The prohibition contained in § 75.3(a) does not apply to a banking entity's underwriting activities conducted in accordance with paragraph (a) of this section.

(2) *Requirements.* The underwriting activities of a banking entity are permitted under paragraph (a)(1) of this section only if:

(i) The banking entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution;

(ii) The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (a) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

(B) Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:

(*1*) Amount, types, and risk of its underwriting position;

(*2*) Level of exposures to relevant risk factors arising from its underwriting position; and

(*3*) Period of time a security may be held;

(C) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(D) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval;

(iv) The compensation arrangements of persons performing the activities described in paragraph (a) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(v) The banking entity is licensed or registered to engage in the activity described in paragraph (a) of this section in accordance with applicable law.

(3) *Definition of distribution.* For purposes of paragraph (a) of this section, a *distribution* of securities means:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

(4) *Definition of underwriter.* For purposes of paragraph (a) of this section, *underwriter* means:

(i) A person who has agreed with an issuer or selling security holder to:

(A) Purchase securities from the issuer or selling security holder for distribution;

(B) Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or

(C) Manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

(5) *Definition of selling security holder.* For purposes of paragraph (a) of this section, *selling security holder* means any person, other than an issuer, on whose behalf a distribution is made.

(6) *Definition of underwriting position.* For purposes of paragraph (a) of this section, *underwriting position* means the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter.

(7) *Definition of client, customer, and counterparty.* For purposes of paragraph (a) of this section, the terms *client, customer,* and *counterparty,* on a collective or individual basis, refer to market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.

(b) *Market making-related activities*—(1) *Permitted market making-related activities.* The prohibition contained in § 75.3(a) does not apply to a banking entity's market making-related activities conducted in accordance with paragraph (b) of this section.

(2) *Requirements.* The market making-related activities of a banking entity are permitted under paragraph (b)(1) of this section only if:

(i) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(ii) The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on:

(A) The liquidity, maturity, and depth of the market for the relevant types of financial instrument(s); and

(B) Demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section;

(B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

(C) Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by paragraph (b)(2)(ii) of this section, on:

(*1*) The amount, types, and risks of its market-maker inventory;

(*2*) The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;

(*3*) The level of exposures to relevant risk factors arising from its financial exposure; and

(*4*) The period of time a financial instrument may be held;

(D) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(E) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of paragraph (b) of this section, and independent review of such demonstrable analysis and approval;

(iv) To the extent that any limit identified pursuant to paragraph (b)(2)(iii)(C) of this section is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;

(v) The compensation arrangements of persons performing the activities described in paragraph (b) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(vi) The banking entity is licensed or registered to engage in activity described in paragraph (b) of this section in accordance with applicable law.

(3) *Definition of client, customer, and counterparty.* For purposes of paragraph (b) of this section, the terms *client, customer,* and *counterparty,* on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that:

(i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § 75.20(d)(1), unless:

(A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of paragraph (b)(2) of this section; or

(B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

(ii) [Reserved]

(4) *Definition of financial exposure.* For purposes of paragraph (b) of this section, *financial exposure* means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.

(5) *Definition of market-maker inventory.* For the purposes of paragraph (b) of this section, *market-maker inventory* means all of the positions in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.

§ 75.5 Permitted risk-mitigating hedging activities.

(a) *Permitted risk-mitigating hedging activities.* The prohibition contained in § 75.3(a) does not apply to the risk-mitigating hedging activities of a banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

(b) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under paragraph (a) of this section only if:

(1) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(i) Reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a particular trading desk may use in its risk-mitigating hedging activities, as well as position and aging limits with respect to such positions, contracts or other holdings;

(ii) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(iii) The conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged, and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged;

(2) The risk-mitigating hedging activity:

(i) Is conducted in accordance with the written policies, procedures, and internal controls required under this section;

(ii) At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;

(iii) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section;

(iv) Is subject to continuing review, monitoring and management by the banking entity that:

(A) Is consistent with the written hedging policies and procedures required under paragraph (b)(1) of this section;

(B) Is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying positions, contracts, and other holdings of the banking entity, based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the

banking entity and the risks and liquidity thereof; and

(C) Requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(2) of this section and is not prohibited proprietary trading; and

(3) The compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.

(c) *Documentation requirement.* (1) A banking entity must comply with the requirements of paragraphs (c)(2) and (c)(3) of this section with respect to any purchase or sale of financial instruments made in reliance on this section for risk-mitigating hedging purposes that is:

(i) Not established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the hedging activity is designed to reduce;

(ii) Established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the purchases or sales are designed to reduce, but that is effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures established under paragraph (b)(1) of this section or under § 75.4(b)(2)(iii)(B) as a product, instrument, exposure, technique, or strategy such trading desk may use for hedging; or

(iii) Established to hedge aggregated positions across two or more trading desks.

(2) In connection with any purchase or sale identified in paragraph (c)(1) of this section, a banking entity must, at a minimum, and contemporaneously with the purchase or sale, document:

(i) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings of the banking entity that the purchase or sale is designed to reduce;

(ii) The specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and

(iii) The trading desk or other business unit that is establishing and responsible for the hedge.

(3) A banking entity must create and retain records sufficient to demonstrate compliance with the requirements of paragraph (c) of this section for a period that is no less than five years in a form that allows the banking entity to promptly produce such records to the Commission on request, or such longer period as required under other law or this part.

§ 75.6 Other permitted proprietary trading activities.

(a) *Permitted trading in domestic government obligations.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale by a banking entity of a financial instrument that is:

(1) An obligation of, or issued or guaranteed by, the United States;

(2) An obligation, participation, or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*);

(3) An obligation of any State or any political subdivision thereof, including any municipal security; or

(4) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(b) *Permitted trading in foreign government obligations*—(1) *Affiliates of foreign banking entities in the United States.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of such foreign sovereign, by a banking entity, so long as:

(i) The banking entity is organized under or is directly or indirectly controlled by a banking entity that is organized under the laws of a foreign sovereign and is not directly or indirectly controlled by a top-tier banking entity that is organized under the laws of the United States;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign banking entity referred to in paragraph (b)(1)(i) of this section is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The purchase or sale as principal is not made by an insured depository institution.

(2) *Foreign affiliates of a U.S. banking entity.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign, by a foreign entity that is owned or controlled by a banking entity organized or established under the laws of the United States or any State, so long as:

(i) The foreign entity is a foreign bank, as defined in § 211.2(j) of the Board's Regulation K (12 CFR 211.2(j)), or is regulated by the foreign sovereign as a securities dealer;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign entity is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The financial instrument is owned by the foreign entity and is not financed by an affiliate that is located in the United States or organized under the laws of the United States or of any State.

(c) *Permitted trading on behalf of customers*—(1) *Fiduciary transactions.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as trustee or in a similar fiduciary capacity, so long as:

(i) The transaction is conducted for the account of, or on behalf of, a customer; and

(ii) The banking entity does not have or retain beneficial ownership of the financial instruments.

(2) *Riskless principal transactions.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.

(d) *Permitted trading by a regulated insurance company.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity that is an insurance company or an affiliate of an insurance company if:

(1) The insurance company or its affiliate purchases or sells the financial instruments solely for:

(i) The general account of the insurance company; or

(ii) A separate account established by the insurance company;

(2) The purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (d)(2) of this section is insufficient to protect the safety and soundness of the covered banking entity, or the financial stability of the United States.

(e) *Permitted trading activities of foreign banking entities.* (1) The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any State;

(ii) The purchase or sale by the banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; and

(iii) The purchase or sale meets the requirements of paragraph (e)(3) of this section.

(2) A purchase or sale of financial instruments by a banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (e)(1)(ii) of this section only if:

(i) The purchase or sale is conducted in accordance with the requirements of paragraph (e) of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) A purchase or sale by a banking entity is permitted for purposes of paragraph (e) of this section only if:

(i) The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;

(iii) The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;

(iv) No financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(v) The purchase or sale is not conducted with or through any U.S. entity, other than:

(A) A purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale;

(B) A purchase or sale with an unaffiliated market intermediary acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

(C) A purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty,

(4) For purposes of paragraph (e) of this section, a U.S. entity is any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of paragraph (e) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(6) For purposes of paragraph (e) of this section, *unaffiliated market intermediary* means an unaffiliated entity, acting as an intermediary, that is:

(i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such;

(ii) A swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such;

(iii) A security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or

(iv) A futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.

§ 75.7 Limitations on permitted proprietary trading activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ 75.4 through 75.6 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section, a material conflict of interest between a

banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§§ 75.8–75.9 [Reserved]

Subpart C—Covered Fund Activities and Investments

§ 75.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

(a) *Prohibition.* (1) Except as otherwise provided in this subpart, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.

(2) Paragraph (a)(1) of this section does not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

(i) Acting solely as agent, broker, or custodian, so long as;

(A) The activity is conducted for the account of, or on behalf of, a customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest;

(ii) Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity (or an affiliate thereof);

(iii) In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such ownership interest for longer than such period permitted by the Commission; or

(iv) On behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as:

(A) The activity is conducted for the account of, or on behalf of, the customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

(b) *Definition of covered fund.* (1) Except as provided in paragraph (c) of this section, covered fund means:

(i) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), *but for* section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(1) or (7));

(ii) Any commodity pool under section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10)) for which:

(A) The commodity pool operator has claimed an exemption under § 4.7 of this chapter; or

(B) (*1*) A commodity pool operator is registered with the CFTC as a commodity pool operator in connection with the operation of the commodity pool;

(*2*) Substantially all participation units of the commodity pool are owned by qualified eligible persons under § 4.7(a)(2) and (3) of this chapter; and

(*3*) Participation units of the commodity pool have not been publicly offered to persons who are not qualified eligible persons under § 4.7(a)(2) and (3) of this chapter; or

(iii) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, an entity that:

(A) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(B) Is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and

(C) (*1*) Has as its sponsor that banking entity (or an affiliate thereof); or

(*2*) Has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

(2) An issuer shall not be deemed to be a covered fund under paragraph (b)(1)(iii) of this section if, were the issuer subject to U.S. securities laws, the issuer could rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act.

(3) For purposes of paragraph (b)(1)(iii) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(c) Notwithstanding paragraph (b) of this section, unless the appropriate Federal banking agencies, the SEC, and

the CFTC jointly determine otherwise, a covered fund does not include:

(1) *Foreign public funds.* (i) Subject to paragraphs (c)(1)(ii) and (iii) of this section, an issuer that:

(A) Is organized or established outside of the United States;

(B) Is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and

(C) Sells ownership interests predominantly through one or more public offerings outside of the United States.

(ii) With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer unless ownership interests in the issuer are sold predominantly to persons other than:

(A) Such sponsoring banking entity;

(B) Such issuer;

(C) Affiliates of such sponsoring banking entity or such issuer; and

(D) Directors and employees of such entities.

(iii) For purposes of paragraph (c)(1)(i)(C) of this section, the term *public offering* means a distribution (as defined in § 75.4(a)(3)) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

(A) The distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;

(B) The distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and

(C) The issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

(2) *Wholly-owned subsidiaries.* An entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that:

(i) Up to five percent of the entity's outstanding ownership interests, less any amounts outstanding under paragraph (c)(2)(ii) of this section, may be held by employees or directors of the banking entity or such affiliate (including former employees or directors if their ownership interest was acquired while employed by or in the service of the banking entity); and

(ii) Up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is acquired or retained by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

(3) *Joint ventures.* A joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons, *provided that* the joint venture:

(i) Is comprised of no more than 10 unaffiliated co-venturers;

(ii) Is in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and

(iii) Is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

(4) *Acquisition vehicles.* An issuer:

(i) Formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction; and

(ii) That exists only for such period as necessary to effectuate the transaction.

(5) *Foreign pension or retirement funds.* A plan, fund, or program providing pension, retirement, or similar benefits that is:

(i) Organized and administered outside the United States;

(ii) A broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and

(iii) Established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision thereof.

(6) *Insurance company separate accounts.* A separate account, provided that no banking entity other than the insurance company participates in the account's profits and losses.

(7) *Bank owned life insurance.* A separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities is beneficiary, provided that no banking entity that purchases the policy:

(i) Controls the investment decisions regarding the underlying assets or holdings of the separate account; or

(ii) Participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.

(8) *Loan securitizations*—(i) *Scope.* An issuing entity for asset-backed securities that satisfies all the conditions of paragraph (c)(8) of this section and the assets or holdings of which are comprised solely of:

(A) Loans as defined in § 75.2(s);

(B) Rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset meets the requirements of paragraph (c)(8)(iii) of this section;

(C) Interest rate or foreign exchange derivatives that meet the requirements of paragraph (c)(8)(iv) of this section; and

(D) Special units of beneficial interest and collateral certificates that meet the requirements of paragraph (c)(8)(v) of this section.

(ii) *Impermissible assets.* For purposes of paragraph (c)(8) of this section, the assets or holdings of the issuing entity shall not include any of the following:

(A) A security, including an asset-backed security, or an interest in an equity or debt security other than as permitted in paragraph (c)(8)(iii) of this section;

(B) A derivative, other than a derivative that meets the requirements of paragraph (c)(8)(iv) of this section; or

(C) A commodity forward contract.

(iii) *Permitted securities.* Notwithstanding paragraph (c)(8)(ii)(A) of this section, the issuing entity may hold securities if those securities are:

(A) Cash equivalents for purposes of the rights and assets in paragraph (c)(8)(i)(B) of this section; or

(B) Securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities.

(iv) *Derivatives.* The holdings of derivatives by the issuing entity shall be limited to interest rate or foreign exchange derivatives that satisfy all of the following conditions:

(A) The written terms of the derivative directly relate to the loans, the asset-backed securities, or the contractual rights of other assets described in paragraph (c)(8)(i)(B) of this section; and

(B) The derivatives reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or other assets described in paragraph (c)(8)(i)(B) of this section.

(v) *Special units of beneficial interest and collateral certificates.* The assets or holdings of the issuing entity may include collateral certificates and special units of beneficial interest issued by a special purpose vehicle, provided that:

(A) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate meets the requirements in paragraph (c)(8) of this section;

(B) The special unit of beneficial interest or collateral certificate is used for the sole purpose of transferring to the issuing entity for the loan securitization the economic risks and benefits of the assets that are permissible for loan securitizations under paragraph (c)(8) of this section and does not directly or indirectly transfer any interest in any other economic or financial exposure;

(C) The special unit of beneficial interest or collateral certificate is created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization; and

(D) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate and the issuing entity are established under the direction of the same entity that initiated the loan securitization.

(9) *Qualifying asset-backed commercial paper conduits.* (i) An issuing entity for asset-backed commercial paper that satisfies all of the following requirements:

(A) The asset-backed commercial paper conduit holds only:

(*1*) Loans and other assets permissible for a loan securitization under paragraph (c)(8)(i) of this section; and

(*2*) Asset-backed securities supported solely by assets that are permissible for loan securitizations under paragraph (c)(8)(i) of this section and acquired by the asset-backed commercial paper conduit as part of an initial issuance either directly from the issuing entity of the asset-backed securities or directly from an underwriter in the distribution of the asset-backed securities;

(B) The asset-backed commercial paper conduit issues only asset-backed securities, comprised of a residual interest and securities with a legal maturity of 397 days or less; and

(C) A regulated liquidity provider has entered into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued by the asset-backed commercial paper conduit (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.

(ii) For purposes of this paragraph (c)(9) of this section, a regulated liquidity provider means:

(A) A depository institution, as defined in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c));

(B) A bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)), or a subsidiary thereof;

(C) A savings and loan holding company, as defined in section 10a of the Home Owners' Loan Act (12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)), or a subsidiary thereof;

(D) A foreign bank whose home country supervisor, as defined in § 211.21(q) of the Board's Regulation K (12 CFR 211.21(q)), has adopted capital standards consistent with the Capital Accord for the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or

(E) The United States or a foreign sovereign.

(10) *Qualifying covered bonds*—(i) *Scope.* An entity owning or holding a dynamic or fixed pool of loans or other assets as provided in paragraph (c)(8) of this section for the benefit of the holders of covered bonds, provided that the assets in the pool are comprised solely of assets that meet the conditions in paragraph (c)(8)(i) of this section.

(ii) *Covered bond.* For purposes of paragraph (c)(10) of this section, a covered bond means:

(A) A debt obligation issued by an entity that meets the definition of foreign banking organization, the payment obligations of which are fully and unconditionally guaranteed by an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section; or

(B) A debt obligation of an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section, provided that the payment obligations are fully and unconditionally guaranteed by an entity that meets the definition of foreign banking organization and the entity is a wholly-owned subsidiary, as defined in paragraph (c)(2) of this section, of such foreign banking organization.

(11) *SBICs and public welfare investment funds.* An issuer:

(i) That is a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), or that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company, which notice or license has not been revoked; or

(ii) The business of which is to make investments that are:

(A) Designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or

(B) Qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

(12) *Registered investment companies and excluded entities.* An issuer:

(i) That is registered as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), or that is formed and operated pursuant to a written plan to become a registered investment company as described in § 75.20(e)(3) and that complies with the requirements of section 18 of the Investment Company Act of 1940 (15 U.S.C. 80a–18);

(ii) That may rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act; or

(iii) That has elected to be regulated as a business development company pursuant to section 54(a) of that Act (15 U.S.C. 80a–53) and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company as described in § 75.20(e)(3) and that complies with the requirements of section 61 of the Investment Company Act of 1940 (15 U.S.C. 80a–60).

(13) *Issuers in conjunction with the FDIC's receivership or conservatorship operations.* An issuer that is an entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(14) *Other excluded issuers.* (i) Any issuer that the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent with the purposes of section 13 of the BHC Act.

(ii) A determination made under paragraph (c)(14)(i) of this section will be promptly made public.

(d) *Definition of other terms related to covered funds.* For purposes of this subpart:

(1) *Applicable accounting standards* means U.S. generally accepted accounting principles, or such other accounting standards applicable to a banking entity that the Commission determines are appropriate and that the banking entity uses in the ordinary course of its business in preparing its consolidated financial statements.

(2) *Asset-backed security* has the meaning specified in section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)).

(3) *Director* has the same meaning as provided in § 215.2(d)(1) of the Board's Regulation O (12 CFR 215.2(d)(1)).

(4) *Issuer* has the same meaning as in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(22)).

(5) *Issuing entity* means with respect to asset-backed securities the special purpose vehicle that owns or holds the pool assets underlying asset-backed securities and in whose name the asset-backed securities supported or serviced by the pool assets are issued.

(6) *Ownership interest*—(i) *Ownership interest* means any equity, partnership, or other similar interest. An ''other similar interest'' means an interest that:

(A) Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(B) Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

(C) Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(D) Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(E) Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(F) Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

(G) Any synthetic right to have, receive, or be allocated any of the rights in paragraphs (d)(6)(i)(A) through (d)(6)(i)(F) of this section.

(ii) *Ownership interest* does not include *restricted profit interest,* which is an interest held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as:

(A) The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

(B) All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;

(C) Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits of § 75.12; and

(D) The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.

(7) *Prime brokerage transaction* means any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

(8) *Resident of the United States* means a person that is a ''U.S. person'' as defined in rule 902(k) of the SEC's Regulation S (17 CFR 230.902(k)).

(9) *Sponsor* means, with respect to a covered fund:

(i) To serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund as defined in (b)(1)(ii) of this section;

(ii) In any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or

(iii) To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

(10) *Trustee.* (i) For purposes of paragraph (d)(9) of this section and § 75.11, a trustee does *not* include:

(A) A trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or

(B) A trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (d)(10)(i)(A) of this section;

(ii) Any entity that directs a person described in paragraph (d)(10)(i) of this section, or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee, shall be considered to be a trustee of such covered fund.

§ 75.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.

(a) *Organizing and offering a covered fund in general.* Notwithstanding § 75.10(a), a banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee, or

commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing, only if:

(1) The banking entity (or an affiliate thereof) provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(2) The covered fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;

(3) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § 75.12;

(4) The banking entity and its affiliates comply with the requirements of § 75.14;

(5) The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(6) The covered fund, for corporate, marketing, promotional, or other purposes:

(i) Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and

(ii) Does not use the word ''bank'' in its name;

(7) No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

(8) The banking entity:

(i) Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

(A) That ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate'';

(B) That such investor should read the fund offering documents before investing in the covered fund;

(C) That the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and

(D) The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and

(ii) Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, as provided in section 13(b)(2) of the BHC Act, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.

(b) *Organizing and offering an issuing entity of asset-backed securities.* (1) Notwithstanding § 75.10(a), a banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund that is an issuing entity of asset-backed securities in connection with, directly or indirectly, organizing and offering that issuing entity, so long as the banking entity and its affiliates comply with all of the requirements of paragraphs (a)(3) through (a)(8) of this section.

(2) For purposes of paragraph (b) of this section, organizing and offering a covered fund that is an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78*o*–11(a)(3)) of the issuing entity, or acquiring or retaining an ownership interest in the issuing entity as required by section 15G of that Act (15 U.S.C. 78*o*–11) and the implementing regulations issued thereunder.

(c) *Underwriting and market making in ownership interests of a covered fund.* The prohibition contained in § 75.10(a) does not apply to a banking entity's underwriting activities or market making-related activities involving a covered fund so long as:

(1) Those activities are conducted in accordance with the requirements of § 75.4(a) or (b), respectively;

(2) With respect to any banking entity (or any affiliate thereof) that acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on paragraph (a) of this section; acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78o–11(a)(3)), or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act (15 U.S.C. 78o–11) and the implementing regulations issued thereunder each as permitted by paragraph (b) of this section; or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § 75.12(a)(2)(ii) and (d); and

(3) With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § 75.11, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities permitted under paragraph (c) of this section, are included in the calculation of all ownership interests under § 75.12(a)(2)(iii) and (d).

§ 75.12 Permitted investment in a covered fund.

(a) *Authority and limitations on permitted investments in covered funds.* (1) Notwithstanding the prohibition contained in § 75.10(a), a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers pursuant to § 75.11, for the purposes of:

(i) *Establishment.* Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to the limits contained in paragraphs (a)(2)(i) and (a)(2)(iii) of this section; or

(ii) *De minimis investment.* Making and retaining an investment in the covered fund subject to the limits contained in paragraphs (a)(2)(ii) and (a)(2)(iii) of this section.

(2) *Investment limits*—(i) *Seeding period.* With respect to an investment in any covered fund made or held pursuant to paragraph (a)(1)(i) of this section, the banking entity and its affiliates:

(A) Must actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund to the amount permitted in paragraph (a)(2)(i)(B) of this section; and

(B) Must, no later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section), conform its ownership interest in the covered fund to the limits in paragraph (a)(2)(ii) of this section;

(ii) *Per-fund limits.* (A) Except as provided in paragraph (a)(2)(ii)(B) of this section, an investment by a banking entity and its affiliates in any covered fund made or held pursuant to paragraph (a)(1)(ii) of this section may not exceed 3 percent of the total number or value of the outstanding ownership interests of the fund.

(B) An investment by a banking entity and its affiliates in a covered fund that is an issuing entity of asset-backed securities may not exceed 3 percent of the total fair market value of the ownership interests of the fund measured in accordance with paragraph (b)(3) of this section, unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act (15 U.S.C. 78*o*–11) and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder.

(iii) *Aggregate limit.* The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this section may not exceed 3 percent of the tier 1 capital of the banking entity, as provided under paragraph (c) of this section, and shall be calculated as of the last day of each calendar quarter.

(iv) *Date of establishment.* For purposes of this section, the date of establishment of a covered fund shall be:

(A) *In general.* The date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund;

(B) *Issuing entities of asset-backed securities.* In the case of an issuing entity of asset-backed securities, the date on which the assets are initially transferred into the issuing entity of asset-backed securities.

(b) *Rules of construction*—(1) *Attribution of ownership interests to a covered banking entity.* (i) For purposes of paragraph (a)(2) of this section, the amount and value of a banking entity's permitted investment in any single covered fund shall include any ownership interest held under § 75.12 directly by the banking entity, including any affiliate of the banking entity.

(ii) *Treatment of registered investment companies, SEC-regulated business development companies and foreign public funds.* For purposes of paragraph (b)(1)(i) of this section, a registered investment company, SEC-regulated business development companies or foreign public fund as described in § 75.10(c)(1) will not be considered to be an affiliate of the banking entity so long as the banking entity:

(A) Does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or fund; and

(B) Provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund in compliance with the limitations under applicable regulation, order, or other authority.

(iii) *Covered funds.* For purposes of paragraph (b)(1)(i) of this section, a covered fund will not be considered to be an affiliate of a banking entity so long as the covered fund is held in compliance with the requirements of this subpart.

(iv) *Treatment of employee and director investments financed by the banking entity.* For purposes of paragraph (b)(1)(i) of this section, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.

(2) *Calculation of permitted ownership interests in a single covered fund.* Except as provided in paragraphs (b)(3) or (4) of this section, for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (ii)(A) of this section:

(i) The aggregate number of the outstanding ownership interests held by the banking entity shall be the total number of ownership interests held under this section by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment);

(ii) The aggregate value of the outstanding ownership interests held by the banking entity shall be the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment). If fair market value cannot be determined, then the value shall be the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;

(iii) For purposes of the calculation under paragraph (b)(2)(ii) of this section, once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.

(3) *Issuing entities of asset-backed securities.* In the case of an ownership interest in an issuing entity of asset-backed securities, for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (a)(2)(ii)(B) of this section:

(i) For securitizations subject to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11), the calculations shall be made as of the date and according to the valuation methodology applicable pursuant to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11) and the implementing regulations issued thereunder; or

(ii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the calculations shall be made as of the date of establishment as defined in paragraph (a)(2)(iv)(B) of this section or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered

fund, and thereafter only upon the date on which additional securities of the issuing entity of asset-backed securities are priced for purposes of the sales of ownership interests to unaffiliated investors.

(iii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the aggregate value of the outstanding ownership interests in the covered fund shall be the fair market value of the assets transferred to the issuing entity of the securitization and any other assets otherwise held by the issuing entity at such time, determined in a manner that is consistent with its determination of the fair market value of those assets for financial statement purposes.

(iv) For purposes of the calculation under paragraph (b)(3)(iii) of this section, the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all others in the covered fund in the same manner and according to the same standards.

(4) *Multi-tier fund investments*—(i) *Master-feeder fund investments.* If the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the investment limitations in paragraphs (a)(2)(i)(B) and (a)(2)(ii) of this section, the banking entity's permitted investment in such funds shall be measured only by reference to the value of the master fund. The banking entity's permitted investment in the master fund shall include any investment by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund; and

(ii) *Fund-of-funds investments.* If a banking entity organizes and offers a covered fund pursuant to § 75.11 for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity is permitted to own, then the banking entity's permitted investment in that other fund shall include any investment by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the fund that is held through the fund of funds. The investment of the banking entity may not represent more than 3 percent of the amount or value of any single covered fund.

(c) *Aggregate permitted investments in all covered funds.* (1) For purposes of paragraph (a)(2)(iii) of this section, the aggregate value of all ownership interests held by a banking entity shall be the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), on a historical cost basis.

(2) *Calculation of tier 1 capital.* For purposes of paragraph (a)(2)(iii) of this section:

(i) *Entities that are required to hold and report tier 1 capital.* If a banking entity is required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be equal to the amount of tier 1 capital of the banking entity as of the last day of the most recent calendar quarter, as reported to its primary financial regulatory agency; and

(ii) If a banking entity is not required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be determined to be equal to:

(A) In the case of a banking entity that is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, be equal to the amount of tier 1 capital reported by such controlling depository institution in the manner described in paragraph (c)(2)(i) of this section;

(B) In the case of a banking entity that is not controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital:

(*1*) *Bank holding company subsidiaries.* If the banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, be equal to the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital in the manner described in paragraph (c)(2)(i) of this section; and

(*2*) *Other holding companies and any subsidiary or affiliate thereof.* If the banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, be equal to the total amount of shareholders' equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.

(iii) *Treatment of foreign banking entities*—(A) *Foreign banking entities.* Except as provided in paragraph (c)(2)(iii)(B) of this section, with respect to a banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the tier 1 capital of the banking entity shall be the consolidated tier 1 capital of the entity as calculated under applicable home country standards.

(B) *U.S. affiliates of foreign banking entities.* With respect to a banking entity that is located or organized under the laws of the United States or of any State and is controlled by a foreign banking entity identified under paragraph (c)(2)(iii)(A) of this section, the banking entity's tier 1 capital shall be as calculated under paragraphs (c)(2)(i) or (ii) of this section.

(d) *Capital treatment for a permitted investment in a covered fund.* For purposes of calculating compliance with the applicable regulatory capital requirements, a banking entity shall deduct from the banking entity's tier 1 capital (as determined under paragraph (c)(2) of this section) the greater of:

(1) The sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), on a historical cost basis, plus any earnings received; and

(2) The fair market value of the banking entity's ownership interests in the covered fund as determined under paragraph (b)(2)(ii) or (3) of this section (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.

(e) *Extension of time to divest an ownership interest.* (1) Upon application by a banking entity, the Board may extend the period under paragraph (a)(2)(i) of this section for up to 2 additional years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must:

(i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for application, including information that addresses the factors in paragraph (e)(2) of this section; and

(iii) Explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2) of this section.

(2) *Factors governing Board determinations.* In reviewing any application under paragraph (e)(1) of this section, the Board may consider all the facts and circumstances related to the permitted investment in a covered fund, including:

(i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(ii) The contractual terms governing the banking entity's interest in the covered fund;

(iii) The date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in paragraph (a)(2)(i) of this section;

(iv) The total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States;

(v) The cost to the banking entity of divesting or disposing of the investment within the applicable period;

(vi) Whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty;

(vii) The banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund;

(viii) Market conditions; and

(ix) Any other factor that the Board believes appropriate.

(3) *Authority to impose restrictions on activities or investment during any extension period.* The Board may impose such conditions on any extension approved under paragraph (e)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the BHC Act and this part.

(4) *Consultation.* In the case of a banking entity that is primarily regulated by another Federal banking agency, the SEC, or the CFTC, the Board will consult with such agency prior to acting on an application by the banking entity for an extension under paragraph (e)(1) of this section.

§ 75.13 Other permitted covered fund activities and investments.

(a) *Permitted risk-mitigating hedging activities.* (1) The prohibition contained in § 75.10(a) does not apply with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund.

(2) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under paragraph (a) of this section only if:

(i) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(A) Reasonably designed written policies and procedures; and

(B) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(ii) The acquisition or retention of the ownership interest:

(A) Is made in accordance with the written policies, procedures and internal controls required under this section;

(B) At the inception of the hedge, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund;

(C) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section; and

(D) Is subject to continuing review, monitoring and management by the banking entity.

(iii) The compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate has acquired an ownership interest pursuant to this paragraph and such compensation arrangement provides that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement.

(b) *Certain permitted covered fund activities and investments outside of the United States.* (1) The prohibition contained in § 75.10(a) does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) The activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity or investment occurs solely outside of the United States.

(2) An activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (b)(1)(ii) of this section only if:

(i) The activity or investment is conducted in accordance with the requirements of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of one or more States and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States.

(4) An activity or investment occurs solely outside of the United States for purposes of paragraph (b)(1)(iv) of this section only if:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(iv) No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this section, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

(c) *Permitted covered fund interests and activities by a regulated insurance company.* The prohibition contained in § 75.10(a) does not apply to the acquisition or retention by an insurance company, or an affiliate thereof, of any ownership interest in, or the sponsorship of, a covered fund only if:

(1) The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company;

(2) The acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (c)(2) of this section is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

§ 75.14 Limitations on relationships with a covered fund.

(a) *Relationships with a covered fund.* (1) Except as provided for in paragraph (a)(2) of this section, no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund pursuant to § 75.11, or that continues to hold an ownership interest in accordance with § 75.11(b), and no affiliate of such entity, may enter into a transaction with the covered fund, or with any other covered fund that is controlled by such covered fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.

(2) Notwithstanding paragraph (a)(1) of this section, a banking entity may:

(i) Acquire and retain any ownership interest in a covered fund in accordance with the requirements of §§ 75.11, 75.12, or 75.13; and

(ii) Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate thereof) has taken an ownership interest, if:

(A) The banking entity is in compliance with each of the limitations set forth in § 75.11 with respect to a covered fund organized and offered by such banking entity (or an affiliate thereof);

(B) The chief executive officer (or equivalent officer) of the banking entity certifies in writing annually to the Commission (with a duty to update the certification if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; and

(C) The Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

(b) *Restrictions on transactions with covered funds.* A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to § 75.11, or that continues to hold an ownership interest in accordance with § 75.11(b), shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1), as if such banking entity were a member bank and such covered fund were an affiliate thereof.

(c) *Restrictions on prime brokerage transactions.* A prime brokerage transaction permitted under paragraph (a)(2)(ii) of this section shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1) as if the counterparty were an affiliate of the banking entity.

§ 75.15 Other limitations on permitted covered fund activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ 75.11 through 75.13 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section, a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a

reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§§ 75.16–75.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

§ 75.20 Program for compliance; reporting.

(a) *Program requirement.* Each banking entity shall develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part. The terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity.

(b) *Contents of compliance program.* Except as provided in paragraph (f) of this section, the compliance program required by paragraph (a) of this section, at a minimum, shall include:

(1) Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities subject to subpart B of this part (including those permitted under §§ 75.3 to 75.6), including setting, monitoring and managing required limits set out in §§ 75.4 and 75.5, and activities and investments with respect to a covered fund subject to subpart C of this part (including those permitted under §§ 75.11 through 75.14) conducted by the banking entity to ensure that all activities and investments conducted by the banking entity that are subject to section 13 of the BHC Act and this part comply with section 13 of the BHC Act and this part;

(2) A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and this part and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;

(3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention;

(4) Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a banking entity must promptly provide to the Commission upon request and retain for a period of no less than 5 years or such longer period as required by the Commission.

(c) *Additional standards.* In addition to the requirements in paragraph (b) of this section, the compliance program of a banking entity must satisfy the requirements and other standards contained in Appendix B of this part, if:

(1) The banking entity engages in proprietary trading permitted under subpart B of this part and is required to comply with the reporting requirements of paragraph (d) of this section;

(2) The banking entity has reported total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States); or

(3) The Commission notifies the banking entity in writing that it must satisfy the requirements and other standards contained in Appendix B of this part.

(d) *Reporting requirements under Appendix A of this Part.* (1) A banking entity engaged in proprietary trading activity permitted under subpart B of this part shall comply with the reporting requirements described in Appendix A of this part, if:

(i) The banking entity (other than a foreign banking entity as provided in paragraph (d)(1)(ii) of this section) has, together with its affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section;

(ii) In the case of a foreign banking entity, the average gross sum of the trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section; or

(iii) The Commission notifies the banking entity in writing that it must satisfy the reporting requirements contained in Appendix A of this part.

(2) The threshold for reporting under paragraph (d)(1) of this section shall be $50 billion beginning on June 30, 2014;

$25 billion beginning on April 30, 2016; and $10 billion beginning on December 31, 2016.

(3) *Frequency of reporting.* Unless the Commission notifies the banking entity in writing that it must report on a different basis, a banking entity with $50 billion or more in trading assets and liabilities (as calculated in accordance with paragraph (d)(1) of this section) shall report the information required by Appendix A of this part for each calendar month within 30 days of the end of the relevant calendar month; beginning with information for the month of January 2015, such information shall be reported within 10 days of the end of each calendar month. Any other banking entity subject to Appendix A of this part shall report the information required by Appendix A of this part for each calendar quarter within 30 days of the end of that calendar quarter unless the Commission notifies the banking entity in writing that it must report on a different basis.

(e) *Additional documentation for covered funds.* Any banking entity that has more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years shall maintain records that include:

(1) Documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund is not a covered fund;

(2) For each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided by § 75.10(c)(1), (5), (8), (9), or (10), documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions;

(3) For each seeding vehicle described in § 75.10(c)(12)(i) or (iii) that will become a registered investment company or SEC-regulated business development company, a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § 75.12(a)(2)(i)(B);

(4) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interests in foreign public funds that are described in § 75.10(c)(1) owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, documentation of the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized, calculated as of the end of each calendar quarter, which documentation must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters; and

(5) For purposes of paragraph (e)(4) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(f) *Simplified programs for less active banking entities*—(1) *Banking entities with no covered activities.* A banking entity that does not engage in activities or investments pursuant to subpart B or subpart C of this part (other than trading activities permitted pursuant to § 75.6(a)) may satisfy the requirements of this section by establishing the required compliance program prior to becoming engaged in such activities or making such investments (other than trading activities permitted pursuant to § 75.6(a)).

(2) *Banking entities with modest activities.* A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in activities or investments pursuant to subpart B or subpart C of this part (other than trading activities permitted under § 75.6(a)) may satisfy the requirements of this section by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 of the BHC Act and this part and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

§ 75.21 Termination of activities or investments; penalties for violations.

(a) Any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or this part, or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or this part, including through an abuse of any activity or investment permitted under subparts B or C of this part, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or this part, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment.

(b) Whenever the Commission finds reasonable cause to believe any banking entity has engaged in an activity or made an investment in violation of section 13 of the BHC Act or this part, or engaged in any activity or made any investment that functions as an evasion of the requirements of section 13 of the BHC Act or this part, the Commission may take any action permitted by law to enforce compliance with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.

Appendix A to Part 75—Reporting and Recordkeeping Requirements for Covered Trading Activities

I. Purpose

a. This appendix sets forth reporting and recordkeeping requirements that certain banking entities must satisfy in connection with the restrictions on proprietary trading set forth in subpart B of this part (''proprietary trading restrictions''). Pursuant to § 75.20(d), this appendix generally applies to a banking entity that, together with its affiliates and subsidiaries, has significant trading assets and liabilities. These entities are required to (i) furnish periodic reports to the Commission regarding a variety of quantitative measurements of their covered trading activities, which vary depending on the scope and size of covered trading activities, and (ii) create and maintain records documenting the preparation and content of these reports. The requirements of this appendix must be incorporated into the banking entity's internal compliance program under § 75.20 and Appendix B of this part.

b. The purpose of this appendix is to assist banking entities and the Commission in:

(i) Better understanding and evaluating the scope, type, and profile of the banking entity's covered trading activities;

(ii) Monitoring the banking entity's covered trading activities;

(iii) Identifying covered trading activities that warrant further review or examination

by the banking entity to verify compliance with the proprietary trading restrictions;

(iv) Evaluating whether the covered trading activities of trading desks engaged in market making-related activities subject to § 75.4(b) are consistent with the requirements governing permitted market making-related activities;

(v) Evaluating whether the covered trading activities of trading desks that are engaged in permitted trading activity subject to § 75.4, 75.5, or 75.6(a) and (b) (i.e., underwriting and market making-related related activity, risk-mitigating hedging, or trading in certain government obligations) are consistent with the requirement that such activity not result, directly or indirectly, in a material exposure to high-risk assets or high-risk trading strategies;

(vi) Identifying the profile of particular covered trading activities of the banking entity, and the individual trading desks of the banking entity, to help establish the appropriate frequency and scope of examination by the Commission of such activities; and

(vii) Assessing and addressing the risks associated with the banking entity's covered trading activities.

c. The quantitative measurements that must be furnished pursuant to this appendix are *not* intended to serve as a dispositive tool for the identification of permissible or impermissible activities.

d. In order to allow banking entities and the Agencies to evaluate the effectiveness of these metrics, banking entities must collect and report these metrics for all trading desks beginning on the dates established in § 75.20. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

e. In addition to the quantitative measurements required in this appendix, a banking entity may need to develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and this part and to have an effective compliance program, as required by § 75.20 and Appendix B of this part. The effectiveness of particular quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading desk, including types of instruments traded, trading activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure that the activities are within risk tolerances established by the banking entity, and to monitor and examine for compliance with the proprietary trading restrictions in this part.

f. On an ongoing basis, banking entities must carefully monitor, review, and evaluate all furnished quantitative measurements, as well as any others that they choose to utilize in order to maintain compliance with section 13 of the BHC Act and this part. All measurement results that indicate a heightened risk of impermissible proprietary trading, including with respect to otherwise-permitted activities under §§ 75.4 through 75.6(a) and (b), or that result in a material exposure to high-risk assets or high-risk trading strategies, must be escalated within the banking entity for review, further analysis, explanation to the Commission, and remediation, where appropriate. The quantitative measurements discussed in this appendix should be helpful to banking entities in identifying and managing the risks related to their covered trading activities.

II. Definitions

The terms used in this appendix have the same meanings as set forth in §§ 75.2 and 75.3. In addition, for purposes of this appendix, the following definitions apply:

Calculation period means the period of time for which a particular quantitative measurement must be calculated.

Comprehensive profit and loss means the net profit or loss of a trading desk's material sources of trading revenue over a specific period of time, including, for example, any increase or decrease in the market value of a trading desk's holdings, dividend income, and interest income and expense.

Covered trading activity means trading conducted by a trading desk under § 75.4, 75.5, or 75.6(a) or (b). A banking entity may include trading under § 75.3(d) or 75.6(c), (d) or (e).

Measurement frequency means the frequency with which a particular quantitative metric must be calculated and recorded.

Trading desk means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

III. Reporting and Recordkeeping of Quantitative Measurements

a. Scope of Required Reporting

General scope. Each banking entity made subject to this part by § 75.20 must furnish the following quantitative measurements for each trading desk of the banking entity, calculated in accordance with this appendix:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio

b. Frequency of Required Calculation and Reporting

A banking entity must calculate any applicable quantitative measurement for each trading day. A banking entity must report each applicable quantitative measurement to the Commission on the reporting schedule established in § 75.20 unless otherwise requested by the Commission. All quantitative measurements for any calendar month must be reported within the time period required by § 75.20.

c. Recordkeeping

A banking entity must, for any quantitative measurement furnished to the Commission pursuant to this appendix and § 75.20(d), create and maintain records documenting the preparation and content of these reports, as well as such information as is necessary to permit the Commission to verify the accuracy of such reports, for a period of 5 years from the end of the calendar year for which the measurement was taken.

IV. Quantitative Measurements

a. Risk-Management Measurements

1. Risk and Position Limits and Usage

i. *Description:* For purposes of this appendix, Risk and Position Limits are the constraints that define the amount of risk that a trading desk is permitted to take at a point in time, as defined by the banking entity for a specific trading desk. Usage represents the portion of the trading desk's limits that are accounted for by the current activity of the desk. Risk and position limits and their usage are key risk management tools used to control and monitor risk taking and include, but are not limited, to the limits set out in §§ 75.4 and 75.5. A number of the metrics that are described below, including ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk,'' relate to a trading desk's risk and position limits and are useful in evaluating and setting these limits in the broader context of the trading desk's overall activities, particularly for the market making activities under § 75.4(b) and hedging activity under § 75.5. Accordingly, the limits required under §§ 75.4(b)(2)(iii) and 75.5(b)(1)(i) must meet the applicable requirements under §§ 75.4(b)(2)(iii) and 75.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.

ii. *General Calculation Guidance:* Risk and Position Limits must be reported in the format used by the banking entity for the purposes of risk management of each trading desk. Risk and Position Limits are often expressed in terms of risk measures, such as VaR and Risk Factor Sensitivities, but may also be expressed in terms of other observable criteria, such as net open positions. When criteria other than VaR or Risk Factor Sensitivities are used to define the Risk and Position Limits, both the value of the Risk and Position Limits and the value of the variables used to assess whether these limits have been reached must be reported.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

2. Risk Factor Sensitivities

i. *Description:* For purposes of this appendix, Risk Factor Sensitivities are changes in a trading desk's Comprehensive Profit and Loss that are expected to occur in the event of a change in one or more

underlying variables that are significant sources of the trading desk's profitability and risk.

ii. *General Calculation Guidance:* A banking entity must report the Risk Factor Sensitivities that are monitored and managed as part of the trading desk's overall risk management policy. The underlying data and methods used to compute a trading desk's Risk Factor Sensitivities will depend on the specific function of the trading desk and the internal risk management models employed. The number and type of Risk Factor Sensitivities that are monitored and managed by a trading desk, and furnished to the Commission, will depend on the explicit risks assumed by the trading desk. In general, however, reported Risk Factor Sensitivities must be sufficiently granular to account for a preponderance of the expected price variation in the trading desk's holdings.

A. Trading desks must take into account any relevant factors in calculating Risk Factor Sensitivities, including, for example, the following with respect to particular asset classes:

- *Commodity derivative positions:* risk factors with respect to the related commodities set out in § 20.2 of this chapter, the maturity of the positions, volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Credit positions:* risk factors with respect to credit spreads that are sufficiently granular to account for specific credit sectors and market segments, the maturity profile of the positions, and risk factors with respect to interest rates of all relevant maturities;
- *Credit-related derivative positions:* risk factor sensitivities, for example credit spreads, shifts (parallel and non-parallel) in credit spreads—volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Equity derivative positions:* risk factor sensitivities such as equity positions, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Equity positions:* risk factors for equity prices and risk factors that differentiate between important equity market sectors and segments, such as a small capitalization equities and international equities;
- *Foreign exchange derivative positions:* risk factors with respect to major currency pairs and maturities, exposure to interest rates at relevant maturities, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), as well as the maturity profile of the positions; and
- *Interest rate positions, including interest rate derivative positions:* risk factors with respect to major interest rate categories and maturities and volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and shifts (parallel and non-parallel) in the interest rate curve, as well as the maturity profile of the positions.

B. The methods used by a banking entity to calculate sensitivities to a common factor shared by multiple trading desks, such as an equity price factor, must be applied consistently across its trading desks so that the sensitivities can be compared from one trading desk to another.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Value-at-Risk and Stress Value-at-Risk

i. *Description:* For purposes of this appendix, Value-at-Risk (''VaR'') is the commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on current market conditions. For purposes of this appendix, Stress Value-at-Risk (''Stress VaR'') is the percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on market conditions during a period of significant financial stress.

ii. *General Calculation Guidance:* Banking entities must compute and report VaR and Stress VaR by employing generally accepted standards and methods of calculation. VaR should reflect a loss in a trading desk that is expected to be exceeded less than one percent of the time over a one-day period. For those banking entities that are subject to regulatory capital requirements imposed by a Federal banking agency, VaR and Stress VaR must be computed and reported in a manner that is consistent with such regulatory capital requirements. In cases where a trading desk does not have a standalone VaR or Stress VaR calculation but is part of a larger aggregation of positions for which a VaR or Stress VaR calculation is performed, a VaR or Stress VaR calculation that includes only the trading desk's holdings must be performed consistent with the VaR or Stress VaR model and methodology used for the larger aggregation of positions.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

b. Source-of-Revenue Measurements

1. Comprehensive Profit and Loss Attribution

i. *Description:* For purposes of this appendix, Comprehensive Profit and Loss Attribution is an analysis that attributes the daily fluctuation in the value of a trading desk's positions to various sources. First, the daily profit and loss of the aggregated positions is divided into three categories: (i) Profit and loss attributable to a trading desk's existing positions that were also positions held by the trading desk as of the end of the prior day (''existing positions''); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions. The sum of (i), (ii), and (iii) must equal the trading desk's comprehensive profit and loss at each point in time. In addition, profit and loss measurements must calculate volatility of comprehensive profit and loss (i.e., the standard deviation of the trading desk's one-day profit and loss, in dollar terms) for the reporting period for at least a 30-, 60- and 90-day lag period, from the end of the reporting period, and any other period that the banking entity deems necessary to meet the requirements of the rule.

A. The comprehensive profit and loss associated with existing positions must reflect changes in the value of these positions on the applicable day. The comprehensive profit and loss from existing positions must be further attributed, as applicable, to changes in (i) the specific Risk Factors and other factors that are monitored and managed as part of the trading desk's overall risk management policies and procedures; and (ii) any other applicable elements, such as cash flows, carry, changes in reserves, and the correction, cancellation, or exercise of a trade.

B. The comprehensive profit and loss attributed to new positions must reflect commissions and fee income or expense and market gains or losses associated with transactions executed on the applicable day. New positions include purchases and sales of financial instruments and other assets/liabilities and negotiated amendments to existing positions. The comprehensive profit and loss from new positions may be reported in the aggregate and does not need to be further attributed to specific sources.

C. The portion of comprehensive profit and loss that cannot be specifically attributed to known sources must be allocated to a residual category identified as an unexplained portion of the comprehensive profit and loss. Significant unexplained profit and loss must be escalated for further investigation and analysis.

ii. *General Calculation Guidance:* The specific categories used by a trading desk in the attribution analysis and amount of detail for the analysis should be tailored to the type and amount of trading activities undertaken by the trading desk. The new position attribution must be computed by calculating the difference between the prices at which instruments were bought and/or sold and the prices at which those instruments are marked to market at the close of business on that day multiplied by the notional or principal amount of each purchase or sale. Any fees, commissions, or other payments received (paid) that are associated with transactions executed on that day must be added (subtracted) from such difference. These factors must be measured consistently over time to facilitate historical comparisons.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

c. Customer-Facing Activity Measurements

1. Inventory Turnover

i. *Description:* For purposes of this appendix, Inventory Turnover is a ratio that measures the turnover of a trading desk's inventory. The numerator of the ratio is the absolute value of all transactions over the reporting period. The denominator of the ratio is the value of the trading desk's inventory at the beginning of the reporting period.

ii. *General Calculation Guidance:* For purposes of this appendix, for derivatives, other than options and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

2. Inventory Aging

i. *Description:* For purposes of this appendix, Inventory Aging generally describes a schedule of the trading desk's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held. Inventory Aging should measure the age profile of the trading desk's assets and liabilities.

ii. *General Calculation Guidance:* In general, Inventory Aging must be computed using a trading desk's trading activity data and must identify the value of a trading desk's aggregate assets and liabilities. Inventory Aging must include two schedules, an asset-aging schedule and a liability-aging schedule. Each schedule must record the value of assets or liabilities held over all holding periods. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value and, for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Customer-Facing Trade Ratio—Trade Count Based and Value Based

i. *Description:* For purposes of this appendix, the Customer-Facing Trade Ratio is a ratio comparing (i) the transactions involving a counterparty that is a customer of the trading desk to (ii) the transactions involving a counterparty that is not a customer of the trading desk. A trade count based ratio must be computed that records the number of transactions involving a counterparty that is a customer of the trading desk and the number of transactions involving a counterparty that is not a customer of the trading desk. A value based ratio must be computed that records the value of transactions involving a counterparty that is a customer of the trading desk and the value of transactions involving a counterparty that is not a customer of the trading desk.

ii. *General Calculation Guidance:* For purposes of calculating the Customer-Facing Trade Ratio, a counterparty is considered to be a customer of the trading desk if the counterparty is a market participant that makes use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services. However, a trading desk or other organizational unit of another banking entity would not be a client, customer, or counterparty of the trading desk if the other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § 75.20(d)(1) unless the trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk. Transactions conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants would be considered transactions with customers of the trading desk. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

Appendix B to Part 75—Enhanced Minimum Standards for Compliance Programs

I. Overview

Section 75.20(c) requires certain banking entities to establish, maintain, and enforce an enhanced compliance program that includes the requirements and standards in this Appendix as well as the minimum written policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping provisions outlined in § 75.20. This Appendix sets forth additional minimum standards with respect to the establishment, oversight, maintenance, and enforcement by these banking entities of an enhanced internal compliance program for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part.

a. This compliance program must:

1. Be reasonably designed to identify, document, monitor, and report the permitted trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and this part;

2. Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and this part;

3. Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;

4. Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and chief executive officer (or equivalent) of the banking entity review the effectiveness of the compliance program; and

5. Facilitate supervision and examination by the Agencies of the banking entity's permitted trading and covered fund activities and investments.

II. Enhanced Compliance Program

a. Proprietary Trading Activities

A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities. The compliance program may be tailored to the types of trading activities conducted by the banking entity, and must include a detailed description of controls established by the banking entity to reasonably ensure that its trading activities are conducted in accordance with the requirements and limitations applicable to those trading activities under section 13 of the BHC Act and this part, and provide for appropriate revision of the compliance program before expansion of the trading activities of the banking entity. A banking entity must devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its trading activities, and promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program, and changes in legal, regulatory or other requirements.

1. *Trading Desks:* The banking entity must have written policies and procedures governing each trading desk that include a description of:

i. The process for identifying, authorizing and documenting financial instruments each trading desk may purchase or sell, with separate documentation for market making-related activities conducted in reliance on § 75.4(b) and for hedging activity conducted in reliance on § 75.5;

ii. A mapping for each trading desk to the division, business line, or other organizational structure that is responsible for managing and overseeing the trading desk's activities;

iii. The mission (*i.e.,* the type of trading activity, such as market-making, trading in sovereign debt, etc.) and strategy (*i.e.,* methods for conducting authorized trading activities) of each trading desk;

iv. The activities that the trading desk is authorized to conduct, including (i) authorized instruments and products, and (ii) authorized hedging strategies, techniques and instruments;

v. The types and amount of risks allocated by the banking entity to each trading desk to implement the mission and strategy of the trading desk, including an enumeration of material risks resulting from the activities in which the trading desk is authorized to engage (including but not limited to price risks, such as basis, volatility and correlation risks, as well as counterparty credit risk). Risk assessments must take into account both the risks inherent in the trading activity and the strength and effectiveness of controls designed to mitigate those risks;

vi. How the risks allocated to each trading desk will be measured;

vii. Why the allocated risks levels are appropriate to the activities authorized for the trading desk;

viii. The limits on the holding period of, and the risk associated with, financial instruments under the responsibility of the trading desk;

ix. The process for setting new or revised limits, as well as escalation procedures for

granting exceptions to any limits or to any policies or procedures governing the desk, the analysis that will be required to support revising limits or granting exceptions, and the process for independently reviewing and documenting those exceptions and the underlying analysis;

x. The process for identifying, documenting and approving new products, trading strategies, and hedging strategies;

xi. The types of clients, customers, and counterparties with whom the trading desk may trade; and

xii. The compensation arrangements, including incentive arrangements, for employees associated with the trading desk, which may not be designed to reward or incentivize prohibited proprietary trading or excessive or imprudent risk-taking.

2. *Description of risks and risk management processes:* The compliance program for the banking entity must include a comprehensive description of the risk management program for the trading activity of the banking entity. The compliance program must also include a description of the governance, approval, reporting, escalation, review and other processes the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and this part. Trading activity in similar financial instruments should be subject to similar governance, limits, testing, controls, and review, unless the banking entity specifically determines to establish different limits or processes and documents those differences. Descriptions must include, at a minimum, the following elements:

i. A description of the supervisory and risk management structure governing all trading activity, including a description of processes for initial and senior-level review of new products and new strategies;

ii. A description of the process for developing, documenting, testing, approving and reviewing all models used for valuing, identifying and monitoring the risks of trading activity and related positions, including the process for periodic independent testing of the reliability and accuracy of those models;

iii. A description of the process for developing, documenting, testing, approving and reviewing the limits established for each trading desk;

iv. A description of the process by which a security may be purchased or sold pursuant to the liquidity management plan, including the process for authorizing and monitoring such activity to ensure compliance with the banking entity's liquidity management plan and the restrictions on liquidity management activities in this part;

v. A description of the management review process, including escalation procedures, for approving any temporary exceptions or permanent adjustments to limits on the activities, positions, strategies, or risks associated with each trading desk; and

vi. The role of the audit, compliance, risk management and other relevant units for conducting independent testing of trading and hedging activities, techniques and strategies.

3. *Authorized risks, instruments, and products.* The banking entity must implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and this part and with the banking entity's written policies and procedures. The banking entity must establish and enforce risk limits appropriate for the activity of each trading desk. These limits should be based on probabilistic and non-probabilistic measures of potential loss (*e.g.,* Value-at-Risk and notional exposure, respectively), and measured under normal and stress market conditions. At a minimum, these internal controls must monitor, establish and enforce limits on:

i. The financial instruments (including, at a minimum, by type and exposure) that the trading desk may trade;

ii. The types and levels of risks that may be taken by each trading desk; and

iii. The types of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged.

4. *Hedging policies and procedures.* The banking entity must establish, maintain, and enforce written policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that, at a minimum, describe:

i. The positions, techniques and strategies that each trading desk may use to hedge the risk of its positions;

ii. The manner in which the banking entity will identify the risks arising in connection with and related to the individual or aggregated positions, contracts or other holdings of the banking entity that are to be hedged and determine that those risks have been properly and effectively hedged;

iii. The level of the organization at which hedging activity and management will occur;

iv. The manner in which hedging strategies will be monitored and the personnel responsible for such monitoring;

v. The risk management processes used to control unhedged or residual risks; and

vi. The process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § 75.5.

5. *Analysis and quantitative measurements.* The banking entity must perform robust analysis and quantitative measurement of its trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. Analysis and models used to determine, measure and limit risk must be rigorously tested and be reviewed by management responsible for trading activity to ensure that trading activities, limits, strategies, and hedging activities do not understate the risk and exposure to the banking entity or allow prohibited proprietary trading. This review should include periodic and independent back-testing and revision of activities, limits, strategies and hedging as appropriate to contain risk and ensure compliance. In addition to the quantitative measurements reported by any banking entity subject to Appendix A of this part, each banking entity must develop and implement, to the extent appropriate to facilitate compliance with this part, additional quantitative measurements specifically tailored to the particular risks, practices, and strategies of its trading desks. The banking entity's analysis and quantitative measurements must incorporate the quantitative measurements reported by the banking entity pursuant to Appendix A of this part (if applicable) and include, at a minimum, the following:

i. Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;

ii. Ongoing, timely monitoring and review of calculated quantitative measurements;

iii. The establishment of numerical thresholds and appropriate trading measures for each trading desk and heightened review of trading activity not consistent with those thresholds to ensure compliance with section 13 of the BHC Act and this part, including analysis of the measurement results or other information, appropriate escalation procedures, and documentation related to the review; and

iv. Immediate review and compliance investigation of the trading desk's activities, escalation to senior management with oversight responsibilities for the applicable trading desk, timely notification to the Commission, appropriate remedial action (*e.g.,* divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when quantitative measurements or other information, considered together with the facts and circumstances, or findings of internal audit, independent testing or other review suggest a reasonable likelihood that the trading desk has violated any part of section 13 of the BHC Act or this part.

6. *Other Compliance Matters.* In addition to the requirements specified above, the banking entity's compliance program must:

i. Identify activities of each trading desk that will be conducted in reliance on exemptions contained in §§ 75.4 through 75.6, including an explanation of:

A. How and where in the organization the activity occurs; and

B. Which exemption is being relied on and how the activity meets the specific requirements for reliance on the applicable exemption;

ii. Include an explanation of the process for documenting, approving and reviewing actions taken pursuant to the liquidity management plan, where in the organization this activity occurs, the securities permissible for liquidity management, the process for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading, and the process for ensuring that securities purchased as part of the liquidity management plan are highly liquid and conform to the requirements of this part;

iii. Describe how the banking entity monitors for and prohibits potential or actual

material exposure to high-risk assets or high-risk trading strategies presented by each trading desk that relies on the exemptions contained in §§ 75.3(d)(3) and 75.4 through 75.6, which must take into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in value cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;

iv. Establish responsibility for compliance with the reporting and recordkeeping requirements of subpart B of this part and § 75.20; and

v. Establish policies for monitoring and prohibiting potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties.

7. *Remediation of violations.* The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any trading activity that may indicate potential violations of section 13 of the BHC Act and this part and to prevent actual violations of section 13 of the BHC Act and this part. The compliance program must describe procedures for identifying and remedying violations of section 13 of the BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

b. Covered Fund Activities or Investments

A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

1. *Identification of covered funds.* The banking entity's compliance program must provide a process, which must include appropriate management review and independent testing, for identifying and documenting covered funds that each unit within the banking entity's organization sponsors or organizes and offers, and covered funds in which each such unit invests. In addition to the documentation requirements for covered funds, as specified under § 75.20(e), the documentation must include information that identifies all pools that the banking entity sponsors or has an interest in and the type of exemption from the Commodity Exchange Act (whether or not the pool relies on § 4.7 of the regulations under the Commodity Exchange Act (§ 4.7 of this chapter)), and the amount of ownership interest the banking entity has in those pools.

2. *Identification of covered fund activities and investments.* The banking entity's compliance program must identify, document and map each unit within the organization that is permitted to acquire or hold an interest in any covered fund or sponsor any covered fund and map each unit to the division, business line, or other organizational structure that will be responsible for managing and overseeing that unit's activities and investments.

3. *Explanation of compliance.* The banking entity's compliance program must explain how:

i. The banking entity monitors for and prohibits potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties related to its covered fund activities and investments;

ii. The banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness of the banking entity related to its covered fund activities and investments; and

iii. The banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by its covered fund activities and investments, taking into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in values cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that expose the banking entity to large and significant concentrations with respect to sectors, risk factors, or counterparties;

4. *Description and documentation of covered fund activities and investments.* For each organizational unit engaged in covered fund activities and investments, the banking entity's compliance program must document:

i. The covered fund activities and investments that the unit is authorized to conduct;

ii. The banking entity's plan for actively seeking unaffiliated investors to ensure that any investment by the banking entity conforms to the limits contained in § 75.12 or registered in compliance with the securities laws and thereby exempt from those limits within the time periods allotted in § 75.12; and

iii. How it complies with the requirements of subpart C of this part.

5. *Internal Controls.* A banking entity must establish, maintain, and enforce internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and this part and are appropriate given the limits on risk established by the banking entity. These written internal controls must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part. The internal controls must, at a minimum require:

i. Monitoring and limiting the banking entity's individual and aggregate investments in covered funds;

ii. Monitoring the amount and timing of seed capital investments for compliance with the limitations under subpart C of this part (including but not limited to the redemption, sale or disposition requirements of § 75.12), and the effectiveness of efforts to seek unaffiliated investors to ensure compliance with those limits;

iii. Calculating the individual and aggregate levels of ownership interests in one or more covered fund required by § 75.12;

iv. Attributing the appropriate instruments to the individual and aggregate ownership interest calculations above;

v. Making disclosures to prospective and actual investors in any covered fund organized and offered or sponsored by the banking entity, as provided under § 75.11(a)(8);

vi. Monitoring for and preventing any relationship or transaction between the banking entity and a covered fund that is prohibited under § 75.14, including where the banking entity has been designated as the sponsor, investment manager, investment adviser, or commodity trading advisor to a covered fund by another banking entity; and

vii. Appropriate management review and supervision across legal entities of the banking entity to ensure that services and products provided by all affiliated entities comply with the limitation on services and products contained in § 75.14.

6. *Remediation of violations.* The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part and to prevent actual violations of section 13 of the BHC Act and this part. The banking entity's compliance program must describe procedures for identifying and remedying violations of section 13 of the

BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, including § 75.21, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity or investment indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

III. Responsibility and Accountability for the Compliance Program

a. A banking entity must establish, maintain, and enforce a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and this part. A banking entity must have an appropriate management framework reasonably designed to ensure that: Appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program; a clear reporting line with a chain of responsibility is delineated; and the compliance program is reviewed periodically by senior management. The board of directors (or equivalent governance body) and senior management should have the appropriate authority and access to personnel and information within the organizations as well as appropriate resources to conduct their oversight activities effectively.

1. *Corporate governance.* The banking entity must adopt a written compliance program approved by the board of directors, an appropriate committee of the board, or equivalent governance body, and senior management.

2. *Management procedures.* The banking entity must establish, maintain, and enforce a governance framework that is reasonably designed to achieve compliance with section 13 of the BHC Act and this part, which, at a minimum, provides for:

i. The designation of appropriate senior management or committee of senior management with authority to carry out the management responsibilities of the banking entity for each trading desk and for each organizational unit engaged in covered fund activities;

ii. Written procedures addressing the management of the activities of the banking entity that are reasonably designed to achieve compliance with section 13 of the BHC Act and this part, including:

A. A description of the management system, including the titles, qualifications, and locations of managers and the specific responsibilities of each person with respect to the banking entity's activities governed by section 13 of the BHC Act and this part; and

B. Procedures for determining compensation arrangements for traders engaged in underwriting or market making-related activities under § 75.4 or risk-mitigating hedging activities under § 75.5 so that such compensation arrangements are designed not to reward or incentivize prohibited proprietary trading and appropriately balance risk and financial results in a manner that does not encourage employees to expose the banking entity to excessive or imprudent risk.

3. *Business line managers.* Managers with responsibility for one or more trading desks of the banking entity are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desk(s).

4. *Board of directors, or similar corporate body, and senior management.* The board of directors, or similar corporate body, and senior management are responsible for setting and communicating an appropriate culture of compliance with section 13 of the BHC Act and this part and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with section 13 of the BHC Act and this part. The board of directors or similar corporate body (such as a designated committee of the board or an equivalent governance body) must ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with this part in light of the organization's business activities and the expectations of the board of directors. The board of directors or similar corporate body must also ensure that senior management has established appropriate incentives and adequate resources to support compliance with this part, including the implementation of a compliance program meeting the requirements of this appendix into management goals and compensation structures across the banking entity.

5. *Senior management.* Senior management is responsible for implementing and enforcing the approved compliance program. Senior management must also ensure that effective corrective action is taken when failures in compliance with section 13 of the BHC Act and this part are identified. Senior management and control personnel charged with overseeing compliance with section 13 of the BHC Act and this part should review the compliance program for the banking entity periodically and report to the board, or an appropriate committee thereof, on the effectiveness of the compliance program and compliance matters with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading activities and covered fund activities or investments, which shall be at least annually.

6. *CEO attestation.* Based on a review by the CEO of the banking entity, the CEO of the banking entity must, annually, attest in writing to the Commission that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established under this appendix and § 75.20 in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this part. In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the United States operations of the foreign banking entity who is located in the United States.

IV. Independent Testing

a. Independent testing must occur with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading and covered fund activities or investments, which shall be at least annually. This independent testing must include an evaluation of:

1. The overall adequacy and effectiveness of the banking entity's compliance program, including an analysis of the extent to which the program contains all the required elements of this appendix;

2. The effectiveness of the banking entity's internal controls, including an analysis and documentation of instances in which such internal controls have been breached, and how such breaches were addressed and resolved; and

3. The effectiveness of the banking entity's management procedures.

b. A banking entity must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties. A banking entity must promptly take appropriate action to remedy any significant deficiencies or material weaknesses in its compliance program and to terminate any violations of section 13 of the BHC Act or this part.

V. Training

Banking entities must provide adequate training to personnel and managers of the banking entity engaged in activities or investments governed by section 13 of the BHC Act or this part, as well as other appropriate supervisory, risk, independent testing, and audit personnel, in order to effectively implement and enforce the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking entity's trading activities and covered fund activities or investments.

VI. Recordkeeping

Banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A banking entity must retain these records for a period that is no less than 5 years or such longer period as required by the Commission in a form that allows it to promptly produce such records to the Commission on request.

Issued in Washington, DC, on December 30, 2013, by the Commission.

Melissa D. Jurgens,

Secretary of the Commission.

Note: The following appendices will not appear in the Code of Federal Regulations.

Appendices to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds—Commission Voting Summary and Statements of Commissioners

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton and Wetjen voted in the affirmative. Commissioner O'Malia voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final ''Volcker Rule'' before the Commission today. It achieves the important balance, as directed by Congress, of prohibiting banking entities from proprietary trading while at the same time allowing banking entities to engage in permitted activities, including market making and risk mitigating hedging.

Further, as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the final rule strikes an appropriate balance regarding banking entities investment in hedge funds and private equity funds. As Congress directed—other than for de minimis investments—banking entities are prohibited from sponsoring, owning, and having certain relationships with hedge funds or private equity funds. The final rule focuses the prohibition on entities formed for investing or trading in securities or derivatives and that are typically offered to institutional investors and high-net-worth individuals. The final definition was tailored to exclude entities that are offered more broadly to retail investors or have a more general corporate purpose, such as loan securitizations.

The Commodity Futures Trading Commission (CFTC) consulted and coordinated with the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Securities and Exchange Commission in developing this rule. Based on this collaboration, the CFTC's final rule mirrors the language being adopted by the other financial regulators.

The CFTC authority to implement the Volcker Rule is for the banking entities for which we are the primary financial regulatory agency. As of today, the CFTC estimates that our authority primarily applies to approximately 110 registered swap dealers and futures commission merchants (FCMs) that would each individually be banking entities under the Volcker Rule. Grouped by corporate affiliation these represent about 45 different business enterprises.

As a foundation, the final Volcker Rule requires banking entities to have a robust compliance program, including defined limits on market making, underwriting and hedging activities as well as continuous monitoring and management of such activities. It also requires reporting to regulators on specific metrics and trading details. This transparency will enhance the CFTC's ability to oversee swap dealers and FCMs.

Banking entities' customers and counterparties will continue to be provided liquidity through the banking entities' permitted market making. The banking entities are permitted to do so as long as each trading desk's market-maker inventory is designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers or counterparties. The banking entities will be required to maintain an ongoing compliance program and follow the rule's limits on market-maker inventory and financial exposure. For instance, banking entities would not be able to stockpile or accumulate positions over time that do not meet expected near-term customer demand.

The final Volcker Rule also permits hedging to reduce identified, specific risks from the banking entity's individual or aggregated positions. Permitted hedging activity will be required to (1) be designed to and (2) demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks. The final rule's preamble further states that this activity is not intended to be hedging of generalized risks based on non-position specific modeling or other considerations. Hedging of the general assets and liabilities of the banking entity or a guess as to the direction of the economy will no longer be permitted.

Hedging strategies and positions are subject to analysis, including required correlation analysis, as well as an ongoing recalibration requirement to ensure it is not prohibited proprietary trading.

The Commission also has the legal authority to enforce the Volcker Rule. If the Commission believes there is a violation, Dodd-Frank Section 619 and the final rule state that it can, after providing an opportunity to respond, order the registrant to stop that activity. The Commission also can use existing authority to discipline registrants, including FCMs, swap dealers, and others. The CEA and Commission rules provide that we may restrict, suspend or revoke a registration for good cause. Depending on the facts and circumstances, violation of Dodd-Frank Section 619 may rise to that level.

The talented CFTC staff working along with my fellow Commissioners—Mike Dunn, Jill Sommers, Bart Chilton, Scott O'Malia and Mark Wetjen—really have delivered for the American public.

With this action, the staff of this small but remarkably effective agency will have completed 68 rulemakings, orders and guidances. Though lacking adequate resources, the CFTC staff has diligently sorted through nearly 60,000 public comment letters. They have met with members of the public more than 2,200 times to discuss reform.

These common-sense reforms have been truly transformative.

Bright lights of transparency now are shining on the $380 trillion swaps market. The public can see the price and volume of every transaction, like a modern-day tickertape. Transparent, regulated trading platforms are trading a quarter of a trillion dollars in swaps each day.

A majority of the swaps market is now being centrally cleared—lowering risk and bringing access to anyone wishing to compete.

Ninety-one swap dealers have registered and—for the first time—are being overseen for their swaps activity.

I couldn't be more proud of this dedicated group of public servants.

I am honored to have served along with them during such a remarkable time in the history of this agency.

Appendix 3—Statement of Commissioner Bart Chilton

High Roller's Room

I'm pleased to be voting on a final Volcker Rule. Frankly, two-and-a-half weeks ago, I had grave doubts about getting this done in a meaningful fashion. It had become weaker than the original proposal. But, thankfully, and I thank the Chairman for his tireless efforts, we have a rigorous and robust rule before us.

If you've ever been to a casino, many of them have a high roller's room. There's usually a sign about a $1000 minimum bet. Many have ornate gaming tables and heavy draperies. If you walk around, you can catch a glimpse inside. But other than betting a lot of money, I'm not sure what goes on in there. And, that's fine . . . some high rollers lose and some win.

But, what if what the high rollers did in that room impacted all of us? What if it impacted consumers, our economy and our country? What if what the high rollers did in that room cost us $417 billion dollars (in a big bank bailout) because the games they were playing were tanking the economy?

That's why we need a strong Volcker Rule. We should never again be put in a circumstance where too big to fail high rollers play games of chance with our nation. This rule takes a heavy velvet rope with brass ends across the doorway and closes the high roller's room. (Maybe they'll put in more Blazing 7s or Wheel of Fortunes.)

The dilemma in drafting the final rule has been that there are certain permitted forms of trading that have been difficult to define. Fortunately, the language has been solidified tightly to avoid loopholes.

First, the key parts of the law, and what I have focused on for a very long time, are the words surrounding hedging. Proprietary hedging is allowed under the law, but speculative trading—risky gambles for the house—are exactly what Volcker sought to end. This rule does that by requiring hedges be designed to mitigate and reduce actual risk, and not just by an accidental or collateral effect of the trade. We also have better correlation language in the rule, correlation that shows that the hedging ''activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged.'' This is key—the risk has to be specific and identifiable. You can't just say, ''Ah, oh, that? Hmm, it was a hedge.'' Nope, we aren't going to let ya play that game. The position needs to be correlated with the risk.

Furthermore, there is now an ongoing requirement to recalibrate the position, the

hedge, in order to ensure that the position remains a hedge and does not become speculative. When people say this version of the Volcker Rule will stop circumstances like the London Whale, this ongoing recalibration provision is exactly what will help avoid similar debacles.

Second, the same goes for market making. Yes, market making is allowed, but only for the benefit of the banks' customers—for their customers and not solely in order to collect market maker fees provided by the exchange or for any proprietary speculative reason. Full stop.

Third, on portfolio hedging: One of the changes that has been made is that we have defined what a portfolio is NOT—it can't be some amorphous set of excuses for doing a trade. You can't call deuces and one-eyed jacks wild after the hand has been dealt. You can't do an after-the-fact extract of a set of trades as a rationale for a hedge.

Fourth, I've spoken many times about perverse bonus structures that reward the macho macho men traders. The idea, and it is contained in actual rule text language, is that big bonuses and rewards in banking should not be tied to flyer bets. Our first proposal was fairly poorly drafted on this. It didn't differentiate between prohibited proprietary trading and permitted proprietary trading very well. My view of the language that compensation should be ''designed'' not to reward or incentivize prohibited trading is that this is a sufficiently narrow test. One of the ways we will determine if something is designed in this way is how, in fact, traders are paid. So we will look after-the-fact at the payouts.

Finally, the Volcker Rule won't be implemented until July of 2015. That's ages in these morphing markets where new games seem to be played all the time. I guarantee there will be efforts to find loopholes, figure out ways around what has been written. That's the way of the world. So, my final thought is that this rule must not be static. Regulators need to continue to monitor what is taking place. We need our regulatory eyes in the sky, but also to look around the corner for what's coming next, and be nimble and quick, to ensure that what we do today holds up and that the high roller's room isn't re-opened.

While this may be the end of part of the rulemaking process, it is, and must be, the beginning of a process, that continues.

Thank you.

Appendix 4—Dissenting Statement of Commissioner Scott D. O'Malia

I respectfully dissent from today's Commission vote on the final rule implementing § 619 of the Dodd-Frank Act,[1] commonly known as the ''Volcker Rule.'' I cannot support a rulemaking that undermines the regulatory process, nor clearly delineates the Commission's new jurisdiction and enforcement authority under § 13 of the Bank Holding Company Act of 1956 (''BHC Act'')[2] and fails to include procedures that afford due process to market participants.

Former Supreme Court Justice Louis D. Brandeis, who earlier in his career was instrumental in establishing the Federal Reserve System, stated: ''If we desire respect for the law, we must first make the law respectable.'' But respect—and integrity of process—is what has been most lacking in the Commission's approach to rulemaking.

I believe the Commission must get back to the basics of good government and proper rulemaking. I cannot vote for a final rule that is hardly the product of meaningful consideration by the full Commission, but instead was negotiated exclusively by the Chairman. In addition, I cannot vote for a final rule where the Commission has not devoted enough attention to providing sufficient clarity and due process in the enforcement of new and untested regulatory authority, but still imposes significant obligations upon market participants at an unknown—but surely considerable—cost.

Abuse of Process

Throughout the Commission's rulemakings under the Dodd-Frank Act, I have urged the Commission to act faithfully in accordance with the applicable statutory authorities and the Administrative Procedure Act (''APA'').[3] However, in the implementation of one of the most important mandates issued by Congress in response to the financial crisis, the Commission seems to have forgotten the basics of agency rulemaking. I am deeply troubled by the egregious abuse of process in this rulemaking. Without a doubt, it far surpasses all other previous transgressions to date.

The first opportunity each Commissioner had to review a partial draft of the nearly 1,000-page final rule came only three weeks prior to today's vote. Further, because the Commission was operating in an information vacuum, the fact that the Commissioners were not reviewing the working interagency draft—but instead had the ''CFTC-preferred'' version of the rule—only came to light a few days later.[4] The Commission did not receive a near-final draft of the rule (with language agreed to by all five agencies) until just six days prior to the vote, despite repeated requests by Commissioners for a version of the draft then in circulation amongst the responsible agencies. This six-day draft was not even accompanied by the courtesy of a summary or term sheet in order to aid the Commission in digesting, at the last minute, this incredibly complex and dense final rule.

I am disappointed that today's vote on the final rule is besmirched by the purposeful circumvention of measured review by each Commissioner's office. It is simply not possible to carefully weigh a final rule—particularly one with as much detail and consequence as the Volcker Rule—in the briefest of timeframes. Accordingly, I am concerned that the lack of meaningful participation by the full Commission in the rulemaking process has therefore seriously impaired the ability of the Commission, as a deliberative body, to engage in reasoned decision-making.

Congress established the CFTC as an independent agency led by a Commission—not a director—to act as steward to the futures and swaps markets. In doing so, Congress entrusted each of the Commissioners to independently use his or her experience and expertise to carefully review and deliberate upon all Commission action, including rulemaking. Final rules should reflect the input and collective opinion of the Commission as a whole, but today's vote falls far short of that fundamental standard.

It is imperative that the Commission respect the letter and spirit of the law and adhere faithfully to APA requirements in our implementation of this new statutory authority granted by Congress under the BHC Act. Unfortunately, the Commission's rulemaking over the past three years has been aptly referred to as ''regulation by fiat.''[5] We cannot continue down this path of reflexive, knee-jerk regulation that fails to provide clarity and certainty to market participants. The Commission must get back to the basics and return to a thoughtful, measured approach to regulating our markets in an open and transparent manner.

Jurisdiction and Enforcement Authority

I also believe that the basics of any rulemaking are jurisdiction and enforcement. However, the final rule fails to provide clear and consistent procedures for both (1) the Commission's new enforcement authority under § 13 of the BHC Act and (2) due process for market participants.

As a threshold matter, the Volcker Rule may give us concurrent, and potentially overlapping, jurisdiction as the ''primary financial regulatory agency''[6] of a Commission registrant or registered entity, so long as there is some type of corporate relationship with a banking entity. It is essential that the Commission continue to work with the other responsible agencies on implementation to further outline the scope of each agency's jurisdiction, maximize regulatory efficiency, and provide consistency for market participants, with a minimum of duplicative and costly requirements and wasted resources.[7] The Commission must also be mindful of foreign

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] 12 U.S.C. 1851.

[3] 5 U.S.C. 500 *et seq.*

[4] Gina Chon, ''CFTC Goes Its Own Way Over Volcker Rule,'' Fin. Times, November 23, 2013.

[5] *See* SIFMA, *ISDA & IIB* v. *CFTC,* No. 13–CV–1916 (D.D.C.).

[6] Dodd-Frank Act § 2(12).

[7] Senators Carl Levin and Jeff Merkley, co-authors of § 619 of the Dodd-Frank Act, emphasized the importance of enforcement to the success of the Volcker Rule by urging the five responsible agencies to ''provide coordinated and consistent enforcement, including data sharing by regulators'' in their implementation of a final rule. Letter from Hon. Jeff Merkley, Member, United States Senate, and Hon. Carl Levin, Member, United States Senate, to Hon. Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Hon. Thomas Curry, Comptroller of the Currency, Department of the Treasury, Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission, Hon. Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Commission, and Hon. Mary Shapiro, Chairman, Securities and Exchange Commission (Apr. 26, 2012) (on file with the Commission).

regulators and seek harmonization in the extraterritorial application of our jurisdiction, in accordance with principles of international comity.

I am concerned that the Commission has not devoted enough attention to delineating our enforcement authority and procedures under the Volcker Rule, including the implications of not promulgating the final rule under the Commodity Exchange Act (''CEA'').[8] This is important because the final rule is only being promulgated under the BHC Act. Consequently, the Commission is limited to only the enforcement measures provided for by § 13(e)(2) of the BHC Act. By not also promulgating the final rule under the CEA, the Commission cannot use its full suite of enforcement tools under the CEA to ensure compliance with the Volcker Rule.

If the Commission wanted to use its enforcement powers under the CEA, the final rule must be promulgated under the CEA and undergo cost-benefit consideration pursuant to § 15(a) of the CEA.[9] But, by choosing to forgo any cost-benefit analysis and promulgate the Volcker Rule solely under the BHC Act, the Commission has thus limited its enforcement powers.

To illustrate this point, it is critical to emphasize that the Commission's authority under the Volcker Rule is not derived from the CEA, which established the CFTC and its jurisdiction over the futures and swaps market. Section 619 of the Dodd-Frank Act amends the BHC Act, which is administered by the Federal Reserve Board. The Volcker Rule is codified as § 13 of the BHC Act and confers limited enforcement authority to the Commission under § 13(e)(2) to order an affected party to ''terminate the [violative] activity'' and ''dispose of the investment.'' [10]

First, although the statutory text of § 13(e)(2) suggests that the Commission may, essentially, issue a cease and desist order to a banking entity engaging in violative activity, the Commission has not promulgated any provisions in the final rule that would define and delineate such an order.

The issue of enforcement action is not a problem for the banking agencies, who have broad supervisory powers over the safety and soundness of banking entities, and considerable enforcement powers under § 8 of the BHC Act, or §§ 8 or 39 of the Federal Deposit Insurance Act [11] (as described in the preamble to the final rule). Those powers are conferred to the banking agencies as prudential regulators. The Commission, however, is not a prudential regulator of its registrants or registered entities and does not have the same powers as the banking agencies.

Second, I have serious concerns that by not including specific procedures in the final rule for an enforcement action taken by the Commission pursuant to § 13(e)(2), the Commission is not affording due process to any party that might be the subject of a future enforcement action. The statutory text in § 13(e)(2) explicitly states that ''due notice and opportunity for hearing'' must be provided. But, the final rule does not contain any procedures for notice or hearing, and in fact does not even mention that statutory requirement.

Third, I am also concerned that the Commission may nevertheless try to read its enforcement powers under the CEA into its limited enforcement authority under the BHC Act. The final rule, in new § 75.21(b), states that ''the Commission may take any action permitted by law to enforce compliance with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.''

That provision, without being promulgated under the CEA and undergoing cost-benefit consideration, cannot permit the use of enforcement powers provided for in the CEA. The enforcement powers the Commission has under the CEA explicitly only apply to violations of ''this Act'' (the CEA), including ''any rule, regulation, or order of the Commission *promulgated in accordance with . . . this Act*'' (emphasis added).[12]

Although it would be possible for the Commission to exercise its power over registration of a Commission registrant or registered entity as a matter of right, it is unclear to me whether the Commission has actually promulgated rules that permit the revocation of registration for a swap dealer.

Section 4s of the CEA [13] governs the registration and regulation of swap dealers and major swap participants, but does not explicitly address revocation of registration. Section 8a of the CEA [14] explicitly applies to the registration of an exclusive list of Commission registrants (intermediaries), but does not include swap dealers. Section 8a of the CEA authorizes the Commission to revoke registration, but only in certain circumstances as described in, for example, §§ 8a(2)(A)–(H), 8a(3), and 8a(4).

Although some of those provisions may permit the revocation of registration of a swap dealer, it is secondary to, for example, either a finding by a court of law or another Federal or State agency that a violation of the CEA occurred,[15] or that the principal of a swap dealer was statutorily disqualified from registration,[16] or that the swap dealer willfully aided or abetted in the violation of the CEA by another person, or failed to supervise a person that violated the CEA.[17] Because these powers over registration only apply where there has been a violation of the CEA, I do not see how they can be applied to a violation of § 13 of the BHC Act.

Commission regulation § 3.60 [18] provides procedures for revocation of registration, but only pursuant to §§ 8a(2), 8a(3), and 8a(4), which do not directly apply to swap dealers as just discussed.

I am concerned that, because there does not appear to be any Commission regulation that permits the revocation of registration for a swap dealer, and because § 75.21 of the final rule does not include any procedures for an enforcement action taken by the Commission pursuant to § 13(e)(2) of the BHC Act, the Commission would not able to effectively enforce the Volcker Rule. Further, the Commission's enforcement powers under the CEA are not available to enforce the Volcker Rule because the final rule was not promulgated under the CEA. I also reiterate that I am deeply troubled by the omission of procedures to afford due process to market participants.

Conclusion

As the Commission moves towards finalizing the last of the rules mandated by the Dodd-Frank Act, I believe it's about time that it got back to the basics of good government and proper rulemaking. The final rule does neither because of the abuse of process in its rulemaking and the lack of due process and clarity in its enforcement procedures. Because of these fundamental flaws in the final rule, I cannot support it.

[FR Doc. 2013–31476 Filed 1–30–14; 8:45 am]

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[8] 7 U.S.C. 1 *et seq.*

[9] 7 U.S.C. 19(a).

[10] Section 619 of the Dodd-Frank Act, paragraph (e)(2), which is entitled Anti-evasion—Termination of Activities or Investment, provides that ''Notwithstanding any other provision of law, whenever an appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, has reasonable cause to believe that a banking entity or nonbank financial company supervised by the Board under the respective agency's jurisdiction has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section, the appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, shall order, after due notice and opportunity for hearing, the banking entity or nonbank financial company supervised by the Board to terminate the activity and, as relevant, dispose of the investment. Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.''

[11] *See, e.g.,* 12 U.S.C. 1818(i).

[12] 7 U.S.C. 9(c)(4)(A).

[13] 7 U.S.C. 6s.

[14] 7 U.S.C. 12a.

[15] 7 U.S.C. 8a(2)(E).

[16] 7 U.S.C. 8a(2)(H).

[17] 7 U.S.C. 8a(3).

[18] 17 CFR 3.60.

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