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Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule

COMMODITY FUTURES TRADING COMMISSION

17 CFR Part 75

RIN 3038–AD05

Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

AGENCY: Commodity Futures Trading Commission.

ACTION: Final rule.

SUMMARY: The Commodity Futures Trading Commission (''CFTC'' or ''Commission'') is adopting a final rule to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the ''Dodd-Frank Act''), which contains certain prohibitions and restrictions on the ability of a banking entity and nonbank financial company supervised by the Board of Governors of the Federal Reserve System (the ''Board'') to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund. Section 619 also requires the Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission to also issue regulations implementing section 619 and directs the CFTC and those four agencies to consult and coordinate with each other, as appropriate, in developing and issuing the implementing rules, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation. To that end, although the Commission is adopting a final rule that is not a joint rule with the other agencies, the CFTC and the other agencies have worked closely together to develop the same rule text and supplementary information, except for information specific to the CFTC or the other agencies, as applicable. In particular, the CFTC's final rule is numbered as part 75 of the Commission's regulations, the rule text refers to the ''Commission'' instead of the ''[Agency]'' and one section of the regulations addresses authority, purpose, scope, and relationship to other authorities with respect to the Commission. Furthermore, it is noted that the supplementary information generally refers to the ''Agencies'' collectively when referring to deliberations and considerations in developing the final rule by the CFTC together with the other four agencies and references to the ''final rule'' should be deemed to refer to the final rule of the Commission as herein adopted.

DATES: The final rule is effective April 1, 2014.

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I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (''BHC Act'') (codified at 12 U.S.C. 1851) that generally prohibits any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (''covered fund''), subject to certain exemptions.[2] New section 13 of the BHC Act also provides that a nonbank financial company designated by the Financial Stability Oversight Council (''FSOC'') for supervision by the Board (while not a banking entity under section 13 of the BHC Act) would be subject to additional capital requirements, quantitative limits, or other restrictions if the company engages in certain proprietary trading or covered fund activities.[3]

Section 13 of the BHC Act generally prohibits banking entities from engaging as principal in proprietary trading for the purpose of selling financial instruments in the near term or otherwise with the intent to resell in order to profit from short-term price movements.[4] Section 13(d)(1) expressly exempts from this prohibition, subject to conditions, certain activities, including:

- Trading in U.S. government, agency and municipal obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activities;
- Trading on behalf of customers;
- Trading for the general account of insurance companies; and
- Foreign trading by non-U.S. banking entities.[5]

Section 13 of the BHC Act also generally prohibits banking entities from acquiring or retaining an ownership interest in, or sponsoring, a hedge fund or private equity fund. Section 13 contains several exemptions that permit banking entities to make limited investments in hedge funds and private equity funds, subject to a number of restrictions designed to ensure that banking entities do not rescue investors in these funds from loss and are not themselves exposed to significant losses from investments or other relationships with these funds.

Section 13 of the BHC Act does not prohibit a nonbank financial company supervised by the Board from engaging in proprietary trading, or from having the types of ownership interests in or relationships with a covered fund that a banking entity is prohibited or restricted from having under section 13 of the BHC Act. However, section 13 of the BHC Act provides that these activities be subject to additional capital charges, quantitative limits, or other restrictions.[6]

II. Notice of Proposed Rulemaking: Summary of General Comments

Authority for developing and adopting regulations to implement the prohibitions and restrictions of section 13 of the BHC Act is divided among the Board, the Federal Deposit Insurance Corporation (''FDIC''), the Office of the Comptroller of the Currency (''OCC''), the Securities and Exchange Commission (''SEC''), and the Commodity Futures Trading Commission (''CFTC'').[7] As required by

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] *See* 12 U.S.C. 1851.

[3] *See* 12 U.S.C. 1851(a)(2) and (f)(4). The Agencies note that two of the three companies currently designated by FSOC for supervision by the Board are affiliated with insured depository institutions, and are therefore currently banking entities for purposes of section 13 of the BHC Act. The Agencies are continuing to review whether the remaining company engages in any activity subject to section 13 of the BHC Act and what, if any, requirements apply under section 13.

[4] *See* 12 U.S.C. 1851(a)(1)(A) and (B).

[5] *See id.* at 1851(d)(1).

[6] *See* 12 U.S.C. 1851(a)(2) and (d)(4).

[7] *See* 12 U.S.C. 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13's prohibitions and restrictions must be issued by: (i) The appropriate Federal banking agencies (*i.e.,* the Board, the OCC, and the FDIC), jointly, with respect to insured depository institutions; (ii) the Board, with respect to any

section 13(b)(2) of the BHC Act, the Board, OCC, FDIC, and SEC in October 2011 invited the public to comment on proposed rules implementing that section's requirements.[8] The period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012.[9] In January 2012, the CFTC requested comment on a proposal for the same common rule to implement section 13 with respect to those entities for which it is the primary financial regulatory agency and invited public comment on its proposed implementing rule through April 16, 2012.[10] The statute requires the Agencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act.[11]

The proposed rules invited comment on a multi-faceted regulatory framework to implement section 13 consistent with the statutory language. In addition, the Agencies invited comments on the potential economic impacts of the proposed rule and posed a number of questions seeking information on the costs and benefits associated with each aspect of the proposal, as well as on any significant alternatives that would minimize the burdens or amplify the benefits of the proposal in a manner consistent with the statute. The Agencies also encouraged commenters to provide quantitative information and data about the impact of the proposal on entities subject to section 13, as well as on their clients, customers, and counterparties, specific markets or asset classes, and any other entities potentially affected by the proposed rule, including non-financial small and mid-size businesses.

The Agencies received over 18,000 comments addressing a wide variety of aspects of the proposal, including definitions used by the proposal and the exemptions for market making-related activities, risk-mitigating hedging activities, covered fund activities and investments, the use of quantitative metrics, and the reporting proposals. The vast majority of these comments were from individuals using a version of a short form letter to express support for the proposed rule. More than 600 comment letters were unique comment letters, including from members of Congress, domestic and foreign banking entities and other financial services firms, trade groups representing banking, insurance, and the broader financial services industry, U.S. state and foreign governments, consumer and public interest groups, and individuals. To improve understanding of the issues raised by commenters, the Agencies met with a number of these commenters to discuss issues relating to the proposed rule, and summaries of these meetings are available on each of the Agency's public Web sites.[12] The CFTC staff also hosted a public roundtable on the proposed rule.[13] Many of the commenters generally expressed support for the broader goals of the proposed rule. At the same time, many commenters expressed concerns about various aspects of the proposed rule. Many of these commenters requested that one or more aspects of the proposed rule be modified in some manner in order to reflect their viewpoints and to better accommodate the scope of activities that they argued were encompassed within section 13 of the BHC Act. The comments addressed all major sections of the proposed rule.

Section 13 of the BHC Act also required the FSOC to conduct a study (''FSOC study'') and make recommendations to the Agencies by January 21, 2011 on the implementation of section 13 of the BHC Act. The FSOC study was issued on January 18, 2011. The FSOC study included a detailed discussion of key issues related to implementation of section 13 and recommended that the Agencies consider taking a number of specified actions in issuing rules under section 13 of the BHC Act.[14] The FSOC study also recommended that the Agencies adopt a four-part implementation and supervisory framework for identifying and preventing prohibited proprietary trading, which included a programmatic compliance regime requirement for banking entities, analysis and reporting of quantitative metrics by banking entities, supervisory review and oversight by the Agencies, and enforcement procedures for violations.[15] The Agencies carefully considered the FSOC study and its recommendations.

In formulating this final rule, the Agencies carefully reviewed all comments submitted in connection with the rulemaking and considered the suggestions and issues they raise in light of the statutory restrictions and provisions as well as the FSOC study. The Agencies have sought to reasonably respond to all of the significant issues commenters raised. The Agencies believe they have succeeded in doing so notwithstanding the complexities involved. The Agencies also carefully considered different options suggested by commenters in light of potential costs and benefits in order to effectively implement section 13 of the BHC Act. The Agencies made numerous changes to the final rule in response to the issues and information provided by commenters. These modifications to the rule and explanations that address comments are described in more detail in the section-by-section description of the final rule. To enhance uniformity in both rules that implement section 13 and administration of the requirements of that section, the Agencies have been regularly consulting with each other in the development of this final rule.

Some commenters requested that the Agencies repropose the rule and/or delay adoption pending the collection of

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

[8] *See* 76 FR 68846 (Nov. 7, 2011) (''Joint Proposal'').

[9] *See* 77 FR 23 (Jan. 23, 2012) (extending the comment period to February 13, 2012).

[10] *See* 77 FR 8332 (Feb 14, 2012) (''CFTC Proposal'').

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

[12] *See http://www.regulations.gov/#!docketDetail;D=OCC-2011-0014* (OCC); *http://www.federalreserve.gov/newsevents/reform_systemic.htm (Board); http://www.fdic.gov/regulations/laws/federal/2011/11comAD85.html* (FDIC); *http://www.sec.gov/comments/s7-41-11/s74111.shtml* (SEC); and *http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_28_VolckerRule/index.htm* (CFTC).

[13] *See* Commodity Futures Trading Commission, CFTC Staff to Host a Public Roundtable to Discuss the Proposed Volcker Rule (May 24, 2012), available at *http://www.cftc.gov/PressRoom/PressReleases/pr6263-12*; transcript available at *http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript053112.pdf.*

[14] *See* Financial Stability Oversight Counsel, Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011), available at *http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20619%20study%20final%201%2018%2011%20rg.pdf.* (''FSOC study''). *See* 12 U.S.C. 1851(b)(1). Prior to publishing its study, FSOC requested public comment on a number of issues to assist in conducting its study. *See* 75 FR 61758 (Oct. 6, 2010). Approximately 8,000 comments were received from the public, including from members of Congress, trade associations, individual banking entities, consumer groups, and individuals.

[15] *See* FSOC study at 5–6.

additional information.[16] As described in part above, the Agencies have provided many and various types of opportunities for commenters to provide input on implementation of section 13 of the BHC Act and have collected substantial information in the process. In addition to the official comment process described above, members of the public submitted comment letters in advance of the official comment period for the proposed rules and met with staff of the Agencies to explain issues of concern; the public also provided substantial comment in response to a request for comment from the FSOC regarding its findings and recommendations for implementing section 13.[17] The Agencies provided a detailed proposal and posed numerous questions in the preamble to the proposal to solicit and explore alternative approaches in many areas. In addition, the Agencies have continued to receive comment letters after the extended comment period deadline, which the Agencies have considered. Thus, the Agencies believe interested parties have had ample opportunity to review the proposed rules, as well as the comments made by others, and to provide views on the proposal, other comment letters, and data to inform our consideration of the final rules.

In addition, the Agencies have been mindful of the importance of providing certainty to banking entities and financial markets and of providing sufficient time for banking entities to understand the requirements of the final rule and to design, test, and implement compliance and reporting systems. The further substantial delay that would necessarily be entailed by reproposing the rule would extend the uncertainty that banking entities would face, which could prove disruptive to banking entities and the financial markets.

The Agencies note, as discussed more fully below, that the final rule incorporates a number of modifications designed to address the issues raised by commenters in a manner consistent with the statute. The preamble below also discusses many of the issues raised by commenters and explains the Agencies' response to those comments.

To achieve the purpose of the statute, without imposing unnecessary costs, the final rule builds on the multi-faceted approach in the proposal, which includes development and implementation of a compliance program at each banking entity engaged in trading activities or that makes investments subject to section 13 of the BHC Act; the collection and evaluation of data regarding these activities as an indicator of areas meriting additional attention by the banking entity and the relevant agency; appropriate limits on trading, hedging, investment and other activities; and supervision by the Agencies. To allow banking entities sufficient time to develop appropriate systems, the Agencies have provided for a phased-in schedule for the collection of data, limited data reporting requirements only to banking entities that engage in significant trading activity, and agreed to review the merits of the data collected and revise the data collection as appropriate over the next 21 months. Importantly, as explained in detail below, the Agencies have also reduced the compliance burden for banking entities with total assets of less than $10 billion. The final rule also eliminates compliance burden for firms that do not engage in covered activities or investments beyond investing in U.S. government obligations, agency guaranteed obligations, or municipal obligations.

Moreover, the Agencies believe the data that will be collected in connection with the final rule, as well as the compliance efforts made by banking entities and the supervisory experience that will be gained by the Agencies in reviewing trading and investment activity under the final rule, will provide valuable insights into the effectiveness of the final rule in achieving the purpose of section 13 of the BHC Act. The Agencies remain committed to implementing the final rule, and revisiting and revising the rule as appropriate, in a manner designed to ensure that the final rule faithfully implements the requirements and purposes of the statute.[18]

Finally, the Board has determined, in accordance with section 13 of the BHC Act, to provide banking entities with additional time to conform their activities and investments to the statute and the final rule. The restrictions and prohibitions of section 13 of the BHC Act became effective on July 21, 2012.[19] The statute provided banking entities a period of two years to conform their activities and investments to the requirement of the statute, until July 21, 2014. Section 13 also permits the Board to extend this conformance period, one year at a time, for a total of no more than three additional years.[20] Pursuant to this authority and in connection with this rulemaking, the Board has in a separate action extended the conformance period for an additional year until July 21, 2015.[21] The Board will continue to monitor developments to determine whether additional extensions of the conformance period are in the public interest, consistent with the statute. Accordingly, the Agencies do not believe that a reproposal or further delay is necessary or appropriate.

Commenters have differing views on the overall economic impacts of section 13 of the BHC Act.

Some commenters remarked that proprietary trading restrictions will have detrimental impacts on the economy such as: Reduction in efficiency of markets, economic growth, and in employment due to a loss in liquidity.[22] In particular, a commenter expressed concern that there may be high transition costs as non-banking entities replace some of the trading activities currently performed by banking entities.[23] Another commenter focused on commodity markets remarked about the potential reduction in commercial output and curtailed resource exploration due to a lack of hedging counterparties.[24] Several commenters stated that section 13 of the BHC Act will reduce access to debt markets—especially for smaller companies—raising the costs of capital for firms and lowering the returns on certain investments.[25] Further, some commenters mentioned that U.S. banks may be competitively disadvantaged relative to foreign banks due to proprietary trading restrictions and compliance costs.[26]

[16] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); Chamber (Nov. 2011); Chamber (Nov. 2013); Members of Congress (Dec. 2011); IIAC; Real Estate Roundtable; Ass'n. of German Banks; Allen & Overy (Clearing); JPMC; Goldman (Prop. Trading); BNY Mellon *et al.;* State Street (Feb. 2012); ICI Global; Chamber (Feb. 2012); Société Générale; HSBC; Western Asset Mgmt.; Abbott Labs *et al.* (Feb. 2012); PUC Texas; Columbia Mgmt.; ICI (Feb. 2012); IIB/EBF; British Bankers' Ass'n.; ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Ralph Saul (Apr. 2012); BPC.

[17] *See* 75 FR 61758 (Oct. 6, 2010).

[18] If any provision of this rule, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

[19] *See* 12 U.S.C. 1851(c)(1).

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

[21] *See,* Board Order Approving Extension of Conformance Period, available at *http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210b1.pdf.*

[22] *See, e.g.,* Oliver Wyman (Dec. 2011); Chamber (Dec. 2011); Thakor Study; Prof. Duffie; IHS.

[23] *See* Prof. Duffie.

[24] *See* IHS.

[25] *See, e.g.,* Chamber (Dec. 2011); Thakor Study; Oliver Wyman (Dec. 2011); IHS.

[26] *See, e.g.,* RBC; Citigroup (Feb. 2012); Goldman (Covered Funds).

On the other hand, other commenters stated that restricting proprietary trading activity by banking entities may reduce systemic risk emanating from the financial system and help to lower the probability of the occurrence of another financial crisis.[27] One commenter contended that large banking entities may have a moral hazard incentive to engage in risky activities without allocating sufficient capital to them, especially if market participants believe these institutions will not be allowed to fail.[28] Commenters argued that large banking entities may engage in activities that increase the upside return at the expense of downside loss exposure which may ultimately be borne by Federal taxpayers [29] and that subsidies associated with bank funding may create distorted economic outcomes.[30] Furthermore, some commenters remarked that non-banking entities may fill much of the void in liquidity provision left by banking entities if banking entities reduce their current trading activities.[31] Finally, some commenters mentioned that hyper-liquidity that arises from, for instance, speculative bubbles, may harm the efficiency and price discovery function of markets.[32]

The Agencies have taken these concerns into account in the final rule. As described below with respect to particular aspects of the final rule, the Agencies have addressed these issues by reducing burdens where appropriate, while at the same time ensuring that the final rule serves its purpose of promoting healthy economic activity. In that regard, the Agencies have sought to achieve the balance intended by Congress under section 13 of the BHC Act. Several comments suggested that a costs and benefits analysis be performed by the Agencies.[33] On the other hand, some commenters[34] correctly stated that a costs and benefits analysis is not legally required.[35] However, the Agencies find certain of the information submitted by commenters concerning costs and benefits and economic effects to be relevant to consideration of the rule, and so have considered this information as appropriate, and, on the basis of these and other considerations, sought to achieve the balance intended by Congress in section 619 of the Dodd-Frank Act. The relevant comments are addressed therein.[36]

III. Scope

Under section 13 of the BHCA, the CFTC's final rule will be applicable to a banking entity for which the CFTC is a ''primary financial regulatory agency'' for that banking entity, as the term is defined by section 2(12) of the Dodd-Frank Act. Accordingly, the final rule may apply to banking entities [37] that are, for example, registered swap dealers,[38] futures commission merchants, commodity trading advisors and commodity pool operators. The CFTC's final rule may also apply to other types of CFTC registrants that are banking entities, but it is likely that many such other registrants will have little or no activities that would implicate the provisions of the final rule. For example, registered introducing brokers are not likely to undertake proprietary trading or invest in covered funds because their activities are generally limited to brokering. Furthermore, the CFTC's final rule will not apply to CFTC registrants who are not banking entities. In addition, it is noted that the CFTC may have overlapping jurisdiction with other Agencies in exercising authority under each Agency's respective final rules. Finally, it is important to note that the jurisdictional scope of the final rule does not limit the regulatory authority of the CFTC or the other Agencies under other applicable provisions of law.

The CFTC believes that many affiliated banking entities would undertake some or all of the compliance activities under the final rule on an affiliated enterprise-wide basis. As of the adoption of the final rule, the CFTC estimates that there are approximately 110 registered swap dealers and futures commission merchants that would be banking entities individually and that grouping these banking entities together based on legal affiliation would result in about 45 different business enterprises.

IV. CFTC-specific comments

In addition to the information sought both by the other Agencies and the CFTC, the CFTC's proposal [39] included 15 additional questions specifically regarding the approach the CFTC should take in regards to certain sections of the rule. The relevant sections included provisions that were either directly related to the CFTC (e.g., definition of commodity pool, clearing exemption) and others that appeared not to be (e.g., underwriting, market making of SEC entities, securitization). Many commenters sent general responses that touched on issues related to these 15 CFTC-specific questions, while other commenters organized their responses by question.[40] The CFTC has considered these commenters' views, and has responded as set forth in the relevant sections below.

V. Overview of Final Rule

The Agencies are adopting this final rule to implement section 13 of the BHC Act with a number of changes to the proposal, as described further below. The final rule adopts a risk-based approach to implementation that relies on a set of clearly articulated characteristics of both prohibited and permitted activities and investments and is designed to effectively accomplish the statutory purpose of reducing risks posed to banking entities by proprietary trading activities and investments in or relationships with covered funds. As explained more fully below in the section-by-section analysis, the final rule has been designed to ensure that banking entities do not engage in prohibited activities or investments and to ensure that banking entities engage in permitted trading and investment activities in a manner designed to identify, monitor and limit the risks posed by these activities and investments. For instance, the final rule requires that any banking entity that is engaged in activity subject to section 13 develop and administer a compliance program that is appropriate to the size,

[27] *See, e.g.,* Profs. Admati & Pfleiderer; AFR (Nov. 2012); Better Markets (Dec. 2011); Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[28] *See* Occupy.

[29] *See* Profs. Admati & Pfleiderer; Better Markets (Feb. 2012); Occupy; Johnson & Prof. Stiglitz; Paul Volcker.

[30] *See* Profs. Admati & Pfleiderer; Johnson & Prof. Stiglitz.

[31] *See* AFR *et al.* (Feb. 2012); Better Markets (Apr. 16, 2012); David McClean; Public Citizen; Occupy.

[32] *See* Johnson & Prof. Stiglitz (citing Thomas Phillipon (2011)); AFR *et al.* (Feb. 2012); Occupy.

[33] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; ABA (Keating); Chamber (Feb. 2012); Société Générale; FTN; SVB; ISDA (Feb. 2012); Comm. on Capital Market Regulation; Real Estate Roundtable.

[34] *See, e.g.,* Better Markets (Feb. 2012); Randel Pilo.

[35] For example, with respect to the CFTC, Section 15(a) of the CEA requires such consideration only when ''promulgating a regulation under this [Commodity Exchange] Act.'' This final rule is not promulgated under the CEA, but under the BHC Act. CEA section 15(a), therefore, does not apply.

[36] This CFTC Rule is being promulgated exclusively under section 13 of the BHC. Therefore, the Commission did not conduct a cost benefit consideration under Section 15(a) of the Commodity Exchange Act. Similarly, Executive Orders 12866 and 13563, referenced by some commenters, do not impose obligations on the CFTC.

[37] See final rule § 75.2(c).

[38] The CFTC notes that provisionally registered swap dealers are registered swap dealers subject to all of the regulatory requirements applicable to registered swap dealers except as may otherwise be expressly provided in the CFTC's regulations.

[39] *See* 77 FR 8332 (Feb 14, 2012).

[40] *See, e.g.,* SIFMA (March Letter); Alfred Brock; Occupy the SEC.

scope and risk of its activities and investments. The rule requires the largest firms engaged in these activities to develop and implement enhanced compliance programs and regularly report data on trading activities to the Agencies. The Agencies believe this will permit banking entities to effectively engage in permitted activities, and the Agencies to enforce compliance with section 13 of the BHC Act. In addition, the enhanced compliance programs will help both the banking entities and the Agencies identify, monitor, and limit risks of activities permitted under section 13, particularly involving banking entities posing the greatest risk to financial stability.

A. General Approach and Summary of Final Rule

The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act, which include prohibiting banking entities from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that are critical to capital generation for businesses of all sizes, households and individuals, and that facilitate liquid markets. These client-oriented financial services, which include underwriting, market making, and asset management services, are important to the U.S. financial markets and the participants in those markets. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions.

As noted above, the final rule takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the final rule includes a framework that clearly describes the key characteristics of both prohibited and permitted activities. The final rule also requires banking entities to establish a comprehensive compliance program designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the banking entity's activities, size, scope and complexity. With respect to proprietary trading, the final rule also requires the large firms that are active participants in trading activities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities.

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

- Subpart A of the final rule describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;
- Subpart B of the final rule prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;
- Subpart C of the final rule prohibits or restricts acquiring or retaining an ownership interest in, and certain relationships with, a covered fund, defines terms relevant to covered fund activities and investments, as well as establishes exemptions from the restrictions on covered fund activities and investments and limitations on those exemptions;
- Subpart D of the final rule generally requires banking entities to establish a compliance program regarding compliance with section 13 of the BHC Act and the final rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;
- Appendix A of the final rule details the quantitative measurements that certain banking entities may be required to compute and report with respect to certain trading activities;
- Appendix B of the final rule details the enhanced minimum standards for programmatic compliance that certain banking entities must meet with respect to their compliance program, as required under subpart D.

B. Proprietary Trading Restrictions

Subpart B of the final rule implements the statutory prohibition on proprietary trading and the various exemptions to this prohibition included in the statute. Section 75.3 of the final rule contains the core prohibition on proprietary trading and defines a number of related terms, including ''proprietary trading'' and ''trading account.'' The final rule's definition of proprietary trading generally parallels the statutory definition and covers engaging as principal for the trading account of a banking entity in any transaction to purchase or sell specified types of financial instruments.[41]

The final rule's definition of trading account also is consistent with the statutory definition.[42] In particular, the definition of trading account in the final rule includes three classes of positions. First, the definition includes the purchase or sale of one or more financial instruments taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[43] For purposes of this part of the definition, the final rule also contains a rebuttable presumption that the purchase or sale of a financial instrument by a banking entity is for the trading account of the banking entity if the banking entity holds the financial instrument for fewer than 60 days or substantially transfers the risk of the financial instrument within 60 days of purchase (or sale).[44] Second, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, the definition includes the purchase or sale of one or more financial instruments subject to the prohibition on proprietary trading that are treated as ''covered positions and trading positions'' (or hedges of other market risk capital rule covered positions) under those capital rules, other than certain foreign exchange and commodities positions.[45] Third, the definition includes the purchase or sale of one or more financial instruments by a banking entity that is licensed or registered or required to be licensed or registered to engage in the business of a dealer, swap dealer, or security-based swap dealer to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such or is engaged in those businesses outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.[46]

The definition of proprietary trading also contains clarifying exclusions for certain purchases and sales of financial instruments that generally do not involve the requisite short-term trading intent, such as the purchase and sale of financial instruments arising under certain repurchase and reverse repurchase arrangements or securities

[41] *See* final rule § 75.3(a).
[42] *See* final rule § 75.3(b).
[43] *See* final rule § 75.3(b)(1)(i).
[44] *See* final rule § 75.3(b)(2).
[45] *See* final rule § 75.3(b)(1)(ii).
[46] *See* final rule § 75.3(b)(1)(iii).

lending transactions and securities acquired or taken for *bona fide* liquidity management purposes.[47]

In section 75.3, the final rule also defines a number of other relevant terms, including the term ''financial instrument.'' This term is used to define the scope of financial instruments subject to the prohibition on proprietary trading. Consistent with the statutory language, such financial instruments include securities, derivatives, commodity futures, and options on such instruments, but do not include loans, spot foreign exchange or spot physical commodities.[48]

In section 75.4, the final rule implements the statutory exemptions for underwriting and market making-related activities. For each of these permitted activities, the final rule defines the exempt activity and provides a number of requirements that must be met in order for a banking entity to rely on the applicable exemption. As more fully discussed below, these include establishment and enforcement of a compliance program targeted to the activity; limits on positions, inventory and risk exposure addressing the requirement that activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; limits on the duration of holdings and positions; defined escalation procedures to change or exceed limits; analysis justifying established limits; internal controls and independent testing of compliance with limits; senior management accountability and limits on incentive compensation. In addition, the final rule requires firms with significant market-making or underwriting activities to report data involving several metrics that may be used by the banking entity and the Agencies to identify trading activity that may warrant more detailed compliance review.

These requirements are generally designed to ensure that the banking entity's trading activity is limited to underwriting and market making-related activities and does not include prohibited proprietary trading.[49] These requirements are also intended to work together to ensure that banking entities identify, monitor and limit the risks associated with these activities.

In section 75.5, the final rule implements the statutory exemption for risk-mitigating hedging. As with the underwriting and market-making exemptions, § 75.5 of the final rule contains a number of requirements that must be met in order for a banking entity to rely on the exemption. These requirements are generally designed to ensure that the banking entity's hedging activity is limited to risk-mitigating hedging in purpose and effect.[50] Section 75.5 also requires banking entities to document, at the time the transaction is executed, the hedging rationale for certain transactions that present heightened compliance risks.[51] As with the exemptions for underwriting and market making-related activity, these requirements form part of a broader implementation approach that also includes the compliance program requirement and the reporting of quantitative measurements.

In section 75.6, the final rule implements statutory exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside of the United States. Section 75.6(a) of the final rule describes the government obligations in which a banking entity may trade, which include U.S. government and agency obligations, obligations and other instruments of specified government sponsored entities, and State and municipal obligations.[52] Section 75.6(b) of the final rule permits trading in certain foreign government obligations by affiliates of foreign banking entities in the United State and foreign affiliates of a U.S. banking entity abroad.[53] Section 75.6(c) of the final rule describes permitted trading on behalf of customers and identifies the types of transactions that would qualify for the exemption.[54] Section 75.6(d) of the final rule describes permitted trading by a regulated insurance company or an affiliate thereof for the general account of the insurance company, and also permits those entities to trade for a separate account of the insurance company.[55] Finally, § 75.6(e) of the final rule describes trading permitted outside of the United States by a foreign banking entity.[56] The exemption in the final rule clarifies when a foreign banking entity will qualify to engage in such trading pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity not currently subject to the BHC Act. As explained in detail below, the exemption also provides that the risk as principal, the decision-making, and the accounting for this activity must occur solely outside of the United States, consistent with the statute.

In section 75.7, the final rule prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[57] This section also describes the terms material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

C. Restrictions on Covered Fund Activities and Investments

Subpart C of the final rule implements the statutory prohibition on, directly or indirectly, acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section 75.10 of the final rule contains the core prohibition on covered fund activities and investments and defines a number of related terms, including ''covered fund'' and ''ownership interest.''[58] The definition of covered fund contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, foreign pension or retirement funds, insurance company separate accounts, and public welfare investment funds. The final rule also implements the statutory rule of construction in section 13(g)(2) and provides that a securitization of loans, which would include loan securitization, qualifying asset backed commercial paper conduit, and qualifying covered bonds, is not covered by section 13 or the final rule.[59]

[47] *See* final rule § 75.3(d).

[48] *See* final rule § 75.3(c).

[49] *See* final rule § 75.4(a), (b).

[50] *See* final rule § 75.5.

[51] *See* final rule § 75.5(c).

[52] *See* final rule § 75.6(a).

[53] *See* final rule § 75.6(b).

[54] *See* final rule § 75.6(c).

[55] *See* final rule § 75.6(d).

[56] *See* final rule § 75.6(e).

[57] *See* final rule § 75.7.

[58] *See* final rule § 75.10(b).

[59] The Agencies believe that most securitization transactions are currently structured so that the issuing entity with respect to the securitization is not an affiliate of a banking entity under the BHC Act. However, with respect to any securitization that is an affiliate of a banking entity and that does not meet the requirements of the loan securitization exclusion, the related banking entity will need to

Continued

The definition of ''ownership interest'' in the final rule provides further guidance regarding the types of interests that would be considered to be an ownership interest in a covered fund.[60] As described in this Supplementary Information, these interests may take various forms. The definition of ownership interest also explicitly excludes from the definition ''restricted profit interest'' that is solely performance compensation for services provided to the covered fund by the banking entity (or an employee or former employee thereof), under certain circumstances.[61] Section 75.10 of the final rule also defines a number of other relevant terms, including the terms ''prime brokerage transaction,'' ''sponsor,'' and ''trustee.''

In section 75.11, the final rule implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. Section 75.11(a) of the final rule outlines the conditions that must be met in order for a banking entity to organize and offer a covered fund under this authority. These requirements are contained in the statute and are intended to allow a banking entity to engage in certain traditional asset management and advisory businesses, subject to certain limits contained in section 13 of the BHC Act.[62] The requirements are discussed in detail in Part VI.B.2. of this Supplementary Information. Section 75.11 also explains how these requirements apply to covered funds that are issuing entities of asset-backed securities, as well as implements the statutory exemption for underwriting and market-making ownership interests of a covered fund, including explaining the limitations imposed on such activities under the final rule.

In section 75.12, the final rule permits a banking entity to acquire and retain, as an investment in a covered fund, an ownership interest in a covered fund that the banking entity organizes and offers or holds pursuant to other authority under § 75.11.[63] This section implements section 13(d)(4) of the BHC Act and related provisions. Section 13(d)(4)(A) of the BHC Act permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section 75.12 of the final rule implements this authority and related limitations, including limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments. In addition, § 75.12 requires that the aggregate value of all investments in covered funds, plus any earnings on these investments, be deducted from the capital of the banking entity for purposes of the regulatory capital requirements, and explains how that deduction must occur. Section 75.12 of the final rule also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from applicable capital, as relevant), and sets forth how a banking entity may request an extension of the period of time within which it must conform an investment in a single covered fund. This section also explains how a banking entity must apply the covered fund investment limits to a covered fund that is an issuing entity of asset backed securities or a covered fund that is part of a master-feeder or fund-of-funds structure.

In section 75.13, the final rule implements the statutory exemptions described in sections 13(d)(1)(C), (D), (F), and (I) of the BHC Act that permit a banking entity: (i) To acquire and retain an ownership interest in a covered fund as a risk-mitigating hedging activity related to employee compensation; (ii) in the case of a non-U.S. banking entity, to acquire and retain an ownership interest in, or act as sponsor to, a covered fund solely outside the United States; and (iii) to acquire and retain an ownership interest in, or act as sponsor to, a covered fund by an insurance company for its general or separate accounts.[64]

In section 75.14, the final rule implements section 13(f) of the BHC Act and generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act.[65] Section 75.14(a)(2) of the final rule describes the transactions between a banking entity and a covered fund that remain permissible under the statute and the final rule. Section 75.14(b) of the final rule implements the statute's requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and a covered fund is subject to section 23B of the Federal Reserve Act,[66] which, in general, requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

In section 75.15, the final rule prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[67] This section also describes material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

D. Metrics Reporting Requirement

Under the final rule, a banking entity that meets relevant thresholds specified in the rule must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

The final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in approach based on the size of trading assets and liabilities. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the

determine how to bring the securitization into compliance with this rule.

[60] *See* final rule § 75.10(d)(6).

[61] *See* final rule § 75.10(b)(6)(ii).

[62] *See* 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

[63] *See* final rule § 75.12.

[64] *See* final rule § 75.13(a)–(c).

[65] *See* 12 U.S.C. 371c; *see also* final rule § 75.14.

[66] 12 U.S.C. 371c–1.

[67] *See* final rule § 75.15.

United States or any agency of the United States). Banking entities with $25 billion or more in trading assets and liabilities and banking entities with $10 billion or more in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in the final rule unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion in consolidated trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis. All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by the final rule unless another time is requested by the primary supervisory Agency for the entity except for a transitional six month period during which reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[68]

E. Compliance Program Requirement

Subpart D of the final rule requires a banking entity engaged in covered trading activities or covered fund activities to develop and implement a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the final rule.[69] To reduce the overall burden of the rule, the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments.[70] In addition, to reduce the burden on smaller banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities or investments may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.[71]

For banking entities with total assets greater than $10 billion and less than $50 billion, the final rule specifies six elements that each compliance program established under subpart D must, at a minimum, include. These requirements focus on written policies and procedures reasonably designed to ensure compliance with the final rules, including limits on underwriting and market-making; a system of internal controls; clear accountability for compliance and review of limits, hedging, incentive compensation, and other matters; independent testing and audits; additional documentation for covered funds; training; and recordkeeping requirements.

A banking entity with $50 billion or more total consolidated assets (or a foreign banking entity that has total U.S. assets of $50 billion or more) or that is required to report metrics under Appendix A is required to adopt an enhanced compliance program with more detailed policies, limits, governance processes, independent testing and reporting. In addition, the Chief Executive Officer of these larger banking entities must attest that the banking entity has in place a program reasonably designed to achieve compliance with the requirements of section 13 of the BHC Act and the final rule.

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

VI. Final Rule

A. Subpart B—Proprietary Trading Restrictions

1. Section 75.3: Prohibition on Proprietary Trading and Related Definitions

Section 13(a)(1)(A) of the BHC Act prohibits a banking entity from engaging in proprietary trading unless otherwise permitted in section 13.[72] Section 13(h)(4) of the BHC Act defines proprietary trading, in relevant part, as engaging as principal for the trading account of the banking entity in any transaction to purchase or sell, or otherwise acquire or dispose of, a security, derivative, contract of sale of a commodity for future delivery, or other financial instrument that the Agencies include by rule.[73]

Section 75.3(a) of the proposed rule implemented section 13(a)(1)(A) of the BHC Act by prohibiting a banking entity from engaging in proprietary trading unless otherwise permitted under §§ 75.4 through 75.6 of the proposed rule. Section 75.3(b)(1) of the proposed rule defined proprietary trading in accordance with section 13(h)(4) of the BHC Act and clarified that proprietary trading does not include acting solely as agent, broker, or custodian for an unaffiliated third party. The preamble to the proposed rule explained that acting in these types of capacities does not involve trading as principal.[74]

Several commenters expressed concern about the breadth of the ban on proprietary trading.[75] Some of these commenters stated that proprietary trading must be carefully and narrowly defined to avoid prohibiting activities that Congress did not intend to limit and to preclude significant, unintended consequences for capital markets, capital formation, and the broader economy.[76] Some commenters asserted that the proposed definition could result in banking entities being unwilling to take principal risk to provide liquidity for institutional investors; could unnecessarily constrain liquidity in secondary markets, forcing asset managers to service client needs through alternative non-U.S. markets; could impose substantial costs for all institutions, especially smaller and mid-size institutions; and could drive risk-

[68] *See* final rule § 75.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

[69] *See* final rule § 75.20.

[70] *See* final rule § 75.20(f)(1).

[71] *See* final rule § 75.20(f)(2).

[72] 12 U.S.C. 1851(a)(1)(A).

[73] 12 U.S.C. 1851(h)(4).

[74] *See* Joint Proposal, 76 FR at 68857.

[75] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); Capital Group; Comm. on Capital Markets Regulation; IAA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Chamber (Feb. 2012); Wellington.

[76] *See* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012).

taking to the shadow banking system.[77] Others urged the Agencies to determine that trading as agent, broker, or custodian for an affiliate was not proprietary trading.[78]

Commenters also suggested alternative approaches for defining proprietary trading. In general, these approaches sought to provide a bright-line definition to provide increased certainty to banking entities [79] or make the prohibition easier to apply in practice.[80] One commenter stated the Agencies should focus on the economics of banking entities' transactions and ban trading if the banking entity is exposed to market risk for a significant period of time or is profiting from changes in the value of the asset.[81] Several commenters, including individual members of the public, urged the Agencies to prohibit banking entities from engaging in any kind of proprietary trading and require separation of trading from traditional banking activities.[82] After carefully considering comments, the Agencies are defining proprietary trading as engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.[83] The Agencies believe this effectively restates the statutory definition. The Agencies are not adopting commenters' suggested modifications to the proposed definition of proprietary trading or the general prohibition on proprietary trading because they generally appear to be inconsistent with Congressional intent. For instance, some commenters appeared to suggest an approach to defining proprietary trading that would capture only bright-line, speculative proprietary trading and treat the activities covered by the statutory exemptions as completely outside the rule.[84] However, such an approach would appear to be inconsistent with Congressional intent because, for instance, it would not give effect to the limitations on permitted activities in section 13(d) of the BHC Act.[85] For similar reasons, the Agencies are not adopting a bright-line definition of proprietary trading.[86]

A number of commenters expressed concern that, as a whole, the proposed rule may result in certain negative economic impacts, including: (i) Reduced market liquidity; [87] (ii) wider spreads or otherwise increased trading costs; [88] (iii) higher borrowing costs for businesses or increased cost of capital; [89] and/or (iv) greater market volatility.[90] The Agencies have carefully considered commenters' concerns about the proposed rule's potential impact on overall market liquidity and quality. As discussed in more detail in Parts VI.A.2. and VI.A.3., the final rule will permit banking entities to continue to provide beneficial market-making and underwriting services to customers, and therefore provide liquidity to customers and facilitate capital-raising. However, the statute upon which the final rule is based prohibits proprietary trading activity that is not exempted. As such, the termination of non-exempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants.[91] Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

To respond to concerns raised by commenters while remaining consistent with Congressional intent, the final rule has been modified to provide that certain purchases and sales are not proprietary trading as described in more detail below.[92]

a. Definition of ''Trading Account''

As explained above, section 13 defines proprietary trading as engaging as principal ''for the trading account of the banking entity'' in certain types of transactions. Section 13(h)(6) of the BHC Act defines trading account as any account used for acquiring or taking positions in financial instruments principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the Agencies may, by rule, determine.[93]

The proposed rule defined trading account to include three separate accounts. First, the proposed definition

[77] *See* Chamber (Feb. 2012).

[78] *See* Japanese Bankers Ass'n.

[79] *See, e.g.,* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[80] *See* Public Citizen.

[81] *See* Sens. Merkley & Levin (Feb. 2012).

[82] *See generally* Occupy; Public Citizen; AFR *et al.* (Feb. 2012). The Agencies received over fifteen thousand form letters in support of a rule with few exemptions, many of which expressed a desire to return to the regulatory scheme as governed by the Glass-Steagall affiliation provisions of the U.S. Banking Act of 1933, as repealed through the Graham-Leach-Bliley Act of 1999. *See generally* Sarah McGee; Christopher Wilson; Michael Itlis; Barry Rein; Edward Bright. Congress rejected such an approach, however, opting instead for the more narrowly tailored regulatory approach embodied in section 13 of the BHC Act.

[83] *See* final rule § 75.3(a). The final rule also replaces all references to the proposed term ''covered financial position'' with the term ''financial instrument.'' This change has no substantive impact because the definition of ''financial instrument'' is substantially identical to the proposed definition of ''covered financial position.'' Consistent with this change, the final rule replaces the undefined verbs ''acquire'' or ''take'' with the defined terms ''purchase'' or ''sale'' and ''sell.'' *See* final rule §§ 75.3(c), 75.2(u), (x).

[84] *See, e.g.,* Ass'n. of Institutional Investors (Feb. 2012); GE (Feb. 2012); Invesco; Sen. Corker; Chamber (Feb. 2012); JPMC.

[85] *See* 156 Cong. Rec. S5895–96 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating the statute ''permits underwriting and market-making-related transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services.'').

[86] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BOK; George Bollenbacher; Credit Suisse (Seidel); NAIB *et al.;* SSgA (Feb. 2012); JPMC.

[87] *See, e.g.,* AllianceBernstein; Obaid Syed; Rep. Bachus *et al.;* EMTA; NASP; Sen. Hagan; Investure; Lord Abbett; Sumitomo Trust; EFAMA; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); STANY; ABA (Keating); ICE; ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Capital Group; RBC; Columbia Mgmt.; SSgA (Feb. 2012); Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Clearing House Ass'n.; Thakor Study. *See also* CalPERS (acknowledging that the systemic protections afforded by the Volcker Rule come at a price, including reduced liquidity to all markets).

[88] *See,* e.g., AllianceBernstein; Obaid Syed; NASP; Investure; Lord Abbett; CalPERS; Credit Suisse (Seidel); Citigroup (Feb. 2012); ABA (Keating); SIFMA (Asset Mgmt.) (Feb. 2012); Putnam; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[89] *See, e.g.,* Rep. Bachus *et al.;* Members of Congress (Dec. 2011); Lord Abbett; Morgan Stanley; Barclays; BoA; Citigroup (Feb. 2012); ABA (Abernathy); ICSA; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ACLI (Feb. 2012); UBS; Wells Fargo (Prop. Trading); Capital Group; Sen. Carper *et al.;* Fidelity; Invesco; Clearing House Ass'n.; Thakor Study.

[90] *See, e.g.,* CalPERS (expressing the belief that a decline in banking entity proprietary trading will increase the volatility of the corporate bond market, especially during times of economic weakness or periods where risk taking declines, but noting that portfolio managers have experienced many different periods of market illiquidity and stating that the market will adapt post-implementation (*e.g.,* portfolio managers will increase their use of CDS to reduce economic risk to specific bond positions as the liquidation process of cash bonds takes more time, alternative market matching networks will be developed)); Morgan Stanley; Capital Group; Fidelity; British Bankers' Ass'n.; Invesco.

[91] *See* David McClean; Public Citizen; Occupy. In response to commenters who expressed concern about risks associated with proprietary trading activities moving to non-banking entities, the Agencies note that section 13's prohibition on proprietary trading and related exemptions apply only to banking entities. *See, e.g.,* Chamber (Feb. 2012).

[92] *See* final rule § 75.3(d).

[93] *See* 12 U.S.C. 1851(h)(6).

of trading account included, consistent with the statute, any account that is used by a banking entity to acquire or take one or more covered financial positions for short-term trading purposes (the ''short-term trading account'').[94] The proposed rule identified four purposes that would indicate short-term trading intent: (i) Short-term resale; (ii) benefitting from actual or expected short-term price movements; (iii) realizing short-term arbitrage profits; or (iv) hedging one or more positions described in (i), (ii) or (iii). The proposed rule presumed that an account is a trading account if it is used to acquire or take a covered financial position (other than a position in the market risk rule trading account or the dealer trading account) that the banking entity holds for 60 days or less.[95]

Second, the proposed definition of trading account included, for certain entities, any account that contains positions that qualify for trading book capital treatment under the banking agencies' market risk capital rules other than positions that are foreign exchange derivatives, commodity derivatives or contracts of sale of a commodity for delivery (the ''market risk rule trading account'').[96] ''Covered positions'' under the banking agencies' market-risk capital rules are positions that are generally held with the intent of sale in the short-term.

Third, the proposed definition of trading account included any account used by a banking entity that is a securities dealer, swap dealer, or security-based swap dealer to acquire or take positions in connection with its dealing activities (the ''dealer trading account'').[97] The proposed rule also included as a trading account any account used to acquire or take any covered financial position by a banking entity in connection with the activities of a dealer, swap dealer, or security-based swap dealer outside of the United States.[98] Covered financial positions held by banking entities that register or file notice as securities or derivatives dealers as part of their dealing activity were included because such positions are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions).[99]

The proposed rule also set forth four clarifying exclusions from the definition of trading account. The proposed rule provided that no account is a trading account to the extent that it is used to acquire or take certain positions under repurchase or reverse repurchase arrangements, positions under securities lending transactions, positions for *bona fide* liquidity management purposes, or positions held by derivatives clearing organizations or clearing agencies.[100]

Overall, commenters did not raise significant concerns with or objections to the short-term trading account. Several commenters argued that the definition of trading account should be limited to only this portion of the proposed definition of trading account.[101] However, a few commenters raised concerns regarding the treatment of arbitrage trading under the proposed rule.[102] Several commenters asserted that the proposed definition of trading account was too broad and covered trading not intended to be covered by the statute.[103] Some of these commenters maintained that the Agencies exceeded their statutory authority under section 13 of the BHC Act in defining trading account to include the market risk rule trading account and dealer trading account, and argued that the definition should be limited to the short-term trading account definition.[104] Commenters argued, for example, that an overly broad definition of trading account may cause traditional bank activities important to safety and soundness of a banking entity to fall within the prohibition on proprietary trading to the detriment of banking organizations, customers, and financial markets.[105] A number of commenters suggested modifying and narrowing the trading account definition to remove the implicit negative presumption that any position creates a trading account, or that all principal trading constitutes prohibited proprietary trading unless it qualifies for a narrowly tailored exemption, and to clearly exempt activities important to safety and soundness.[106] For example, one commenter recommended that a covered financial position be considered a trading account position only if it qualifies as a GAAP trading position.[107] A few commenters requested the Agencies define the phrase ''short term'' in the rule.[108]

Several commenters argued that the market risk rule should not be referenced as part of the definition of trading account.[109] A few of these commenters argued instead that the capital treatment of a position be used only as an indicative factor rather than a dispositive test.[110] One commenter thought that the market risk rule trading account was redundant because it includes only positions that have short-term trading intent.[111] Commenters also contended that it was difficult to consider and comment on this aspect of the proposal because the market risk capital rules had not been finalized.[112]

A number of commenters objected to the dealer trading account prong of the definition.[113] Commenters asserted that this prong was an unnecessary and unhelpful addition that went beyond the requirements of section 13 of the BHC Act, and that it made the trading account determination more complex and difficult.[114] In particular, commenters argued that the dealer trading account was too broad and introduced uncertainty because it presumed that dealers always enter into positions with short-term intent.[115] Commenters also expressed concern about the difficulty of applying this test outside the United States and requested that, if this account is retained, the final rule be explicit about how it applies to a swap dealer outside the United States

[94] *See* proposed rule § 75.3(b)(2)(i)(A).

[95] *See* proposed rule § 75.3(b)(2)(ii).

[96] *See* proposed rule §§ 75.3(b)(2)(i)(B); 75.3(b)(3).

[97] *See* proposed rule § 75.3(b)(2)(i)(C).

[98] *See* proposed rule § 75.3(b)(2)(i)(C)(5).

[99] *See* Joint Proposal, 76 FR 68860.

[100] *See* proposed rule § 75.3(b)(2)(iii).

[101] *See* ABA (Keating); JPMC.

[102] *See* AFR *et al.* (Feb. 2012); Paul Volcker; Credit Suisse (Seidel); ISDA (Feb. 2012); Japanese Bankers Ass'n.

[103] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[104] *See* ABA (Keating); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[105] *See* ABA (Keating); Credit Suisse (Seidel).

[106] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Wellington.

[107] *See* ABA (Keating).

[108] *See* NAIB *et al.;* Occupy; *but see* Alfred Brock.

[109] *See* ABA; BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[110] *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[111] *See* ISDA (Feb. 2012).

[112] *See* ABA (Keating); BoA; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC. The banking agencies adopted a final rule that amends their respective market risk capital rules on August 30, 2012. *See* 77 FR 53060 (Aug. 30, 2012). The Agencies continued to receive and consider comments on the proposed rule to implement section 13 of the BHC Act after that time.

[113] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); Japanese Bankers Ass'n.; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[114] *See* ABA (Keating); Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); JPMC; State Street (Feb. 2012); ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[115] *See* ABA (Keating); Am. Express; Goldman (Prop. Trading); ISDA (Feb. 2012); JPMC.

and treat U.S. swap dealers consistently.[116]

In contrast, other commenters contended that the proposed rule's definition of trading account was too narrow, particularly in its focus on short-term positions,[117] or should be simplified.[118] One commenter argued that the breadth of the trading account definition was critical because positions excluded from the trading account definition would not be subject to the proposed rule.[119] One commenter supported the proposed definition of trading account.[120] Other commenters believed that reference to the market-risk rule was an important addition to the definition of trading account. Some expressed the view that it should include all market risk capital rule covered positions and not just those requiring short-term trading intent.[121]

Certain commenters proposed alternate definitions. Several commenters argued against using the term ''account'' and instead advocated applying the prohibition on proprietary trading to trading positions.[122] Foreign banks recommended applying the definition of trading account applicable to such banks in their home country, if the home country provided a clear definition of this term.[123] These commenters argued that new definitions in the proposed rule, like trading account, would require foreign banking entities to develop new and complex procedures and expensive systems.[124]

Commenters also argued that various types of trading activities should be excluded from the trading account definition. For example, one commenter asserted that arbitrage trading should not be considered trading account activity,[125] while other commenters argued that arbitrage positions and strategies are proprietary trading and should be included in the definition of trading account and prohibited by the final rule.[126] Another commenter argued that the trading account should include only positions primarily intended, when the position is entered into, to profit from short-term changes in the value of the assets, and that liquidity investments that do not have price changes and that can be sold whenever the banking entity needs cash should be excluded from the trading account definition.[127]

After carefully reviewing the comments, the Agencies have determined to retain in the final rule the proposed approach for defining trading account that includes the short-term, market risk rule, and dealer trading accounts with modifications to address issues raised by commenters. The Agencies believe that this multi-prong approach is consistent with both the language and intent of section 13 of the BHC Act, including the express statutory authority to include ''any such other account'' as determined by the Agencies.[128] The final definition effectuates Congress's purpose to generally focus on short-term trading while addressing commenters' desire for greater certainty regarding the definition of the trading account.[129] In addition, the Agencies believe commenters' concerns about the scope of the proposed definition of trading account are substantially addressed by the refined exemptions in the final rule for customer-oriented activities, such as market making-related activities, and the exclusions from proprietary trading.[130] Moreover, the Agencies believe that it is appropriate to focus on the economics of a banking entity's trading activity to help determine whether it is engaged in proprietary trading, as discussed further below.[131]

As explained above, the short-term trading prong of the definition largely incorporates the statutory provisions. This prong covers trading involving short-term resale, price movements, and arbitrage profits, and hedging positions that result from these activities. Specifically, the reference to short-term resale is taken from the statute's definition of trading account. The Agencies continue to believe it is also appropriate to include in the short-term trading prong an account that is used by a banking entity to purchase or sell one or more financial instruments principally for the purpose of benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging one or more positions captured by the short-term trading prong. The provisions regarding price movements and arbitrage focus on the intent to engage in transactions to benefit from short-term price movements (*e.g.,* entering into a subsequent transaction in the near term to offset or close out, rather than sell, the risks of a position held by the banking entity to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction) or to benefit from differences in multiple market prices, including scenarios where movement in those prices is not necessary to realize the intended profit.[132] These types of transactions are economically equivalent to transactions that are principally for the purpose of selling in the near term or with the intent to resell to profit from short-term price movements, which are expressly covered by the statute's definition of trading account. Thus, the Agencies believe it is necessary to include these provisions in the final rule's short-term trading prong to provide clarity about the scope of the definition and to prevent evasion of the statute and final rule.[133] In addition, like the proposed rule, the final rule's short-term trading prong includes hedging one or more of the positions captured by this prong because the Agencies assume that a banking entity generally intends to hold the hedging position for only so long as the underlying position is held.

The remaining two prongs to the trading account definition apply to types of entities that engage actively in trading activities. Each prong focuses on analogous or parallel short-term trading activities. A few commenters stated these prongs were duplicative of the short-term trading prong, and argued the Agencies should not include these prongs in the definition of trading

[116] *See* Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations); Am. Express; JPMC.

[117] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[118] *See, e.g.,* Public Citizen.

[119] *See* AFR *et al.* (Feb. 2012).

[120] *See* Alfred Brock.

[121] *See* AFR *et al.* (Feb. 2012).

[122] *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[123] *See* Japanese Bankers Ass'n.; Norinchukin.

[124] *See* Japanese Bankers Ass'n.

[125] *See* Alfred Brock.

[126] *See* AFR *et al.* (Feb. 2012); Paul Volcker.

[127] *See* NAIB *et al. See infra* Part VI.A.1.d.2. (discussing the liquidity management exclusion).

[128] 12 U.S.C. 1851(h)(6).

[129] In response to commenters' concerns about the meaning of account, the Agencies note the term ''trading account'' is a statutory concept and does not necessarily refer to an actual account. Trading account is simply nomenclature for the set of transactions that are subject to the final rule's restrictions on proprietary trading. *See* ABA (Keating); Goldman (Prop. Trading); NAIB *et al.*

[130] For example, several commenters' concerns about the potential impact of the proposed definition of trading account were tied to the perceived narrowness of the proposed exemptions. *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; Capital Group; IAA; Credit Suisse (Seidel); ICI (Feb. 2012); ISDA (Feb. 2012); NAIB *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); SVB; Wellington.

[131] *See* Sens. Merkley & Levin (Feb. 2012). However, as discussed in this **SUPPLEMENTARY INFORMATION**, the Agencies are not prohibiting any trading that involves profiting from changes in the value of the asset, as suggested by this commenter, because permitted activities, such as market making, can involve price appreciation-related revenues. *See infra* Part VI.A.3. (discussing the final market-making exemption).

[132] *See* Joint Proposal, 76 FR at 68857–68858.

[133] As a result, the Agencies are not excluding arbitrage trading from the trading account definition, as suggested by at least one commenter. *See, e.g.,* Alfred Brock.

account, or should only consider them as non-determinative factors.[134] To the extent that an overlap exists between the prongs of this definition, the Agencies believe they are mutually reinforcing, strengthen the rule's effectiveness, and may help simplify the analysis of whether a purchase or sale is conducted for the trading account.[135]

The market risk capital prong covers trading positions that are covered positions for purposes of the banking agency market-risk capital rules, as well as hedges of those positions. Trading positions under those rules are positions held by the covered entity ''for the purpose of short-term resale or with the intent of benefitting from actual or expected short-term price movements, or to lock-in arbitrage profits.'' [136] This definition largely parallels the provisions of section 13(h)(4) of the BHC Act and mirrors the short-term trading account prong of both the proposed and final rules. Covered positions are trading positions under the rule that subject the covered entity to risks and exposures that must be actively managed and limited—a requirement consistent with the purposes of the section 13 of the BHC Act.

Incorporating this prong into the trading account definition reinforces the consistency between governance of the types of positions that banking entities identify as ''trading'' for purposes of the market risk capital rules and those that are trading for purposes of the final rule under section 13 of the BHC Act. Moreover, this aspect of the final rule reduces the compliance burden on banking entities with substantial trading activities by establishing a clear, bright-line rule for determining that a trade is within the trading account.[137]

After reviewing comments, the Agencies also continue to believe that financial instruments purchased or sold by registered dealers in connection with their dealing activity are generally held with short-term intent and should be captured within the trading account. The Agencies believe the scope of the dealer prong is appropriate because, as noted in the proposal, positions held by a registered dealer in connection with its dealing activity are generally held for sale to customers upon request or otherwise support the firm's trading activities (*e.g.,* by hedging its dealing positions), which is indicative of short-term intent.[138] Moreover, the final rule includes a number of exemptions for the activities in which securities dealers, swap dealers, and security-based swap dealers typically engage, such as market making, hedging, and underwriting. Thus, the Agencies believe the broad scope of the dealer trading account is balanced by the exemptions that are designed to permit dealer entities to continue to engage in customer-oriented trading activities, consistent with the statute. This approach is designed to ensure that registered dealer entities are engaged in permitted trading activities, rather than prohibited proprietary trading.

The final rule adopts the dealer trading account substantially as proposed,[139] with streamlining that eliminates the specific references to different types of securities and derivatives dealers. The final rule adopts the proposed approach to covering trading accounts of banking entities that regularly engage in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States. In the case of both domestic and foreign entities, this provision applies only to financial instruments purchased or sold in connection with the activities that require the banking entity to be licensed or registered to engage in the business of dealing, which is not necessarily *all* of the activities of that banking entity.[140] Activities of a banking entity that are not covered by the dealer prong may, however, be covered by the short-term or market risk rule trading accounts if the purchase or sale satisfies the requirements of §§ 75.3(b)(1)(i) or (ii).[141]

A few commenters stated that they do not currently analyze whether a particular activity would require dealer registration, so the dealer prong of the trading account definition would require banking entities to engage in a new type of analysis.[142] The Agencies recognize that banking entities that are registered dealers may not currently engage in such an analysis with respect to their current trading activities and, thus, this may represent a new regulatory requirement for these entities. If the regulatory analysis otherwise engaged in by banking entities is substantially similar to the dealer prong analysis required under the trading account definition, then any increased compliance burden could be small or insubstantial.[143]

In response to commenters' concerns regarding the application of this prong to banking entities acting as dealers in jurisdictions outside the United States,[144] the Agencies continue to believe including the activities of a banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business, is appropriate. As noted above, dealer activity generally involves short-term trading. Further, the Agencies are concerned that differing requirements for U.S. and foreign dealers may lead to regulatory arbitrage. For foreign banking entities acting as dealers outside of the United States that are eligible for the exemption for trading conducted by foreign banking entities, the Agencies believe the risk-based approach to this exemption in the final rule should help address the concerns about the scope of this prong of the definition.[145]

In response to one commenter's suggestion that the Agencies define the term trading account to allow a foreign banking entity to use of the relevant foreign regulator's definition of this term, where available, the Agencies are concerned such an approach could lead to regulatory arbitrage and otherwise inconsistent applications of the rule.[146] The Agencies believe this commenter's general concern about the impact of the statute and rule on foreign banking entities' activities outside the United States should be substantially addressed by the exemption for trading conducted by foreign banking entities under § 75.6(e) of the final rule.

[134] *See* ISDA (Feb. 2012); JPMC; ABA (Keating); BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[135] *See* Occupy.

[136] 12 CFR 225, Appendix E.

[137] Accordingly, the Agencies are not using a position's capital treatment as merely an indicative factor, as suggested by a few commenters.

[138] *See* Joint Proposal, 76 FR at 68860.

[139] *See* final rule § 75.3(b)(1)(iii).

[140] An insured depository institution may be registered as a swap dealer, but only the swap dealing activities that require it to be so registered are covered by the dealer trading account. If an insured depository institution purchases or sells a financial instrument in connection with activities of the insured depository institution that do not trigger registration as a swap dealer, such as lending, deposit-taking, the hedging of business risks, or other end-user activity, the financial instrument is included in the trading account only if the instrument falls within the statutory trading account under § 75.3(b)(1)(i) or the market risk rule trading account under § 75.3(b)(1)(ii) of the final rule.

[141] *See* final rule §§ 75.3(b)(1)(i) and (ii).

[142] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[143] *See, e.g.,* Goldman (Prop. Trading) (''For instance, a banking entity's market making-related activities with respect to credit trading may involve making a market in bonds (traded in a broker-dealer), single-name CDSs (in a security-based swap dealer) and CDS indexes (in a swap dealer). For regulatory or other reasons, these transactions could take place in different legal entities . . .'').

[144] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Allen & Overy (on behalf of Large Int'l Banks with U.S. Operations).

[145] *See* final rule § 75.6(e).

[146] *See* Japanese Bankers Ass'n.

Finally, the Agencies have declined to adopt one commenter's recommendation that a position in a financial instrument be considered a trading account position only if it qualifies as a GAAP trading position.[147] The Agencies continue to believe that formally incorporating accounting standards governing trading securities is not appropriate because: (i) The statutory proprietary trading provisions under section 13 of the BHC Act applies to financial instruments, such as derivatives, to which the trading security accounting standards may not apply; (ii) these accounting standards permit companies to classify, at their discretion, assets as trading securities, even where the assets would not otherwise meet the definition of trading securities; and (iii) these accounting standards could change in the future without consideration of the potential impact on section 13 of the BHC Act and these rules.[148]

b. Rebuttable Presumption for the Short-Term Trading Account

The proposed rule included a rebuttable presumption clarifying when a covered financial position, by reason of its holding period, is traded with short-term intent for purposes of the short-term trading account. The Agencies proposed this presumption primarily to provide guidance to banking entities that are not subject to the market risk capital rules or are not covered dealers or swap entities and accordingly may not have experience evaluating short-term trading intent. In particular, § 75.3(b)(2)(ii) of the proposed rule provided that an account would be presumed to be a short-term trading account if it was used to acquire or take a covered financial position that the banking entity held for a period of 60 days or less.

Several commenters supported the rebuttable presumption, but suggested either shortening the holding period to 30 days or less,[149] or extending the period to 90 days,[150] to several months,[151] or to one year.[152] Some of these commenters argued that specifying an overly short holding period would be contrary to the statute, invite gamesmanship,[153] and miss speculative positions held for longer than the specified period.[154] Commenters also suggested turning the presumption into a safe harbor[155] or into guidance.[156]

Other commenters opposed the inclusion of the rebuttable presumption for a number of reasons and requested that it be removed.[157] For example, these commenters argued that the presumption had no statutory basis;[158] was arbitrary;[159] was not supported by data, facts, or analysis;[160] would dampen market-making and underwriting activity;[161] or did not take into account the nature of trading in different types of securities.[162] Some commenters also questioned whether the Agencies would interpret rebuttals of the presumption consistently,[163] and stressed the difficulty and costliness of rebutting the presumption,[164] such as enhanced documentation or other administrative burdens.[165] One foreign banking association also argued that requiring foreign banking entities to rebut a U.S. regulatory requirement would be costly and inappropriate given that the trading activities of the banking entity are already reviewed by home country supervisors.[166] This commenter also contended that the presumption could be problematic for financial instruments purchased for long-term investment purposes that are closed within 60 days due to market fluctuations or other changed circumstances.[167]

After carefully considering the comments received, the Agencies continue to believe the rebuttable presumption is appropriate to generally define the meaning of ''short-term'' for purposes of the short-term trading account, especially for small and regional banking entities that are not subject to the market risk capital rules and are not registered dealers or swap entities. The range of comments the Agencies received on what ''short-term'' should mean—from 30 days to one year—suggests that a clear presumption would ensure consistency in interpretation and create a level playing field for all banking entities with covered trading activities subject to the short-term trading account. Based on their supervisory experience, the Agencies find that 60 days is an appropriate cut off for a regulatory presumption.[168] Further, because the purpose of the rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the trading account, the Agencies believe that implementing different holding periods based on the type of financial instrument would insert unnecessary complexity into the presumption.[169] The Agencies are not providing a safe harbor or a reverse presumption (*i.e.,* a presumption for positions that are outside of the trading account), as suggested by some commenters, in recognition that some proprietary trading could occur outside of the 60 day period.[170]

Adopting a presumption allows the Agencies and affected banking entities to evaluate all the facts and circumstances surrounding trading activity in determining whether the activity implicates the purpose of the statute. For example, trading in a financial instrument for long-term investment that is disposed of within 60 days because of unexpected developments (*e.g.,* an unexpected increase in the financial instrument's volatility or a need to liquidate the instrument to meet unexpected liquidity demands) may not be trading activity covered by the statute. To reduce the costs and burdens of rebutting the

[147] *See* ABA (Keating).

[148] *See* Joint Proposal, 76 FR at 68859.

[149] *See* Japanese Bankers Ass'n.

[150] *See* Capital Group.

[151] *See* AFR *et al.* (Feb. 2012).

[152] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen (arguing that one-year demarks tax law covering short term capital gains).

[153] *See* Sens. Merkley & Levin (Feb. 2012).

[154] *See* Occupy.

[155] *See* Capital Group.

[156] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[157] *See* ABA (Keating); Am. Express; Business Roundtable; Capital Group; ICI (Feb. 2012); Investure; JPMC; Liberty Global; STANY; Chamber (Feb. 2012).

[158] *See* ABA (Keating); JPMC; Chamber (Feb. 2012).

[159] *See* Am. Express; ICI (Feb. 2012).

[160] *See* ABA (Keating); Chamber (Feb. 2012).

[161] *See* AllianceBernstein; Business Roundtable; ICI (Feb. 2012); Investure; Liberty Global; STANY. Because the rebuttable presumption does not impact the availability of the exemptions for underwriting, market making, and other permitted activities, the Agencies do not believe this provision creates any additional burdens on permissible activities.

[162] *See* Am. Express (noting that most foreign exchange forward transactions settle in less than one week and are used as commercial payment instruments, and not speculative trades); Capital Group.

[163] *See* ABA (Keating). As discussed below in Part VI.C., the Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.

[164] *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC.

[165] *See* NAIB *et al.;* Capital Group.

[166] *See* Japanese Bankers Ass'n. As noted above, the Agencies believe concerns about the impacts of the definition of trading account on foreign banking entity trading activity outside of the United States are substantially addressed by the final rule's exemption for proprietary trading conducted by foreign banking entities in final rule § 75.6(e).

[167] *Id.*

[168] *See* final rule § 75.3(b)(2). Commenters did not provide persuasive evidence of the benefits associated with a rebuttable presumption for positions held for greater or fewer than 60 days.

[169] *See, e.g.,* Am. Express; Capital Group; Sens. Merkley & Levin (Feb. 2012).

[170] *See* Capital Group; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

presumption, the Agencies will allow a banking entity to rebut the presumption for a group of related positions.[171]

The final rule provides three clarifying changes to the proposed rebuttable presumption. First, in response to comments, the final rule replaces the reference to an ''account'' that is presumed to be a trading account with the purchase or sale of a ''financial instrument.'' [172] This change clarifies that the presumption only applies to the purchase or sale of a financial instrument that is held for fewer than 60 days, and not the entire account that is used to make the purchase or sale. Second, the final rule clarifies that basis trades, in which a banking entity buys one instrument and sells a substantially similar instrument (or otherwise transfers the first instrument's risk), are subject to the rebuttable presumption.[173] Third, in order to maintain consistency with definitions used throughout the final rule, the references to ''acquire'' or ''take'' a financial position have been replaced with references to ''purchase'' or ''sell'' a financial instrument.[174]

c. Definition of ''Financial Instrument''

Section 13 of the BHC Act generally prohibits proprietary trading, which is defined in section 13(h)(4) to mean engaging as principal for the trading account in any purchase or sale of any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instruments that the Agencies may, by rule, determine.[175] The proposed rule defined the term ''covered financial position'' to reference the instruments listed in section 13(h)(4), including: (i) A security, including an option on a security; (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or an option on such a contract.[176] To provide additional clarity, the proposed rule also provided that, consistent with the statute, any position that is itself a loan, a commodity, or foreign exchange or currency was not a covered financial position.[177]

The proposal also defined a number of other terms used in the definition of covered financial position, including commodity, derivative, loan, and security.[178] These terms were generally defined by reference to the Federal securities laws or the Commodity Exchange Act because these existing definitions are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities, commodities, and derivatives trading.

As noted above, the proposed rule included derivatives within the definition of covered financial position. Derivative was defined to include any swap (as that term is defined in the Commodity Exchange Act) and security-based swap (as that term is defined in the Exchange Act), in each case as further defined by the CFTC and SEC by joint regulation, interpretation, guidance, or other action, in consultation with the Board pursuant to section 712(d) of the Dodd-Frank Act.[179] The proposed rule also included within the definition of derivative certain other transactions that, although not included within the definition of swap or security-based swap, also appear to be, or operate in economic substance as, derivatives, and which if not included could permit banking entities to engage in proprietary trading that is inconsistent with the purpose of section 13 of the BHC Act. Specifically, the proposed definition also included: (i) Any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as those terms are defined in the Commodity Exchange Act); [180] (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act; [181] (iv) any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act; [182] and (v) any transactions authorized under section 19 of the Commodity Exchange Act.[183] In addition, the proposed rule excluded from the definition of derivative (i) any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap or security-based swap, and (ii) any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

Commenters expressed a variety of views regarding the definition of covered financial position, as well as other defined terms used in that definition. For instance, some commenters argued that the definition should be expanded to include transactions in spot commodities or foreign currency, even though those instruments are not included by the statute.[184] Other commenters strongly supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute, arguing that these instruments are part of the traditional business of banking and do not represent the types of instruments that Congress designed section 13 to address. These commenters argued that including spot commodities and foreign exchange within the definition of covered financial position in the final rule would put U.S. banking entities at a competitive disadvantage and prevent them from conducting routine banking operations.[185] One commenter argued that the proposed definition of covered financial position was effective and recommended that the definition should not be expanded.[186] Another commenter argued that an instrument be considered to be a spot foreign exchange transaction, and thus not a covered financial position, if it settles within 5 days of purchase.[187] Another commenter argued that covered financial positions used in interaffiliate transactions should expressly be excluded because they are used for

[171] The Agencies believe this should help address commenters' concerns about the burdens associated with rebutting the presumption. *See* ABA (Keating); AllianceBernstein; Capital Group; Japanese Bankers Ass'n.; Liberty Global; JPMC; NAIB *et al.;* Capital Group.

[172] *See, e.g.,* ABA (Keating); Clearing House Ass'n.; JPMC.

[173] The rebuttable presumption covered these trades in the proposal, but the final rule's use of ''financial instrument'' rather than ''covered financial position'' necessitated clarifying this point in the rule text. *See* final rule § 75.3(b)(2). *See also* Public Citizen.

[174] The Agencies do not believe these revisions have a substantive effect on the operation or scope of the final rule in comparison to the statute or proposed rule.

[175] *See* 12 U.S.C. 1851(h)(4).

[176] *See* proposed rule § 75.3(c)(3)(i).

[177] *See* proposed rule § 75.3(c)(3)(ii).

[178] *See* proposed rule § 75.2(l), (q), (w); § 75.3(c)(1) and (2).

[179] *See* 7 U.S.C. 1a(47) (defining ''swap''); 15 U.S.C. 78c(a)(68) (defining ''security-based swap'').

[180] 7 U.S.C. 1a(24), (25).

[181] 7 U.S.C. 2(c)(2)(C)(i).

[182] 7 U.S.C. 2(c)(2)(D)(i).

[183] 7 U.S.C. 23.

[184] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[185] *See* Northern Trust; Morgan Stanley; JPMC; Credit Suisse (Seidel); Am. Express; *see also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange).

[186] *See* Alfred Brock.

[187] *See* Credit Suisse (Seidel).

internal risk management purposes and not for proprietary trading.[188]

Some commenters requested that the final rule exclude additional instruments from the definition of covered financial position. For instance, some commenters requested that the Agencies exclude commodity and foreign exchange futures, forwards, and swaps, arguing that these instruments typically have a commercial and not financial purpose and that making them subject to the prohibitions of section 13 would negatively affect the spot market for these instruments.[189] A few commenters also argued that foreign exchange swaps and forwards are used in many jurisdictions to provide U.S. dollar-funding for foreign banking entities and that these instruments should be excluded since they contribute to the stability and liquidity of the market for spot foreign exchange.[190] Other commenters contended that foreign exchange swaps and forwards should be excluded because they are an integral part of banking entities' ability to provide trust and custody services to customers and are necessary to enable banking entities to deal in the exchange of currencies for customers.[191]

One commenter argued that the inclusion of certain instruments within the definition of derivative, such as purchases or sales of nonfinancial commodities for deferred shipment or delivery that are intended to be physically settled, was inappropriate.[192] This commenter alleged that these instruments are not derivatives but should instead be viewed as contracts for purchase of specific commodities to be delivered at a future date. This commenter also argued that the Agencies do not have authority under section 13 to include these instruments as ''other securities or financial instruments'' subject to the prohibition on proprietary trading.[193]

Some commenters also argued that, because the CFTC and SEC had not yet finalized their definitions of swap and security-based swap, it was inappropriate to use those definitions as part of the proposed definition of derivative.[194] One commenter argued that the definition of derivative was effective, although this commenter argued that the final rule should not cross-reference the definition of swap and security-based swap under the Federal commodities and securities laws.[195]

After carefully considering the comments received on the proposal, the final rule continues to apply the prohibition on proprietary trading to the same types of instruments as listed in the statute and the proposal, which the final rule defines as ''financial instrument.'' Under the final rule, a financial instrument is defined as: (i) A security, including an option on a security;[196] (ii) a derivative, including an option on a derivative; or (iii) a contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.[197] The final rule excludes from the definition of financial instrument: (i) A loan;[198] (ii) a commodity that is not an excluded commodity (other than foreign exchange or currency), a derivative, a contract of sale of a commodity for future delivery, or an option on a contract of sale of a commodity for future delivery; or (iii) foreign exchange or currency.[199] An excluded commodity is defined to have the same meaning as in section 1a(19) of the Commodity Exchange Act.

The Agencies continue to believe that these instruments and transactions, which are consistent with those referenced in section 13(h)(4) of the BHC Act as part of the statutory definition of proprietary trading, represent the type of financial instruments which the proprietary trading prohibition of section 13 was designed to cover. While some commenters requested that this definition be expanded to include spot transactions[200] or loans,[201] the Agencies do not believe that it is appropriate at this time to expand the scope of instruments subject to the ban on proprietary trading.[202] Similarly, while some commenters requested that certain other instruments, such as foreign exchange swaps and forwards, be excluded from the definition of financial instrument,[203] the Agencies believe that these instruments appear to be, or operate in economic substance as, derivatives (which are by statute included within the scope of instruments subject to the prohibitions of section 13). If these instruments were not included within the definition of financial instrument, banking entities could use them to engage in proprietary trading that is inconsistent with the purpose and design of section 13 of the BHC Act.

As under the proposal, loans, commodities, and foreign exchange or currency are not included within the scope of instruments subject to section 13. The exclusion of these types of instruments is intended to eliminate potential confusion by making clear that the purchase and sale of loans, commodities, and foreign exchange or currency—none of which are referred to in section 13(h)(4) of the BHC Act—are outside the scope of transactions to which the proprietary trading restrictions apply. For example, the spot purchase of a commodity would meet the terms of the exclusion, but the acquisition of a futures position in the same commodity would not qualify for the exclusion.

The final rule also adopts the definitions of security and derivative as proposed.[204] These definitions, which reference existing definitions under the Federal securities and commodities laws, are generally well-understood by market participants and have been subject to extensive interpretation in the context of securities and commodities trading activities. While some commenters argued that it would be inappropriate to use the definition of swap and security-based swap because those terms had not yet been finalized pursuant to public notice and comment,[205] the CFTC and SEC have subsequently finalized those definitions after receiving extensive public comment on the rulemakings.[206] The

[188] *See* GE (Feb. 2012).

[189] *See* JPMC; BoA; Citigroup (Feb. 2012).

[190] *See* Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; *see also* Norinchukin.

[191] *See* Northern Trust; Citigroup (Feb. 2012).

[192] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[193] *See id.*

[194] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[195] *See* Alfred Brock.

[196] The definition of security under the final rule is the same as under the proposal. *See* final rule § 75.2(y).

[197] *See* final rule § 75.3(c)(1).

[198] The definition of loan, as well as comments received regarding that definition, is discussed in detail below in Part VI.B.1.c.8.a.

[199] *See* final rule § 75.3(c)(2).

[200] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Occupy.

[201] *See* Occupy.

[202] Several commenters supported the exclusion of spot commodity and foreign currency transactions as consistent with the statute. *See* Northern Trust; Morgan Stanley; State Street (Feb. 2012); JPMC; Credit Suisse (Seidel); Am. Express; *see also* AFR *et al.* (Feb. 2012) (arguing that the final rule should explicitly exclude ''spot'' commodities and foreign exchange). One commenter stated that the proposed definition should not be expanded. *See* Alfred Brock. With respect to the exclusion for loans, the Agencies note this is generally consistent with the rule of statutory construction regarding the sale and securitization of loans. *See* 12 U.S.C. 1851(g)(2).

[203] *See* JPMC; BAC; Citigroup (Feb. 2012); Govt. of Japan/Bank of Japan; Japanese Bankers Ass'n.; Northern Trust; *see also* Norinchukin.

[204] *See* final rule § 75.2(h), (y).

[205] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[206] *See* CFTC and SEC, Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed swaps; Security Based Swap Agreement Recordkeeping, 78 FR 48208 (Aug. 13, 2012).

Agencies believe that this notice and comment process provided adequate opportunity for market participants to comment on and understand those terms, and as such they are incorporated in the definition of derivative under this final rule.

While some commenters requested that foreign exchange swaps and forwards be excluded from the definition of derivative or financial instrument, the Agencies have not done so for the reasons discussed above. However, as explained below in Part VI.A.1.d., the Agencies note that to the extent a banking entity purchases or sells a foreign exchange forward or swap, or any other financial instrument, in a manner that meets an exclusion from proprietary trading, that transaction would not be considered to be proprietary trading and thus would not be subject to the requirements of section 13 of the BHC Act and the final rule. This includes, for instance, the purchase or sale of a financial instrument by a banking entity acting solely as agent, broker, or custodian, or the purchase or sale of a security as part of a *bona fide* liquidity management plan.

d. Proprietary Trading Exclusions

The proposed rule contained four exclusions from the definition of trading account for categories of transactions that do not fall within the scope of section 13 of the BHC Act because they do not involve short-term trading activities subject to the statutory prohibition on proprietary trading. These exclusions covered the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending arrangements, for *bona fide* liquidity management purposes, and by a clearing agency or derivatives clearing organization in connection with clearing activities.

As discussed below, the final rule provides exclusions for the purchase or sale of a financial instrument under certain repurchase and reverse repurchase agreements and securities lending agreements; for *bona fide* liquidity management purposes; by certain clearing agencies, derivatives clearing organizations in connection with clearing activities; by a member of a clearing agency, derivatives clearing organization, or designated financial market utility engaged in excluded clearing activities; to satisfy existing delivery obligations; to satisfy an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding; solely as broker, agent, or custodian; through a deferred compensation or similar plan; and to satisfy a debt previously contracted. After considering comments on these issues, which are discussed in more detail below, the Agencies believe that providing clarifying exclusions for these non-proprietary activities will likely promote more cost-effective financial intermediation and robust capital formation. Overly narrow exclusions for these activities would potentially increase the cost of core banking services, while overly broad exclusions would increase the risk of allowing the types of trades the statute was designed to prohibit. The Agencies considered these issues in determining the appropriate scope of these exclusions. Because the Agencies do not believe these excluded activities involve proprietary trading, as defined by the statute and the final rule, the Agencies do not believe it is necessary to use our exemptive authority in section 13(d)(1)(J) of the BHC Act to deem these activities a form of permitted proprietary trading.

1. Repurchase and Reverse Repurchase Arrangements and Securities Lending

The proposed rule's definition of trading account excluded an account used to acquire or take one or more covered financial positions that arise under (i) a repurchase or reverse repurchase agreement pursuant to which the banking entity had simultaneously agreed, in writing at the start of the transaction, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty,[207] or (ii) a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security and has the right to terminate the transaction and to recall the loaned security on terms agreed to by the parties.[208] Positions held under these agreements operate in economic substance as a secured loan and are not based on expected or anticipated movements in asset prices. Accordingly, these types of transactions do not appear to be of the type the statutory definition of trading account was designed to cover.[209]

Several commenters expressed support for these exclusions and requested that the Agencies expand them.[210] For example, one commenter requested clarification that all types of repurchase transactions qualify for the exclusion.[211] Some commenters requested expanding this exclusion to cover all positions financed by, or transactions related to, repurchase and reverse repurchase agreements.[212] Other commenters requested that the exclusion apply to all transactions that are analogous to extensions of credit and are not based on expected or anticipated movements in asset prices, arguing that the exclusion would be too limited in scope to achieve its objective if it is based on the legal form of the underlying contract.[213] Additionally, some commenters suggested expanding the exclusion to cover transactions that are for funding purposes, including prime brokerage transactions, or for the purpose of asset-liability management.[214] Commenters also recommended expanding the exclusion to include re-hypothecation of customer securities, which can produce financing structures that, like a repurchase agreement, are functionally loans.[215]

In contrast, other commenters argued that there was no statutory or policy justification for excluding repurchase and reverse repurchase agreements from the trading account, and requested that this exclusion be removed from the final rule.[216] Some of these commenters argued that repurchase agreements could be used for prohibited proprietary trading[217] and suggested that, if repurchase agreements are excluded from the trading account, documentation detailing the use of liquidity derived from repurchase agreements should be required.[218] These

[207] *See* proposed rule § 75.3(b)(2)(iii)(A).

[208] *See* proposed rule § 75.3(b)(2)(iii)(B). The language that described securities lending transactions in the proposed rule generally mirrored that contained in Rule 3a5–3 under the Exchange Act. *See* 17 CFR 240.3a5–3.

[209] *See* Joint Proposal, 76 FR at 68862.

[210] *See generally* ABA (Keating); Alfred Brock; Citigroup (Feb. 2012); GE (Feb. 2012); Goldman (Prop. Trading); ICBA; Japanese Bankers Ass'n.; JPMC; Norinchukin; RBC; RMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012); T. Rowe Price; UBS; Wells Fargo (Prop. Trading). *See infra* Part VI.A.d.10. for the discussion of commenters' requests for additional exclusions from the trading account.

[211] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[212] *See* FIA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[213] *See* Goldman (Prop. Trading); JPMC; UBS.

[214] *See* Goldman (Prop. Trading); UBS. For example, one commenter suggested that fully collateralized swap transactions should be exempted from the definition of trading account because they serve as funding transactions and are economically similar to repurchase agreements. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[215] *See* Goldman (Prop. Trading).

[216] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[217] *See* AFR *et al.* (Feb. 2012).

[218] *See* Public Citizen.

commenters suggested that unless the liquidity is used to secure a position for a willing customer, repurchase agreements should be regarded as a strong indicator of proprietary trading.[219] As an alternative, commenters suggested that the Agencies instead use their exemptive authority pursuant to section 13(d)(1)(J) of the BHC Act to permit repurchase and reverse repurchase transactions so that such transactions must comply with the statutory limits on material conflicts of interests and high-risks assets and trading strategies, and compliance requirements under the final rule.[220] These commenters urged the Agencies to specify permissible collateral types, haircuts, and contract terms for securities lending agreements and require that the investment of proceeds from securities lending transactions be limited to high-quality liquid assets in order to limit potential risks of these activities.[221]

After considering the comments received, the Agencies have determined to exclude repurchase and reverse repurchase agreements and securities lending agreements from the definition of proprietary trading under the final rule. The final rule defines these terms subject to the same conditions as were in the proposal. This determination recognizes that repurchase and reverse repurchase agreements and securities lending agreements excluded from the definition operate in economic substance as secured loans and do not in normal practice represent proprietary trading.[222] The Agencies will, however, monitor these transactions to ensure this exclusion is not used to engage in prohibited proprietary trading activities.

To avoid evasion of the rule, the Agencies note that, in contrast to certain commenters' requests,[223] only the transactions pursuant to the repurchase agreement, reverse repurchase agreement, or securities lending agreement are excluded. For example, the collateral or position that is being financed by the repurchase or reverse repurchase agreement is not excluded and may involve proprietary trading. The Agencies further note that if a banking entity uses a repurchase or reverse repurchase agreement to finance a purchase of a financial instrument, other transactions involving that financial instrument may not qualify for this exclusion.[224] Similarly, short positions resulting from securities lending agreements cannot rely upon this exclusion and may involve proprietary trading.

Additionally, the Agencies have determined not to exclude all transactions, in whatever legal form that may be construed to be an extension of credit, as suggested by commenters, because such a broad exclusion would be too difficult to assess for compliance and would provide significant opportunity for evasion of the prohibitions in section 13 of the BHC Act.

2. Liquidity Management Activities

The proposed definition of trading account excluded an account used to acquire or take a position for the purpose of *bona fide* liquidity management, subject to certain requirements.[225] The preamble to the proposed rule explained that *bona fide* liquidity management seeks to ensure that the banking entity has sufficient, readily-marketable assets available to meet its expected near-term liquidity needs, not to realize short-term profit or benefit from short-term price movements.[226]

To curb abuse, the proposed rule required that a banking entity acquire or take a position for liquidity management in accordance with a documented liquidity management plan that meets five criteria.[227] Moreover, the Agencies stated in the preamble that liquidity management positions that give rise to appreciable profits or losses as a result of short-term price movements would be subject to significant Agency scrutiny and, absent compelling explanatory facts and circumstances, would be considered proprietary trading.[228]

The Agencies received a number of comments regarding the exclusion. Many commenters supported the exclusion of liquidity management activities from the definition of trading account as appropriate and necessary. At the same time, some commenters expressed the view that the exclusion was too narrow and should be replaced with a broader exclusion permitting trading activity for asset-liability management (''ALM''). Commenters argued that two aspects of the proposed rule's definition of ''trading account'' would cause ALM transactions to fall within the prohibition on proprietary trading—the 60-day rebuttable presumption and the reference to the market risk rule trading account.[229] For example, commenters expressed concern that hedging transactions associated with a banking entity's residential mortgage pipeline and mortgage servicing rights, and managing credit risk, earnings at risk, capital, asset-liability mismatches, and foreign exchange risks would be among positions that may be held for 60 days or less.[230] These commenters contended that the exclusion for liquidity management and the activity exemptions for risk-mitigating hedging and trading in U.S. government obligations would not be sufficient to permit a wide variety of ALM activities.[231] These commenters contended that prohibiting trading for ALM purposes would be contrary to the goals of enhancing sound risk management, the safety and soundness of banking entities, and U.S. financial stability,[232] and would limit banking entities' ability to manage liquidity.[233]

Some commenters argued that the requirements of the exclusion would not provide a banking entity with sufficient flexibility to respond to liquidity needs arising from changing economic conditions.[234] Some commenters argued the requirement that any position taken for liquidity management purposes be limited to the banking entity's near-term funding needs failed to account for longer-term liquidity management requirements.[235] These commenters further argued that the requirements of the liquidity management exclusion might not be synchronized with the Basel III framework, particularly with respect to the liquidity coverage ratio if ''near-term'' is considered less than 30 days.[236]

[219] *See* Public Citizen.

[220] *See* AFR *et al.* (Feb. 2012); Occupy.

[221] *See* AFR *et al.* (Feb. 2012); Occupy.

[222] Congress recognized that repurchase agreements and securities lending agreements are loans or extensions of credit by including them in the legal lending limit. *See* Dodd–Frank Act section 610 (amending 12 U.S.C. 84b). The Agencies believe the conditions of the final rule's exclusions for repurchase agreements and securities lending agreements identify those activities that do not in normal practice represent proprietary trading and, thus, the Agencies decline to provide additional requirements for these activities, as suggested by some commenters. *See* Public Citizen; AFR *et al.* (Feb. 2012); Occupy.

[223] *See* Goldman (Prop. Trading); JPMC; UBS.

[224] *See* CFTC Proposal, 77 FR at 8348.

[225] *See* proposed rule § 75.3(b)(2)(iii)(C).

[226] *Id.*

[227] *See* proposed rule § 75.3(b)(2)(iii)(C)(*1*)–(*5*).

[228] *See* Joint Proposal, 76 FR at 68862.

[229] *See* ABA (Keating); BoA; CH/ABASA; JPMC. *See supra* Part VI.A.1.b. (discussing the rebuttable presumption under § 75.3(b)(2) of the final rule); *see also supra* Part VI.A.1.a. (discussing the market risk rule trading account under § 75.3(b)(1)(ii) of the final rule).

[230] *See* CH/ABASA; Wells Fargo (Prop. Trading).

[231] *See* CH/ABASA; JPMC; State Street (Feb. 2012); Wells Fargo (Prop. Trading). *See also* BaFin/Deutsche Bundesbank.

[232] *See* BoA; JPMC; RBC.

[233] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); JPMC; NAIB *et al.;* State Street (Feb. 2012); T. Rowe Price.

[234] *See* ABA (Keating); CH/ABASA; JPMC.

[235] *See* ABA (Keating); BoA; CH/ABASA; JPMC.

[236] *See* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); BoA; CH/ABASA.

Commenters also requested clarification on a number of other issues regarding the exclusion. For example, one commenter requested clarification that purchases and sales of U.S. registered mutual funds sponsored by a banking entity would be permissible.[237] Another commenter requested clarification that the deposits resulting from providing custodial services that are invested largely in high-quality securities in conformance with the banking entity's ALM policy would not be presumed to be ''short-term trading'' under the final rule.[238] Commenters also urged that the final rule not prohibit interaffiliate transactions essential to the ALM function.[239]

In contrast, other commenters supported the liquidity management exclusion criteria[240] and suggested tightening these requirements. For example, one commenter recommended that the rule require that investments made under the liquidity management exclusion consist only of high-quality liquid assets.[241] Other commenters argued that the exclusion for liquidity management should be eliminated.[242] One commenter argued that there was no need to provide a special exemption for liquidity management or ALM activities given the exemptions for trading in government obligations and risk-mitigating hedging activities.[243]

After carefully reviewing the comments received, the Agencies have adopted the proposed exclusion for liquidity management with several important modifications. As limited below, liquidity management activity serves the important prudential purpose, recognized in other provisions of the Dodd-Frank Act and in rules and guidance of the Agencies, of ensuring banking entities have sufficient liquidity to manage their short-term liquidity needs.[244]

To ensure that this exclusion is not misused for the purpose of proprietary trading, the final rule imposes a number of requirements. First, the liquidity management plan of the banking entity must be limited to securities (in keeping with the liquidity management requirements proposed by the Federal banking agencies) and specifically contemplate and authorize the particular securities to be used for liquidity management purposes; describe the amount, types, and risks of securities that are consistent with the entity's liquidity management; and the liquidity circumstances in which the particular securities may or must be used.[245] Second, any purchase or sale of securities contemplated and authorized by the plan must be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes. Third, the plan must require that any securities purchased or sold for liquidity management purposes be highly liquid and limited to instruments the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements.[246] Fourth, the plan must limit any securities purchased or sold for liquidity management purposes to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan.[247] Fifth, the banking entity must incorporate into its compliance program internal controls, analysis and independent testing designed to ensure that activities undertaken for liquidity management purposes are conducted in accordance with the requirements of the final rule and the entity's liquidity management plan. Finally, the plan must be consistent with the supervisory requirements, guidance and expectations regarding liquidity management of the Agency responsible for regulating the banking entity.

The final rule retains the provision that the financial instruments purchased and sold as part of a liquidity management plan be highly liquid and not reasonably expected to give rise to appreciable profits or losses as a result of short-term price movements. This requirement is consistent with the Agencies' expectation for liquidity management plans in the supervisory context. It is not intended to prevent firms from recognizing profits (or losses) on instruments purchased and sold for liquidity management purposes. Instead, this requirement is intended to underscore that the purpose of these transactions must be liquidity management. Thus, the timing of purchases and sales, the types and duration of positions taken and the incentives provided to managers of these purchases and sales must all indicate that managing liquidity, and not taking short-term profits (or limiting short-term losses), is the purpose of these activities.

The exclusion as adopted does not apply to activities undertaken with the stated purpose or effect of hedging aggregate risks incurred by the banking entity or its affiliates related to asset-liability mismatches or other general market risks to which the entity or affiliates may be exposed. Further, the exclusion does not apply to any trading activities that expose banking entities to substantial risk from fluctuations in market values, unrelated to the management of near-term funding needs, regardless of the stated purpose of the activities.[248]

Overall, the Agencies do not believe that the final rule will stand as an obstacle to or otherwise impair the ability of banking entities to manage the

[237] *See* T. Rowe Price.

[238] *See* State Street (Feb. 2012).

[239] *See* State Street (Feb. 2012); JPMC. *See also* Part VI.A.1.d.10. (discussing commenter requests to exclude inter-affiliate transactions).

[240] *See* AFR *et al.* (Feb. 2012); Occupy.

[241] *See* Occupy.

[242] *See* Sens. Merkley & Levin (Feb. 2012).

[243] *See* Sens. Merkley & Levin (Feb. 2012).

[244] *See* section 165(b)(1)(A)(ii) of the Dodd-Frank Act; Enhanced Prudential Standards, 77 FR 644 at 645 (Jan. 5, 2012), available at *http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf*; *see also* Enhanced Prudential Standards, 77 FR 76678 at 76682 (Dec. 28, 2012), available at *http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.*

[245] To ensure sufficient flexibility to respond to liquidity needs arising from changing economic times, a banking entity should envision and address a range of liquidity circumstances in its liquidity management plan, and provide a mechanism for periodically reviewing and revising the liquidity management plan.

[246] The requirement to use highly liquid instruments is consistent with the focus of the clarifying exclusion on a banking entity's near-term liquidity needs. Thus, the final rules do not include commenters' suggested revisions to this requirement. *See* Clearing House Ass'n.; *see also* Occupy; Sens. Merkley & Levin (Feb. 2012). The Agencies decline to identify particular types of securities that will be considered highly liquid for purposes of the exclusion, as requested by some commenters, in recognition that such a determination will depend on the facts and circumstances. *See* T. Rowe Price; State Street (Feb. 2012).

[247] The Agencies plan to construe ''near-term funding needs'' in a manner that is consistent with the laws, regulations, and issuances related to liquidity risk management. *See, e.g.,* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring, 78 FR 71818 (Nov. 29, 2013); Basel Committee on Bank Supervision, Basel III: The Liquidity Coverage Ratio and Liquidity Risk Management Tools (January 2013) available at *http://www.bis.org/publ/bcbs238.htm.* The Agencies believe this should help address commenters' concerns about the proposed requirement. *See, e.g.,* ABA (Keating); Allen & Overy (on behalf of Canadian Banks); CH/ABASA; BoA; JPMC.

[248] *See, e.g.,* Staff of S. Comm. on Homeland Sec. & Governmental Affairs Permanent Subcomm. on Investigations, 113th Cong., Report: JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses (Apr. 11, 2013), available at *http://www.hsgac.senate.gov/download/report-jpmorgan-chase-whale-trades-a-case-history-of-derivatives-risks-and-abuses-march-15-2013.*

risks of their businesses and operate in a safe and sound manner. Banking entities engaging in *bona fide* liquidity management activities generally do not purchase or sell financial instruments for the purpose of short-term resale or to benefit from actual or expected short-term price movements. The Agencies have determined, in contrast to certain commenters' requests, not to expand this liquidity management provision to broadly allow asset-liability management, earnings management, or scenario hedging.[249] To the extent these activities are for the purpose of profiting from short-term price movements or to hedge risks not related to short-term funding needs, they represent proprietary trading subject to section 13 of the BHC Act and the final rule; the activity would then be permissible only if it meets all of the requirements for an exemption, such as the risk-mitigating hedging exemption, the exemption for trading in U.S. government securities, or another exemption.

3. Transactions of Derivatives Clearing Organizations and Clearing Agencies

A banking entity that is a central counterparty for clearing and settlement activities engages in the purchase and sale of financial instruments as an integral part of clearing and settling those instruments. The proposed definition of trading account excluded an account used to acquire or take one or more covered financial positions by a derivatives clearing organization registered under the Commodity Exchange Act or a clearing agency registered under the Securities Exchange Act of 1934 in connection with clearing derivatives or securities transactions.[250] The preamble to the proposed rule noted that the purpose of these transactions is to provide a clearing service to third parties, not to profit from short-term resale or short-term price movements.[251]

Several commenters supported the proposed exclusion for derivatives clearing organizations and urged the Agencies to expand the exclusion to cover a banking entity's clearing-related activities, such as clearing a trade for a customer, trading with a clearinghouse, or accepting positions of a defaulting member, on grounds that these activities are not proprietary trades and reduce systemic risk.[252] One commenter recommended expanding the exclusion to non-U.S. central counterparties[253] In contrast, one commenter argued that the exclusion for derivatives clearing organizations and clearing agencies had no statutory basis and should instead be a permitted activity under section 13(d)(1)(J).[254]

After considering the comments received, the final rule retains the exclusion for purchases and sales of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with its clearing activities.[255] In response to comments,[256] the Agencies have also incorporated two changes to the rule. First, the final rule applies the exclusion to the purchase and sale of financial instruments by a banking entity that is a clearing agency or derivatives clearing organization in connection with clearing financial instrument transactions. Second, in response to comments,[257] the exclusion in the final rule is not limited to clearing agencies or derivatives clearing organizations that are subject to SEC or CFTC registration requirements and, instead, certain foreign clearing agencies and foreign derivatives clearing organizations will be permitted to rely on the exclusion if they are banking entities.

The Agencies believe that clearing and settlement activity is not designed to create short-term trading profits. Moreover, excluding clearing and settlement activities prevents the final rule from inadvertently hindering the Dodd–Frank Act's goal of promoting central clearing of financial transactions. The Agencies have narrowly tailored this exclusion by allowing only central counterparties to use it and only with respect to their clearing and settlement activity.

4. Excluded Clearing-Related Activities of Clearinghouse Members

In addition to the exclusion for trading activities of a derivatives clearing organization or clearing agency, some commenters requested an additional exclusion from the definition of ''trading account'' for clearing-related activities of members of these entities.[258] These commenters noted that the proposed definition of ''trading account'' provides an exclusion for positions taken by registered derivatives clearing organizations and registered clearing agencie s[259] and requested a corresponding exclusion for certain clearing-related activities of banking entities that are members of a clearing agency or members of a derivatives clearing organization (collectively, ''clearing members'').[260]

Several commenters argued that certain aspects of the clearing process may require a clearing member to engage in principal transactions. For example, some commenters argued that a clearinghouse's default management process may require clearing members to take positions in financial instruments upon default of another clearing member.[261] According to commenters, default management processes can involve: (i) Collection of initial and variation margin from customers under an ''agency model'' of clearing; (ii) porting, where a defaulting clearing member's customer positions and margin are transferred to another non-defaulting clearing member;[262] (iii) hedging, where the clearing house looks to clearing members and third parties to enter into risk-reducing transactions and to flatten the market risk associated with the defaulting clearing member's house positions and non-ported customer positions; (iv) unwinding, where the defaulting member's open positions may be allocated to other clearing members, affiliates, or third parties pursuant to a mandatory auction process or forced allocation;[263] and (v) imposing certain obligations on clearing members upon exhaustion of a guaranty fund.[264]

Commenters argued that, absent an exclusion from the definition of ''trading account,'' some of these clearing-related activities could be considered prohibited proprietary trading under the proposal. Two commenters specifically contended that

[249] *See, e.g.,* ABA (Keating); BoA; CH/ABASA; JPMC.

[250] *See* proposed rule § 75.3(b)(2)(iii)(D).

[251] *See* Joint Proposal, 76 FR at 68863.

[252] *See* Allen & Overy (Clearing); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); State Street (Feb. 2012).

[253] *See* IIB/EBF.

[254] *See* Sens. Merkley & Levin (Feb. 2012).

[255] ''Clearing agency'' is defined in the final rule with reference to the definition of this term in the Exchange Act. *See* final rule § 75.3(e)(2). ''Derivatives clearing organization'' is defined in the final rule as (i) a derivatives clearing organization registered under section 5b of the Commodity Exchange Act; (ii) a derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act; or (iii) a foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

[256] *See* IIB/EBF; BNY Mellon *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading).

[257] *See* IIB/EBF; Allen & Overy (Clearing).

[258] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[259] *See* proposed rule § 75.3(b)(2)(iii)(D).

[260] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); Goldman (Prop. Trading); State Street (Feb. 2012).

[261] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[262] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing).

[263] *See* Allen & Overy (Clearing).

[264] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

the dealer prong of the definition of ''trading account'' may cause certain of these activities to be considered proprietary trading.[265] Some commenters suggested alternative avenues for permitting such clearing-related activity under the rules.[266] Commenters argued that such clearing-related activities of banking entities should not be subject to the rule because they are risk-reducing, beneficial for the financial system, required by law under certain circumstances (*e.g.,* central clearing requirements for swaps and security-based swaps under Title VII of the Dodd-Frank Act), and not used by banking entities to engage in proprietary trading.[267]

Commenters further argued that certain activities undertaken as part of a clearing house's daily risk management process may be impacted by the rule, including unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired credit default swap (''CDS'') protection on itself as a result of a merger with another firm) [268] and trade crossing, a mechanism employed by certain clearing houses to ensure the accuracy of the price discovery process in the course of, among other things, calculating settlement prices and margin requirements.[269]

The Agencies do not believe that certain core clearing-related activities conducted by a clearing member, often as required by regulation or the rules and procedures of a clearing agency, derivatives clearing organization, or designated financial market utility, represent proprietary trading as contemplated by the statute. For example, the clearing and settlement activities discussed above are not conducted for the purpose of profiting from short-term price movements. The Agencies believe that these clearing-related activities provide important benefits to the financial system.[270] In particular, central clearing reduces counterparty credit risk,[271] which can lead to a host of other benefits, including lower hedging costs, increased market participation, greater liquidity, more efficient risk sharing that promotes capital formation, and reduced operational risk.[272]

Accordingly, in response to comments, the final rule provides that proprietary trading does not include specified excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility.[273] ''Excluded clearing activities'' is defined in the rule to identify particular core clearing-related activities, many of which were raised by commenters.[274] Specifically, the final rule will exclude the following activities by clearing members: (i) Any purchase or sale necessary to correct error trades made by or on behalf of customers with respect to customer transactions that are cleared, provided the purchase or sale is conducted in accordance with certain regulations, rules, or procedures; (ii) any purchase or sale related to the management of a default or threatened imminent default of a customer, subject to certain conditions, another clearing member, or the clearing agency, derivatives clearing organization, or designated financial market utility itself; [275] and (iii) any purchase or sale required by the rules or procedures of a clearing agency, derivatives clearing organization, or designated financial market utility that mitigates risk to such agency, organization, or utility that would result from the clearing by a clearing member of security-based swaps that references the member or an affiliate of the member.[276]

The Agencies are identifying specific activities in the rule to limit the potential for evasion that may arise from a more generalized approach. However, the relevant supervisory Agencies will be prepared to provide further guidance or relief, if appropriate, to ensure that the terms of the exclusion do not limit the ability of clearing agencies, derivatives clearing organizations, or designated financial market utilities to effectively manage their risks in accordance with their rules and procedures. In response to commenters requesting that the exclusion be available when a clearing member is required by rules of a clearing agency, derivatives clearing organization, or designated financial market utility to purchase or sell a financial instrument as part of establishing accurate prices to be used by the clearing agency, derivatives clearing organization, or designated financial market utility in its end of day settlement process,[277] the Agencies note that whether this is an excluded clearing activity depends on the facts and circumstances. Similarly, the availability of other exemptions to the rule, such as the market-making exemption, depend on the facts and circumstances. This exclusion applies only to excluded clearing activities of clearing members. It does not permit a banking entity to engage in proprietary trading and claim protection for that activity because trades are cleared or settled through a central counterparty.

5. Satisfying an Existing Delivery Obligation

A few commenters requested additional or expanded exclusions from the definition of ''trading account'' for covering short sales or failures to deliver.[278] These commenters alleged that a banking entity engages in this activity for purposes other than to

[265] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (arguing that the SEC has suggested that entities that collect margins from customers for cleared swaps may be required to be registered as broker-dealers); State Street (Feb. 2012).

[266] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012).

[267] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); State Street (Feb. 2012); Allen & Overy (Clearing).

[268] *See* Allen & Overy (Clearing).

[269] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop. Trading) (Feb. 2012). These commenters stated that, in order to ensure that a clearing member is providing accurate end-of-day prices for its open positions, a clearing house may require the member to provide firm bids for such positions, which may be tested through a ''forced trade'' with another member. *See id.; see also* ISDA (Feb. 2012).

[270] For example, Title VII of the Dodd-Frank Act mandates the central clearing of swaps and security-based swaps, and requires that banking entities that are swap dealers, security-based swap dealers, major swap participants or major security-based swap participants collect variation margin from many counterparties on a daily basis for their swap or security-based swap activity. *See* 7 U.S.C. 2(h); 15 U.S.C. 78c–3; 7 U.S.C. 6s(e); 15 U.S.C. 78o–10(e); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011). Additionally, the SEC's Rule 17Ad–22(d)(11) requires that each registered clearing agency establish, implement, maintain and enforce policies and procedures that set forth the clearing agency's default management procedures. *See* 17 CFR 240.17Ad–22(d)(11). *See also* Exchange Act Release No. 68,080 (Oct. 12, 2012), 77 FR 66220, 66,283 (Nov. 2, 2012).

[271] Centralized clearing affects counterparty risk in three basic ways. First, it redistributes counterparty risk among members through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. Second, margin requirements and monitoring reduce moral hazard, reducing counterparty risk. Finally, clearing may reallocate counterparty risk outside of the clearing agency because netting may implicitly subordinate outside creditors' claims relative to other clearing member claims.

[272] *See* Proposed Rule, Cross-Border Security-Based Swap Activities, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968, 31,162–31,163 (May 23, 2013).

[273] *See* final rule § 75.3(d)(5).

[274] *See* final rule § 75.3(e)(7).

[275] A number of commenters discussed the default management process and requested an exclusion for such activities. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Clearing); State Street (Feb. 2012). *See also* ISDA (Feb. 2012).

[276] *See* Allen & Overy (Clearing) (discussing rules that require unwinding self-referencing transactions through a mandatory auction (*e.g.,* where a firm acquired CDS protection on itself as a result of a merger with another firm)).

[277] *See* Allen & Overy (Clearing); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ISDA (Feb. 2012).

[278] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

benefit from short term price movements and that it is not proprietary trading as defined in the statute. In response to these comments, the final rule provides that a purchase or sale by a banking entity that satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity is not proprietary trading.

Among other things, this exclusion will allow a banking entity that is an SEC-registered broker-dealer to take action to address failures to deliver arising from its own trading activity or the trading activity of its customers.[279] In certain circumstances, SEC-registered broker-dealers are required to take such action under SEC rules.[280] In addition, buy-in procedures of a clearing agency, securities exchange, or national securities association may require a banking entity to deliver securities if a party with a fail to receive position takes certain action.[281] When a banking entity purchases securities to meet an existing delivery obligation, it is engaging in activity that facilitates timely settlement of securities transactions and helps provide a purchaser of the securities with the benefits of ownership (*e.g.,* voting and lending rights). In addition, a banking entity has limited discretion to determine when and how to take action to meet an existing delivery obligation.[282] Providing a limited exclusion for this activity will avoid the potential for SEC-registered broker-dealers being subject to conflicting or inconsistent regulatory requirements with respect to activity required to meet the broker-dealer's existing delivery obligations.

6. Satisfying an Obligation in Connection With a Judicial, Administrative, Self-Regulatory Organization, or Arbitration Proceeding

The Agencies recognize that, under certain circumstances, a banking entity may be required to purchase or sell a financial instrument at the direction of a judicial or regulatory body. For example, an administrative agency or self-regulatory organization (''SRO'') may require a banking entity to purchase or sell a financial instrument in the course of disciplinary proceedings against that banking entity.[283] A banking entity may also be obligated to purchase or sell a financial instrument in connection with a judicial or arbitration proceeding.[284] Such transactions do not represent trading for short-term profit or gain and do not constitute proprietary trading under the statute.

Accordingly, the Agencies have determined to adopt a provision clarifying that a purchase or sale of one or more financial instruments that satisfies an obligation of the banking entity in connection with a judicial, administrative, self-regulatory organization, or arbitration proceeding is not proprietary trading for purposes of these rules. This clarification will avoid the potential for conflicting or inconsistent legal requirements for banking entities.

7. Acting Solely as Agent, Broker, or Custodian

The proposal clarified that proprietary trading did not include acting solely as agent, broker, or custodian for an unaffiliated third party.[285] Commenters generally supported this aspect of the proposal. One commenter suggested that acting as agent, broker, or custodian for affiliates should be explicitly excluded from the definition of proprietary trading in the same manner as acting as agent, broker, or custodian for unaffiliated third parties.[286]

Like the proposal, the final rule expressly provides that the purchase or sale of one or more financial instruments by a banking entity acting solely as agent, broker, or custodian is not proprietary trading because acting in these types of capacities does not involve trading as principal, which is one of the requisite aspects of the statutory definition of proprietary trading.[287] The final rule has been modified to include acting solely as agent, broker, or custodian on behalf of an affiliate. However, the affiliate must comply with section 13 of the BHC Act and the final implementing rule; and may not itself engage in prohibited proprietary trading. To the extent a banking entity acts in both a principal and agency capacity for a purchase or sale, it may only use this exclusion for the portion of the purchase or sale for which it is acting as agent. The banking entity must use a separate exemption or exclusion, if applicable, to the extent it is acting in a principal capacity.

8. Purchases or Sales Through a Deferred Compensation or Similar Plan

While the proposed rule provided that the prohibition on covered fund activities and investments did not apply to certain instances where the banking entity acted through or on behalf of a pension or similar deferred compensation plan, no such similar treatment was given for proprietary trading. One commenter argued that the proposal restricted a banking entity's ability to engage in principal-based trading as an asset manager that serves the needs of the institutional investors, such as through ERISA pension and 401(k) plans.[288]

To address these concerns, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established

[279] In order to qualify for this exclusion, a banking entity's principal trading activity that results in its own failure to deliver must have been conducted in compliance with these rules.

[280] *See, e.g.,* 17 CFR 242.204 (requiring, among other things, that a participant of a registered clearing agency or, upon reasonable allocation, a broker-dealer for which the participant clears trades or from which the participant receives trades for settlement, take action to close out a fail to deliver position in any equity security by borrowing or purchasing securities of like kind and quantity); 17 CFR 240.15c3–3(m) (providing that, if a broker-dealer executes a sell order of a customer and does not obtain possession of the securities from the customer within 10 business days after settlement, the broker-dealer must immediately close the transaction with the customer by purchasing securities of like kind and quantity).

[281] *See, e.g.,* NSCC Rule 11, NASDAQ Rule 11810, FINRA Rule 11810.

[282] *See, e.g.,* 17 CFR 242.204 (requiring action to close out a fail to deliver position in an equity security within certain specified timeframes); 17 CFR 240.15c3–3(m) (requiring a broker-dealer to ''immediately'' close a transaction under certain circumstances).

[283] For example, an administrative agency or SRO may require a broker-dealer to offer to buy securities back from customers where the agency or SRO finds the broker-dealer fraudulently sold securities to those customers. *See, e.g.,* In re Raymond James & Assocs., Exchange Act Release No. 64767, 101 S.E.C. Docket 1749 (June 29, 2011); FINRA Dep't of Enforcement v. Pinnacle Partners Fin. Corp., Disciplinary Proceeding No. 2010021324501 (Apr. 25, 2012); FINRA Dep't of Enforcement v. Fifth Third Sec., Inc., No. 2005002244101 (Press Rel. Apr. 14, 2009).

[284] For instance, section 29 of the Exchange Act may require a broker-dealer to rescind a contract with a customer that was made in violation of the Exchange Act. Such rescission relief may involve the broker-dealer's repurchase of a financial instrument from a customer. *See* 15 U.S.C. 78cc; Reg'l Props., Inc. v. Fin. & Real Estate Consulting Co., 678 F.2d 552 (5th Cir. 1982); Freeman v. Marine Midland Bank N.Y., 419 F.Supp. 440 (E.D.N.Y. 1976).

[285] *See* proposed rule § 75.3(b)(1).

[286] *See* Japanese Bankers Ass'n.

[287] *See* 12 U.S.C. 1851(h)(4). A common or collective investment fund that is an investment company under section 3(c)(3) or 3(c)(11) will not be deemed to be acting as principal within the meaning of § 75.3(a) because the fund is performing a traditional trust activity and purchases and sells financial instruments solely on behalf of customers as trustee or in a similar fiduciary capacity, as evidenced by its regulation under 12 CFR part 9 (Fiduciary Activities of National Banks) or similar state laws.

[288] *See* Ass'n. of Institutional Investors (Nov. 2012).

and administered in accordance with the laws of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of the employees of the banking entity or members of their immediate family. Banking entities often establish and act as trustee to pension or similar deferred compensation plans for their employees and, as part of managing these plans, may engage in trading activity. The Agencies believe that purchases or sales by a banking entity when acting through pension and similar deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute.

The Agencies note that if a banking entity engages in trading activity for an unaffiliated pension or similar deferred compensation plan, the trading activity of the banking entity would not be proprietary trading under the final rule to the extent the banking entity was acting solely as agent, broker, or custodian.

9. Collecting a Debt Previously Contracted

Several commenters argued that the final rule should exclude collecting and disposing of collateral in satisfaction of debts previously contracted from the definition of proprietary trading.[289] Commenters argued that acquiring and disposing of collateral in satisfaction of debt previously contracted does not involve trading with the intent of profiting from short-term price movements and, thus, should not be proprietary trading for purposes of this rule. Rather, this activity is a prudent and desirable part of lending and debt collection activities.

The Agencies believe that the purchase and sale of a financial instrument in satisfaction of a debt previously contracted does not constitute proprietary trading. The Agencies believe an exclusion for purchases and sales in satisfaction of debts previously contracted is necessary for banking entities to continue to lend to customers, because it allows banking entities to continue lending activity with the knowledge that they will not be penalized for recouping losses should a customer default. Accordingly, the final rule provides that proprietary trading does not include the purchase or sale of one or more financial instruments in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable within the time period permitted or required by the appropriate financial supervisory agency.[290]

As a result of this exclusion, banking entities, including SEC-registered broker-dealers, will be able to continue providing margin loans to their customers and may take possession of margined collateral following a customer's default or failure to meet a margin call under applicable regulatory requirements.[291] Similarly, a banking entity that is a CFTC-registered swap dealer or SEC-registered security-based swap dealer may take, hold, and exchange any margin collateral as counterparty to a cleared or uncleared swap or security-based swap transaction, in accordance with the rules of the Agencies.[292] This exclusion will allow banking entities to comply with existing regulatory requirements regarding the divestiture of collateral taken in satisfaction of a debt.

10. Other Requested Exclusions

Commenters requested a number of additional exclusions from the trading account and, in turn, the prohibition on proprietary trading. In order to avoid potential evasion of the final rule, the Agencies decline to adopt any exclusions from the trading account other than the exclusions described above.[293] The Agencies believe that various modifications to the final rule, including in particular to the exemption for market-making related activities, address many of commenters' concerns regarding unintended consequences of the prohibition on proprietary trading.

2. Section 75.4(a): Underwriting Exemption

a. Introduction

After carefully considering comments on the proposed underwriting exemption, the Agencies are adopting the proposed underwriting exemption substantially as proposed, but with certain refinements and clarifications to the proposed approach to better reflect the range of securities offerings that an underwriter may help facilitate on behalf of an issuer or selling security holder and the types of activities an underwriter may undertake in connection with a distribution of securities to facilitate the distribution process and provide important benefits to issuers, selling security holders, or purchasers in the distribution. The Agencies are adopting such an approach because the statute specifically permits banking entities to continue providing these beneficial services to clients, customers, and counterparties. At the same time, to reduce the potential for evasion of the general prohibition on proprietary trading, the Agencies are requiring, among other things, that the trading desk make reasonable efforts to sell or otherwise reduce its underwriting position (accounting for the liquidity, maturity, and depth of the market for the relevant type of security) and be subject to a robust risk limit structure that is designed to prevent a trading desk from having an underwriting position that exceeds the reasonably expected near term demands of clients, customers, or counterparties.

b. Overview

1. Proposed Underwriting Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities and certain other instruments in connection with underwriting activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[294]

Section 75.4(a) of the proposed rule would have implemented this exemption by requiring that a banking entity's underwriting activities comply with seven requirements. As discussed

[289] *See* LSTA (Feb. 2012); JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[290] *See* final rule § 75.3(d)(9).

[291] For example, if any margin call is not met in full within the time required by Regulation T, then Regulation T requires a broker-dealer to liquidate securities sufficient to meet the margin call or to eliminate any margin deficiency existing on the day such liquidation is required, whichever is less. *See* 12 CFR 220.4(d).

[292] *See* SEC Proposed Rule, Capital, Margin, Segregation, Reporting and Recordkeeping Requirements for Security-Based Swap Dealers, Exchange Act Release No. 68071, 77 FR 70214 (Nov. 23, 2012); CFTC Proposed Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (Apr. 28, 2011); Banking Agencies' Proposed Rule, Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564 (May 11, 2011).

[293] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (transactions that are not based on expected or anticipated movements in asset prices, such as fully collateralized swap transactions that serve funding purposes); Norinchukin and Wells Fargo (Prop. Trading) (derivatives that qualify for hedge accounting); GE (Feb. 2012) (transactions related to commercial contracts); Citigroup (Feb. 2012) (FX swaps and FX forwards); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (interaffiliate transactions); T. Rowe Price (purchase and sale of shares in sponsored mutual funds); RMA (cash collateral pools); Alfred Brock (arbitrage trading); ICBA (securities traded pursuant to 12 U.S.C. 1831a(f)). The Agencies are concerned that these exclusions could be used to conduct impermissible proprietary trading, and the Agencies believe some of these exclusions are more appropriately addressed by other provisions of the rule. For example, derivatives qualifying for hedge accounting may be permitted under the hedging exemption.

[294] 12 U.S.C. 1851(d)(1)(B).

in more detail below, the proposed underwriting exemption required that: (i) A banking entity establish a compliance program under § 75.20; (ii) the covered financial position be a security; (iii) the purchase or sale be effected solely in connection with a distribution of securities for which the banking entity is acting as underwriter; (iv) the banking entity meet certain dealer registration requirements, where applicable; (v) the underwriting activities be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; (vi) the underwriting activities be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or to hedging of covered financial positions; and (vii) the compensation arrangements of persons performing underwriting activities be designed not to reward proprietary risk-taking.[295] The proposal explained that these seven criteria were proposed so that any banking entity relying on the underwriting exemption would be engaged in *bona fide* underwriting activities and would conduct those activities in a way that would not be susceptible to abuse through the taking of speculative, proprietary positions as part of, or mischaracterized as, underwriting activity.[296]

2. Comments on Proposed Underwriting Exemption

As a general matter, a few commenters expressed overall support for the proposed underwriting exemption.[297] Some commenters indicated that the proposed exemption is too narrow and may negatively impact capital markets.[298] As discussed in more detail below, many commenters expressed views on the effectiveness of specific requirements of the proposed exemption. Further, some commenters requested clarification or expansion of the proposed exemption for certain activities that may be conducted in the course of underwriting.

Several commenters suggested alternative approaches to implementing the statutory exemption for underwriting activities.[299] More specifically, commenters recommended that the Agencies: (i) Provide a safe harbor for low risk, standard underwritings;[300] (ii) better incorporate the statutory limitations on high-risk activity or conflicts of interest;[301] (iii) prohibit banking entities from underwriting illiquid securities;[302] (iv) prohibit banking entities from participating in private placements;[303] (v) place greater emphasis on adequate internal compliance and risk management procedures;[304] or (vi) make the exemption as broad as possible.[305]

3. Final Underwriting Exemption

After considering the comments received, the Agencies are adopting the underwriting exemption substantially as proposed, but with important modifications to clarify provisions or to address commenters' concerns. As discussed above, some commenters were generally supportive of the proposed approach to implementing the underwriting exemption, but noted certain areas of concern or uncertainty. The underwriting exemption the Agencies are adopting addresses these issues by further clarifying the scope of activities that qualify for the exemption. In particular, the Agencies are refining the proposed exemption to better capture the broad range of capital-raising activities facilitated by banking entities acting as underwriters on behalf of issuers and selling security holders.

The final underwriting exemption includes the following components:

- A framework that recognizes the differences in underwriting activities across markets and asset classes by establishing criteria that will be applied flexibly based on the liquidity, maturity, and depth of the market for the particular type of security.
- A general focus on the ''underwriting position'' held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with the distribution of securities for which such banking entity or affiliate is acting as an underwriter.[306]
- A definition of the term ''trading desk'' that focuses on the functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a banking entity or across two or more affiliates.[307]
- Five standards for determining whether a banking entity is engaged in permitted underwriting activities. Many of these criteria have similarities to those included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - The banking entity act as an ''underwriter'' for a ''distribution'' of securities and the trading desk's underwriting position be related to such distribution. The final rule includes refined definitions of ''distribution'' and ''underwriter'' to better capture the broad scope of securities offerings used by issuers and selling security holders and the range of roles that a banking entity may play as intermediary in such offerings.[308]
  - The amount and types of securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[309]

[295] *See* proposed rule § 75.4(a).

[296] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[297] *See* Barclays (stating that the proposed exemption generally effectuates the aims of the statute while largely avoiding undue interference, although the commenter also requested certain technical changes to the rule text); Alfred Brock.

[298] *See, e.g.,* Lord Abbett; BoA; Fidelity; Chamber (Feb. 2012).

[299] *See* Sens. Merkley & Levin (Feb. 2012); BoA; Fidelity; Occupy; AFR *et al.* (Feb. 2012).

[300] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting a safe harbor for underwriting efforts that meet certain low-risk criteria, including that: The underwriting be in plain vanilla stock or bond offerings, including commercial paper, for established business and governments; and the distribution be completed within relevant time periods, as determined by asset classes, with relevant factors being the size of the issuer and the market served); Johnson & Prof. Stiglitz (expressing support for a narrow safe harbor for underwriting of basic stocks and bonds that raise capital for real economy firms).

[301] *See* Sens. Merkley & Levin (Feb. 2012) (suggesting that, for example, the exemption plainly prevent high-risk, conflict ridden underwritings of securitizations and structured products and cross-reference Section 621 of the Dodd-Frank Act, which prohibits certain material conflicts of interest in connection with asset-backed securities).

[302] *See* AFR *et al.* (Feb. 2012) (recommending that the Agencies prohibit banking entities from acting as underwriter for assets classified as Level 3 under FAS 157, which would prohibit underwriting of illiquid and opaque securities without a genuine external market, and representing that such a restriction would be consistent with the statutory limitation on exposures to high-risk assets).

[303] *See* Occupy.

[304] *See* BoA (recommending that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rules as long as the banking entity has adequate compliance and risk management procedures).

[305] *See* Fidelity (suggested that the rules be revised to ''provide the broadest exemptions possible under the statute'' for underwriting and certain other permitted activities).

[306] *See infra* Part VI.A.2.c.1.c.

[307] *See infra* Part VI.A.2.c.1.c. The term ''trading desk'' is defined in final rule § 75.3(e)(13) as ''the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.''

[308] *See* final rule §§ 75.4(a)(2)(i), 75.4(a)(3), 75.4(a)(4); *see also infra* Part VI.A.2.c.1.c.

[309] *See* final rule § 75.4(a)(2)(ii); *see also infra* Part VI.A.2.c.2.c.

○ The banking entity establish, implement, maintain, and enforce an internal compliance program that is reasonably designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

▪ The products, instruments, or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

▪ Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the amount, types, and risk of the trading desk's underwriting position, level of exposures to relevant risk factors arising from the trading desk's underwriting position, and period of time a security may be held;

▪ Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

▪ Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval.[310]

○ The compensation arrangements of persons performing the banking entity's underwriting activities are designed not to reward or incentivize prohibited proprietary trading.[311]

○ The banking entity is licensed or registered to engage in the activity described in the underwriting exemption in accordance with applicable law.[312]

After considering commenters' suggested alternative approaches to implementing the statute's underwriting exemption, the Agencies have determined to retain the general structure of the proposed underwriting exemption. For instance, two commenters suggested providing a safe harbor for ''plain vanilla'' or ''basic'' underwritings of stocks and bonds.[313] The Agencies do not believe that a safe harbor is necessary to provide certainty that a banking entity may act as an underwriter in these particular types of offerings. This is because ''plain vanilla'' or ''basic'' underwriting activity should be able to meet the requirements of the final rule. For example, the final definition of ''distribution'' includes any offering of securities made pursuant to an effective registration statement under the Securities Act.[314]

Further, in response to one commenter's request that the final rule prohibit a banking entity from acting as an underwriter in illiquid assets that are determined to not have observable price inputs under accounting standards,[315] the Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule.[316] Moreover, the Agencies do not believe it is necessary to differentiate between liquid and less liquid securities for purposes of determining whether a banking entity may underwrite a distribution of securities because, in either case, a banking entity must have a reasonable expectation of purchaser demand for the securities and must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period under the final rule.[317]

Another commenter suggested that the Agencies establish a strong presumption that all of a banking entity's activities related to underwriting are permitted under the rule as long as the banking entity has adequate compliance and risk management procedures.[318] While strong compliance and risk management procedures are important for banking entities' permitted activities, the Agencies believe that an approach focused solely on the establishment of a compliance program would likely increase the potential for evasion of the general prohibition on proprietary trading. Similarly, the Agencies are not adopting an exemption that is unlimited, as requested by one commenter, because the Agencies believe controls are necessary to prevent potential evasion of the statute through, among other things, retaining an unsold allotment when there is sufficient customer interest for the securities and to limit the risks associated with these activities.[319]

Underwriters play an important role in facilitating issuers' access to funding, and thus underwriters are important to the capital formation process and economic growth.[320] Obtaining new financing can be expensive for an issuer because of the natural information advantage that less well-known issuers have over investors about the quality of their future investment opportunities. An underwriter can help reduce these costs by mitigating the information asymmetry between an issuer and its potential investors. The underwriter does this based in part on its familiarity with the issuer and other similar issuers as well as by collecting information about the issuer. This allows investors to look to the reputation and experience of the underwriter as well as its ability to provide information about the issuer and the underwriting. For these and other reasons, most U.S. issuers rely on the services of an underwriter when raising funds through public offerings. As recognized in the statute, the exemption is intended to permit banking entities to continue to perform the underwriting function, which contributes to capital formation and its positive economic effects.

c. Detailed Explanation of the Underwriting Exemption

1. Acting as an Underwriter for a Distribution of Securities

a. Proposed Requirements That the Purchase or Sale Be Effected Solely in Connection With a Distribution of Securities for Which the Banking Entity Acts as an Underwriter and That the Covered Financial Position Be a Security

Section 75.4(a)(2)(iii) of the proposed rule required that the purchase or sale be effected solely in connection with a distribution of securities for which a banking entity is acting as

[310] *See* final rule § 75.4(a)(2)(iii); *see also infra* Part VI.A.2.c.3.c.

[311] *See* final rule § 75.4(a)(2)(iv); *see also infra* Part VI.A.2.c.4.c.

[312] *See* final rule § 75.4(a)(2)(v); *see also infra* Part VI.A.2.c.5.c.

[313] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz. One of these commenters also suggested that the Agencies better incorporate the statutory limitations on material conflicts of interest and high-risk activities in the underwriting exemption by including additional provisions in the exemption to refer to these limitations. *See* Sens. Merkley & Levin (Feb. 2012). The Agencies note that these limitations are adopted in § 75.7 of the final rules, and this provision will apply to underwriting activities, as well as all other exempted activities.

[314] *See* final rule § 75.4(a)(3).

[315] *See* AFR *et al.* (Feb. 2012).

[316] *See* Joint Proposal, 76 FR at 68859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR at 8344 n.107.

[317] *See infra* Part VI.A.2.c.2.c.

[318] *See* BoA.

[319] *See* Fidelity.

[320] *See, e.g.,* BoA (''The underwriting activities of U.S. banking entities are essential to capital formation and, therefore, economic growth and job creation.''); Goldman (Prop. Trading); Sens. Merkley & Levin (Feb. 2012).

underwriter.[321] As discussed below, the Agencies proposed to define the terms ''distribution'' and ''underwriter'' in the proposed rule. The proposed rule also required that the covered financial position being purchased or sold by the banking entity be a security.[322]

i. Proposed Definition of ''Distribution''

The proposed definition of ''distribution'' mirrored the definition of this term used in the SEC's Regulation M under the Exchange Act.[323] More specifically, the proposed rule defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.'' [324] The Agencies did not propose to define the terms ''magnitude'' and ''special selling efforts and selling methods,'' but stated that the Agencies would expect to rely on the same factors considered in Regulation M for assessing these elements.[325] The Agencies noted that ''magnitude'' does not imply that a distribution must be large and, therefore, this factor would not preclude small offerings or private placements from qualifying for the proposed underwriting exemption.[326]

ii. Proposed Definition of ''Underwriter''

Like the proposed definition of ''distribution,'' the Agencies proposed to define ''underwriter'' in a manner similar to the definition of this term in the SEC's Regulation M.[327] The definition of ''underwriter'' in the proposed rule was: (i) Any person who has agreed with an issuer or selling security holder to: (a) Purchase securities for distribution; (b) engage in a distribution of securities for or on behalf of such issuer or selling security holder; or (c) manage a distribution of securities for or on behalf of such issuer or selling security holder; and (ii) a person who has an agreement with another person described in the preceding provisions to engage in a distribution of such securities for or on behalf of the issuer or selling security holder.[328]

In connection with this proposed requirement, the Agencies noted that the precise activities performed by an underwriter may vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. To determine whether a banking entity is acting as an underwriter as part of a distribution of securities, the Agencies proposed to take into consideration the extent to which a banking entity is engaged in the following activities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[329]

The proposal recognized that there may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. The Agencies stated that if the unsold securities were acquired in connection with underwriting under the proposed exemption, then the underwriter would be able to dispose of such securities at a later time.[330]

iii. Proposed Requirement That the Covered Financial Position Be a Security

Pursuant to § 75.4(a)(2)(ii) of the proposed exemption, a banking entity would be permitted to purchase or sell a covered financial position that is a security only in connection with its underwriting activities.[331] The proposal stated that this requirement was meant to reflect the common usage and understanding of the term ''underwriting.'' [332] It was noted, however, that a derivative or commodity future transaction may be otherwise permitted under another exemption (*e.g.,* the exemptions for market making-related or risk-mitigating hedging activities).[333]

b. Comments on the Proposed Requirements That the Trade Be Effected Solely in Connection With a Distribution for Which the Banking Entity Is Acting as an Underwriter and That the Covered Financial Position Be a Security

In response to the proposed requirement that a purchase or sale be ''effected solely in connection with a distribution of securities'' for which the ''banking entity is acting as underwriter,'' commenters generally focused on the proposed definitions of ''distribution'' and ''underwriter'' and the types of activities that should be permitted under the ''in connection with'' standard. Commenters did not directly address the requirement in § 75.4(a)(2)(ii) of the proposed rule, which provided that the covered financial position purchased or sold under the exemption must be a security. A number of commenters expressed general concern that the proposed underwriting exemption's references to a ''purchase or sale of a covered financial position'' could be interpreted to require compliance with the proposed rule on a transaction-by-transaction basis. These commenters indicated that such an approach would be overly burdensome.[334]

i. Definition of ''Distribution''

Several commenters stated that the proposed definition of ''distribution'' is too narrow,[335] while one commenter stated that the proposed definition is too broad.[336] Commenters who viewed the proposed definition as too narrow stated that it may exclude important capital-raising and financing transactions that do not appear to involve ''special selling

[321] *See* proposed rule § 75.4(a)(2)(iii).

[322] *See* proposed rule § 75.4(a)(2)(ii).

[323] *See* Joint Proposal, 76 FR at 68866–68867; CFTC Proposal, 77 FR at 8352; 17 CFR 242.101; proposed rule § 75.4(a)(3).

[324] *See* proposed rule § 75.4(a)(3).

[325] *See* Joint Proposal, 76 FR at 68867 (''For example, the number of shares to be sold, the percentage of the outstanding shares, public float, and trading volume that those shares represent are all relevant to an assessment of magnitude. In addition, delivering a sales document, such as a prospectus, and conducting road shows are generally indicative of special selling efforts and selling methods. Another indicator of special selling efforts and selling methods is compensation that is greater than that for secondary trades but consistent with underwriting compensation for an offering.''); CFTC Proposal, 77 FR at 8352; Review of Antimanipulation Regulation of Securities Offering, Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681, 21684–21685 (Apr. 26, 1994).

[326] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[327] *See* Joint Proposal, 76 FR at 68866–68867; CFTC Proposal, 77 FR at 8352; 17 CFR 242.101; proposed rule § 75.4(a)(4).

[328] *See* proposed rule § 75.4(a)(4). As noted in the proposal, the proposed rule's definition differed from the definition in Regulation M because the proposed rule's definition would also include a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder. *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[329] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[330] *See id.*

[331] *See* proposed rule § 75.4(a)(2)(ii).

[332] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[333] *See* Joint Proposal, 76 FR at 68866 n.132; CFTC Proposal, 77 FR at 8352 n.138.

[334] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[335] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[336] *See* Occupy.

efforts and selling methods'' or ''magnitude.''[337] In particular, these commenters stated that the proposed definition of ''distribution'' may preclude a banking entity from participating in commercial paper issuances,[338] bridge loans,[339] ''at-the-market'' offerings or ''dribble out'' programs conducted off issuer shelf registrations,[340] offerings in response to reverse inquiries,[341] offerings through an automated execution system,[342] small private offerings,[343] or selling security holders' sales of securities of issuers with large market capitalizations that are executed as underwriting transactions in the normal course.[344]

Several commenters suggested that the proposed definition be modified to include some or all of these types of offerings.[345] For example, two commenters requested that the definition explicitly include all offerings of securities by an issuer.[346] One of these commenters further requested a broader definition that would include any offering by a selling security holder that is registered under the Securities Act or that involves an offering document prepared by the issuer.[347] Another commenter suggested that the rule explicitly authorize certain forms of offerings, such as offerings under Rule 144A, Regulation S, Rule 101(b)(10) of Regulation M, or the so-called ''section 4(1½)'' of the Securities Act, as well as transactions on behalf of selling security holders.[348] Two commenters proposed approaches that would include the resale of notes or other debt securities received by a banking entity from a borrower to replace or refinance a bridge loan.[349] One of these commenters stated that permitting a banking entity to receive and resell notes or other debt securities from a borrower to replace or refinance a bridge loan would preserve the ability of a banking entity to extend credit and offer customers a range of financing options. This commenter further represented that such an approach would be consistent with the exclusion of loans from the proposed definition of ''covered financial position'' and the commenter's recommended exclusion from the definition of ''trading account'' for collecting debts previously contracted.[350]

One commenter, however, stated that the proposed definition of ''distribution'' is too broad. This commenter suggested that the underwriting exemption should only be available for registered offerings, and the rule should preclude a banking entity from participating in a private placement. According to the commenter, permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading.[351]

ii. Definition of ''Underwriter''

Several commenters stated that the proposed definition of ''underwriter'' is too narrow.[352] Other commenters, however, stated that the proposed definition is too broad, particularly due to the proposed inclusion of selling group members.[353]

Commenters requesting a broader definition generally stated that the Agencies should instead use the Regulation M definition of ''distribution participant'' or otherwise revise the definition of ''underwriter'' to incorporate the concept of a ''distribution participant,'' as defined under Regulation M.[354] According to these commenters, using the term ''distribution participant'' would better reflect current market practice and would include dealers that participate in an offering but that do not deal directly with the issuer or selling security holder and do not have a written agreement with the underwriter.[355] One commenter further represented that the proposed provision for selling group members may be less inclusive than the Agencies intended because individual selling dealers or dealer groups may or may not have written agreements with an underwriter in privity of contract with the issuer.[356] Another commenter requested that, if the ''distribution participant'' concept is not incorporated into the rule, the proposed definition of ''underwriter'' be modified to include a person who has an agreement with an affiliate of an issuer or selling security holder (*e.g.,* an agreement with a parent company to distribute the issuer's securities).[357]

Other commenters opposed the inclusion of selling group members in the proposed definition of ''underwriter.'' These commenters stated that because selling group members do not provide a price guarantee to an issuer, they do not provide services to a customer and their activities should not qualify for the underwriting exemption.[358]

A number of commenters stated that it is unclear whether the proposed underwriting exemption would permit a banking entity to act as an authorized participant (''AP'') to an ETF issuer, particularly with respect to the creation and redemption of ETF shares or ''seeding'' an ETF for a short period of

[337] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[338] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). In addition, one commenter expressed general concern that the proposed rule would cause a reduction in underwriting services with respect to commercial paper, which would reduce liquidity in commercial paper markets and raise the costs of capital in already tight credit markets. *See* Chamber (Feb. 2012).

[339] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC; LSTA (Feb. 2012).

[340] *See* Goldman (Prop. Trading).

[341] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[342] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[343] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[344] *See* RBC.

[345] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[346] *See* Goldman (Prop. Trading) (stating that this would capture, among other things, commercial paper issuances, issuer ''dribble out'' programs, and small private offerings, which involve the purchase of securities directly from an issuer with a view toward resale, but may not always be clearly distinguished by ''special selling efforts and selling methods'' or by ''magnitude''); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[347] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter indicated that expanding the definition of ''distribution'' to include both offerings of securities by an issuer and offerings by a selling security holder that are registered under the Securities Act or that involve an offering document prepared by the issuer would ''include, for example, an offering of securities by an issuer or a selling security holder where securities are sold through an automated order execution system, offerings in response to reverse inquiries and commercial paper issuances.'' *Id.*

[348] *See* RBC.

[349] *See* Goldman (Prop. Trading); RBC. In addition, one commenter requested the Agencies clarify that permitted underwriting activities include the acquisition and resale of securities issued in lieu of or to refinance bridge loan facilities, irrespective of whether such activities qualify as ''distributions'' under the proposal. *See* LSTA (Feb. 2012).

[350] *See* Goldman (Prop. Trading).

[351] *See* Occupy.

[352] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[353] *See* AFR *et al.* (Feb. 2012); Public Citizen; Occupy (suggesting that the Agencies exceeded their statutory authority by incorporating the Regulation M definition of ''underwriter,'' rather than the Securities Act definition of ''underwriter'').

[354] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading). The term ''distribution participant'' is defined in Rule 100 of Regulation M as ''an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution.'' 17 CFR 242.100.

[355] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading).

[356] *See* Goldman (Prop. Trading).

[357] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also requested a technical amendment to proposed rule § 75.4(a)(4)(ii) to clarify that the person is ''participating'' in a distribution, not ''engaging'' in a distribution. *See id.*

[358] *See* AFR *et al.* (Feb. 2012); Public Citizen.

time when it is initially launched.[359] For example, a few commenters noted that APs typically do not perform some or all of the activities that the Agencies proposed to consider to help determine whether a banking entity is acting as an underwriter in connection with a distribution of securities, including due diligence, advising an issuer on market conditions and assisting in preparation of a registration statement or offering documents, and participating in or organizing a syndicate of investment banks.[360]

However, one commenter appeared to oppose applying the underwriting exemption to certain AP activities. According to this commenter, APs are generally reluctant to concede that they are statutory underwriters because they do not perform all the activities associated with the underwriting of an operating company's securities. Further, this commenter expressed concern that, if an AP had to rely on the proposed underwriting exemption, the AP could be subject to heightened risk of incurring underwriting liability on the issuance of ETF shares traded by the AP. As a result of these considerations, the commenter believed that a banking entity may be less willing to act as an AP for an ETF issuer if it were required to rely on the underwriting exemption.[361]

iii. ''Solely in Connection With'' Standard

To qualify for the underwriting exemption, the proposed rule required a purchase or sale of a covered financial position to be effected ''solely in connection with'' a distribution of securities for which the banking entity is acting as underwriter. Several commenters expressed concern that the word ''solely'' in this provision may result in an overly narrow interpretation of permissible activities. In particular, these commenters indicated that the ''solely in connection with'' standard creates uncertainty about certain activities that are currently conducted in the course of an underwriting, such as customary underwriting syndicate activities.[362] One commenter represented that such activities are traditionally undertaken to: Support the success of a distribution; mitigate risk to issuers, investors, and underwriters; and facilitate an orderly aftermarket.[363] A few commenters further stated that requiring a trade to be ''solely'' in connection with a distribution by an underwriter would be inconsistent with the statute,[364] may reduce future innovation in the capital-raising process,[365] and could create market disruptions.[366]

A number of commenters stated that it is unclear whether certain activities would qualify for the proposed underwriting exemption and requested that the Agencies adopt an exemption that is broad enough to permit such activities.[367] Commenters stated that there are a number of activities that should be permitted under the underwriting exemption, including: (i) Creating a naked or covered syndicate short position in connection with an offering;[368] (ii) creating a stabilizing bid;[369] (iii) acquiring positions via overallotments[370] or trading in the market to close out short positions in connection with an overallotment option or in connection with other stabilization activities;[371] (iv) using call spread options in a convertible debt offering to mitigate dilution of existing shareholders;[372] (v) repurchasing existing debt securities of an issuer in the course of underwriting a new series of debt securities in order to stimulate demand for the new issuance;[373] (vi) purchasing debt securities of comparable issuers as a price discovery mechanism in connection with underwriting a new debt security;[374] (vii) hedging the underwriter's exposure to a derivative strategy engaged in with an issuer;[375] (viii) organizing and assembling a resecuritized product, including, for example, sourcing bond collateral over a period of time in anticipation of issuing new securities;[376] and (ix) selling a security to an intermediate entity as part of the creation of certain structured products.[377]

c. Final Requirement That the Banking Entity Act as an Underwriter for a Distribution of Securities and the Trading Desk's Underwriting Position Be Related to Such Distribution

The final rule requires that the banking entity act as an underwriter for a distribution of securities and the trading desk's underwriting position be related to such distribution.[378] This requirement is substantially similar to the proposed rule,[379] but with five key refinements. First, to address commenters' confusion about whether

[359] *See* BoA; ICI Global; Vanguard; ICI (Feb. 2012); SSgA (Feb. 2012). As one commenter explained, an AP may ''seed'' an ETF for a short period of time at its inception by entering into several initial creation transactions with the ETF issuer and refraining from selling those shares to investors or redeeming them for a period of time to facilitate the ETF achieving its liquidity launch goals. *See* BoA.

[360] *See* ICI Global; ICI (Feb. 2012); Vanguard.

[361] *See* SSgA (Feb. 2012).

[362] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Wells Fargo (Prop. Trading); Comm. on Capital Markets Regulation.

[363] *See* Goldman (Prop. Trading).

[364] *See* Goldman (Prop. Trading); Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[365] *See* Goldman (Prop. Trading).

[366] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[367] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Wells Fargo (Prop. Trading); RBC.

[368] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''The reason for creating the short positions (covered and naked) is to facilitate an orderly aftermarket and to reduce price volatility of newly offered securities. This provides significant value to issuers and selling security holders, as well as to investors, by giving the syndicate buying power that helps protect against immediate volatility in the aftermarket.''); RBC; Goldman (Prop. Trading).

[369] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (''Underwriters may also engage in stabilization activities under Regulation M by creating a stabilizing bid to prevent or slow a decline in the market price of a security. These activities should be encouraged rather than restricted by the Volcker Rule because they reduce price volatility and facilitate the orderly pricing and aftermarket trading of underwritten securities, thereby contributing to capital formation.'').

[370] *See* RBC.

[371] *See* Goldman (Prop. Trading).

[372] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (stating that the call spread arrangement ''may make a wider range of financing options feasible for the issuer of the convertible debt'' and ''can help it to raise more capital at more attractive prices'').

[373] *See* Wells Fargo (Prop. Trading). The commenter further stated that the need to purchase the issuer's other debt securities from investors may arise if an investor has limited risk tolerance to the issuer's credit or has portfolio restrictions. According to the commenter, the underwriter would typically sell the debt securities it purchased from existing investors to new investors. *See id.*

[374] *See* Wells Fargo (Prop. Trading).

[375] *See* Goldman (Prop. Trading).

[376] *See* ASF (Feb. 2012) (stating that, for example, a banking entity may respond to customer or general market demand for highly-rated mortgage paper by accumulating residential mortgage-backed securities over time and holding such securities in inventory until the transaction can be organized and assembled).

[377] *See* ICI (Feb. 2012) (stating that the sale of assets to an intermediate asset-backed commercial paper or tender option bond program should be permitted under the underwriting exemption if the sale is part of the creation of a structured security). *See also* AFR *et al.* (Feb. 2012) (stating that the treatment of a sale to an intermediate entity should depend on whether the banking entity or an external client is the driver of the demand and, if the banking entity is the driver of the demand, then the near term demand requirement should not be met). Two commenters stated that the underwriting exemption should not permit a banking entity to sell a security to an intermediate entity in the course of creating a structured product. *See* Occupy; Alfred Brock. These commenters were generally responding to a question on this issue in the proposal. *See* Joint Proposal, 76 FR at 68868–68869 (question 78); CFTC Proposal, 77 FR at 8354 (question 78).

[378] Final rule § 75.4(a)(2)(i). The terms ''distribution'' and ''underwriter'' are defined in final rule § 75.4(a)(3) and § 75.4(a)(4), respectively.

[379] Proposed rule § 75.4(a)(2)(iii) required that ''[t]he purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter.''

the underwriting exemption applies on a transaction-by-transaction basis, the phrase ''purchase or sale'' has been modified to instead refer to the trading desk's ''underwriting position.'' Second, to balance this more aggregated position-based approach, the final rule specifies that the trading desk is the organizational level of a banking entity (or across one or more affiliated banking entities) at which the requirements of the underwriting exemption will be assessed. Third, the Agencies have made important modifications to the definition of ''distribution'' to better capture the various types of private and registered offerings a banking entity may be asked to underwrite by an issuer or selling security holder. Fourth, the definition of ''underwriter'' has been refined to clarify that both members of the underwriting syndicate and selling group members may qualify as underwriters for purposes of this exemption. Finally, the word ''solely'' has been removed to clarify that a broader scope of activities conducted in connection with underwriting (*e.g.,* stabilization activities) are permitted under this exemption. These issues are discussed in turn below.

i. Definition of ''Underwriting Position''

In response to commenters' concerns about transaction-by-transaction analyses,[380] the Agencies are modifying the exemption to clarify the level at which compliance with certain provisions will be assessed. The proposal was not intended to impose a transaction-by-transaction approach, and the final rule's requirements generally focus on the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or its affiliate is acting as an underwriter. Like § 75.4(a)(2)(ii) of the proposed rule, the definition of ''underwriting position'' is limited to positions in securities because the common usage and understanding of the term ''underwriting'' is limited to activities in securities.

A trading desk's underwriting position constitutes the securities positions that are acquired in connection with a single distribution for which the relevant banking entity is acting as an underwriter. A trading desk may not aggregate securities positions acquired in connection with two or more distributions to determine its ''underwriting position.'' A trading desk may, however, have more than one ''underwriting position'' at a particular point in time if the banking entity is acting as an underwriter for more than one distribution. As a result, the underwriting exemption's requirements pertaining to a trading desk's underwriting position will apply on a distribution-by-distribution basis.

A trading desk's underwriting position can include positions in securities held at different affiliated legal entities, provided the banking entity is able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section 13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's underwriting position for purposes of the underwriting exemption. Banking entities should be prepared to provide all records that identify all of the positions included in a trading desk's underwriting position and where such positions are held.

The Agencies believe that a distribution-by-distribution approach is appropriate due to the relatively distinct nature of underwriting activities for a single distribution on behalf of an issuer or selling security holder. The Agencies do not believe that a narrower transaction-by-transaction analysis is necessary to determine whether a banking entity is engaged in permitted underwriting activities. The Agencies also decline to take a broader approach, which would allow a banking entity to aggregate positions from multiple distributions for which it is acting as an underwriter, because it would be more difficult for the banking entity's internal compliance personnel and Agency supervisors and examiners to review the trading desk's positions to assess the desk's compliance with the underwriting exemption. A more aggregated approach would increase the number of positions in different types of securities that could be included in the underwriting position, which would make it more difficult to determine that an individual position is related to a particular distribution of securities for which the banking entity is acting as an underwriter and, in turn, increase the potential for evasion of the general prohibition on proprietary trading.

ii. Definition of ''Trading Desk''

The proposed underwriting exemption would have applied certain requirements across an entire banking entity. To promote consistency with the market-making exemption and address potential evasion concerns, the final rule applies the requirements of the underwriting exemption at the trading desk level of organization.[381] This approach will result in the requirements of the underwriting exemption applying to the aggregate trading activities of a relatively limited group of employees on a single desk. Applying requirements at the trading desk level should facilitate banking entity and Agency monitoring and review of compliance with the exemption by limiting the location where underwriting activity may occur and allowing better identification of the aggregate trading volume that must be reviewed to determine whether the desk's activities are being conducted in a manner that is consistent with the underwriting exemption, while also allowing adequate consideration of the particular facts and circumstances of the desk's trading activities.

The trading desk should be managed and operated as an individual unit and should reflect the level at which the profit and loss of employees engaged in underwriting activities is attributed. The term ''trading desk'' in the underwriting context is intended to encompass what is commonly thought of as an underwriting desk. A trading desk engaged in underwriting activities would not necessarily be an active market participant that engages in frequent trading activities.

A trading desk may manage an underwriting position that includes positions held by different affiliated legal entities.[382] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. The geographic location of individual traders is not dispositive for purposes of determining whether the employees are engaged in activities for a single trading desk.

iii. Definition of ''Distribution''

The term ''distribution'' is defined in the final rule as: (i) An offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) an offering of securities made pursuant to an effective registration statement under the Securities Act.[383] In response to comments, the proposed definition has been revised to eliminate the need to consider the ''magnitude'' of an offering and instead supplements the definition

[380] *See, e.g.,* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[381] *See infra* Part VI.A.3.c. (discussing the final market-making exemption).

[382] *See supra* note 307 and accompanying text.

[383] Final rule § 75.4(a)(3).

with an alternative prong for registered offerings under the Securities Act.[384]

The proposed definition's reference to magnitude caused some commenter concern with respect to whether it could be interpreted to preclude a banking entity from intermediating a small private placement. After considering comments, the Agencies have determined that the requirement to have special selling efforts and selling methods is sufficient to distinguish between permissible securities offerings and prohibited proprietary trading, and the additional magnitude factor is not needed to further this objective.[385] As proposed, the Agencies will rely on the same factors considered under Regulation M to analyze the presence of special selling efforts and selling methods.[386] Indicators of special selling efforts and selling methods include delivering a sales document (*e.g.,* a prospectus), conducting road shows, and receiving compensation that is greater than that for secondary trades but consistent with underwriting compensation.[387] For purposes of the final rule, each of these factors need not be present under all circumstances. Offerings that qualify as distributions under this prong of the definition include, among others, private placements in which resales may be made in reliance on the SEC's Rule 144A or other available exemptions [388] and, to the extent the commercial paper being offered is a security, commercial paper offerings that involve the underwriter receiving special compensation.[389]

The Agencies are also adopting a second prong to this definition, which will independently capture all offerings of securities that are made pursuant to an effective registration statement under the Securities Act.[390] The registration prong of the definition is intended to provide another avenue by which an offering of securities may be conducted under the exemption, absent other special selling efforts and selling methods or a determination of whether such efforts and methods are being conducted. The Agencies believe this prong reduces potential administrative burdens by providing a bright-line test for what constitutes a distribution for purposes of the final rule. In addition, this prong is consistent with the purpose and goals of the statute because it reflects a common type of securities offering and does not raise evasion concerns as it is unlikely that an entity would go through the registration process solely to facilitate or engage in speculative proprietary trading.[391] This prong would include, among other things, the following types of registered securities offerings: Offerings made pursuant to a shelf registration statement (whether on a continuous or delayed basis),[392] bought deals,[393] at the market offerings,[394] debt offerings, asset-backed security offerings, initial public offerings, and other registered offerings. An offering can be a distribution for purposes of either § 75.4(a)(3)(i) or § 75.4(a)(3)(ii) of the final rule regardless of whether the offering is issuer driven, selling security holder driven, or arises as a result of a reverse inquiry.[395] Provided the definition of distribution is met, an offering can be a distribution for purposes of this rule regardless of how it is conducted, whether by direct communication, exchange transactions, or automated execution system.[396]

As discussed above, some commenters expressed concern that the proposed definition of ''distribution'' would prevent a banking entity from acquiring and reselling securities issued in lieu of or to refinance bridge loan facilities in reliance on the underwriting exemption. Bridge financing arrangements can be structured in many different ways, depending on the context and the specific objectives of the parties involved. As a result, the treatment of securities acquired in lieu of or to refinance a bridge loan and the subsequent sale of such securities under the final rule depends on the facts and circumstances. A banking entity may meet the terms of the underwriting exemption for its bridge loan activity, or it may be able to rely on the market-making exemption. If the banking entity's bridge loan activity does not qualify for an exemption under the rule, then it would not be permitted to engage in such activity.

[384] Proposed rule § 75.4(a)(3) defined ''distribution'' as ''an offering of securities, whether or not subject to registration under the Securities Act, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.''

[385] The policy goals of this rule differ from those of the SEC's Regulation M, which is an anti-manipulation rule. The focus on magnitude is appropriate for that regulation because it helps identify offerings that can give rise to an incentive to condition the market for the offered security. To the contrary, this rule is intended to allow banking entities to continue to provide client-oriented financial services, including underwriting services. The SEC emphasizes that this rule does not have any impact on Regulation M.

[386] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352.

[387] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352; Review of Antimanipulation Regulation of Securities Offering, Exchange Act Release No. 33924 (Apr. 19, 1994), 59 FR 21681, 21684–21685 (Apr. 26, 1994).

[388] The final rule does not provide safe harbors for particular distribution techniques. A safe harbor-based approach would provide certainty for specific types of offerings, but may not account for evolving market practices and distribution techniques that could technically satisfy a safe harbor but that might implicate the concerns that led Congress to enact section 13 of the BHC Act. *See* RBC.

[389] This clarification is intended to address commenters' concern regarding potential limitations on banking entities' ability to facilitate commercial paper offerings under the proposed underwriting exemption. *See supra* Part VI.A.2.c.1.b.i.

[390] *See, e.g.,* Form S–1 (17 CFR 239.11); Form S–3 (17 CFR 239.13); Form S–8 (17 CFR 239.16b); Form F–1 (17 CFR 239.31); Form F–3 (17 CFR 239.33).

[391] Although the Agencies are providing an additional prong to the definition of ''distribution'' for registered offerings, the final rule does not limit the availability of the underwriting exemption to registered offerings, as suggested by one commenter. The statute does not include such an express limitation, and the Agencies decline to construe the statute to require such an approach. In response to the commenter stating that permitting a banking entity to participate in a private placement may facilitate evasion of the prohibition on proprietary trading, the Agencies believe this concern is addressed by the provision in the final rule requiring that a trading desk have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution and make reasonable efforts to sell its underwriting position within a reasonable period. As discussed below, the Agencies believe this requirement in the final rule appropriately addresses evasion concerns that a banking entity may retain an unsold allotment for purely speculative purposes. Further, the Agencies believe that preventing a banking entity from facilitating a private offering could unnecessarily hinder capital-raising without providing commensurate benefits because issuers use private offerings to raise capital in a variety of situations and the underwriting exemption's requirements limit the potential for evasion for both registered and private offerings, as noted above.

[392] *See* Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (Aug. 3, 2005); 17 CFR 230.405 (defining ''automatic shelf registration statement'' as a registration statement filed on Form S–3 (17 CFR 239.13) or Form F–3 (17 CFR 239.33) by a well-known seasoned issuer pursuant to General Instruction I.D. or I.C. of such forms, respectively); 17 CFR 230.415.

[393] A bought deal is a distribution technique whereby an underwriter makes a bid for securities without engaging in a preselling effort, such as book building or distribution of a preliminary prospectus. *See, e.g.,* Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 6470 (June 9, 1983), n.5.

[394] *See, e.g.,* 17 CFR 230.415(a)(4) (defining ''at the market offering'' as ''an offering of equity securities into an existing trading market for outstanding shares of the same class at other than a fixed price''). At the market offerings may also be referred to as ''dribble out'' programs.

[395] Under the ''reverse inquiry'' process, an investor may be allowed to purchase securities from the issuer through an underwriter that is not designated in the prospectus as the issuer's agent by having such underwriter approach the issuer with an interest from the investor. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012).

[396] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

iv. Definition of ''Underwriter''

In response to comments, the Agencies are adopting certain modifications to the proposed definition of ''underwriter'' to better capture selling group members and to more closely resemble the definition of ''distribution participant'' in Regulation M. In particular, the Agencies are defining ''underwriter'' as: (i) A person who has agreed with an issuer or selling security holder to: (A) Purchase Securities from the issuer or selling security holder for distribution; (B) engage in a distribution of securities for or on behalf of the issuer or selling security holder; or (C) manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) a person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.[397]

A number of commenters requested that the Agencies broaden the underwriting exemption to permit activities in connection with a distribution of securities by any distribution participant. A few of these commenters interpreted the proposed definition of ''underwriter'' as requiring a selling group member to have a written agreement with the underwriter to participate in the distribution.[398] These commenters noted that such a written agreement may not exist under all circumstances. The Agencies did not intend to require that members of the underwriting syndicate or the lead underwriter have a written agreement with all selling group members for each offering or that they be in privity of contract with the issuer or selling security holder. To provide clarity on this issue, the Agencies have modified the language of subparagraph (ii) of the definition to include firms that, while not members of the underwriting syndicate, have agreed to participate or are participating in a distribution of securities for or on behalf of the issuer or selling security holder.

The final rule does not adopt a narrower definition of ''underwriter,'' as suggested by two commenters.[399] Although selling group members do not have a direct relationship with the issuer or selling security holder, they do help facilitate the successful distribution of securities to a wider variety of purchasers, such as regional or retail purchasers that members of the underwriting syndicate may not be able to access as easily. Thus, the Agencies believe it is consistent with the purpose of the statutory underwriting exemption and beneficial to recognize and allow the current market practice of an underwriting syndicate and selling group members collectively facilitating a distribution of securities. The Agencies note that because banking entities that are selling group members will be underwriters under the final rule, they will be subject to all the requirements of the underwriting exemption.

As provided in the preamble to the proposed rule, engaging in the following activities may indicate that a banking entity is acting as an underwriter under § 75.4(a)(4) as part of a distribution of securities:

- Assisting an issuer in capital-raising;
- Performing due diligence;
- Advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering document;
- Purchasing securities from an issuer, a selling security holder, or an underwriter for resale to the public;
- Participating in or organizing a syndicate of investment banks;
- Marketing securities; and
- Transacting to provide a post-issuance secondary market and to facilitate price discovery.[400]

The Agencies continue to take the view that the precise activities performed by an underwriter will vary depending on the liquidity of the securities being underwritten and the type of distribution being conducted. A banking entity is not required to engage in each of the above-noted activities to be considered an underwriter for purposes of this rule. In addition, the Agencies note that, to the extent a banking entity does not meet the definition of ''underwriter'' in the final rule, it may be able to rely on the market-making exemption in the final rule for its trading activity. In response to comments noting that APs for ETFs do not engage in certain of these activities and inquiring whether an AP would be able to qualify for the underwriting exemption for certain of its activities, the Agencies believe that many AP activities, such as conducting general creations and redemptions of ETF shares, are better suited for analysis under the market-making exemption because they are driven by the demands of other market participants rather than the issuer, the ETF.[401] Whether an AP may rely on the underwriting exemption for its activities in an ETF will depend on the facts and circumstances, including, among other things, whether the AP meets the definition of ''underwriter'' and the offering of ETF shares qualifies as a ''distribution.''

To provide further clarity about the scope of the definition of ''underwriter,'' the Agencies are defining the terms ''selling security holder'' and ''issuer'' in the final rule. The Agencies are using the definition of ''issuer'' from the Securities Act because this definition is commonly used in the context of securities offerings and is well understood by market participants.[402] A ''selling security holder'' is defined as ''any person, other than an issuer, on whose behalf a distribution is made.''[403] This definition is consistent with the

[397] *See* final rule § 75.4(a)(4).

[398] The basic documents in firm commitment underwritten securities offerings generally are: (i) The agreement among underwriters, which establishes the relationship among the managing underwriter, any co-managers, and the other members of the underwriting syndicate; (ii) the underwriting (or ''purchase'') agreement, in which the underwriters commit to purchase the securities from the issuer or selling security holder; and (iii) the selected dealers agreement, in which selling group members agree to certain provisions relating to the distribution. *See* Joseph McLaughlin and Charles J. Johnson, Jr., ''Corporate Finance and the Securities Laws'' (4th ed. 2006, supplemented 2012), Ch. 2. The Agencies understand that two firms may enter into a master agreement that governs all offerings in which both firms participate as members of the underwriting syndicate or as a member of the syndicate and a selling group member. *See, e.g.,* SIFMA Master Selected Dealers Agreement (June 10, 2011), available at *www.sifma.org*.

[399] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[400] *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8352. Post-issuance secondary market activity is expected to be conducted in accordance with the market-making exemption.

[401] *See infra* Part VI.A.3.

[402] *See* final rule § 75.3(e)(9) (defining the term ''issuer'' for purposes of the proprietary trading provisions in subpart B of the final rule). Under section 2(a)(4) of the Securities Act, ''issuer'' is defined as ''every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term 'issuer' means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term 'issuer' means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term 'issuer' means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.'' 15 U.S.C. 77b(a)(4).

[403] Final rule § 75.4(a)(5).

definition of ''selling security holder'' found in the SEC's Regulation M.[404]

v. Activities Conducted ''in Connection With'' a Distribution

As discussed above, several commenters expressed concern that the proposed underwriting exemption would not allow a banking entity to engage in certain auxiliary activities that may be conducted in connection with acting as an underwriter for a distribution of securities in the normal course. These commenters' concerns generally arose from the use of the word ''solely'' in § 75.4(a)(2)(iii) of the proposed rule, which commenters noted was not included in the statute's underwriting exemption.[405] In addition, a number of commenters discussed particular activities they believed should be permitted under the underwriting exemption and indicated the term ''solely'' created uncertainty about whether such activities would be permitted.[406]

To reduce uncertainty in response to comments, the final rule requires a trading desk's underwriting position to be ''held . . . and managed . . . in connection with'' a single distribution for which the relevant banking entity is acting as an underwriter, rather than requiring that a purchase or sale be ''effected solely in connection with'' such a distribution. Importantly, for purposes of establishing an underwriting position in reliance on the underwriting exemption, a trading desk may only engage in activities that are related to a particular distribution of securities for which the banking entity is acting as an underwriter. Activities that may be permitted under the underwriting exemption include stabilization activities,[407] syndicate shorting and aftermarket short covering,[408] holding an unsold allotment when market conditions may make it impracticable to sell the entire allotment at a reasonable price at the time of the distribution and selling such position when it is reasonable to do so,[409] and helping the issuer mitigate its risk exposure arising from the distribution of its securities (*e.g.,* entering into a call-spread option with an issuer as part of a convertible debt offering to mitigate dilution to existing shareholders).[410] Such activities should be intended to effectuate the distribution process and provide benefits to issuers, selling security holders, or purchasers in the distribution. Existing laws, regulations, and self-regulatory organization rules limit or place certain requirements around many of these activities. For example, an underwriter's subsequent sale of an unsold allotment must comply with applicable provisions of the Federal securities laws and the rules thereunder. Moreover, any position resulting from these activities must be included in the trading desk's underwriting position, which is subject to a number of restrictions in the final rule. Specifically, as discussed in more detail below, the trading desk must make reasonable efforts to sell or otherwise reduce its underwriting position within a reasonable period,[411] and each trading desk must have robust limits on, among other things, the amount, types, and risks of its underwriting position and the period of time a security may be held.[412] Thus, in general, the underwriting exemption would not permit a trading desk, for example, to acquire a position as part of its stabilization activities and hold that position for an extended period.

This approach does not mean that any activity that is arguably connected to a distribution of securities is permitted under the underwriting exemption. Certain activities noted by commenters are not core to the underwriting function and, thus, are not permitted under the final underwriting exemption. However, a banking entity may be able to rely on another exemption for such activities (*e.g.,* the market-making or hedging exemptions), if applicable. For example, a trading desk would not be able to use the underwriting exemption to purchase a financial instrument from a customer to facilitate the customer's ability to buy securities in the distribution.[413] Further, purchasing another financial instrument to help determine how to price the securities that are subject to a distribution would not be permitted under the underwriting exemption.[414] These two activities may be permitted under the market-making exemption, depending on the facts and circumstances. In response to one commenter's suggestion that hedging the underwriter's risk exposure be permissible under this exemption, the Agencies emphasize that hedging the underwriter's risk exposure is not permitted under the underwriting exemption.[415] A banking entity must comply with the hedging exemption for such activity.

In response to comments about the sale of a security to an intermediate entity in connection with a structured

[404] *See* 17 CFR 242.100(b).

[405] *See supra* Part VI.A.2.c.1.b.iii.

[406] *See supra* notes 362, 363, 368–77 and accompanying text.

[407] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See* Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 38067 (Dec. 20, 1996), 62 FR 520, 535 (Jan. 3, 1997) (''Although stabilization is price-influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an effective mechanism for fostering an orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers.'').

[408] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). *See* Proposed Amendments to Regulation M: Anti-Manipulation Rules Concerning Securities Offerings, Exchange Act Release No. 50831 (Dec. 9, 2004), 69 FR 75774, 75780 (Dec. 17, 2004) (''In the typical offering, the syndicate agreement allows the managing underwriter to 'oversell' the offering, *i.e.,* establish a short position beyond the number of shares to which the underwriting commitment relates. The underwriting agreement with the issuer often provides for an 'overallotment option' whereby the syndicate can purchase additional shares from the issuer or selling shareholders in order to cover its short position. To the extent that the syndicate short position is in excess of the overallotment option, the syndicate is said to have taken an 'uncovered' short position. The syndicate short position, up to the amount of the overallotment option, may be covered by exercising the option or by purchasing shares in the market once secondary trading begins.'').

[409] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; BoA; BDA (Feb. 2012).

[410] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading).

[411] *See* final rule § 75.4(a)(2)(ii); *infra* Part VI.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[412] *See* final rule § 75.4(a)(2)(iii)(B); *infra* Part VI.A.2.c.3.c. (discussing the required limits for trading desks engaged in underwriting activity).

[413] *See* Wells Fargo (Prop. Trading). The Agencies do not believe this activity is consistent with underwriting activity because it could result in an underwriting desk holding a variety of positions over time that are not directly related to a distribution of securities the desk is conducting on behalf of an issuer or selling security holder. Further, the Agencies believe this activity may be more appropriately analyzed under the market-making exemption because market makers generally purchase or sell a financial instrument at the request of customers and otherwise routinely stand ready to purchase and sell a variety of related financial instruments.

[414] *See id.* The Agencies view this activity as inconsistent with underwriting because underwriters typically engage in other activities, such as book-building and other marketing efforts, to determine the appropriate price for a security and these activities do not involve taking positions that are unrelated to the securities subject to distribution. *See infra* VI.A.2.c.2.

[415] Although one commenter suggested that an underwriter's hedging activity be permitted under the underwriting exemption, we do not believe the requirements in the proposed hedging exemption would be unworkable or overly burdensome in the context of an underwriter's hedging activity. *See* Goldman (Prop. Trading). As noted above, underwriting activity is of a relatively distinct nature, which is substantially different from market-making activity, which is more dynamic and involves more frequent trading activity giving rise to a variety of positions that may naturally hedge the risks of certain other positions. The Agencies believe it is appropriate to require that a trading desk comply with the requirements of the hedging exemption when it is hedging the risks of its underwriting position, while allowing a trading desk's market making-related hedging under the market-making exemption.

finance product,[416] the Agencies have not modified the underwriting exemption. Underwriting is distinct from product development. Thus, parties must adjust activities associated with developing structured finance products or meet the terms of other available exemptions. Similarly, the accumulation of securities or other assets in anticipation of a securitization or resecuritization is not an activity conducted ''in connection with'' underwriting for purposes of the exemption.[417] This activity is typically engaged in by an issuer or sponsor of a securitized product in that capacity, rather than in the capacity of an underwriter. The underwriting exemption only permits a banking entity's activities when it is acting as an underwriter.

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Like the statute, § 75.4(a)(2)(v) of the proposed rule required that the underwriting activities of the banking entity with respect to the covered financial position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[418]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

Both the statute and the proposed rule require a banking entity's underwriting activity to be ''designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.'' [419] Several commenters requested that this standard be interpreted in a flexible manner to allow a banking entity to participate in an offering that may require it to retain an unsold allotment for a period of time.[420] In addition, one commenter stated that the final rule should provide flexibility in this standard by recognizing that the concept of ''near term'' differs between asset classes and depends on the liquidity of the market.[421] Two commenters expressed views on how the near term customer demand requirement should work in the context of a securitization or creating what the commenters characterized as ''structured products'' or ''structured instruments.''[422]

Many commenters expressed concern that the proposed requirement, if narrowly interpreted, could prevent an underwriter from holding a residual position for which there is no immediate demand from clients, customers, or counterparties.[423] Commenters noted that there are a variety of offerings that present some risk of an underwriter having to hold a residual position that cannot be sold in the initial distribution, including ''bought deals,'' [424] rights offerings,[425] and fixed-income offerings.[426] A few commenters noted that similar scenarios can arise in the case of an AP creating more shares of an ETF than it can sell[427] and bridge loans.[428] Two commenters indicated that if the rule does not provide greater clarity and flexibility with respect to the near term customer demand requirement, a banking entity may be less inclined to participate in a distribution where there is the potential risk of an unsold allotment, may price such risk into the fees charged to underwriting clients, or may be forced into a ''fire sale'' of the unsold allotment.[429]

Several other commenters provided views on whether a banking entity should be able to hold a residual position from an offering pursuant to the underwriting exemption, although they did not generally link their comments to the proposed near term demand requirement.[430] Many of these commenters expressed concern about permitting a banking entity to retain a portion of an underwriting and noted potential risks that may arise from such activity.[431] For example, some of these commenters stated that retention or warehousing of underwritten securities can be an indication of impermissible proprietary trading intent (particularly if systematic), or may otherwise result in high-risk exposures or conflicts of interests.[432] One of these commenters recommended the Agencies use a metric to monitor the size of residual positions retained by an underwriter,[433] while another commenter suggested adding a requirement to the proposed exemption to provide that a ''substantial'' unsold or retained allotment would be an indication of prohibited proprietary trading.[434] Similarly, one commenter recommended that the Agencies consider whether there are sufficient provisions in the proposed rule to reduce the risks posed by banking entities retaining or warehousing underwritten instruments, such as subprime mortgages, collateralized debt obligation tranches, and high yield debt of leveraged buyout issuers, which

[416] *See* ICI (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Alfred Brock.

[417] A banking entity may accumulate loans in anticipation of securitization because loans are not financial instruments under the final rule. *See supra* Part VI.A.1.c.

[418] *See* proposed rule § 75.4(a)(2)(v); Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353.

[419] *See supra* Part VI.A.2.c.2.a.

[420] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC. Another commenter requested that this requirement be eliminated or changed to ''underwriting activities of the banking entity with respect to the covered financial position must be designed to meet the near-term demands of clients, customers, or counterparties.'' *See* Japanese Bankers Ass'n.

[421] *See* RBC (stating that the Board has found acceptable the retention of assets acquired in connection with underwriting activities for a period of 90 to 180 days and has further permitted holding periods of up to a year in certain circumstances, such as for less liquid securities).

[422] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[423] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[424] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC. These commenters generally stated that an underwriter for a ''bought deal'' may end up with an unsold allotment because, pursuant to this type of offering, an underwriter makes a commitment to purchase securities from an issuer or selling security holder, without pre-commitment marketing to gauge customer interest, in order to provide greater speed and certainty of execution. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[425] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (representing that because an underwriter generally backstops a rights offering by committing to exercise any rights not exercised by shareholders, the underwriter may end up holding a residual portion of the offering if investors do not exercise all of the rights).

[426] *See* BDA (Feb. 2012). This commenter stated that underwriters frequently underwrite bonds in the fixed-income market knowing that they may need to retain unsold allotments in their inventory. The commenter indicated that this scenario arises because the fixed-income market is not as deep as other markets, so underwriters frequently cannot sell bonds when they go to market; instead, the underwriters will retain the bonds until a sufficient amount of liquidity is available in the market. *See id.*

[427] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[428] *See* BoA; RBC; LSTA (Feb. 2012). One of these commenters stated that, in the case of securities issued in lieu of or to refinance bridge loan facilities, market conditions or investor demand may change during the period of time between extension of the bridge commitment and when the bridge loan is required to be funded or such securities are required to be issued. As a result, this commenter requested that the near term demands of clients, customers, or counterparties be measured at the time of the initial extension of the bridge commitment. *See* LSTA (Feb. 2012).

[429] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

[430] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Goldman (Prop. Trading); Fidelity; Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[431] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[432] *See* AFR *et al.* (Feb. 2012) (recognizing, however, that a small portion of an underwriting may occasionally be ''hung''); CalPERS; Occupy (stating that a banking entity's retention of unsold allotments may result in potential conflicts of interest).

[433] *See* AFR *et al.* (Feb. 2012).

[434] *See* Occupy (stating that the meaning of the term ''substantial'' would depend on the circumstances of the particular offering).

poses heightened financial risk at the top of economic cycles.[435]

Other commenters indicated that undue restrictions on an underwriter's ability to retain a portion of an offering may result in certain harms to the capital-raising process. These commenters represented that unclear or negative treatment of residual positions will make banking entities averse to the risk of an unsold allotment, which may result in banking entities underwriting smaller offerings, less capital generation for issuers, or higher underwriting discounts, which would increase the cost of raising capital for businesses.[436] One of these commenters suggested that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions.[437]

In addition, in response to a question in the proposal, one commenter expressed the view that the rule should not require documentation with respect to residual positions held by an underwriter.[438] In the case of securitizations, one commenter stated that if the underwriter wishes to retain some of the securities or bonds in its longer-term investment book, such decisions should be made by a separate officer, subject to different standards and compensation.[439]

Two commenters discussed how the near term customer demand requirement should apply in the context of a banking entity acting as an underwriter for a securitization or structured product.[440] One of these commenters indicated that the near term demand requirement should be interpreted to require that a distribution of securities facilitate pre-existing client demand. This commenter stated that a banking entity should not be considered to meet the terms of the proposed requirement if, on the firm's own initiative, it designs and structures a complex, novel instrument and then seeks customers for the instrument, while retaining part of the issuance on its own book. The commenter further emphasized that underwriting should involve two-way demand—clients who want assistance in marketing their securities and customers who may wish to purchase the securities—with the banking entity serving as an intermediary.[441] Another commenter indicated that an underwriting should likely be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding any amount required for credit risk retention purposes) along a time line designed not to exceed reasonably expected near term demands of clients, customers, or counterparties. According to the commenter, this approach would serve to minimize the arbitrage and risk concentration possibilities that can arise through the securitization and sale of some tranches and the retention of other tranches.[442]

One commenter expressed concern that the proposed near term customer demand requirement may impact a banking entity's ability to act as primary dealer because some primary dealers are obligated to bid on each issuance of a government's sovereign debt, without regard to expected customer demand.[443] Two other commenters expressed general concern that the proposed underwriting exemption may be too narrow to permit banking entities that act as primary dealers in or for foreign jurisdictions to continue to meet the relevant jurisdiction's primary dealer requirements.[444]

c. Final Near Term Customer Demand Requirement

The final rule requires that the amount and types of the securities in the trading desk's underwriting position be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts be made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security.[445] As noted above, the near term demand standard originates from section 13(d)(1)(B) of the BHC Act, and a similar requirement was included in the proposed rule.[446] The Agencies are making certain modifications to the proposed approach in response to comments.

In particular, the Agencies are clarifying the operation of this requirement, particularly with respect to unsold allotments.[447] Under this requirement, a trading desk must have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[448] Such reasonable expectation may be based on factors such as current market conditions and prior experience with similar offerings of securities. A banking entity is not required to engage in book-building or similar marketing efforts to determine investor demand for the securities pursuant to this requirement, although such efforts may form the basis for the trading desk's reasonable expectation of demand. While an issuer or selling security holder can be considered to be a client, customer, or counterparty of a banking entity acting as an underwriter for its distribution of securities, this requirement cannot be met by accounting solely for the issuer's or selling security holder's desire to sell the securities.[449] However, the

[435] *See* CalPERS.

[436] *See* Goldman (Prop. Trading); Fidelity (expressing concern that this may result in a more concentrated supply of securities and, thus, decrease the opportunity for diversification in the portfolios of shareholders' funds).

[437] *See* Goldman (Prop. Trading).

[438] *See* Japanese Bankers Ass'n.

[439] *See* Sens. Merkley & Levin (Feb. 2012).

[440] *See* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[441] *See* AFR *et al.* (Feb. 2012).

[442] *See* Sens. Merkley & Levin (Feb. 2012).

[443] *See* Banco de México.

[444] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIB/EBF. One of these commenters represented that many banking entities serve as primary dealers in jurisdictions in which they operate, and primary dealers often: (i) Are subject to minimum purchase and other obligations in the jurisdiction's foreign sovereign debt; (ii) play important roles in underwriting and market making in State, provincial, and municipal debt issuances; and (iii) act as intermediaries through which a government's financial and monetary policies operate. This commenter stated that, due to these considerations, restrictions on the ability of banking entities to act as primary dealer are likely to harm the governments they serve. *See* IIB/EBF.

[445] Final rule § 75.4(a)(2)(ii).

[446] The proposed rule required the underwriting activities of the banking entity with respect to the covered financial position to be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § 75.4(a)(2)(v).

[447] *See supra* Part VI.A.2.c.2.b. (discussing commenters' concerns that the proposed near term customer demand requirement may limit a banking entity's ability to retain an unsold allotment).

[448] A banking entity may not structure a complex instrument on its own initiative using the underwriting exemption. It may use the underwriting exemption only with respect to distributions of securities that comply with the final rule. The Agencies believe this requirement addresses one commenter's concern that a banking entity could rely on the underwriting exemption without regard to anticipated customer demand. *See* AFR *et al.* (Feb. 2012) In addition, a trading desk hedging the risks of an underwriting position in a complex, novel instrument must comply with the hedging exemption in the final rule.

[449] An issuer or selling security holder for purposes of this rule may include, among others, corporate issuers, sovereign issuers for which the banking entity acts as primary dealer (or functional equivalent), or any other person that is an issuer, as defined in final rule § 75.3(e)(9), or a selling security holder, as defined in final rule § 75.4(a)(5). The Agencies believe that the underwriting exemption in the final rule should generally allow a primary dealer (or functional equivalent) to act as an underwriter for a sovereign government's issuance of its debt because, similar to other underwriting activities, this involves a banking entity agreeing to distribute securities for an issuer (in this case, the foreign sovereign) and engaging in a distribution of such securities. *See* SIFMA *et al.*

expectation of demand does not require a belief that the securities will be placed immediately. The time it takes to carry out a distribution may differ based on the liquidity, maturity, and depth of the market for the type of security.[450]

This requirement is not intended to prevent a trading desk from distributing an offering over a reasonable time consistent with market conditions or from retaining an unsold allotment of the securities acquired from an issuer or selling security holder where holding such securities is necessary due to circumstances such as less-than-expected purchaser demand at a given price.[451] An unsold allotment is, however, subject to the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position.[452] The definition of ''underwriting position'' includes, among other things, any residual position from the distribution that is managed by the trading desk. The final rule includes the requirement to make reasonable efforts to sell or otherwise reduce the trading desk's underwriting position in order to respond to comments on the issue of when a banking entity may retain an unsold allotment when it is acting as an underwriter, as discussed in more detail below, and ensure that the exemption is available only for activities that involve underwriting activities, and not prohibited proprietary trading.[453]

As a general matter, commenters expressed differing views on whether an underwriter should be permitted to hold an unsold allotment for a certain period of time after the initial distribution. For example, a few commenters suggested that limitations on retaining an unsold allotment would increase the cost of raising capital[454] or would negatively impact certain types of securities offerings (*e.g.,* bought deals, rights offerings, and fixed-income offerings).[455] Other commenters, however, expressed concern that the proposed exemption would allow a banking entity to retain a portion of a distribution for speculative purposes.[456]

The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position appropriately addresses both sets of comments. More specifically, this standard clarifies that an underwriter generally may retain an unsold allotment that it was unable to sell to purchasers as part of the initial distribution of securities, provided it had a reasonable expectation of buying interest and engaged in reasonable selling efforts.[457] This should reduce the potential for the negative impacts of a more stringent approach predicted by commenters, such as increased fees for underwriting, greater costs to businesses for raising capital, and potential fire sales of unsold allotments.[458] However, to address concerns that a banking entity may retain an unsold allotment for purely speculative purposes, the Agencies are requiring that reasonable efforts be made to sell or otherwise

(Prop. Trading) (Feb. 2012); IIB/EBF; Banco de México. A banking entity acting as primary dealer (or functional equivalent) may also be able to rely on the market-making exemption or other exemptions for some of its activities. *See infra* Part VI.A.3.c.2.c. The final rule defines ''client, customer, or counterparty'' for purposes of the underwriting exemption as ''market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.'' Final rule § 75.4(a)(7).

[450] One commenter stated that, in the case of a securitization, an underwriting should be seen as a distribution of all, or nearly all, of the securities related to a securitization (excluding the amount required for credit risk retention purposes) along a time line designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* Sens. Merkley & Levin (Feb. 2012). The final rule's near term customer demand requirement considers the liquidity, maturity, and depth of the market for the type of security and recognizes that the amount of time a trading desk may need to hold an underwriting position may vary based on these factors. The final rule does not, however, adopt a standard that applies differently based solely on the particular type of security being distributed (*e.g.,* an asset-backed security versus an equity security) or that precludes certain types of securities from being distributed by a banking entity acting as an underwriter in accordance with the requirements of this exemption because the Agencies believe the statute is best read to permit a banking entity to engage in underwriting activity to facilitate distributions of securities by issuers and selling security holders, regardless of type, to provide client-oriented financial services. That reading is consistent with the statute's language and finds support in the legislative history. *See* 156 Cong. Rec. S5895–S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the underwriting exemption permits ''transactions that are technically trading for the account of the firm but, in fact, facilitate the provision of near-term client-oriented financial services''). In addition, with respect to this commenter's statement regarding credit risk retention requirements, the Agencies note that compliance with the credit risk retention requirements of Section 15G of the Exchange Act would not impact the availability of the underwriting exemption in the final rule.

[451] This approach should help address commenters' concerns that an inflexible interpretation of the near term demand requirement could result in fire sales, higher fees for underwriting services, or reluctance to act as an underwriter for certain types of distributions that present a greater risk of unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. Further, the Agencies believe this should reduce commenters' concerns that, to the extent a delayed distribution of securities, which are acquired as a result of an outstanding bridge loan, is able to qualify for the underwriting exemption, a stringent interpretation of the near term demand requirement could prevent a banking entity from retaining such securities if market conditions are suboptimal or marketing efforts are not entirely successful. *See* RBC; BoA; LSTA (Feb. 2012). In response to one commenter's request that the Agencies allow a banking entity to assess near term demand at the time of the initial extension of the bridge commitment, the Agencies believe it could be appropriate to determine whether the banking entity has a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired at that time, but note that the trading desk would continue to be subject to the requirement to make reasonable efforts to sell the resulting underwriting position at the time of the initial distribution and for the remaining time the securities are in its inventory. *See* LSTA (Feb. 2012).

[452] The Agencies believe that requiring a trading desk to make reasonable efforts to sell or otherwise reduce its underwriting position addresses commenters' concerns about the risks associated with unsold allotments or the retention of underwritten instruments because this requirement is designed to prevent a trading desk from retaining an unsold allotment for speculative purposes when there is customer buying interest for the relevant security at commercially reasonable prices. Thus, the Agencies believe this obviates the need for certain additional requirements suggested by commenters. *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); CalPERS. The final rule strikes an appropriate balance between the concerns raised by these commenters and those noted by other commenters regarding the potential market impacts of strict requirements against holding an unsold allotment, such as higher fees to underwriting clients, fire sales of unsold allotments, or general reluctance to participate in any distribution that presents a risk of an unsold allotment. The requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should not cause the market impacts predicted by these commenters because it does not prevent an underwriter from retaining an unsold allotment for a reasonable period or impose strict holding period limits on unsold allotments. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading); Fidelity.

[453] This approach is generally consistent with one commenter's suggested approach to addressing the issue of unsold allotments. *See, e.g.,* Goldman (Prop. Trading) (suggesting that a banking entity be permitted to hold a residual position under the underwriting exemption as long as it continues to take reasonable steps to attempt to dispose of the residual position in light of existing market conditions). In addition, allowing an underwriter to retain an unsold allotment under certain circumstances is consistent with the proposal. *See* Joint Proposal, 76 FR at 68867 (''There may be circumstances in which an underwriter would hold securities that it could not sell in the distribution for investment purposes. If the acquisition of such unsold securities were in connection with the underwriting pursuant to the permitted underwriting activities exemption, the underwriter would also be able to dispose of such securities at a later time.''); CFTC Proposal, 77 FR at 8352. A number of commenters raised questions about whether the rule would permit retaining an unsold allotment. *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC; AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[454] *See* Goldman (Prop. Trading); Fidelity.

[455] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; RBC.

[456] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy; Public Citizen; Alfred Brock.

[457] To the extent that an AP for an ETF is able to meet the terms of the underwriting exemption for its activity, it may be able to retain ETF shares that it created if it had a reasonable expectation of buying interest in the ETF shares and engages in reasonable efforts to sell the ETF shares. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[458] *See* Goldman (Prop. Trading); Fidelity; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC.

reduce the underwriting position, which includes any unsold allotment, within a reasonable period. The Agencies agree with these commenters that systematic retention of an underwriting position, without engaging in efforts to sell the position and without regard to whether the trading desk is able to sell the securities at a commercially reasonable price, would be indicative of impermissible proprietary trading intent.[459] The Agencies recognize that the meaning of ''reasonable period'' may differ based on the liquidity, maturity, and depth of the market for the relevant type of securities. For example, an underwriter may be more likely to retain an unsold allotment in a bond offering because liquidity in the fixed-income market is generally not as deep as that in the equity market. If a trading desk retains an underwriting position for a period of time after the distribution, the trading desk must manage the risk of its underwriting position in accordance with its inventory and risk limits and authorization procedures. As discussed above, hedging transactions undertaken in connection with such risk management activities must be conducted in compliance with the hedging exemption in § 75.5 of the final rule.

The Agencies emphasize that the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position applies to the entirety of the trading desk's underwriting position. As a result, this requirement applies to a number of different scenarios in which an underwriter may hold a long or short position in the securities that are the subject of a distribution for a period of time. For example, if an underwriter is facilitating a distribution of securities for which there is sufficient investor demand to purchase the securities at the offering price, this requirement would prevent the underwriter from retaining a portion of the allotment for its own account instead of selling the securities to interested investors. If instead there was insufficient investor demand at the time of the initial offering, this requirement would recognize that it may be appropriate for the underwriter to hold an unsold allotment for a reasonable period of time. Under these circumstances, the underwriter would need to make reasonable efforts to sell the unsold allotment when there is sufficient market demand for the securities.[460] This requirement would also apply in situations where the underwriters sell securities in excess of the number of securities to which the underwriting commitment relates, resulting in a syndicate short position in the same class of securities that were the subject of the distribution.[461] This provision of the final exemption would require reasonable efforts to reduce any portion of the syndicate short position attributable to the banking entity that is acting as an underwriter. Such reduction could be accomplished if, for example, the managing underwriter exercises an overallotment option or shares are purchased in the secondary market to cover the short position.

The near term demand requirement, including the requirement to make reasonable efforts to reduce the underwriting position, represents a new regulatory requirement for banking entities engaged in underwriting. At the margins, this requirement could alter the participation decision for some banking entities with respect to certain types of distributions, such as distributions that are more likely to result in the banking entity retaining an underwriting position for a period of time.[462] However, the Agencies recognize that liquidity, maturity, and depth of the market vary across types of securities, and the Agencies expect that the express recognition of these differences in the rule should help mitigate any incentive to exit the underwriting business for certain types of securities or types of distributions.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

Section 75.4(a)(2)(i) of the proposed exemption required a banking entity to establish an internal compliance program, as required by § 75.20 of the proposed rule, that is designed to ensure the banking entity's compliance with the requirements of the underwriting exemption, including reasonably designed written policies and procedures, internal controls, and independent testing.[463] This requirement was proposed so that any banking entity relying on the underwriting exemption would have reasonably designed written policies and procedures, internal controls, and independent testing in place to support its compliance with the terms of the exemption.[464]

b. Comments on the Proposed Compliance Program Requirement

Commenters did not directly address the proposed compliance program requirement in the underwriting exemption. Comments on the proposed compliance program requirement of § 75.20 of the proposed rule are discussed in Part VI.C., below.

c. Final Compliance Program Requirement

The final rule includes a compliance program requirement that is similar to the proposed requirement, but the Agencies are making certain enhancements to emphasize the importance of a strong internal compliance program. More specifically, the final rule requires that a banking entity's compliance program specifically include reasonably designed written policies and procedures, internal controls, analysis and independent testing[465] identifying and addressing: (i) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;[466] (ii) limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties;[467] (iii) internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits;[468] and (iv) authorization procedures, including escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis of the basis for any temporary or permanent increase to one or more of a trading desk's limits, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of

[459] *See* AFR *et al.* (Feb. 2012); CalPERS; Occupy.

[460] The trading desk's retention and sale of the unsold allotment must comply with the Federal securities laws and regulations, but is otherwise permitted under the underwriting exemption.

[461] *See supra* note 408.

[462] For example, some commenters suggested that the proposed underwriting exemption could have a chilling effect on banking entities' willingness to engage in underwriting activities. *See, e.g.,* Lord Abbett; Fidelity. Further, some commenters expressed concern that the proposed near term customer demand requirement might negatively impact certain forms of capital-raising if the requirement is interpreted narrowly or inflexibly. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; BDA (Feb. 2012); RBC.

[463] *See* proposed rule § 75.4(a)(2)(i).

[464] *See* Joint Proposal, 76 FR at 68866; CFTC Proposal, 77 FR at 8352.

[465] The independent testing standard is discussed in more detail in Part VI.C., which discusses the compliance program requirement in § 75.20 of the final rule.

[466] *See* final rule § 75.4(a)(2)(iii)(A).

[467] *See* final rule § 75.4(a)(2)(iii)(B). A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. *See id.*

[468] *See* final rule § 75.4(a)(2)(iii)(C).

such demonstrable analysis and approval.[469]

As noted above, the proposed compliance program requirement did not include the four specific elements listed above in the proposed underwriting exemption, although each of these provisions was included in some form in the detailed compliance program requirement under Appendix C of the proposed rule.[470] The Agencies are moving these particular requirements, with certain enhancements, into the underwriting exemption because the Agencies believe these are core elements of a program to ensure compliance with the underwriting exemption. These compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in underwriting activity under § 75.4(a) of the final rule. Each of the requirements in paragraphs (a)(2)(iii)(A) through (D) must be appropriately tailored to the individual trading activities and strategies of each trading desk.

The compliance program requirement in the underwriting exemption is substantially similar to the compliance program requirement in the market-making exemption, except that the Agencies are requiring more detailed risk management procedures in the market-making exemption due to the nature of that activity.[471] The Agencies believe including similar compliance program requirements in the underwriting and market-making exemptions may reduce burdens associated with building and maintaining compliance programs for each trading desk.

Identifying in the compliance program the relevant products, instruments, and exposures in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the underwriting exemption. For example, this requirement should prevent an individual trader on an underwriting desk from establishing positions in instruments that are unrelated to the desk's underwriting function. Further, the identification of permissible products, instruments, and exposures will help form the basis for the specific types of position and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, maturity, and depth of the market for the relevant type of security.

A trading desk must have limits on the amount, types, and risk of the securities in its underwriting position, level of exposures to relevant risk factors arising from its underwriting position, and period of time a security may be held. Limits established under this provision, and any modifications to these limits made through the required escalation procedures, must account for the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties. Among other things, these limits should be designed to prevent a trading desk from systematically retaining unsold allotments even when there is customer demand for the positions that remain in the trading desk's inventory. The Agencies recognize that trading desks' limits may differ across types of securities and acknowledge that trading desks engaged in underwriting activities in less liquid securities, such as corporate bonds, may require different inventory, risk exposure, and holding period limits than trading desks engaged in underwriting activities in more liquid securities, such as certain equity securities. A trading desk hedging the risks of an underwriting position must comply with the hedging exemption, which provides for compliance procedures regarding risk management.[472]

Furthermore, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits.[473] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes).

As noted above, a banking entity's compliance program for trading desks engaged in underwriting activity must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval.[474] Thus, to increase a limit of a trading desk, there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § 75.20(b)(6).

As discussed in more detail in Part VI.C., the Agencies recognize that the compliance program requirements in the final rule will impose certain costs on banking entities but, on balance, the Agencies believe such requirements are necessary to facilitate compliance with the statute and the final rule and to reduce the risk of evasion.[475]

4. Compensation Requirement

a. Proposed Compensation Requirement

Another provision of the proposed underwriting exemption required that the compensation arrangements of persons performing underwriting activities at the banking entity must be designed not to encourage proprietary risk-taking.[476] In connection with this requirement, the proposal clarified that although a banking entity relying on the underwriting exemption may appropriately take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk, the banking entity should provide compensation incentives that primarily reward client revenues and effective client service, not proprietary risk-taking.[477]

b. Comments on the Proposed Compensation Requirement

A few commenters expressed general support for the proposed requirement, but suggested certain modifications that they believed would enhance the requirement and make it more effective.[478] Specifically, one

[469] *See* final rule § 75.4(a)(2)(iii)(D).

[470] *See* Joint Proposal, 76 FR at 68963–68967 (requiring certain banking entities to establish, maintain, and enforce compliance programs with, among other things: (i) Written policies and procedures that describe a trading unit's authorized instruments and products; (ii) internal controls for each trading unit, including risk limits for each trading unit and surveillance procedures; and (iii) a management framework, including management procedures for overseeing compliance with the proposed rule).

[471] *See* final rule §§ 75.4(a)(2)(iii), 75.4(b)(2)(iii).

[472] *See* final rule § 75.5.

[473] *See* final rule § 75.4(a)(2)(iii)(C).

[474] *See* final rule § 75.4(a)(2)(iii)(D).

[475] *See* Part VI.C. (discussing the compliance program requirement in § 75.20 of the final rule).

[476] *See* proposed rule § 75.4(a)(2)(vii); Joint Proposal, 76 FR at 68868; CFTC Proposal, 77 FR at 8353.

[477] *See id.*

[478] *See* Occupy; AFR *et al.* (Feb. 2012); Better Markets (Feb. 2012).

commenter suggested tailoring the requirement to underwriting activity by, for example, ensuring that personnel involved in underwriting are given compensation incentives for the successful distribution of securities off the firm's balance sheet and are not rewarded for profits associated with securities that are not successfully distributed (although losses from such positions should be taken into consideration in determining the employee's compensation). This commenter further recommended that bonus compensation for a deal be withheld until all or a high percentage of the relevant securities are distributed.[479] Finally, one commenter suggested that the term ''designed'' should be removed from this provision.[480]

c. Final Compensation Requirement

Similar to the proposed rule, the underwriting exemption in the final rule requires that the compensation arrangements of persons performing the banking entity's underwriting activities, as described in the exemption, be designed not to reward or incentivize prohibited proprietary trading.[481] The Agencies do not intend to preclude an employee of an underwriting desk from being compensated for successful underwriting, which involves some risk-taking.

Consistent with the proposal, activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of securities underwritten by the banking entity are inconsistent with the underwriting exemption. A banking entity may, however, take into account revenues resulting from movements in the price of securities that the banking entity underwrites to the extent that such revenues reflect the effectiveness with which personnel have managed underwriting risk. The banking entity should provide compensation incentives that primarily reward client revenues and effective client services, not prohibited proprietary trading. For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the underwriting exemption.

The Agencies are not adopting an approach that prevents an employee from receiving any compensation related to profits arising from an unsold allotment, as suggested by one commenter, because the Agencies believe the final rule already includes sufficient controls to prevent a trading desk from intentionally retaining an unsold allotment to make a speculative profit when such allotment could be sold to customers.[482] The Agencies also are not requiring compensation to be vested for a period of time, as recommended by one commenter to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement because a banking entity must establish limits for a trading desk's underwriting position and the trading desk must make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period.[483] The Agencies continue to believe it is appropriate to focus on the design of a banking entity's compensation structure, so the Agencies are not removing the term ''designed'' from this provision.[484] This retains an objective focus on actions that the banking entity can control—the design of its incentive compensation program—and avoids a subjective focus on whether an employee feels incentivized by compensation, which may be more difficult to assess. In addition, the framework of the final compensation requirement will allow banking entities to better plan and control the design of their compensation arrangements, which should reduce costs and uncertainty and enhance monitoring, than an approach focused solely on individual outcomes.

5. Registration Requirement

a. Proposed Registration Requirement

Section 75.4(a)(2)(iv) of the proposed rule would have required that a banking entity have the appropriate dealer registration or be exempt from registration or excluded from regulation as a dealer to the extent that, in order to underwrite the security at issue, a person must generally be a registered securities dealer, municipal securities dealer, or government securities dealer.[485] Further, if the banking entity was engaged in the business of a dealer outside the United States in a manner for which no U.S. registration is required, the proposed rule would have required the banking entity to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.

b. Comments on Proposed Registration Requirement

Commenters generally did not address the proposed dealer requirement in the underwriting exemption. However, as discussed below in Part VI.A.3.c.2.b., a number of commenters addressed a similar requirement in the proposed market-making exemption.

c. Final Registration Requirement

The requirement in § 75.4(a)(2)(vi) of the underwriting exemption, which provides that the banking entity must be licensed or registered to engage in underwriting activity in accordance with applicable law, is substantively similar to the proposed dealer registration requirement in § 75.4(a)(2)(iv) of the proposed rule. The primary difference between the proposed requirement and the final requirement is that the Agencies have simplified the language of the rule. The Agencies have also made conforming changes to the corresponding requirement in the market-making exemption to promote consistency across the exemptions, where appropriate.[486]

As was proposed, this provision will require a U.S. banking entity to be an SEC-registered dealer in order to rely on the underwriting exemption in connection with a distribution of securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[487] To the extent that a banking entity relies on the underwriting exemption in

[479] *See* AFR *et al.* (Feb. 2012).

[480] *See* Occupy.

[481] *See* final rule § 75.4(a)(2)(iv); proposed rule § 75.4(a)(2)(vii). This is consistent with the final compensation requirements in the market-making and hedging exemptions. *See* final rule § 75.4(b)(2)(v); final rule § 75.5(b)(3).

[482] *See* AFR *et al.* (Feb. 2012); *supra* Part VI.A.2.c.2.c. (discussing the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position).

[483] *See* AFR *et al.* (Feb. 2012).

[484] *See* Occupy.

[485] *See* proposed rule § 75.4(a)(2)(iv); Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353. The proposal clarified that, in the case of a financial institution that is a government securities dealer, such institution must have filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act. *See* Joint Proposal, 76 FR at 68867; CFTC Proposal, 77 FR at 8353.

[486] *See* Part VI.A.3.c.6. (discussing the registration requirement in the market-making exemption).

[487] For example, if a banking entity is a bank engaged in underwriting asset-backed securities for which it would be required to register as a securities dealer but for the exclusion contained in section 3(a)(5)(C)(iii) of the Exchange Act, the final rule would not require the banking entity to be a registered securities dealer to underwrite the asset-backed securities. *See* 15 U.S.C. 78c(a)(5)(C)(iii).

connection with a distribution of municipal securities or government securities, rather than the exemption in § 75.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer, if required by applicable law. However, this provision does not require a banking entity to register in order to qualify for the underwriting exemption if the banking entity is not otherwise required to register by applicable law.

The Agencies have determined that, for purposes of the underwriting exemption, rather than require a banking entity engaged in the business of a securities dealer outside the United States to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration provisions if required under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). In response to comments, the final rule recognizes that certain foreign jurisdictions may not provide for substantive regulation of dealing businesses.[488] The Agencies do not believe it is necessary to preclude banking entities from engaging in underwriting activities in such foreign jurisdictions to achieve the goals of section 13 of the BHC Act because these banking entities would continue to be subject to the other requirements of the underwriting exemption.

6. Source of Revenue Requirement

a. Proposed Source of Revenue Requirement

Under § 75.4(a)(2)(vi) of the proposed rule, the underwriting activities of a banking entity would have been required to be designed to generate revenues primarily from fees, commissions, underwriting spreads, or other income not attributable to appreciation in the value of covered financial positions or hedging of covered financial positions.[489] The proposal clarified that underwriting spreads would include any ''gross spread'' (*i.e.,* the difference between the price an underwriter sells securities to the public and the price it purchases them from the issuer) designed to compensate the underwriter for its services.[490] This requirement provided that activities conducted in reliance on the underwriting exemption should demonstrate patterns of revenue generation and profitability consistent with, and related to, the services an underwriter provides to its customers in bringing securities to market, rather than changes in the market value of the underwritten securities.[491]

b. Comments on the Proposed Source of Revenue Requirement

A few commenters requested certain modifications to the proposed source of revenue requirement. These commenters' suggested revisions were generally intended either to refine the standard to better account for certain activities or to make it more stringent.[492] Three commenters expressed concern that the proposed source of revenue requirement would negatively impact a banking entity's ability to act as a primary dealer or in a similar capacity.[493]

With respect to suggested modifications, one commenter recommended that ''customer revenue'' include revenues attributable to syndicate activities, hedging activities, and profits and losses from sales of residual positions, as long as the underwriter makes a reasonable effort to dispose of any residual position in light of existing market conditions.[494] Another commenter indicated that the rule would better address securitization if it required compensation to be linked in part to risk minimization for the securitizer and in part to serving customers. This commenter suggested that such a framework would be preferable because, in the context of securitizations, fee-based compensation structures did not previously prevent banking entities from accumulating large and risky positions with significant market exposure.[495]

To strengthen the proposed requirement, one commenter requested that the terms ''designed'' and ''primarily'' be removed and replaced by the word ''solely.''[496] Two other commenters requested that this requirement be interpreted to prevent a banking entity from acting as an underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price.[497]

c. Final Rule's Approach To Assessing Source of Revenue

The Agencies believe the final rule includes sufficient controls around an underwriter's source of revenue and have determined not to adopt the additional requirement included in proposed rule § 75.4(a)(2)(vi). The Agencies believe that removing this requirement addresses commenters' concerns that the proposed requirement did not appropriately reflect certain revenue sources from underwriting activity[498] or may impact primary dealer activities.[499] At the same time, the final rule continues to include provisions that focus on whether an underwriter is generating underwriting-related revenue and that should limit an underwriter's ability to generate revenues purely from price appreciation. In particular, the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position within a reasonable period, which was not included in the proposed rule, should limit an underwriter's ability to gain revenues purely from price appreciation related to its underwriter position. Similarly, the determination of whether an underwriter receives special compensation for purposes of the definition of ''distribution'' takes into account whether a banking entity is generating underwriting-related revenue.

The final rule does not adopt a requirement that prevents an underwriter from generating any revenue from price appreciation out of concern that such a requirement could prevent an underwriter from retaining an unsold allotment under any

[488] *See infra* Part VI.A.3.c.6.c. (discussing comments on this issue with respect to the proposed dealer registration requirement in the market-making exemption).

[489] *See* proposed rule § 75.4(a)(2)(vi); Joint Proposal, 76 FR at 68867–68868; CFTC Proposal, 77 FR at 8353.

[490] *See* Joint Proposal, 76 FR at 68867–68868 n.142; CFTC Proposal, 77 FR at 8353 n.148.

[491] *See* Joint Proposal, 76 FR at 68867–68868; CFTC Proposal, 77 FR at 8353.

[492] *See* Goldman (Prop. Trading); Occupy; Sens. Merkley & Levin (Feb. 2012).

[493] *See* Banco de México (stating that primary dealers need to profit from resulting proprietary positions in foreign sovereign debt, including by holding significant positions in anticipation of future price movements, in order to make the primary dealer business financially attractive); IIB/EBF (noting that primary dealers may actively seek to profit from price and interest rate movements of their holdings, which the relevant sovereign entity supports because such activity provides much-needed liquidity for securities that are otherwise largely purchased pursuant to buy-and-hold strategies by institutional investors and other entities seeking safe returns and liquidity buffers); Japanese Bankers Ass'n.

[494] *See* Goldman (Prop. Trading).

[495] *See* Sens. Merkley & Levin (Feb. 2012).

[496] *See* Occupy (requesting that the rule require automatic disgorgement of any profits arising from appreciation in the value of positions in connection with underwriting activities).

[497] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[498] *See* Goldman (Prop. Trading).

[499] *See* Banco de México; IIB/EBF; Japanese Bankers Ass'n.

circumstances, which would be inconsistent with other provisions of the exemption.[500] Similarly, the Agencies are not adopting a source of revenue requirement that would prevent a banking entity from acting as underwriter for a distribution of securities if such securities lack a discernible and sufficiently liquid pre-existing market and a foreseeable market price, as suggested by two commenters.[501] The Agencies believe these commenters' concern is mitigated by the near term demand requirement, which requires a trading desk to have a reasonable expectation of demand from other market participants for the amount and type of securities to be acquired from an issuer or selling security holder for distribution.[502] Further, one commenter recommended a revenue requirement directed at securitization activities to prevent banking entities from accumulating large and risky positions with significant market exposure.[503] The Agencies believe the requirement to make reasonable efforts to sell or otherwise reduce the underwriting position should achieve this stated goal and, thus, the Agencies do not believe an additional revenue requirement for securitization activity is needed.[504]

3. Section 75.4(b): Market-Making Exemption

a. Introduction

In adopting the final rule, the Agencies are striving to balance two goals of section 13 of the BHC Act: To allow market making, which is important to well-functioning markets as well as to the economy, and simultaneously to prohibit proprietary trading, unrelated to market making or other permitted activities, that poses significant risks to banking entities and the financial system. In response to comments on the proposed market-making exemption, the Agencies are adopting certain modifications to the proposed exemption to better account for the varying characteristics of market making-related activities across markets and asset classes, while requiring that banking entities maintain a robust set of risk controls for their market making-related activities. A flexible approach to this exemption is appropriate because the activities a market maker undertakes to provide important intermediation and liquidity services will differ based on the liquidity, maturity, and depth of the market for a given type of financial instrument. The statute specifically permits banking entities to continue to provide these beneficial services to their clients, customers, and counterparties.[505] Thus, the Agencies are adopting an approach that recognizes the full scope of market making-related activities banking entities currently undertake and requires that these activities be subject to clearly defined, verifiable, and monitored risk parameters.

b. Overview

1. Proposed Market-Making Exemption

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of securities, derivatives, contracts of sale of a commodity for future delivery, and options on any of the foregoing in connection with market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[506]

Section 75.4(b) of the proposed rule would have implemented this statutory exemption by requiring that a banking entity's market making-related activities comply with seven standards. As discussed in the proposal, these standards were designed to ensure that any banking entity relying on the exemption would be engaged in *bona fide* market making-related activities and, further, would conduct such activities in a way that was not susceptible to abuse through the taking of speculative, proprietary positions as a part of, or mischaracterized as, market making-related activities. The Agencies proposed to use additional regulatory and supervisory tools in conjunction with the proposed market-making exemption, including quantitative measurements for banking entities engaged in significant covered trading activity in proposed Appendix A, commentary on how the Agencies proposed to distinguish between permitted market making-related activity and prohibited proprietary trading in proposed Appendix B, and a compliance regime in proposed § 75.20 and, where applicable, Appendix C of the proposal. This multi-faceted approach was intended to address the complexities of differentiating permitted market making-related activities from prohibited proprietary trading.[507]

2. Comments on the Proposed Market-Making Exemption

The Agencies received significant comment regarding the proposed market-making exemption. In this Part, the Agencies highlight the main issues, concerns, and suggestions raised by commenters with respect to the proposed market-making exemption. As discussed in greater detail below, commenters' views on the effectiveness of the proposed exemption varied. Commenters discussed a broad range of topics related to the proposed market-making exemption including, among others: The overall scope of the proposed exemption and potential restrictions on market making in certain markets or asset classes; the potential market impact of the proposed market-making exemption; the appropriate level of analysis for compliance with the proposed exemption; the effectiveness of the individual requirements of the proposed exemption; and specific activities that should or should not be considered permitted market making-related activity under the rule.

a. Comments on the Overall Scope of the Proposed Exemption

With respect to the general scope of the exemption, a number of commenters expressed concern that the proposed approach to implementing the market-making exemption is too narrow or restrictive, particularly with respect to less liquid markets. These commenters expressed concern that the proposed exemption would not be workable in many markets and asset classes and does not take into account how market-making services are provided in those markets and asset classes.[508] Some

[500] *See* Occupy; *supra* Part VI.A.2.c.2. (discussing comments on unsold allotments and the requirement in the final rule to make reasonable efforts to sell or otherwise reduce the underwriting position).

[501] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[502] *See supra* Part VI.A.2.c.2.

[503] *See* Sens. Merkley & Levin (Feb. 2012).

[504] *See* final rule § 75.4(a)(2)(ii). Further, as noted above, this exemption does not permit the accumulation of assets for securitization. *See supra* Part VI.A.2.c.1.c.v.

[505] As discussed in Part VI.A.3.c.2.c.i., *infra,* the terms ''client,'' ''customer,'' and ''counterparty'' are defined in the same manner in the final rule. Thus, the Agencies use these terms synonymously throughout this discussion and sometimes use the term ''customer'' to refer to all entities that meet the definition of ''client, customer, and counterparty'' in the final rule's market-making exemption.

[506] 12 U.S.C. 1851(d)(1)(B).

[507] *See* Joint Proposal, 76 FR at 68869; CFTC Proposal, 77 FR at 8354–8355.

[508] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that the proposed exemption ''seems to view market making based on a liquid, exchange-traded equity model in which market makers are simple intermediaries akin to agents'' and that ''[t]his view does not fit market making even in equity markets and widely misses the mark for the vast majority of markets and asset classes''); SIFMA (Asset Mgmt.) (Feb. 2012); Credit Suisse (Seidel); ICI (Feb. 2012); BoA; Columbia Mgmt.; Comm. on Capital Markets Regulation; Invesco; ASF (Feb. 2012) (''The seven criteria in the proposed rule, and

commenters expressed particular concern that the proposed exemption may restrict or limit certain activities currently conducted by market makers (*e.g.,* holding inventory or interdealer trading).[509] Several commenters stated that the proposed exemption would create too much uncertainty regarding compliance [510] and, further, may have a chilling effect on banking entities' market making-related activities.[511] Due to the perceived restrictions and burdens of the proposed exemption, many commenters indicated that the rule may change the way in which market-making services are provided.[512] A number of commenters expressed the view that the proposed exemption is inconsistent with Congressional intent because it would restrict and reduce banking entities' current market making-related activities.[513]

Other commenters, however, stated that the proposed exemption was too broad and recommended that the rule place greater restrictions on market making, particularly in illiquid, nontransparent markets.[514] Many of these commenters suggested that the exemption should only be available for traditional market-making activity in relatively safe, ''plain vanilla'' instruments.[515] Two commenters represented that the proposed exemption would have little to no impact on banking entities' current market making-related services.[516]

Commenters expressed differing views regarding the ease or difficulty of distinguishing permitted market making-related activity from prohibited proprietary trading. A number of commenters represented that it is difficult or impossible to distinguish prohibited proprietary trading from permitted market making-related activity.[517] With regard to this issue, several commenters recommended that the Agencies not try to remove all aspects of proprietary trading from market making-related activity because doing so would likely restrict certain legitimate market-making activity.[518]

Other commenters were of the view that it is possible to differentiate between prohibited proprietary trading and permitted market making-related activity.[519] For example, one commenter stated that, while the analysis may involve subtle distinctions, the fundamental difference between a banking entity's market-making activities and proprietary trading activities is the emphasis in market making on seeking to meet customer needs on a consistent and reliable basis throughout a market cycle.[520] According to another commenter, holding substantial securities in a trading book for an extended period of time assumes the character of a proprietary position and, while there may be occasions when a customer-oriented purchase and subsequent sale extend over days and cannot be more quickly executed or hedged, substantial holdings of this character should be relatively rare and limited to less liquid markets.[521]

Several commenters expressed general concern that the proposed exemption may be applied on a transaction-by-transaction basis and explained the burdens that may result from such an approach.[522] Commenters appeared to attribute these concerns to language in the proposed exemption referring to a ''purchase or sale of a [financial instrument]'' [523] or to language in Appendix B indicating that the Agencies may assess certain factors and criteria at different levels, including a ''single significant transaction.'' [524] With respect to the burdens of a transaction-by-transaction analysis,

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the related criterion for identifying permitted hedging, are overly restrictive and will make it impractical for dealers to continue making markets in most securitized products.''); Chamber (Feb. 2012) (expressing particular concern about the commercial paper market).

[509] Several commenters stated that the proposed rule would limit a market maker's ability to maintain inventory. *See, e.g.,* NASP; Oliver Wyman (Dec. 2011); Wellington; Prof. Duffie; Standish Mellon; MetLife; Lord Abbett; NYSE Euronext; CIEBA; British Columbia; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Shadow Fin. Regulatory Comm.; Credit Suisse (Seidel); Morgan Stanley; Goldman (Prop. Trading); BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); IRSG; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); Australian Bankers Ass'n. (Feb. 2012); FEI; ASF (Feb. 2012); RBC; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; IHS; Oliver Wyman (Feb. 2012); Thakor Study (stating that by artificially constraining the security holdings that a banking entity can have in its inventory for market making or proprietary trading purposes, section 13 of the BHC Act will make bank risk management less efficient and may adversely impact the diversified financial services business model of banks). However, some commenters stated that market makers should seek to minimize their inventory or should not need large inventories. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz. Other commenters expressed concern that the proposed rule could limit interdealer trading. *See, e.g.,* Prof. Duffie; Credit Suisse (Seidel); JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); Oliver Wyman (Dec. 2011).

[510] *See, e.g.,* BlackRock; Putnam; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); MetLife; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Sen. Bennet; Sen. Corker; PUC Texas; Fidelity; ICI (Feb. 2012); Invesco.

[511] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Commissioner Barnier; NYSE Euronext; BoA; Citigroup (Feb. 2012); STANY; ICE; Chamber (Feb. 2012); BDA (Feb. 2012); Putnam; FTN; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; CME Group; Capital Group; PUC Texas; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; ICI (Feb. 2012); Invesco; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Thakor Study.

[512] For example, some commenters stated that market makers may revert to an agency or ''special order'' model. *See, e.g.,* Barclays; Goldman (Prop. Trading); ACLI (Feb. 2012); Vanguard; RBC. In addition, some commenters stated that new systems will be developed, such as alternative market matching networks, but these commenters disagreed about whether such changes would happen in the near term. *See, e.g.,* CalPERS; BlackRock; Stuyvesant; Comm. on Capital Markets Regulation. Other commenters stated that it is unlikely that new systems will be developed. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012). One commenter stated that the proposed rule may cause a banking organization that engages in significant market-making activity to give up its banking charter or spin off its market-making operations to avoid compliance with the proposed exemption. *See* Prof. Duffie.

[513] *See, e.g.,* NASP; Wellington; JPMC; Morgan Stanley; Credit Suisse (Seidel); BoA; Goldman (Prop. Trading); Citigroup (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); Chamber (Feb. 2012); Putnam; ICI (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Sen. Corker; Invesco.

[514] *See, e.g.,* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[515] *See, e.g.,* Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[516] *See* Occupy (''[I]t is unclear that this rule, as written, will markedly alter the current customer-serving business. Indeed, this rule has gone to excessive lengths to protect the covered banking entities' ability to maintain responsible customer-facing business.''); Alfred Brock.

[517] *See, e.g.,* Rep. Bachus *et al.;* IIF; Morgan Stanley (stating that beyond walled-off proprietary trading, the line is hard to draw, particularly because both require principal risk-taking and the features of market making vary across markets and asset classes and become more pronounced in times of market stress); CFA Inst. (representing that the distinction is particularly difficult in the fixed-income market); ICFR; Prof. Duffie; WR Hambrecht.

[518] *See, e.g.,* Chamber (Feb. 2012) (citing an article by Stephen Breyer stating that society should not expend disproportionate resources trying to reduce or eliminate ''the last 10 percent'' of the risks of a certain problem); JPMC; RBC; ICFR; Sen. Hagan. One of these commenters indicated that any concerns that banking entities would engage in speculative trading as a result of an expansive market-making exemption would be addressed by other reform initiatives (*e.g.,* Basel III implementation will provide laddered disincentives to holding positions as principal as a result of capital and liquidity requirements). *See* RBC.

[519] *See* Wellington; Paul Volcker; Better Markets (Feb. 2012); Occupy.

[520] *See* Wellington.

[521] *See* Paul Volcker.

[522] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); HSBC; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); PUC Texas; ERCOT; Invesco. *See also* IAA (stating that it is unclear whether the requirements must be applied on a transaction-by-transaction basis or if compliance with the requirements is based on overall activities). This issue is addressed in Part VI.A.3.c.1.c., *infra.*

[523] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading) (Feb. 2012). As explained above, the term ''covered financial position'' from the proposal has been replaced by the term ''financial instrument'' in the final rule. Because the types of instruments included in both definitions are identical, the term ''financial instrument'' is used throughout this Part.

[524] *See, e.g.,* Goldman (Prop. Trading); Wellington.

some commenters noted that banking entities can engage in a large volume of market-making transactions daily, which would make it burdensome to apply the exemption to each trade.[525] A few commenters indicated that, even if the Agencies did not intend to require transaction-by-transaction analysis, the proposed rule's language can be read to imply such a requirement. These commenters indicated that ambiguity on this issue could have a chilling effect on market making or could allow some examiners to rigidly apply the requirements of the exemption on a trade-by-trade basis.[526] Other commenters indicated that it would be difficult to determine whether a particular trade was or was not a market-making trade without consideration of the relevant unit's overall activities.[527] One commenter elaborated on this point by stating that ''an analysis that seeks to characterize specific transactions as either market making . . . or prohibited activity does not accord with the way in which modern trading units operate, which generally view individual positions as a bundle of characteristics that contribute to their complete portfolio.'' [528] This commenter noted that a position entered into as part of market making-related activities may serve multiple functions at one time, such as responding to customer demand, hedging a risk, and building inventory. The commenter also expressed concern that individual transactions or positions may not be severable or separately identifiable as serving a market-making purpose.[529] Two commenters suggested that the requirements in the market-making exemption be applied at the portfolio level rather than the trade level.[530]

Moreover, commenters also set forth their views on the organizational level at which the requirements of the proposed market-making exemption should apply.[531] The proposed exemption generally applied requirements to a ''trading desk or other organizational unit'' of a banking entity. In response to this proposed approach, commenters stated that compliance should be assessed at each trading desk or aggregation unit[532] or at each trading unit.[533]

Several commenters suggested alternative or additive means of implementing the statutory exemption for market making-related activity.[534] Commenters' recommended approaches varied, but a number of commenters requested approaches involving one or more of the following elements: (i) Safe harbors,[535] bright lines,[536] or presumptions of compliance with the exemption based on the existence of certain factors (*e.g.,* compliance program, metrics, general customer focus or orientation, providing liquidity, and/or exchange registration as a market maker); [537] (ii) a focus on metrics or other objective factors; [538] (iii) guidance on permitted market making-related activity, rather than rule requirements; [539] (iv) risk management structures and/or risk limits; [540] (v) adding a new customer-facing criterion or focusing on client-related activities; [541] (vi) capital and liquidity requirements; [542] (vii) development of individualized plans for each banking entity, in coordination with regulators; [543] (viii) ring fencing affiliates engaged in market making-related activity; [544] (ix) margin requirements; [545] (x) a compensation-focused approach; [546] (xi) permitting all swap dealing activity; [547] (xii) additional provisions regarding material conflicts of interest and high-risk assets and trading strategies; [548] and/or (xiii) making the exemption as broad as possible under the statute.[549]

[525] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays (stating that ''hundreds or thousands of trades can occur in a single day in a single trading unit'').

[526] *See, e.g.,* ICI (Feb. 2012); Barclays; Goldman (Prop. Trading).

[527] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[528] SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[529] *See id.* (suggesting that the Agencies ''give full effect to the statutory intent to allow market making by viewing the permitted activity on a holistic basis'').

[530] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable.

[531] *See* Wellington; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable. The Agencies address this topic in Part VI.A.3.c.1.c., *infra.*

[532] *See* Wellington. This commenter did not provide greater specificity about how it would define ''trading desk'' or ''aggregation unit.'' *See id.*

[533] *See* Morgan Stanley (stating that ''trading unit'' should be defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity''); SIFMA *et al.* (Prop. Trading) (Feb. 2012). One of these commenters discussed its suggested definition of ''trading unit'' in the context of the proposed requirement to record and report certain quantitative measurements, but it is unclear that the commenter was also suggesting that this definition be used for purposes of the market-making exemption. For example, this commenter expressed support for a multi-level approach to defining ''trading unit,'' and it is not clear how a definition that captures multiple organizational levels across a banking organization would work in the context of the market-making exemption. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggested that ''trading unit'' be defined ''at a level that presents its activities in the context of the whole'' and noting that the appropriate level may differ depending on the structure of the banking entity).

[534] *See, e.g.,* Wellington; Japanese Bankers Ass'n.; Prof. Duffie; IR&M; G2 FinTech; MetLife; NYSE Euronext; Anthony Flynn and Koral Fusselman; IIF; CalPERS; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Shadow Fin. Regulatory Comm.; John Reed; Prof. Richardson; Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Johnson & Prof. Stiglitz; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); WR Hambrecht; Vanguard; Capital Group; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Fidelity; Occupy; AFR *et al.* (Feb. 2012); Invesco; ISDA (Feb. 2012); Stephen Roach; Oliver Wyman (Feb. 2012). The Agencies respond to these comments in Part VI.A.3.b.3., *infra.*

[535] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Feb. 2012) (Oct. 2012) (suggesting a safe harbor for any trading desk that effects more than 50 percent of its transactions through sales representatives).

[536] *See, e.g.,* Flynn & Fusselman; Prof. Colesanti *et al.*

[537] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading) (suggesting that the rule: (i) Provide a general grant of authority to engage in any transactions entered into as part of a banking entity's market-making business, where ''market making'' is defined as ''the business of being willing to facilitate customer purchases and sales of [financial instruments] as an intermediary over time and in size, including by holding positions in inventory;'' and (ii) allow banking entities to monitor compliance with this exemption internally through their compliance and risk management infrastructure); PNC *et al.;* Oliver Wyman (Feb. 2012).

[538] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[539] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[540] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[541] *See, e.g.,* Morgan Stanley; Stephen Roach.

[542] *See, e.g.,* Prof. Duffie; CalPERS; STANY; ICE; Vanguard; Capital Group.

[543] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[544] *See, e.g.,* Prof. Duffie; Shadow Fin. Regulatory Comm. *See also* Wedbush.

[545] *See* WR Hambrecht.

[546] *See* G2 FinTech.

[547] *See* ISDA (Feb. 2012); ISDA (Apr. 2012).

[548] *See* Sens. Merkley & Levin (Feb. 2012) (stating that the exemption should expressly mention the conflicts provision and provide examples to warn against particular conflicts, such as recommending clients buy poorly performing assets in order to remove them from the banking entity's book or attempting to move market prices in favor of trading positions a banking entity has built up in order to make a profit); Stephen Roach (suggesting that the exemption integrate the limitations on permitted activities).

[549] *See* Fidelity (stating that the exemption needs to be as broad as possible to account for customer-facing principal trades, block trades, and market making in OTC derivatives). *See also* STANY (stating that it is better to make the exemption too broad than too narrow).

b. Comments Regarding the Potential Market Impact of the Proposed Exemption

As discussed above, several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity. Many of these commenters represented that, as a result, the proposed exemption would likely result in reduced liquidity,[550] wider bid-ask spreads,[551] increased market volatility,[552] reduced price discovery or price transparency,[553] increased costs of raising capital or higher financing costs,[554] greater costs for investors or consumers,[555] and slower execution times.[556] Some commenters expressed particular concern about potential impacts on institutional investors (*e.g.,* mutual funds and pension funds)[557] or on small or midsized companies.[558] A number of commenters discussed the interrelationship between primary and secondary market activity and indicated that restrictions on market making would impact the underwriting process.[559]

A few commenters expressed the view that reduced liquidity would not necessarily be a negative result.[560] For example, two commenters noted that liquidity is vulnerable to liquidity spirals, in which a high level of market liquidity during one period feeds a sharp decline in liquidity during the next period by initially driving asset prices upward and supporting increased leverage. The commenters explained that liquidity spirals lead to ''fire sales'' by market speculators when events reveal that assets are overpriced and speculators must sell their assets to reduce their leverage.[561] According to another commenter, banking entities' access to the safety net allows them to distort market prices and, arguably, produce excess liquidity. The commenter further represented that it would be preferable to allow the discipline of the market to choose the pricing of securities and the amount of liquidity.[562] Some commenters cited an economic study indicating that the U.S. financial system has become less efficient in generating economic growth

[550] *See, e.g.,* AllianceBernstein; Rep. Bachus *et al.* (Dec. 2011); EMTA; NASP; Wellington; Japanese Bankers Ass'n.; Sen. Hagan; Prof. Duffie; Investure; Standish Mellon; IR&M; MetLife; Lord Abbett; Commissioner Barnier; Quebec; IIF; Sumitomo Trust; Liberty Global; NYSE Euronext; CIEBA; EFAMA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); BDA (Feb. 2012); Putnam; Fixed Income Forum/Credit Roundtable; Western Asset Mgmt.; ACLI (Feb. 2012); IAA; CME Group; Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Australian Bankers Ass'n. (Feb. 2012); FEI; AFMA; Sen. Carper *et al.;* PUC Texas; ERCOT; IHS; Columbia Mgmt.; SSgA (Feb. 2012); PNC *et al.;* Eaton Vance; Fidelity; ICI (Feb. 2012); British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Union Asset; Sen. Casey; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012) (providing estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on hypothetical liquidity reduction scenarios); Thakor Study. The Agencies respond to comments regarding the potential market impact of the rule in Part VI.A.3.b.3., *infra.*

[551] *See, e.g.,* AllianceBernstein; Wellington; Investure; Standish Mellon; MetLife; Lord Abbett; Barclays; Goldman (Prop. Trading); Citigroup (Feb. 2012); BlackRock; Putnam; ACLI (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Sen. Carper *et al.;* IHS; Columbia Mgmt.; ICI (Feb. 2012) British Bankers' Ass'n.; Comm. on Capital Markets Regulation; Thakor Study (stating that section 13 of the BHC Act will likely result in higher bid-ask spreads by causing at least some retrenchment of banks from market making, resulting in fewer market makers and less competition).

[552] *See, e.g.,* Wellington; Prof. Duffie; Standish Mellon; Lord Abbett; IIF; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; Goldman (Prop. Trading); BDA (Feb. 2012); IHS; FTN; IAA; Wells Fargo (Prop. Trading); T. Rowe Price; Columbia Mgmt.; SSgA (Feb. 2012); Eaton Vance; British Bankers' Ass'n.; Comm. on Capital Markets Regulation.

[553] *See, e.g.,* Prof. Duffie (arguing that, for example, ''during the financial crisis of 2007–2009, the reduced market making capacity of major dealer banks caused by their insufficient capital levels resulted in dramatic downward distortions in corporate bond prices''); IIF; Barclays; IAA; Vanguard; Wellington; FTN.

[554] *See, e.g.,* AllianceBernstein; Chamber (Dec. 2011); Members of Congress (Dec. 2011); Wellington; Sen. Hagan; Prof. Duffie; IR&M; MetLife; Lord Abbett; Liberty Global; NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); NCSHA; ASF (Feb. 2012) (stating that ''[f]ailure to permit the activities necessary for banking entities to act in [a] market-making capacity [in asset-backed securities] would have a dramatic adverse effect on the ability of securitizers to access the asset-backed securities markets and thus to obtain the debt financing necessary to ensure a vibrant U.S. economy''); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; Chamber (Feb. 2012); IHS; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); Wells Fargo (Prop. Trading); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; FEI; AFMA; SSgA (Feb. 2012); PNC *et al.;* ICI (Feb. 2012); British Bankers' Ass'n.; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); GE (Feb. 2012); Thakor Study (stating that when a firm's cost of capital goes up, it invests less—resulting in lower economic growth and lower employment—and citing supporting data indicating that a 1 percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in aggregate annual capital spending by U.S. nonfarm firms and job losses between 550,000 and 1.1 million per year in the nonfarm sector). One commenter further noted that a higher cost of capital can lead a firm to make riskier, short-term investments. *See* Thakor Study.

[555] *See, e.g.,* Wellington; Standish Mellon; IR&M; MetLife; Lord Abbett; NYSE Euronext; CIEBA; Barclays; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; ICE; BlackRock; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); IAA; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); T. Rowe Price; Vanguard; Australian Bankers Ass'n. (Feb. 2012); FEI; Sen. Carper *et al.;* Columbia Mgmt.; SSgA (Feb. 2012); ICI (Feb. 2012); Comm. on Capital Markets Regulation; TMA Hong Kong; Sen. Casey; IHS; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); Thakor Study.

[556] *See, e.g.,* Barclays; FTN; Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012).

[557] *See, e.g.,* AllianceBernstein (stating that, to the extent the rule reduces liquidity provided by market makers, open end mutual funds that are largely driven by the need to respond to both redemptions and subscriptions will be immediately impacted in terms of higher trading costs); Wellington (indicating that periods of extreme market stress are likely to exacerbate costs and challenges, which could force investors such as mutual funds and pension funds to accept distressed prices to fund redemptions or pay current benefits); Lord Abbett (stating that certain factors, such as reduced bank capital to support market-making businesses and economic uncertainty, have already reduced liquidity and caused asset managers to have an increased preference for highly liquid credits and expressing concern that, if section 13 of the BHC Act further reduces liquidity, then: (i) asset managers' increased preference for highly liquid credit could lead to unhealthy portfolio concentrations, and (ii) asset managers will maintain a larger cash cushion in portfolios that may be subject to redemption, which will likely result in investors getting poorer returns); EFAMA; BlackRock (stating that investment decisions are heavily dependent on a liquidity factor input, so as liquidity dissipates, investment strategies become more limited and returns to investors are diminished by wider spreads and higher transaction costs); CFA Inst. (noting that a mutual fund that tries to liquidate holdings to meet redemptions may have difficulty selling at acceptable prices, thus impairing the fund's NAV for both redeeming investors and for those that remain in the fund); Putnam; Fixed Income Forum/Credit Roundtable; ACLI; T. Rowe Price; Vanguard; IAA; FEI; Sen. Carper *et al.;* Columbia Mgmt.; ICI (Feb. 2012); Invesco; Union Asset; Standish Mellon; Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[558] *See, e.g.,* CIEBA (stating that for smaller issuers in particular, market makers need to have incentives to make markets, and the proposal removes important incentives); ACLI (indicating that lower liquidity will most likely result in higher costs for issuers of debt and, for lesser known or lower quality issuers, this cost may be significant and in some cases prohibitive because the cost will vary depending on the credit quality of the issuer, the amount of debt it has in the market, and the maturity of the security); PNC *et al.* (expressing concern that a regional bank's market-making activity for small and middle market customers is more likely to be inappropriately characterized as impermissible proprietary trading due to lower trading volume involving less liquid securities); Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); Abbott Labs *et al.* (Feb. 21, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[559] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; RBC; NYSE Euronext; Credit Suisse (Seidel).

[560] *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson.

[561] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker (stating that at some point, greater liquidity, or the perception of greater liquidity, may encourage more speculative trading).

[562] *See* Prof. Richardson.

in recent years, despite increased trading volumes.[563]

Some commenters stated that it is unlikely the proposed rule would result in the negative market impacts identified above, such as reduced market liquidity.[564] For example, a few commenters stated that other market participants, who are not subject to section 13 of the BHC Act, may enter the market or increase their trading activities to make up for any reduction in banking entities' market-making activity or other trading activity.[565] For instance, one of these commenters suggested that the revenue and profits from market making will be sufficient to attract capital and competition to that activity.[566] In addition, one commenter expressed the view that prohibiting proprietary trading may support more liquid markets by ensuring that banking entities focus on providing liquidity as market makers, rather than taking liquidity from the market in the course of ''trading to beat'' institutional buyers like pension funds, university endowments, and mutual funds.[567] Another commenter stated that, while section 13 of the BHC Act may temporarily reduce trading volume and excessive liquidity at the peak of market bubbles, it should increase the long-run stability of the financial system and render genuine liquidity and credit availability more reliable over the long term.[568]

Other commenters, however, indicated that it is uncertain or unlikely that non-banking entities will enter the market or increase their trading activities, particularly in the short term.[569] For example, one commenter noted the investment that banking entities have made in infrastructure for trading and compliance would take smaller or new firms years and billions of dollars to replicate.[570] Another commenter questioned whether other market participants, such as hedge funds, would be willing to dedicate capital to fully serving customer needs, which is required to provide ongoing liquidity.[571] One commenter stated that even if non-banking entities move in to replace lost trading activity from banking entities, the value of the current interdealer network among market makers will be reduced due to the exit of banking entities.[572] Several commenters expressed the view that migration of market making-related activities to firms outside the banking system would be inconsistent with Congressional intent and would have potentially adverse consequences for the safety and soundness of the U.S. financial system.[573]

Many commenters requested additional clarification on how the proposed market-making exemption would apply to certain asset classes and markets or to particular types of market making-related activities. In particular, commenters requested greater clarity regarding the permissibility of: (i) Interdealer trading,[574] including trading for price discovery purposes or to test market depth; [575] (ii) inventory management; [576] (iii) block positioning activity; [577] (iv) acting as an authorized participant or market maker in ETFs; [578] (v) arbitrage or other activities that promote price transparency and liquidity; [579] (vi) primary dealer activity; [580] (vii) market making in futures and options; [581] (viii) market making in new or bespoke products or customized hedging contracts; [582] and (ix) inter-affiliate transactions.[583] As discussed in more detail in Part VI.B.2.c., a number of commenters requested that the market-making exemption apply to the restrictions on acquiring or retaining an ownership

[563] *See, e.g.,* Johnson & Prof. Stiglitz (citing Thomas Phillippon, ''Has the U.S. Finance Industry Become Less Efficient?,'' NYU Working Paper, Nov. 2011); AFR *et al.* (Feb. 2012); Public Citizen; Better Markets (Feb. 2012); Prof. Johnson.

[564] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012) (stating that there is no convincing, independent evidence that the rule would increase trading costs or reduce liquidity, and the best evidence available suggests that the buy-side firms would greatly benefit from the competitive pressures that transparency can bring); Better Markets (Feb. 2012) (''Industry's claim that [section 13 of the BHC Act] will 'reduce market liquidity, capital formation, and credit availability, and thereby hamper economic growth and job creation' disregard the fact that the financial crisis did more damage to those concerns than any rule or reform possibly could.''); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012); AFR *et al.* (Feb. 2012). One commenter stated that the proposed rule would improve market liquidity, efficiency, and price transparency. *See* Alfred Brock.

[565] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012). Similarly, one commenter indicated that non-banking entity market participants could fill the current role of banking entities in the market if implementation of the rule is phased in. *See* ACLI (Feb. 2012).

[566] *See* Better Markets (Feb. 2012).

[567] *See* Prof. Johnson.

[568] *See* AFR *et al.* (Feb. 2012).

[569] *See, e.g.,* Wellington; Prof. Duffie; Investure; IIF; Liberty Global; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Morgan Stanley; Barclays; BoA; STANY; SIFMA (Asset Mgmt.) (Feb. 2012); FTN; Western Asset Mgmt.; IAA; PUC Texas; ICI (Feb. 2012); IIB/EBF; Invesco. In addition, some commenters recognized that other market participants are likely to fill banking entities' roles in the long term, but not in the short term. *See, e.g.,* ICFR; Comm. on Capital Markets Regulation; Oliver Wyman (Feb. 2012).

[570] *See* Oliver Wyman (Feb. 2012) (''Major bank-affiliated market makers have large capital bases, balance sheets, technology platforms, global operations, relationships with clients, sales forces, risk infrastructure, and management processes that would take smaller or new dealers years and billions of dollars to replicate.'').

[571] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[572] *See* Thakor Study.

[573] *See, e.g.,* Prof. Duffie; Oliver Wyman (Feb. 2012).

[574] *See, e.g.,* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[575] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading).

[576] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[577] *See infra* Part VI.A.3.c.1.b.ii. (discussing commenters' requests for greater clarity regarding the permissibility of block positioning activity).

[578] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012).

[579] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012).

[580] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); Banco de México; IIB/EBF.

[581] *See* CME Group (requesting clarification that the market-making exemption permits a banking entity to engage in market making in exchange-traded futures and options because the dealer registration requirement in § 75.4(b)(2)(iv) of the proposed rule did not refer to such instruments and stating that lack of an explicit exemption would reduce market-making activities in these instruments, which would decrease liquidity). *But see* Johnson & Prof. Stiglitz (stating that the Agencies should pay special attention to options trading and other derivatives because they are highly volatile assets that are difficult if not impossible to effectively hedge, except through a completely matched position, and suggesting that options and similar derivatives may need to be required to be sold only as riskless principal under § 75.6(b)(1)(ii) of the proposed rule or significantly limited through capital charges); Sens. Merkley & Levin (Feb. 2012) (stating that asset classes that are particularly hard to hedge, such as options, should be given special attention under the hedging exemption).

[582] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). Other commenters, however, stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or customized derivatives. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

[583] *See, e.g.,* Japanese Bankers Ass'n. (stating that transactions with affiliates and subsidiaries and related to hedging activities are a type of market making-related activity or risk-mitigating hedging activity that should be exempted by the rule); SIFMA *et al.* (Prop. Trading) (Feb. 2012). According to one of these commenters, inter-affiliate transactions should be viewed as part of a coordinated activity for purposes of determining whether a banking entity qualifies for an exemption. This commenter stated that, for example, if a market maker shifts positions held in inventory to an affiliate that is better able to manage the risk of such positions, both the market maker and its affiliate would be engaged in permitted market making-related activity. This commenter further represented that fitting the inter-affiliate swap into the exemption may be difficult (*e.g.,* one of the affiliates entering into the swap may not be holding itself out as a willing counterparty). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

interest in a covered fund.[584] Some commenters stated that no other activities should be considered permitted market making-related activity under the rule.[585] In addition, a few commenters requested clarification that high-frequency trading would not qualify for the market-making exemption.[586]

3. Final Market-Making Exemption

After carefully considering comment letters, the Agencies are adopting certain refinements to the proposed market-making exemption. The Agencies are adopting a market-making exemption that is consistent with the statutory exemption for this activity and designed to permit banking entities to continue providing intermediation and liquidity services. The Agencies note that, while all market-making activity should ultimately be related to the intermediation of trading, whether directly to individual customers through bilateral transactions or more broadly to a given marketplace, certain characteristics of a market-making business may differ among markets and asset classes.[587] The final rule is intended to account for these differences to allow banking entities to continue to engage in market making-related activities by providing customer intermediation and liquidity services across markets and asset classes, if such activities do not violate the statutory limitations on permitted activities (*e.g.,* by involving or resulting in a material conflict of interest with a client, customer, or counterparty) and are conducted in conformance with the exemption.

At the same time, the final rule requires development and implementation of trading, risk and inventory limits, risk management strategies, analyses of how the specific market making-related activities are designed not to exceed the reasonably expected near term demands of customers, compensation standards, and monitoring and review requirements that are consistent with market-making activities.[588] These requirements are designed to distinguish exempt market making-related activities from impermissible proprietary trading. In addition, these requirements are designed to ensure that a banking entity is aware of, monitors, and limits the risks of its exempt activities consistent with the prudent conduct of market making-related activities.

As described in detail below, the final market-making exemption consists of the following elements:

- A framework that recognizes the differences in market making-related activities across markets and asset classes by establishing criteria that can be applied based on the liquidity, maturity, and depth of the market for the particular type of financial instrument.
- A general focus on analyzing the overall ''financial exposure'' and ''market-maker inventory'' held by any given trading desk rather than a transaction-by-transaction analysis. The ''financial exposure'' reflects the aggregate risks of the financial instruments, and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of its market making-related activities. The ''market-maker inventory'' means all of the positions, in the financial instruments for which the trading desk stands ready to make a market that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[589]
- A definition of the term ''trading desk'' that focuses on the operational functionality of the desk rather than its legal status, and requirements that apply at the trading desk level of organization within a single banking entity or across two or more affiliates.[590]
- Five requirements for determining whether a banking entity is engaged in permitted market making-related activities. Many of these criteria have similarities to the factors included in the proposed rule, but with important modifications in response to comments. These standards require that:
  - The trading desk that establishes and manages a financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;[591]
  - The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute and based on certain factors and analysis;[592]
  - The banking entity has established and implements, maintains, and enforces an internal compliance program that is reasonably designed to ensure its compliance with the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:
    - The financial instruments each trading desk stands ready to purchase and sell in accordance with § 75.4(b)(2)(i) of the final rule;
    - The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with its established limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading

[584] *See, e.g.,* Cleary Gottlieb; JPMC; BoA; Credit Suisse (Williams).

[585] *See, e.g.,* Occupy; Alfred Brock.

[586] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

[587] Consistent with the FSOC study and the proposal, the final rule recognizes that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular type of financial instrument. *See* Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8356; FSOC study (stating that ''characteristics of permitted activities in one market or asset class may not be the same in another market (e.g., permitted activities in a liquid equity securities market may vary significantly from an illiquid over-the-counter derivatives market)'').

[588] Certain of these requirements, like the requirements to have risk and inventory limits, risk management strategies, and monitoring and review requirements were included in the enhanced compliance program requirement in proposed Appendix C, but were not separately included in the proposed market-making exemption. Like the statute, the proposed rule would have required that market making-related activities be designed not to exceed the reasonably expected near term demand of clients, customers, or counterparties. The Agencies are adding an explicit requirement in the final rule that a trading desk conduct analyses of customer demand for purposes of complying with this statutory requirement.

[589] *See infra* Part VI.A.3.c.1.c.ii. *See also* final rule §§ 75.4(b)(4), (5).

[590] *See infra* Part VI.A.3.c.1.c.i. The term ''trading desk'' is defined as ''the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof.'' Final rule § 75.3(e)(13).

[591] *See* final rule § 75.4(b)(2)(i); *infra* Part VI.A.3.c.1.c.iii.

[592] *See* final rule § 75.4(b)(2)(ii); *infra* Part VI.A.3.c.2.c. In addition, the Agencies are adopting a definition of the terms ''client,'' ''customer,'' and ''counterparty'' in § 75.4(b)(3) of the final rule.

desk to mitigate these risks are and continue to be effective;[593]

▪ Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, including factors used to determine the reasonably expected near term demands of clients, customers, or counterparties, on: the amount, types, and risks of its market-maker inventory; the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; the level of exposures to relevant risk factors arising from its financial exposure; and the period of time a financial instrument may be held;

▪ Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

▪ Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of the market-making exemption, and independent review of such demonstrable analysis and approval;[594]

○ To the extent that any limit identified above is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;[595]

○ The compensation arrangements of persons performing market making-related activities are designed not to reward or incentivize prohibited proprietary trading;[596] and

• The banking entity is licensed or registered to engage in market making-related activities in accordance with applicable law.[597]

• The use of quantitative measurements to highlight activities that warrant further review for compliance with the exemption.[598] As discussed further in Part VI.C.3., the Agencies have reduced some of the compliance burdens by adopting a more tailored subset of metrics than was proposed to better focus on those metrics that the Agencies believe are most germane to the evaluation of the activities that firms conduct under the market-making exemption.

In refining the proposed approach to implementing the statute's market-making exemption, the Agencies closely considered the various alternative approaches suggested by commenters.[599] However, like the proposed approach, the final market-making exemption continues to adhere to the statutory mandate that provides for an exemption to the prohibition on proprietary trading for market making-related activities. Therefore, the final rule focuses on providing a framework for assessing whether trading activities are consistent with market making. The Agencies believe this approach is consistent with the statute[600] and strikes an appropriate balance between commenters' desire for both clarity and flexibility. For example, while a bright-line or safe harbor based approach would generally provide a high degree of certainty about whether an activity qualifies for the market-making exemption, it would also provide less flexibility to recognize the differences in market-making activities across markets and asset classes.[601] In addition, any bright-line approach would be more likely to be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the market-making exemption.[602] Although a purely guidance-based approach would provide greater flexibility, it would also provide less clarity, which could make it difficult for trading personnel, internal compliance personnel, and Agency supervisors and examiners to determine whether an activity complies with the rule and would lead to an increased risk of evasion of the statutory requirements.[603]

Some commenters suggested an approach to implementing the market-making exemption that would focus on metrics or other objective factors.[604] As discussed below, a number of commenters expressed support for using the metrics as a tool to monitor trading activity and not to determine compliance with the rule.[605] While the Agencies agree that quantitative measurements are useful for purposes of monitoring a trading desk's activities and are requiring certain banking entities to calculate, record, and report quantitative measurements to the Agencies in the final rule, the Agencies do not believe that quantitative measurements should be used as a dispositive tool for determining

[593] Routine market making-related risk management activity by a trading desk is permitted under the market-making exemption and, provided the standards of the exemption are met, is not required to separately meet the requirements of the hedging exemption. The circumstances under which risk management activity relating to the trading desk's financial exposure is permitted under the market-making exemption or must separately comply with the hedging exemption are discussed in more detail in Parts VI.A.3.c.1.c.ii. and VI.A.3.c.4., *infra*.

[594] *See* final rule § 75.4(b)(2)(iii); *infra* Part VI.A.3.c.3.

[595] *See* final rule § 75.4(b)(2)(iv).

[596] *See* final rule § 75.4(b)(2)(v); *infra* Part VI.A.3.c.5.

[597] *See* final rule § 75.4(b)(2)(vi); *infra* Part VI.A.3.c.6. As discussed further below, this provision pertains to legal registration or licensing requirements that may apply to an entity engaged in market making-related activities, depending on the facts and circumstances. This provision would not require a banking entity to comply with registration requirements that are not required by law, such as discretionary registration with a national securities exchange as a market maker on that exchange.

[598] *See infra* Part VI.C.3.

[599] *See supra* Part VI.A.3.b.2.

[600] Certain approaches suggested by commenters, such as relying solely on capital requirements, requiring ring fencing, permitting all swap dealing activity, or focusing solely on how traders are compensated do not appear to be consistent with the statutory language because they do not appear to limit market making-related activity to that which is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as required by the statute. *See* Prof. Duffie; STANY; ICE; Shadow Fin. Regulatory Comm.; ISDA (Feb. 2012); ISDA (Apr. 2012); G2 FinTech.

[601] While an approach establishing a number of safe harbors that are each tailored to a specific asset class would address the need to recognize differences across asset classes, such an approach may also increase the complexity of the final rule. Further, commenters did not provide sufficient information to determine the appropriate parameters of a safe harbor-based approach.

[602] As noted above, a number of commenters suggested the Agencies adopt a bright-line rule, provide a safe harbor for certain types of activities, or establish a presumption of compliance based on certain factors. *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); John Reed; Prof. Richardson; Johnson & Prof. Stiglitz; Capital Group; Invesco; BDA (Oct. 2012); Flynn & Fusselman; Prof. Colesanti *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); IIF; NYSE Euronext; Credit Suisse (Seidel); JPMC; Barclays; BoA; Wells Fargo (Prop. Trading); PNC *et al.;* Oliver Wyman (Feb. 2012). Many of these commenters expressed general concern that the proposed market-making exemption may create uncertainty for individual traders engaged in market making-related activity and suggested that their proposed approach would alleviate such concern. The Agencies believe that the enhanced focus on risk and inventory limits for each trading desk (which must be tied to the near term customer demand requirement) and the clarification that the final market-making exemption does not require a trade-by-trade analysis should address concerns about individual traders having to assess whether they are complying with the market-making exemption on a trade-by-trade basis.

[603] Several commenters suggested a guidance-based approach, rather than requirements in the final rule. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that this guidance could then be incorporated in banking entities' policies and procedures for purposes of complying with the rule, in addition to the establishment of risk limits, controls, and metrics); JPMC; BoA; PUC Texas; SSgA (Feb. 2012); PNC *et al.;* Wells Fargo (Prop. Trading).

[604] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; Barclays; Wellington; CalPERS; BlackRock; SSgA (Feb. 2012); Invesco.

[605] *See infra* Part VI.C.3. (discussing the final rule's metrics requirement). *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); RBC; ICI (Feb. 2012); Occupy (stating that there are serious limits to the capabilities of the metrics and the potential for abuse and manipulation of the input data is significant); Alfred Brock.

compliance with the market-making exemption.[606]

In response to two commenters' request that the final rule focus on a banking entity's risk management structures or risk limits and not on attempting to define market-making activities,[607] the Agencies do not believe that management of risk, on its own, is sufficient to differentiate permitted market making-related activities from impermissible proprietary trading. For example, the existence of a risk management framework or risk limits, while important, would not ensure that a trading desk is acting as a market maker by engaging in customer-facing activity and providing intermediation and liquidity services.[608] The Agencies also decline to take an approach to implementing the market-making exemption that would require the development of individualized plans for each banking entity in coordination with the Agencies, as suggested by a few commenters.[609] The Agencies believe it is useful to establish a consistent framework that will apply to all banking entities to reduce the potential for unintended competitive impacts that could arise if each banking entity is subject to an individualized plan that is tailored to its specific organizational structure and trading activities and strategies.

Although the Agencies are not in the final rule modifying the basic structure of the proposed market-making exemption, certain general items suggested by commenters, such as enhanced compliance program elements and risk limits, have been incorporated in the final rule text for the market-making exemption, instead of a separate appendix.[610] Moreover, as described below, the final market-making exemption includes specific substantive changes in response to a wide variety of commenter concerns.

The Agencies understand that the economics of market making—and financial intermediation in general—require a market maker to be active in markets. In determining the appropriate scope of the market-making exemption, the Agencies have been mindful of commenters' views on market making and liquidity. Several commenters stated that the proposed rule would impact a banking entity's ability to engage in market making-related activity, with corresponding reductions in market liquidity.[611] However, commenters disagreed about whether reduced liquidity would be beneficial or detrimental to the market, or if any such reductions would even materialize.[612] Many commenters stated that reduced liquidity could lead to other negative market impacts, such as wider spreads, higher transaction costs, greater market volatility, diminished price discovery, and increased cost of capital.

The Agencies understand that market makers play an important role in providing and maintaining liquidity throughout market cycles and that restricting market-making activity may result in reduced liquidity, with corresponding negative market impacts. For instance, absent a market maker who stands ready to buy and sell, investors may have to make large price concessions or otherwise expend resources searching for counterparties. By stepping in to intermediate trades and provide liquidity, market makers thus add value to the financial system by, for example, absorbing supply and demand imbalances. This often means taking on financial exposures, in a principal capacity, to satisfy reasonably expected near term customer demand, as well as to manage the risks associated with meeting such demand.

The Agencies recognize that, as noted by commenters, liquidity can be associated with narrower spreads, lower transaction costs, reduced volatility, greater price discovery, and lower costs of capital.[613] The Agencies agree with these commenters that liquidity provides important benefits to the financial system, as more liquid markets are characterized by competitive market makers, narrow bid-ask spreads, and frequent trading, and that a narrowly tailored market-making exemption could negatively impact the market by, as described above, forcing investors to make price concessions or unnecessarily expend resources searching for counterparties.[614] For example, while bid-ask spreads compensate market makers for providing liquidity when asset values are uncertain, under competitive forces, dealers compete with respect to spreads, thus lowering their profit margins on a per trade basis and benefitting investors.[615] Volatility is

[606] *See infra* Part VI.C.3. (discussing the final metrics requirement).

[607] *See, e.g.,* Japanese Bankers Ass'n.; Citigroup (Feb. 2012).

[608] However, as discussed below, the Agencies believe risk limits can be a useful tool when they must account for the nature and amount of a particular trading desk's market making-related activities, including the reasonably expected near term demands of clients, customers, or counterparties.

[609] *See* MetLife; Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012).

[610] The Agencies are not, however, adding certain additional requirements suggested by commenters, such as a new customer-facing criterion, margin requirements, or additional provisions regarding material conflicts of interest or high-risk assets or trading strategies. *See, e.g.,* Morgan Stanley; Stephen Roach; WR Hambrecht; Sens. Merkley & Levin (Feb. 2012). The Agencies believe that the final rule includes sufficient requirements to ensure that a trading desk relying on the market-making exemption is engaged in customer-facing activity (for example, the final rule requires the trading desk to stand ready to buy and sell a type of financial instrument as market maker and that the trading desk's market-maker inventory is designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties). The Agencies decline to include margin requirements in the final exemption because banking entities are currently subject to a number of different margin requirements, including those applicable to, among others: SEC-registered broker-dealers; CFTC-registered swap dealers; SEC-registered security-based swap dealers: and foreign dealer entities. Further, the Agencies are not providing new requirements regarding material conflicts of interest and high-risk assets and trading strategies in the market-making exemption because the Agencies believe these issues are adequately addressed in § 75.7 of the final rule. The limitations in § 75.7 will apply to market making-related activities and all other exempted activities.

[611] *See supra* note 550 and accompanying text. The Agencies acknowledge that reduced liquidity can be costly. One commenter provided estimated impacts on asset valuation, borrowing costs, and transaction costs in the corporate bond market based on certain hypothetical scenarios of reduced market liquidity. This commenter noted that its hypothetical liquidity shifts of 5, 10, and 15 percentile points were ''necessarily arbitrary'' but judged ''to be realistic potential outcomes of the proposed rule.'' Oliver Wyman (Feb. 2012). Because the Agencies have made significant modifications to the proposed rule in response to comments, the Agencies believe this commenter's concerns about the market impacts of the proposed rule have been substantially addressed.

[612] As noted above, a few commenters stated that reduced liquidity may provide certain benefits. *See, e.g.,* Paul Volcker; AFR *et al.* (Feb. 2012); Public Citizen; Prof. Richardson; Johnson & Prof. Stiglitz; Better Markets (Feb. 2012); Prof. Johnson. However, a number of commenters stated that reduced liquidity would have negative market impacts. *See supra* note 550 and accompanying text.

[613] *See supra* Part VI.A.3.b.2.b.

[614] *See supra* Part VI.A.3.b.2.b. As discussed above, a few other commenters suggested that to the extent liquidity is vulnerable to destabilizing liquidity spirals, any reduced liquidity stemming from section 13 of the BHC Act and its implementing rules would not necessarily be a negative result. *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Paul Volcker. These commenters also suggested that the Agencies adopt stricter conditions in the market-making exemption, as discussed throughout this Part VI.A.3. However, liquidity—essentially, the ease with which assets can be converted into cash—is not destabilizing in and of itself. Rather, liquidity spirals are a function of how firms are funded. During market downturns, when margin requirements tend to increase, firms that fund their operations with leverage face higher costs of providing liquidity; firms that run up against their maximum leverage ratios may be forced to retreat from market making, contributing to the liquidity spiral. Viewed in this light, it is institutional features of financial markets—in particular, leverage—rather than liquidity itself that contributes to liquidity spirals.

[615] Wider spreads can be costly for investors. For example, one commenter estimated that a 10 basis point increase in spreads in the corporate bond market would cost investors $29 billion per year. *See* Wellington. Wider spreads can also be particularly costly for open-end mutual funds, which must trade in and out of the fund's portfolio holdings on a daily basis in order to satisfy

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driven by both uncertainty about fundamental value and the liquidity needs of investors. When markets are illiquid, participants may have to make large price concessions to find a counterparty willing to trade, increasing the importance of the liquidity channel for addressing volatility. If liquidity-based volatility is not diversifiable, investors will require a risk premium for holding liquidity risk, increasing the cost of capital.[616] Commenters additionally suggested that the effects of diminished liquidity could be concentrated in securities markets for small or midsize companies or for lesser-known issuers, where trading is already infrequent.[617] Volume in these markets can be low, increasing the inventory risk of market makers. The Agencies recognize that, if the final rule creates disincentives for banking entities to provide liquidity, these low volume markets may be impacted first.

As discussed above, the Agencies received several comments suggesting that the negative consequences associated with reduced liquidity would be unlikely to materialize under the proposed rule. For example, a few commenters stated that non-bank financial intermediaries, who are not subject to section 13 of the BHC Act, may increase their market-making activities in response to any reduction in market making by banking entities, a topic the Agencies discuss in more detail below.[618] In addition, some commenters suggested that the restrictions on proprietary trading would support liquid markets by encouraging banking entities to focus on financial intermediation activities that supply liquidity, rather than proprietary trades that demand liquidity, such as speculative trades or trades that front-run institutional investors.[619] The statute prohibits proprietary trading activity that is not exempted. As such, the termination of nonexempt proprietary trading activities of banking entities may lead to some general reductions in liquidity of certain asset classes. Although the Agencies cannot say with any certainty, there is good reason to believe that to a significant extent the liquidity reductions of this type may be temporary since the statute does not restrict proprietary trading activities of other market participants. Thus, over time, non-banking entities may provide much of the liquidity that is lost by restrictions on banking entities' trading activities. If so, eventually, the detrimental effects of increased trading costs, higher costs of capital, and greater market volatility should be mitigated.

Based on the many detailed comments provided, the Agencies have made substantive refinements to the market-making exemption that the Agencies believe will reduce the likelihood that the rule, as implemented, will negatively impact the ability of banking entities to engage in the types of market making-related activities permitted under the statute and, therefore, will continue to promote the benefits to investors and other market participants described above, including greater market liquidity, narrower bid-ask spreads, reduced price concessions and price impact, lower volatility, and reduced counterparty search costs, thus reducing the cost of capital. For instance, the final market-making exemption does not require a trade-by-trade analysis, which was a significant source of concern from commenters who represented, among other things, that a trade-by-trade analysis could have a chilling effect on individual traders' willingness to engage in market-making activities.[620] Rather, the final rule has been crafted around the overall market making-related activities of individual trading desks, with various requirements that these activities be demonstrably related to satisfying reasonably expected near term customer demands and other market-making activities. The Agencies believe that applying certain requirements to the aggregate risk exposure of a trading desk, along with the requirement to establish risk and inventory limits to routinize a trading desk's compliance with the near term customer demand requirement, will reduce negative potential impacts on individual traders' decision-making process in the normal course of market making.[621] In addition, in response to a large number of comments expressing concern that the proposed market-making exemption would restrict or prohibit market making-related activities in less liquid markets, the Agencies are clarifying that the application of certain requirements in the final rule, such as the frequency of required quoting and the near term demand requirement, will account for the liquidity, maturity, and depth of the market for a given type of financial instrument. Thus, banking entities will be able to continue to engage in market making-related activities across markets and asset classes.

At the same time, the Agencies recognize that an overly broad market-making exemption may allow banking entities to mask speculative positions as liquidity provision or related hedges. The Agencies believe the requirements included in the final rule are necessary to prevent such evasion of the market-making exemption, ensure compliance with the statute, and facilitate internal banking entity and external Agency reviews of compliance with the final rule. Nevertheless, the Agencies acknowledge that these additional costs may have an impact on banking entities' willingness to engage in market making-related activities. Banking entities will incur certain compliance costs in connection with their market making-related activities under the final rule. For example, banking entities may not currently limit their trading desks' market-maker inventory to that which is designed not to exceed reasonably expected near term customer demand, as required by the statute.

As discussed above, commenters presented diverging views on whether non-banking entities are likely to enter the market or increase their market-making activities if the final rule should cause banking entities to reduce their market-making activities.[622] The

redemptions and subscriptions. *See* Wellington; AllianceBernstein.

[616] A higher cost of capital increases financing costs and translates into reduced capital investment. While one commenter estimated that a one percent increase in the cost of capital would lead to a $55 to $82.5 billion decline in capital investments by U.S. nonfarm firms, the Agencies cannot independently verify these potential costs. Further, this commenter did not indicate what aspect of the proposed rule could cause a one percent increase in the cost of capital. *See* Thakor Study. In any event, the Agencies have made significant changes to the proposed approach to implementing the market-making exemption that should help address this commenter's concern.

[617] *See, e.g.,* CIEBA; ACLI; PNC *et al.;* Morgan Stanley; Chamber (Feb. 2012); Abbott Labs *et al.* (Feb. 14, 2012); FEI; ICI (Feb. 2012); TMA Hong Kong; Sen. Casey.

[618] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Prof. Richardson; Better Markets (Feb. 2012); Profs. Stout & Hastings; Prof. Johnson; Occupy; Public Citizen; Profs. Admati & Pfleiderer; Better Markets (June 2012).

[619] *See, e.g.,* Prof. Johnson.

[620] *See supra* note 522 (discussing commenters' concerns regarding a trade-by-trade analysis).

[621] For example, by clarifying that individual trades will not be viewed in isolation and requiring strong compliance procedures, this approach will generally allow an individual trader to operate within the compliance framework established for his or her trading desk without having to assess whether each individual transaction complies with all requirements of the market-making exemption.

[622] *See supra* notes 565 and 569 and accompanying text (discussing comments on the issue of whether non-banking entities are likely to enter the market or increase their trading activities in response to reduced trading activity by banking entities). For example, one commenter stated that broker-dealers that are not affiliated with a bank would have reduced access to lender-of-last resort liquidity from the central bank, which could limit their ability to make markets during times of market stress or when capital buffers are small. *See* Prof. Duffie. However, another commenter noted that the

Agencies note that prior to the Gramm-Leach-Bliley Act of 1999, market-making services were more commonly provided by non-bank-affiliated broker-dealers than by banking entities. As discussed above, by intermediating and facilitating trading, market makers provide value to the markets and profit from providing liquidity. Should banking entities retreat from making markets, the profit opportunities available from providing liquidity will provide an incentive for non-bank-affiliated broker-dealers to enter the market and intermediate trades. The Agencies are unable to assess the likely effect with any certainty, but the Agencies recognize that a market-making operation requires certain infrastructure and capital, which will impact the ability of non-banking entities to enter the market-making business or to increase their presence. Therefore, should banking entities retreat from making markets, there could be a transition period with reduced liquidity as non-banking entities build up the needed infrastructure and obtain capital. However, because the Agencies have substantially modified this exemption in response to comments to ensure that market making related to near-term customer demand is permitted as contemplated by the statute, the Agencies do not believe the final rule should significantly impact currently-available market-making services.[623]

c. Detailed Explanation of the Market-Making Exemption

1. Requirement to Routinely Stand Ready To Purchase and Sell

a. Proposed Requirement To Hold Self Out

Section 75.4(b)(2)(ii) of the proposed rule would have required the trading desk or other organizational unit that conducts the purchase or sale in reliance on the market-making exemption to hold itself out as being willing to buy and sell, including through entering into long and short positions in, the financial instrument for its own account on a regular or continuous basis.[624] The proposal stated that a banking entity could rely on the proposed exemption only for the type of financial instrument that the entity actually made a market in.[625]

The proposal recognized that the precise nature of a market maker's activities often varies depending on the liquidity, trade size, market infrastructure, trading volumes and frequency, and geographic location of the market for any particular financial instrument.[626] To account for these variations, the Agencies proposed indicia for assessing compliance with this requirement that differed between relatively liquid markets and less liquid markets. Further, the Agencies recognized that the proposed indicia could not be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making-related activity is conducted.

In particular, the proposal stated that a trading desk or other organizational unit's market making-related activities in relatively liquid markets, such as equity securities or other exchange-traded instruments, should generally include: (i) Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis; (ii) a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity; (iii) making continuous quotations that are at or near the market on both sides; and (iv) providing widely accessible and broadly disseminated quotes.[627] With respect to market making in less liquid markets, the proposal noted that the appropriate indicia of market making-related activities will vary, but should generally include: (i) Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;[628] (ii) with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market; and (iii) transaction volumes and risk proportionate to historical customer liquidity and investments needs.[629]

In discussing this proposed requirement, the Agencies stated that *bona fide* market making-related activity may include certain block positioning and anticipatory position-taking. More specifically, the proposal indicated that the *bona fide* market making-related activity described in § 75.4(b)(2)(ii) of the proposed rule would include: (i) Block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading;[630] and (ii) taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[631]

b. Comments on the Proposed Requirement To Hold Self Out

Commenters raised many issues regarding § 75.4(b)(2)(ii) of the proposed exemption, which would require a trading desk or other organizational unit to hold itself out as willing to buy and sell the financial instrument for its own account on a regular or continuous basis. As discussed below, some commenters viewed the proposed requirement as too restrictive, while other commenters stated that the requirement was too permissive. Two commenters expressed support for the proposed requirement.[632] A number of

presence and evolution of market making after the enactment of the Glass-Steagall Act mutes this particular concern. *See* Prof. Richardson.

[623] Certain non-banking entities, such as some SEC-registered broker-dealers that are not banking entities subject to the final rule, currently engage in market-making activities and, thus, should have the needed infrastructure and may attract additional capital. If the final rule has a marginal impact on banking entities' willingness to engage in market making-related activities, these non-banking entities should be able to respond by increasing their market making-related activities. The Agencies recognize, however, that firms that do not have existing infrastructure or sufficient capital are unlikely to be able to act as market makers shortly after the final rule is implemented. Nevertheless, because some non-bank-affiliated broker-dealers currently operate market-making desks, and because it was the dominant model prior to the Gramm-Leach-Bliley Act, the Agencies believe that non-bank-affiliated financial intermediaries will be able to provide market-making services longer term.

[624] *See* proposed rule § 75.4(b)(2)(ii).

[625] *See* Joint Proposal, 76 FR at 68870 (''Notably, this criterion requires that a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the [financial instrument] involved; simply because a banking entity makes a market in one type of [financial instrument] does not permit it to rely on the market-making exemption for another type of [financial instrument].''); CFTC Proposal, 77 FR at 8355–8356.

[626] *See* Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8356.

[627] *See* Joint Proposal, 76 FR at 68870–68871; CFTC Proposal, 77 FR at 8356. These proposed factors are generally consistent with the indicia used by the SEC to assess whether a broker-dealer is engaged in *bona fide* market making for purposes of Regulation SHO under the Exchange Act. *See* Joint Proposal, 76 FR at 68871 n.148; CFTC Proposal, 77 FR at 8356 n.155.

[628] The Agencies noted that, with respect to this factor, the frequency of regular quotations will vary, as moderately illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment. *See* Joint Proposal, 76 FR at 68871 n.149; CFTC Proposal, 77 FR at 8356 n.156.

[629] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356.

[630] In the preamble to the proposed rule, the Agencies stated that the SEC's definition of ''qualified block positioner'' may serve as guidance in determining whether a block positioner engaged in block positioning is engaged in *bona fide* market making for purposes of § 75.4(b)(2)(ii) of the proposed rule. *See* Joint Proposal, 76 FR at 68871 n.151; CFTC Proposal, 77 FR at 8356 n.157.

[631] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[632] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

commenters provided views on statements in the proposal regarding indicia of *bona fide* market making in more and less liquid markets and the permissibility of block positioning and anticipatory position-taking.

Several commenters represented that the proposed requirement was too restrictive.[633] For example, a number of these commenters expressed concern that the proposed requirement may limit a banking entity's ability to act as a market maker under certain circumstances, including in less liquid markets, for instruments lacking a two-sided market, or in customer-driven, structured transactions.[634] In addition, a few commenters expressed specific concern about how this requirement would impact more limited market-making activity conducted by banks.[635]

Many commenters indicated that it was unclear whether this provision would require a trading desk or other organizational unit to regularly or continuously quote every financial instrument in which a market is made, but expressed concern that the proposed language could be interpreted in this manner.[636] These commenters noted that there are thousands of individual instruments within a given asset class, such as corporate bonds, and that it would be burdensome for a market maker to provide quotes in such a large number of instruments on a regular or continuous basis.[637] One of these commenters represented that, because customer demand may be infrequent in a particular instrument, requiring a banking entity to provide regular or continuous quotes in the instrument may not provide a benefit to its customers.[638] A few commenters requested that the Agencies provide further guidance on this issue or modify the proposed standard to state that holding oneself out in a range of similar instruments will be considered to be within the scope of permitted market making-related activities.[639]

To address concerns about the restrictiveness of this requirement, commenters suggested certain modifications. For example, some commenters suggested adding language to the requirement to account for market making in markets that do not typically involve regular or continuous, or two-sided, quoting.[640] In addition, a few commenters requested that the requirement expressly include transactions in new instruments or transactions in instruments that occur infrequently to address situations where a banking entity may not have previously had the opportunity to hold itself out as willing to buy and sell the applicable instrument.[641] Other commenters supported alternative criteria for assessing whether a banking entity is acting as a market maker, such as: (i) A willingness to respond to customer demand by providing prices upon request;[642] (ii) being in the business of providing prices upon request for that financial instrument or other financial instruments in the same or similar asset class or product class;[643] or (iii) a historical test of market-making activity, with compliance judged on the basis of actual trades.[644] Finally, two commenters stated that this requirement should be moved to Appendix B of the rule,[645] which, according to one of these commenters, would provide the Agencies greater flexibility to consider the facts and circumstances of a particular activity.[646]

Other commenters took the view that the proposed requirement was too permissive.[647] For example, one commenter stated that the proposed standard provided too much room for interpretation and would be difficult to measure and monitor. This commenter expressed particular concern that a trading desk or other organizational unit could meet this requirement by regularly or continuously making wide, out of context quotes that do not present any real risk of execution and do not contribute to market liquidity.[648] Some commenters suggested the Agencies place greater restrictions on a banking entity's ability to rely on the market-making exemption in certain illiquid

[633] *See infra* Part VI.A.3.c.1.c.iii. (addressing these concerns).

[634] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; IHS; SSgA (Feb. 2012).

[635] *See, e.g.,* PNC (stating that the proposed rule needs to account for market making by regional banks on behalf of small and middle-market customers whose securities are less liquid); ABA (stating that the rule should continue to permit banks to provide limited liquidity by buying securities that they feel are suitable for their retail and institutional customer base by stating that a bank is ''holding itself out'' when it buys and sells securities that are suitable for its customers).

[636] This issue is further discussed in Part VI.A.3.c.1.c.iii., *infra.*

[637] *See, e.g.,* Goldman (Prop. Trading) (stating that it would be burdensome for a U.S. credit market-making business to be required to produce and disseminate quotes for thousands of individual bond CUSIPs that trade infrequently and noting that a market maker in credit markets will typically disseminate indicative prices for the most liquid instruments but, for the thousands of other instruments that trade infrequently, the market maker will generally provide a price for a trade upon request from another market participant); Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* BDA (Feb. 2012); FTN (stating that in some markets, such as the markets for residential mortgage-backed securities and investment grade corporate debt, a market maker will hold itself out in a subset of instruments (*e.g.,* particular issues in the investment grade corporate debt market with heavy trading volume or that are in the midst of particular credit developments), but will trade in other instruments within the group or sector upon inquiry from customers and other dealers); Oliver Wyman (Feb. 2012) (discussing data regarding the number of U.S. corporate bonds and frequency of trading in such bonds in 2009).

[638] *See* Goldman (Prop. Trading).

[639] *See, e.g.,* RBC (recommending that the Agencies clarify that a trading desk is required to hold itself out as willing to buy and sell a particular type of ''product''); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (suggesting that the Agencies use the term ''instrument,'' rather than ''covered financial position,'' to provide greater clarity); CIEBA (supporting alternative criteria that would require a banking entity to hold itself out generally as a market maker for the relevant asset class, but not for every instrument it purchases and sells); Goldman (Prop. Trading). One of these commenters recommended that the Agencies recognize and permit the following kinds of activity in related financial instruments: (i) Options market makers should be deemed to be engaged in market making in all put and call series related to a particular underlying security and should be permitted to trade the underlying security regardless of whether such trade qualifies for the hedging exemption; (ii) convertible bond traders should be permitted to trade in the associated equity security; (iii) a market maker in one issuer's bonds should be considered a market maker in similar bonds of other issuers; and (iv) a market maker in standardized interest rate swaps should be considered to be engaged in market making-related activity if it engages in a customized interest rate swap with a customer upon request. *See* RBC.

[640] *See, e.g.,* Morgan Stanley (suggesting that the Agencies add the phrase ''or, in markets where regular or continuous quotes are not typically provided, the trading unit stands ready to provide quotes upon request''); Barclays (suggesting addition of the phrase ''to the extent that two-sided markets are typically made by market makers in a given product,'' as well as changing the reference to ''purchase or sale'' to ''market making-related activity'' to avoid any inference of a trade-by-trade analysis). *See also* Fixed Income Forum/Credit Roundtable. To address concerns about the requirement's application to bespoke products, one commenter suggested that the rule clearly state that a banking entity fulfills this requirement if it markets structured transactions to its client base and stands ready to enter into such transactions with customers, even though transactions may occur on a relatively infrequent basis. *See* JPMC.

[641] *See* Wells Fargo (Prop. Trading); RBC (supporting this approach as an alternative to removing the requirement from the rule, but primarily supporting its removal). *See also* ISDA (Feb. 2012) (stating that the analysis of compliance with the proposed requirement must carefully consider the degree of presence a market maker wishes to have in a given market, which may include being a leader in certain types of instruments, having a secondary presence in others, and potentially leaving or entering other submarkets).

[642] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter also suggested that such test be assessed at the ''trading unit'' level. *See id.*

[643] *See* Goldman (Prop. Trading).

[644] *See* FTN.

[645] *See* Flynn & Fusselman; JPMorgan.

[646] *See* JPMC.

[647] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; John Reed. *See infra* note 751 and accompanying text (responding to these comments).

[648] *See* Occupy.

markets, such as assets that cannot be reliably valued, products that do not have a genuine external market, or instruments for which a banking entity does not expect to have customers wishing to both buy and sell.[649] In support of these requests, commenters stated that trading in illiquid products raises certain concerns under the rule, including: A lack of reliable data for purposes of using metrics to monitor a banking entity's market making-related activity (*e.g.,* products whose valuations are determined by an internal model that can be manipulated, rather than an observable market price);[650] relation to the last financial crisis;[651] lack of important benefits to the real economy;[652] similarity to prohibited proprietary trading;[653] and inconsistency with the statute's requirements that market making-related activity must be ''designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties'' and must not result in a material exposure to high-risk assets or high-risk trading strategies.[654]

These commenters also requested that the proposed requirement be modified in certain ways. In particular, several commenters stated that the proposed exemption should only permit market making in assets that can be reliably valued through external market transactions.[655] In order to implement such a limitation, three commenters suggested that the Agencies prohibit banking entities from market making in assets classified as Level 3 under FAS 157.[656] One of these commenters explained that Level 3 assets are generally highly illiquid assets whose fair value cannot be determined using either market prices or models.[657] In addition, a few commenters suggested that banking entities be subject to additional capital charges for market making in illiquid products.[658] Another commenter stated that the Agencies should require all market making-related activity to be conducted on a multilateral organized electronic trading platform or exchange to make it possible to monitor and confirm certain trading data.[659] Two commenters emphasized that their recommended restrictions on market making in illiquid markets should not prohibit banking entities from making markets in corporate bonds.[660]

i. The Proposed Indicia

As noted above, the proposal set forth certain indicia of *bona fide* market making-related activity in liquid and less liquid markets that the Agencies proposed to apply when evaluating whether a banking entity was eligible for the proposed exemption.[661] Several commenters provided their views regarding the effectiveness of the proposed indicia.

With respect to the proposed indicia for liquid markets, a few commenters expressed support for the proposed indicia.[662] One of these commenters stated that while the proposed factors are reasonably consistent with *bona fide* market making, the Agencies should add two other factors: (i) A willingness to transact in reasonable quantities at quoted prices, and (ii) inventory turnover.[663]

Other commenters, however, stated that the proposed use of factors from the SEC's analysis of *bona fide* market making under Regulation SHO was inappropriate in this context. In particular, these commenters represented that *bona fide* market making for purposes of Regulation SHO is a purposefully narrow concept that permits a subset of market makers to qualify for an exception from the ''locate'' requirement in Rule 203 of Regulation SHO. The commenters further expressed the belief that the policy goals of section 13 of the BHC Act do not necessitate a similarly narrow interpretation of market making.[664]

A few commenters expressed particular concern about how the factor regarding patterns of purchases and sales in roughly comparable amounts would apply to market making in exchange-traded funds (''ETFs''). According to these commenters, demonstrating this factor could be difficult because ETF market making involves a pattern of purchases and sales of groups of equivalent securities (*i.e.,* the ETF shares and the basket of securities and cash that is exchanged for them), not a single security. In addition, the commenters were unsure whether this factor could be demonstrated in times of limited trading in ETF shares.[665]

The preamble to the proposed rule also provided certain proposed indicia of *bona fide* market making-related activity in less liquid markets.[666] As discussed above, commenters had differing views about whether the exemption for market making-related activity should permit banking entities to engage in market making in some or all illiquid markets. Thus, with respect to the proposed indicia for market making in less liquid markets, commenters generally stated that the indicia should be broader or narrower, depending on the commenter's overall view on the issue of market making in illiquid markets. One commenter stated

[649] *See* Occupy; AFR *et al.* (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz; Sens. Merkley & Levin (Feb. 2012); John Reed.

[650] *See* AFR *et al.* (Feb. 2012); Occupy.

[651] *See* Occupy.

[652] *See* John Reed.

[653] *See* Johnson & Prof. Stiglitz.

[654] *See* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity must have or reasonably expect at least two customers—one for each side of the trade—and must have a reasonable expectation of the second customer coming to take the position or risk off its books in the ''near term''); AFR *et al.* (Feb. 2012); Public Citizen.

[655] *See* AFR *et al.* (Feb. 2012) (stating that the rule should ban market making in illiquid and opaque securities with no genuine external market, but permit market making in somewhat illiquid securities, such as certain corporate bonds, as long as the securities can be reliably valued with reference to other extremely similar securities that are regularly traded in liquid markets and the financial outcome of the transaction is reasonably predictable); Johnson & Prof. Stiglitz (recommending that permitted market making be limited to assets that can be reliably valued in, at a minimum, a moderately liquid market evidenced by trading within a reasonable period, such as a week, through a real transaction and not simply with interdealer trades); Public Citizen (stating that market making should be limited to assets that can be reliably valued in a market where transactions take place on a weekly basis).

[656] *See* AFR *et al.* (Feb. 2012) (stating that such a limitation would be consistent with the proposed limitation on ''high-risk assets'' and the discussion of this limitation in proposed Appendix C); Public Citizen; Prof. Richardson.

[657] *See* Prof. Richardson.

[658] Two commenters recommended that banking entities be required to treat trading in assets that cannot be reliably valued and that trade only by appointment, such as bespoke derivatives and structured products, as providing an illiquid bespoke loan, which are subject to higher capital charges under the Federal banking agencies' capital rules. *See* Johnson & Prof. Stiglitz; John Reed. Another commenter suggested that, if not directly prohibited, trading in bespoke instruments that cannot be reliably valued should be assessed an appropriate capital charge. *See* Public Citizen.

[659] *See* Occupy. This commenter further suggested that the exemption exclude all activities that include: (i) Assets whose changes in value cannot be mitigated by effective hedges; (ii) new products with rapid growth, including those that do not have a market history; (iii) assets or strategies that include significant imbedded leverage; (iv) assets or strategies that have demonstrated significant historical volatility; (v) assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and (vi) assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties. *See id.*

[660] *See* AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz.

[661] *See supra* Part VI.A.3.c.1.a.

[662] *See* Occupy; AFR *et al.* (Feb. 2012); NYSE Euronext (expressing support for the indicia set forth in the FSOC study, which are substantially the same as the indicia in the proposal); Alfred Brock.

[663] *See* AFR *et al.* (Feb. 2012).

[664] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[665] *See* ICI (Feb. 2012); ICI Global.

[666] *See supra* Part VI.A.3.c.1.a.

that the proposed indicia are effective.[667]

The first proposed factor of market making-related activity in less liquid markets was holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis. As noted above, several commenters expressed concern about a requirement that market makers provide regular quotations in less liquid instruments, including in fixed income markets and bespoke, customized derivatives.[668] With respect to the interaction between the rule language requiring ''regular'' quoting and the proposal's language permitting trading by appointment under certain circumstances, some of these commenters expressed uncertainty about how a market maker trading only by appointment would be able to satisfy the proposed rule's regular quotation requirement.[669] In addition, another commenter stated that the proposal's recognition of trading by appointment does not alleviate concerns about applying the ''regular'' quotation requirement to market making in less liquid instruments in markets that are not, as a whole, highly illiquid, such as credit and interest rate markets.[670]

Other commenters expressed concern about only requiring a market maker to provide regular quotations or permitting trading by appointment to qualify for the market-making exemption. With respect to regular quotations, some commenters stated that such a requirement enables evasion of the prohibition on proprietary trading because a proprietary trader may post a quote at a time of little interest in a financial product or may post wide, out of context quotes on a regular basis with no real risk of execution.[671] Several commenters stated that trading only by appointment should not qualify as market making for purposes of the proposed rule.[672] Some of these commenters stated that there is no ''market'' for assets that trade only by appointment, such as customized, structured products and OTC derivatives.[673]

The second proposed criterion for market making-related activity in less liquid markets was, with respect to securities, regularly purchasing securities from, or selling securities to, clients, customers, or counterparties in the secondary market. Two commenters expressed concern about this proposed factor.[674] In particular, one of these commenters stated that the language is fundamentally inconsistent with market making because it contemplates that only taking one side of the market is sufficient, rather than both buying and selling an instrument.[675] The other commenter expressed concern that banking entities would be allowed to accumulate a significant amount of illiquid risk because the indicia for market making-related activity in less liquid markets did not require a market maker to buy and sell in comparable amounts (as required by the indicia for liquid markets).[676]

Finally, the third proposed factor of market making in less liquid markets would consider transaction volumes and risk proportionate to historical customer liquidity and investment needs. A few commenters indicated that there may not be sufficient information available for a banking entity to conduct such an analysis.[677] For example, one commenter stated that historical information may not necessarily be available for new businesses or developing markets in which a market maker may seek to establish trading operations.[678] Another commenter expressed concern that this factor would not help differentiate market making from prohibited proprietary trading because most illiquid markets do not have a source for such historical risk and volume data.[679]

ii. Treatment of Block Positioning Activity

The proposal provided that the activity described in § 75.4(b)(2)(ii) of the proposed rule would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.[680]

A number of commenters supported the general language in the proposal permitting block positioning, but expressed concern about the reference to the definition of ''qualified block positioner'' in SEC Rule 3b–8(c).[681] With respect to using Rule 3b–8(c) as guidance under the proposed rule, these commenters represented that Rule 3b–8(c)'s requirement to resell block positions ''as rapidly as possible'' would cause negative results (*e.g.,* fire sales) or create market uncertainty (*e.g.,* when, if ever, a longer unwind would be permitted).[682] According to one of these commenters, gradually disposing of a large long position purchased from a customer may be the best means of reducing near term price volatility associated with the supply shock of trying to sell the position at once.[683] Another commenter expressed concern about the second requirement of Rule 3b–8(c), which provides that the dealer must determine in the exercise of reasonable diligence that the block cannot be sold to or purchased from others on equivalent or better terms. This commenter stated that this kind of determination would be difficult in less liquid markets because those markets do not have widely disseminated quotes that dealers can use for purposes of comparison.[684]

Beyond the reference to Rule 3b–8(c), a few commenters expressed more general concern about the proposed rule's application to block positioning activity.[685] One commenter noted that the proposal only discussed block positioning in the context of the proposed requirement to hold oneself out, which implies that block positioning activity also must meet the other requirements of the market-making exemption. This commenter requested an explicit recognition that banking entities meet the requirements of the market-making exemption when they enter into block trades for customers, including related trades entered to support the block, such as

[667] *See* Alfred Brock.

[668] *See supra* note 634 accompanying text. With respect to this factor, one commenter requested that the Agencies delete the parenthetical of ''but not necessarily continuous'' from the proposed factor as part of a broader effort to recognize the relative illiquidity of swap markets. *See* ISDA (Feb. 2012).

[669] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA. These commenters requested greater clarity or guidance on the meaning of ''regular'' in the instance of a market maker trading only by appointment. *See id.*

[670] *See* Goldman (Prop. Trading).

[671] *See* Public Citizen; Occupy. One of these commenters further noted that most markets lack a structural framework that would enable monitoring of compliance with this requirement. *See* Occupy.

[672] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; John Reed; Public Citizen.

[673] *See, e.g.,* John Reed; Public Citizen.

[674] *See* AFR *et al.* (Feb. 2012); Occupy.

[675] *See* AFR *et al.* (Feb. 2012)

[676] *See* Occupy.

[677] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy.

[678] *See* Goldman (Prop. Trading).

[679] *See* Occupy.

[680] *See* Joint Proposal, 76 FR at 68871.

[681] *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). *See also infra* note 740 (responding to these comments).

[682] *See* RBC (expressing concern about fire sales); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing concern about fire sales, particularly in less liquid markets where a block position would overwhelm the market and undercut the price a market maker can obtain); Goldman (Prop. Trading) (representing that this requirement could create uncertainty about whether a longer unwind would be permissible and, if so, under what circumstances).

[683] *See* Goldman (Prop. Trading).

[684] *See* RBC.

[685] *See* SIFMA (Asset Mgmt.) (Feb. 2012); Fidelity (requesting that the Agencies explicitly recognize that block trades qualify for the market-making exemption); Oliver Wyman (Feb. 2012).

hedging transactions.[686] Finally, one commenter expressed concern that the inventory metrics in proposed Appendix A would make dealers reluctant to execute large, principal transactions because such trades would have a transparent impact on inventory metrics in the relevant asset class.[687]

iii. Treatment of Anticipatory Market Making

In the proposal, the Agencies proposed that ''*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.'' [688] Many commenters indicated that the language in the proposal is inconsistent with the statute's language regarding near term demands of clients, customers, or counterparties. According to these commenters, the statute's ''designed'' and ''reasonably expected'' language expressly acknowledges that a market maker may need to accumulate inventory before customer demand manifests itself. Commenters further represented that the proposed standard may unduly limit a banking entity's ability to accumulate inventory in anticipation of customer demand.[689]

In addition, two commenters expressed concern that the proposal's language would effectively require a banking entity to engage in impermissible front running.[690] One of these commenters indicated that the Agencies should not restrict anticipatory trading to such a short time period.[691] To the contrary, the other commenter stated that anticipatory accumulation of inventory should be considered to be prohibited proprietary trading.[692] A few commenters noted that the standard in the proposal explicitly refers to securities and requested that the reference be changed to encompass the full scope of financial instruments covered by the rule to avoid ambiguity.[693] Several commenters recommended that the language be eliminated [694] or modified [695] to address the concerns discussed above.

iv. High-Frequency Trading

A few commenters stated that high-frequency trading should be considered prohibited proprietary trading under the rule, not permitted market making-related activity.[696] For example, one commenter stated that the Agencies should not confuse high volume trading and market making. This commenter emphasized that algorithmic traders in general—and high-frequency traders in particular—do not hold themselves out in the manner required by the proposed rule, but instead only offer to buy and sell when they think it is profitable.[697] Another commenter suggested the Agencies impose a resting period on any order placed by a banking entity in reliance on any exemption in the rule by, for example, prohibiting a banking entity from buying and subsequently selling a position within a span of two seconds.[698]

c. Final Requirement To Routinely Stand Ready To Purchase and Sell

Section 75.4(b)(2)(i) of the final rule provides that the trading desk that establishes and manages the financial exposure must routinely stand ready to purchase and sell one or more types of financial instruments related to its financial exposure and be willing and available to quote, buy and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles, on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments. As discussed in more detail below, the standard of ''routinely'' standing ready to purchase and sell one or more types of financial instruments will be interpreted to account for differences across markets and asset classes. In addition, this requirement provides that a trading desk must be willing and available to provide quotations and transact in the particular types of financial instruments in commercially reasonable amounts and throughout market cycles. Thus, a trading desk's activities would not meet the terms of the market-making exemption if, for example, the trading desk only provides wide quotations on one or both sides of the market relative to prevailing market conditions or is only willing to trade on an irregular, intermittent basis.

While this provision of the market-making exemption has some similarity to the requirement to hold oneself out in § 75.4(b)(2)(ii) of the proposed rule, the Agencies have made a number of refinements in response to comments. Specifically, a number of commenters expressed concern that the proposed requirement did not sufficiently account for differences between markets and asset classes and would unduly limit certain types of market making by requiring ''regular or continuous'' quoting in a particular instrument.[699]

[686] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[687] *See* Oliver Wyman (Feb. 2012). This commenter estimated that investors trading out of large block positions on their own, without a market maker directly providing liquidity, would have to pay incremental transaction costs between $1.7 and $3.4 billion per year. This commenter estimated a block trading size of $850 billion, based on a haircut of total block trading volume reported for NYSE and Nasdaq. The commenter then estimated, based on market interviews and analysis of standard market impact models provided by dealers, that the market impact of executing large block orders without direct market maker liquidity provision would be the difference between the market impact costs of executing a block trade over a 5-day period versus a 1-day period—which would be approximately 20 to 50 basis points, depending on the size of the trade. *See id.*

[688] Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[689] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (expressing concern that requiring trades to be related to clear demonstrable trading interest could curtail the market-making function by removing a market maker's discretion to develop inventory to best serve its customers and adversely restrict liquidity); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA (Asset Mgmt.) (Feb. 2012) (expressing general concern that the standard creates limitations on a market maker's inventory). These comments are addressed in Part VI.A.3.c.2., *infra.*

[690] *See* Goldman (Prop. Trading); Occupy. *See also* Public Citizen (expressing general concern that accumulating positions in anticipation of demand opens issues of front running).

[691] *See* Goldman (Prop. Trading).

[692] *See* Occupy.

[693] *See* Goldman (Prop. Trading); ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[694] *See* BoA (stating that a market maker must acquire inventory in advance of express customer demand and customers expect a market maker's inventory to include not only the financial instruments in which customers have previously traded, but also instruments that the banking entity believes they may want to trade); Occupy.

[695] *See* Morgan Stanley (suggesting a new standard providing that a purchase or sale must be ''reasonably consistent with observable customer demand patterns and, in the case of new asset classes or markets, with reasonably expected future developments on the basis of the trading unit's client relationships''); Chamber (Feb. 2012) (requesting that the final rule permit market makers to make individualized assessments of anticipated customer demand based on their expertise and experience in the markets and make trades according to those assessments); Goldman (Prop. Trading) (recommending that the Agencies instead focus on how trading activities are ''designed'' to meet the reasonably expected near term demands of clients over time, rather than whether those demands have actually manifested themselves at a given point in time); ISDA (Feb. 2012) (stating that the Agencies should clarify this language to recognize differences between liquid and illiquid markets and noting that illiquid and low volume markets necessitate that swap dealers take a longer and broader view than dealers in liquid markets).

[696] *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[697] *See* Better Markets (Feb. 2012). *See also infra* note 747 (addressing this issue).

[698] *See* Occupy.

[699] *See supra* Part VI.A.3.c.1.b. (discussing comments on this issue). The Agencies did not intend for the reference to ''covered financial

Continued

The explanation of this requirement in the proposal was intended to address many of these concerns. For example, the Agencies stated that the proposed ''indicia cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market-making activity is conducted.'' [700] Nonetheless, the Agencies believe that certain modifications are warranted to clarify the rule and to prevent a potential chilling effect on market making-related activities conducted by banking entities.

Commenters represented that the requirement that a trading desk hold itself out as being willing to buy and sell ''on a regular or continuous basis,'' as was originally proposed, was impossible to meet or impractical in the context of many markets, especially less liquid markets.[701] Accordingly, the final rule requires a trading desk that establishes and manages the financial exposure to ''routinely'' stand ready to trade one or more types of financial instruments related to its financial exposure. As discussed below, the meaning of ''routinely'' will account for the liquidity, maturity, and depth of the market for a type of financial instrument, which should address commenter concern that the proposed standard would not work in less liquid markets and would have a chilling effect on banking entities' ability to act as market makers in less liquid markets. A concept of market making that is applicable across securities, commodity futures, and derivatives markets has not previously been defined by any of the Agencies. Thus, while this standard is based generally on concepts from the securities laws and is consistent with the CFTC's and SEC's description of market making in swaps,[702] the Agencies note that it is not directly based on an existing definition of market making.[703] Instead, the approach taken in the final rule is intended to take into account and accommodate the conditions in the relevant market for the financial instrument in which the banking entity is making a market.

i. Definition of ''Trading Desk''

The Agencies are adopting a market-making exemption with requirements that generally focus on a financial exposure managed by a ''trading desk'' of a banking entity and such trading desk's market-maker inventory. The market-making exemption as originally proposed would have applied to ''a trading desk or other organizational unit'' of a banking entity. In addition, for purposes of the proposed requirement to report and record certain quantitative measurements, the proposal defined the term ''trading unit'' as each of the following units of organization of a banking entity: (i) Each discrete unit that is engaged in the coordinated implementation of a revenue-generation strategy and that participates in the execution of any covered trading activity; (ii) each organizational unit that is used to structure and control the aggregate risk-taking activities and employees of one or more trading units described in paragraph (i); and (iii) all trading operations, collectively.[704]

The Agencies received few comments regarding the organizational level at which the requirements of the market-making exemption should apply, and many of the commenters that addressed this issue did not describe their suggested approach in detail.[705] One commenter suggested that the market-making exemption apply to each ''trading unit'' of a banking entity, defined as ''each organizational unit that is used to structure and control the aggregate risk-taking activities and employees that are engaged in the coordinated implementation of a customer-facing revenue generation strategy and that participate in the execution of any covered trading activity.'' [706] This suggested approach is substantially similar to the second prong of the Agencies' proposed definition of ''trading unit'' in Appendix A of the proposal. The Agencies described this prong as generally including management or reporting divisions, groups, sub-groups, or other intermediate units of organization used by the banking entity to manage one or more discrete trading units (*e.g.,* ''North American Credit Trading,'' ''Global Credit Trading,'' etc.).[707] The Agencies are concerned that this commenter's suggested approach, or any other approach applying the exemption's requirements to a higher level of organization than the trading desk, would impede monitoring of market making-related activity and detection of impermissible proprietary trading by combining a number of different trading strategies and aggregating a larger volume of trading activities.[708] Further, key requirements in the market-making exemption, such as the required limits and risk management procedures, are generally used by banking entities for risk control and applied at the trading desk level. Thus, applying them at a broader organizational level than the trading desk would create a separate system for compliance with this exemption designed to permit a banking entity to aggregate disparate trading activities and apply limits more generally. Applying the conditions of the exemption at a more aggregated level would allow banking entities more flexibility in trading and could result in a higher volume of trading that could contribute modestly to liquidity.[709]

position'' in the proposed rule to imply a single instrument, although commenters contended that the proposal may not have been sufficiently clear on this point.

[700] Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356.

[701] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); ABA; Chamber (Feb. 2012); BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; ACLI (Feb. 2012); T. Rowe Price; PUC Texas; PNC; MetLife; RBC; SSgA (Feb. 2012). Some commenters suggested alternative criteria, such as providing prices upon request, using a historical test of market making, or a purely guidance-based approach. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); FTN; Flynn & Fusselman; JPMC. The Agencies are not adopting a requirement that the trading desk only provide prices upon request because the Agencies believe it would be inconsistent with market making in liquid exchange-traded instruments where market makers regularly or continuously post quotes on an exchange. With respect to one commenter's suggested approach of a historical test of market making, this commenter did not provide enough information about how such a test would work for the Agencies' consideration. Finally, the final rule does not adopt a purely guidance-based approach because, as discussed further above, the Agencies believe it could lead to an increased risk of evasion.

[702] *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant,'' 77 FR 30596, 30609 (May 23, 2012) (describing market making in swaps as ''routinely standing ready to enter into swaps at the request or demand of a counterparty'').

[703] As a result, activity that is considered market making under this final rule may not necessarily be considered market making for purposes of other laws or regulations, such as the U.S. securities laws, the rules and regulations thereunder, or self-regulatory organization rules. In addition, the Agencies note that a banking entity acting as an underwriter would continue to be treated as an underwriter for purposes of the securities laws and the regulations thereunder, including any liability arising under the securities laws as a result of acting in such capacity, regardless of whether it is able to meet the terms of the market-making exemption for its activities. *See* Sens. Merkley & Levin (Feb. 2012).

[704] *See* Joint Proposal, 76 FR at 68957; CFTC Proposal, 77 FR at 8436.

[705] *See* Wellington; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[706] Morgan Stanley.

[707] *See* Joint Proposal, 76 FR at 68957 n.2.

[708] *See, e.g.,* Occupy (expressing concern that, with respect to the proposed definition of ''trading unit,'' an ''oversized'' unit could combine significantly unrelated trading desks, which would impede detection of proprietary trading activity).

[709] The Agencies recognize that the proposed rule's application to a trading desk ''or other organizational unit'' would have provided banking entities with this type of flexibility to determine the level of organization at which the market-making exemption should apply based on the entity's particular business structure and trading strategies, which would likely reduce the burdens of this aspect of the final rule. However, for the reasons noted above regarding application of this exemption to a higher organizational level than the trading

Instead of taking that approach, the Agencies have determined to permit a broader range of market making-related activities that can be effectively controlled by building on risk controls used by trading desks for business purposes. This will allow an individual trader to use instruments or strategies within limits established in the compliance program to confidently trade in the type of financial instruments in which his or her trading desk makes a market. The Agencies believe this addresses concerns that uncertainty would negatively impact liquidity. It also addresses concerns that applying the market-making exemption at a higher level of organization would reduce the effectiveness of the requirements in the final rule aimed at ensuring that the quality and character of trading is consistent with market making-related activity and would increase the risk of evasion. Moreover, several provisions of the final rule are intended to account for the liquidity, maturity, and depth of the market for a given type of financial instrument in which the trading desk makes a market. The final rule takes account of these factors to, among other things, respond to commenters' concerns about the proposed rule's potential impact on market making in less liquid markets. Applying these requirements at an organizational level above the trading desk would be more likely to result in aggregation of trading in various types of instruments with differing levels of liquidity, which would make it more difficult for these market factors to be taken into account for purposes of the exemption (for example, these factors are considered for purposes of tailoring the analysis of reasonably expected near-term demands of customers and establishing risk, inventory, and duration limits).

Thus, the Agencies continue to believe that certain requirements of the exemption should apply to a relatively granular level of organization within a banking entity (or across two or more affiliated banking entities). These requirements of the final market-making exemption have been formulated to best reflect the nature of activities at the trading desk level of granularity.

As explained below, the Agencies are applying certain requirements to a ''trading desk'' of a banking entity and adopting a definition of this term in the final rule.[710] The definition of ''trading desk'' is similar to the first prong of the proposed definition of ''trading unit.'' The Agencies are not adopting the proposed ''or other organizational unit'' language because the Agencies are concerned that approach would have provided banking entities with too much discretion to independently determine the organizational level at which the requirements should apply, including a more aggregated level of organization, which could lead to evasion of the general prohibition on proprietary trading and the other concerns noted above. The Agencies believe that adopting an approach focused on the trading desk level will allow banking entities and the Agencies to better distinguish between permitted market making-related activities and trading that is prohibited by section 13 of the BHC Act and, thus, will prevent evasion of the statutory requirements, as discussed in more detail below. Further, as discussed below, the Agencies believe that applying requirements at the trading desk level is balanced by the financial exposure-based approach, which will address commenters' concerns about the burdens of trade-by-trade analyses.

In the final rule, trading desk is defined to mean the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies expect that a trading desk would be managed and operated as an individual unit and should reflect the level at which the profit and loss of market-making traders is attributed.[711] The geographic location of individual traders is not dispositive for purposes of the analysis of whether the traders may comprise a single trading desk. For instance, a trading desk making markets in U.S. investment grade telecom corporate credits may use trading personnel in both New York (to trade U.S. dollar-denominated bonds issued by U.S.-incorporated telecom companies) and London (to trade Euro-denominated bonds issued by the same type of companies). This approach allows more effective management of risks of trading activity by requiring the establishment of limits, management oversight, and accountability at the level where trading activity actually occurs. It also allows banking entities to tailor the limits and procedures to the type of instruments traded and markets served by each trading desk.

In response to comments, and as discussed below in the context of the ''financial exposure'' definition, a trading desk may manage a financial exposure that includes positions in different affiliated legal entities.[712] Similarly, a trading desk may include employees working on behalf of multiple affiliated legal entities or booking trades in multiple affiliated entities. Using the previous example, the U.S. investment grade telecom corporate credit trading desk may include traders working for or booking into a broker-dealer entity (for corporate bond trades), a security-based swap dealer entity (for single-name CDS trades), and/or a swap dealer entity (for index CDS or interest rate swap hedges). To clarify this issue, the definition of ''trading desk'' specifically provides that the desk can buy or sell financial instruments ''for the trading account of a banking entity or an affiliate thereof.'' Thus, a trading desk need not be constrained to a single legal entity, although it is permissible for a trading desk to only trade for a single legal entity. A trading desk booking positions in different affiliated legal entities must have records that identify all positions included in the trading desk's financial exposure and where such positions are held, as discussed below.[713]

The Agencies believe that establishing a defined organizational level at which many of the market-making exemption's requirements apply will address potential evasion concerns. Applying certain requirements of the market-making exemption at the trading desk level will strengthen their effectiveness and prevent evasion of the exemption by ensuring that the aggregate trading activities of a relatively limited group of traders on a single desk are conducted in a manner that is consistent with the exemption's standards. In particular, because many of the requirements in the market-making exemption look to the specific type(s) of financial instruments in which a market is being made, and such requirements are designed to take into account differences among markets and asset classes, the Agencies believe it is important that these requirements be applied to a discrete and identifiable unit engaged in, and operated by personnel whose responsibilities relate to, making a market in a specific set or

desk, the Agencies are not adopting the ''or other organizational unit'' language.

[710] *See* final rule § 75.3(e)(13).

[711] For example, the Agencies expect a banking entity may determine the foreign exchange options desk to be a trading desk; however, the Agencies do not expect a banking entity to consider an individual Japanese Yen options trader (*i.e.,* the trader in charge of all Yen-based options trades) as a trading desk, unless the banking entity manages its profit and loss, market making, and hedging in Japanese Yen options independently of all other financial instruments.

[712] *See infra* note 729 and accompanying text. Several commenters noted that market-making activities may be conducted across separate affiliated legal entities. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[713] *See infra* note 732 and accompanying text.

type of financial instruments. Further, applying requirements at the trading desk level should facilitate banking entity monitoring and review of compliance with the exemption by limiting the aggregate trading volume that must be reviewed, as well as allowing consideration of the particular facts and circumstances of the desk's trading activities (*e.g.,* the liquidity, maturity, and depth of the market for the relevant types of financial instruments). As discussed above, the Agencies believe that applying the requirements of the market-making exemption to a higher level of organization would reduce the ability to consider the liquidity, maturity, and depth of the market for a type of financial instrument, would impede effective monitoring and compliance reviews, and would increase the risk of evasion.

ii. Definitions of ''Financial Exposure'' and ''Market-Maker Inventory''

Certain requirements of the proposed market-making exemption referred to a ''purchase or sale of a [financial instrument].'' [714] Even though the Agencies did not intend to require a trade-by-trade review, a significant number of commenters expressed concern that this language could be read to require compliance with the proposed market-making exemption on a transaction-by-transaction basis.[715] In response to these concerns, the Agencies are modifying the exemption to clarify the manner in which compliance with certain provisions will be assessed. In particular, rather than a transaction-by-transaction focus, the market-making exemption in the final rule focuses on two related aspects of market-making activity: A trading desk's ''market-maker inventory'' and its overall ''financial exposure.''[716]

The Agencies are adopting an approach that focuses on both a trading desk's financial exposure and market-maker inventory in recognition that market making-related activity is best viewed in a holistic manner and that, during a single day, a trading desk may engage in a large number of purchases and sales of financial instruments. While all these transactions must be conducted in compliance with the market-making exemption, the Agencies recognize that they involve financial instruments for which the trading desk acts as market maker (*i.e.,* by standing ready to purchase and sell that type of financial instrument) and instruments that are acquired to manage the risks of positions in financial instruments for which the desk acts as market maker, but in which the desk is not itself a market maker.[717]

The final rule requires that activity by a trading desk under the market-making exemption be evaluated by a banking entity through monitoring and setting limits for the trading desk's market-maker inventory and financial exposure. The market-maker inventory of a trading desk includes the positions in financial instruments, including derivatives, in which the trading desk acts as market maker. The financial exposure of the trading desk includes the aggregate risks of financial instruments in the market-maker inventory of the trading desk plus the financial instruments, including derivatives, that are acquired to manage the risks of the positions in financial instruments for which the trading desk acts as a market maker, but in which the trading desk does not itself make a market, as well as any associated loans, commodities, and foreign exchange that are acquired as incident to acting as a market maker. In addition, the trading desk generally must maintain its market-maker inventory and financial exposure within its market-maker inventory limit and its financial exposure limit, respectively and, to the extent that any limit of the trading desk is exceeded, the trading desk must take action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[718] Thus, if market movements cause a trading desk's financial exposure to exceed one or more of its risk limits, the trading desk must promptly take action to reduce its financial exposure or obtain approval for an increase to its limits through the required escalation procedures, detailed below. A trading desk may not, however, enter into a trade that would cause it to exceed its limits without first receiving approval through its escalation procedures.[719]

Under the final rule, the term market-maker inventory is defined to mean all of the positions, in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section, that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.[720] Those financial instruments in which a trading desk acts as market maker must be identified in the trading desk's compliance program under § 75.4(b)(2)(iii)(A) of the final rule. As used throughout this **SUPPLEMENTARY INFORMATION**, the term ''inventory'' refers to both the retention of financial instruments (*e.g.,* securities) and, in the context of derivatives trading, the risk exposures arising out of market-making related activities.[721] Consistent with the statute, the final rule requires that the market-maker inventory of a trading desk be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

The financial exposure concept is broader in scope than market-maker inventory and reflects the aggregate risks of the financial instruments (as well as any associated loans, spot commodities, or spot foreign exchange or currency) the trading desk manages as part of its market making-related activities.[722] Thus, a trading desk's financial exposure will take into account a trading desk's positions in instruments for which it does not act as a market maker, but which are

[714] *See* proposed rule § 75.4(b).

[715] Some commenters also contended that language in proposed Appendix B raised transaction-by-transaction implications. *See supra* notes 522 to 529 and accompanying text (discussing commenters' transaction-by-transaction concerns).

[716] The Agencies are not adopting a transaction-by-transaction approach because the Agencies are concerned that such an approach would be unduly burdensome or impractical and inconsistent with the manner in which *bona fide* market making-related activity is conducted. Additionally, the Agencies are concerned that the burdens of such an approach would cause banking entities to significantly reduce or cease market making-related activities, which would cause negative market impacts harmful to both investors and issuers, as well as the financial system generally.

[717] *See* Joint Proposal, 76 FR at 68870 n.146 (''The Agencies note that a market maker may often make a market in one type of [financial instrument] and hedge its activities using different [financial instruments] in which it does not make a market.''); CFTC Proposal, 77 FR at 8356 n.152.

[718] *See* final rule § 75.4(b)(2)(iv).

[719] *See* final rule § 75.4(b)(2)(iii)(E).

[720] *See* final rule § 75.4(b)(5).

[721] As noted in the proposal, certain types of market making-related activities, such as market making in derivatives, involves the retention of principal exposures rather than the retention of actual financial instruments. *See* Joint Proposal, 76 FR at 68869 n.143; CFTC Proposal, 77 FR at 8354 n.149. This type of activity would be included under the concept of ''inventory'' in the final rule.

[722] The Agencies recognize that under the statute a banking entity's positions in loans, spot commodities, and spot foreign exchange or currency are not subject to the final rule's restrictions on proprietary trading. Thus, a banking entity's trading in these instruments does not need to comply with the market-making exemption or any other exemption to the prohibition on proprietary trading. A banking entity may, however, include exposures in loans, spot commodities, and spot foreign exchange or currency that are related to the desk's market-making activities in determining the trading desk's financial exposure and in turn, the desk' s financial exposure limits under the market-making exemption. The Agencies believe this will provide a more accurate picture of the trading desk's financial exposure. For example, a market maker in foreign exchange forwards or swaps may mitigate the risks of its market-maker inventory with spot foreign exchange.

established as part of its market making-related activities, which includes risk mitigation and hedging. For instance, a trading desk that acts as a market maker in Euro-denominated corporate bonds may, in addition to Euro-denominated bonds, enter into credit default swap transactions on individual European corporate bond issuers or an index of European corporate bond issuers in order to hedge its exposure arising from its corporate bond inventory, in accordance with its documented hedging policies and procedures. Though only the corporate bonds would be considered as part of the trading desk's market-maker inventory, its overall financial exposure would also include the credit default swaps used for hedging purposes.

As noted above, the Agencies believe the extent to which a trading desk is engaged in permitted market making-related activities is best determined by evaluating both the financial exposure that results from the desk's trading activity and the amount, types, and risks of the financial instruments in the desk's market-maker inventory. Both concepts are independently valuable and will contribute to the effectiveness of the market-making exemption. Specifically, a trading desk's financial exposure will highlight the net exposure and risks of its positions and, along with an analysis of the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of that exposure consistent with its limits, the extent to which it is appropriately managing the risk of its market-maker inventory consistent with applicable limits, all of which are significant to an analysis of whether a trading desk is engaged in market making-related activities. An assessment of the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory will identify the aggregate amount of the desk's inventory in financial instruments for which it acts as market maker, the types of these financial instruments that the desk holds at a particular time, and the risks arising from such holdings. Importantly, an analysis of a trading desk's market-maker inventory will inform the extent to which this inventory is related to the reasonably expected near term demands of clients, customers, or counterparties.

Because the market-maker inventory concept is more directly related to the financial instruments that a trading desk buys and sells from customers than the financial exposure concept, the Agencies believe that requiring review and analysis of a trading desk's market-maker inventory, as well as its financial exposure, will enhance compliance with the statute's near-term customer demand requirement. While the amount, types, and risks of a trading desk's market-maker inventory are constrained by the near-term customer demand requirement, any other positions in financial instruments managed by the trading desk as part of its market making-related activities (*i.e.,* those reflected in the trading desk's financial exposure, but not included in the trading desk's market-maker inventory) are also constrained because they must be consistent with the market-maker inventory or, if taken for hedging purposes, designed to reduce the risks of the trading desk's market-maker inventory.

The Agencies note that disaggregating the trading desk's market-maker inventory from its other exposures also allows for better identification of the trading desk's hedging positions in instruments for which the trading desk does not make a market. As a result, a banking entity's systems should be able to readily identify and monitor the trading desk's hedging positions that are not in its market-maker inventory. As discussed in Part VI.A.3.c.3., a trading desk must have certain inventory and risk limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its financial exposure that are designed to facilitate the trading desk's compliance with the exemption and that are based on the nature and amount of the trading desk's market making-related activities, including analyses regarding the reasonably expected near term demands of customers.[723]

The final rule also requires these policies and procedures to contain escalation procedures if a trade would exceed the limits set for the trading desk. However, the final rule does not permit a trading desk to exceed the limits solely based on customer demand. Rather, before executing a trade that would exceed the desk's limits or changing the desk's limits, a trading desk must first follow the relevant escalation procedures, which may require additional approval within the banking entity and provide demonstrable analysis that the basis for any temporary or permanent increase in limits is consistent with the reasonably expected near term demands of customers.

Due to these considerations, the Agencies believe the final rule should result in more efficient compliance analyses on the part of both banking entities and Agency supervisors and examiners and should be less costly for banking entities to implement than a transaction-by-transaction or instrument-by-instrument approach. For example, the Agencies believe that some banking entities already compute and monitor most trading desks' financial exposures for risk management or other purposes.[724] The Agencies also believe that focusing on the financial exposure and market-maker inventory of a trading desk, as opposed to each separate individual transaction, is consistent with the statute's goal of reducing proprietary trading risk in the banking system and its exemption for market making-related activities. The Agencies recognize that banking entities may not currently disaggregate trading desks' market-maker inventory from their financial exposures and that, to the extent banking entities do not currently separately identify trading desks' market-maker inventory, requiring such disaggregation for purposes of this rule will impose certain costs. In addition, the Agencies understand that an approach focused solely on the aggregate of all the unit's trading positions, as suggested by some commenters, would present fewer burdens.[725] However, for the reasons discussed above, the Agencies believe such disaggregation is necessary to give full effect to the statute's near term customer demand requirement.

The Agencies note that whether a financial instrument or exposure stemming from a derivative is considered to be market-maker inventory is based only on whether the desk makes a market in the financial instrument, regardless of the type of counterparty or the purpose of the transaction. Thus, the Agencies believe that banking entities should be able to develop a standardized methodology for identifying a trading desk's positions and exposures in the financial instruments for which it acts as a market maker. As further discussed in this Part, a trading desk's financial exposure must reflect the aggregate risks managed by the trading desk as part of its market

[723] *See infra* Part VI.A.3.c.2.c.; final rule § 75.4(b)(2)(iii)(C).

[724] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that modern trading units generally view individual positions as a bundle of characteristics that contribute to their complete portfolio). *See also* Federal Reserve Board, Trading and Capital-Markets Activities Manual § 2000.1 (Feb. 1998) (''The risk-measurement system should also permit disaggregation of risk by type and by customer, instrument, or business unit to effectively support the management and control of risks.'').

[725] *See* ACLI (Feb. 2012); Fixed Income Forum/Credit Roundtable; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

making-related activities,[726] and a banking entity should be able to demonstrate that the financial exposure of a trading desk is related to its market-making activities.

The final rule defines ''financial exposure'' to mean the ''aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.'' [727] In this context, the term ''aggregate'' does not imply that a long exposure in one instrument can be combined with a short exposure in a similar or related instrument to yield a total exposure of zero. Instead, such a combination may reduce a trading desk's economic exposure to certain risk factors that are common to both instruments, but it would still retain any basis risk between those financial instruments or potentially generate a new risk exposure in the case of purposeful hedging.

With respect to the frequency with which a trading desk should determine its financial exposure and the amount, types, and risks of the financial instruments in its market-maker inventory, a trading desk's financial exposure and market-maker inventory should be evaluated and monitored at a frequency that is appropriate for the trading desk's trading strategies and the characteristics of the financial instruments the desk trades, including historical intraday volatility. For example, a trading desk that repeatedly acquired and then terminated significant financial exposures throughout the day but that had little or no financial exposure at the end of the day should assess its financial exposure based on its intraday activities, not simply its end-of-day financial exposure. The frequency with which a trading desk's financial exposure and market-maker inventory will be monitored and analyzed should be specified in the trading desk's compliance program.

A trading desk's financial exposure reflects its aggregate risk exposures. The types of ''aggregate risks'' identified in the trading desk's financial exposure should reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk acts as market maker or that the desk uses for risk management purposes pursuant to this exemption, including the liquidity, maturity, and depth of the market for the relevant types of financial instruments. Thus, market factors reflected in a trading desk's financial exposure should include all significant and relevant factors associated with the products and instruments in which the desk trades as market maker or for risk management purposes, including basis risk arising from such positions.[728] Similarly, an assessment of the risks of the trading desk's market-maker inventory must reflect consideration of all significant market factors relevant to the financial instruments in which the trading desk makes a market. Importantly, a trading desk's financial exposure and the risks of its market-maker inventory will change based on the desk's trading activity (*e.g.,* buying an instrument that it did not previously hold, increasing its position in an instrument, or decreasing its position in an instrument) as well as changing market conditions related to instruments or positions managed by the trading desk.

Because the final rule defines ''trading desk'' based on operational functionality rather than corporate formality, a trading desk's financial exposure may include positions that are booked in different affiliated legal entities.[729] The Agencies understand that positions may be booked in different legal entities for a variety of reasons, including regulatory reasons. For example, a trading desk that makes a market in corporate bonds may book its corporate bond positions in an SEC-registered broker-dealer and may book index CDS positions acquired for hedging purposes in a CFTC-registered swap dealer. A financial exposure that reflects both the corporate bond position and the index CDS position better reflects the economic reality of the trading desk's risk exposure (*i.e.,* by showing that the risk of the corporate bond position has been reduced by the index CDS position).

In addition, a trading desk engaged in market making-related activities in compliance with the final rule may direct another organizational unit of the banking entity or an affiliate to execute a risk-mitigating transaction on the trading desk's behalf.[730] The other organizational unit may rely on the market-making exemption for these purposes only if: (i) The other organizational unit acts in accordance with the trading desk's risk management policies and procedures established in accordance with § 75.4(b)(2)(iii) of the final rule; and (ii) the resulting risk-mitigating position is attributed to the trading desk's financial exposure (and not the other organizational unit's financial exposure) and is included in the trading desk's daily profit and loss calculation. If another organizational unit of the banking entity or an affiliate establishes a risk-mitigating position for the trading desk on its own accord (*i.e.,* not at the direction of the trading desk) or if the risk-mitigating position is included in the other organizational unit's financial exposure or daily profit and loss calculation, then the other organizational unit must comply with the requirements of the hedging exemption for such activity.[731] It may not rely on the market-making exemption under these circumstances. If a trading desk engages in a risk-mitigating transaction with a second trading desk of the banking entity or an affiliate that is also engaged in permissible market making-related activities, then the risk-mitigating position would be included in the first trading desk's financial exposure and the contra-risk would be included in the second trading desk's market-maker inventory and financial exposure. The Agencies believe the net effect of the final rule is to allow individual trading desks to efficiently manage their own hedging and risk mitigation activities on a holistic basis, while only allowing for external hedging directed by staff outside of the trading desk under the additional requirements of the hedging exemption.

To include in a trading desk's financial exposure either positions held at an affiliated legal entity or positions established by another organizational unit on the trading desk's behalf, a banking entity must be able to provide supervisors or examiners of any Agency that has regulatory authority over the banking entity pursuant to section

[726] *See* final rule § 75.4(b)(4).

[727] Final rule § 75.4(b)(4). For example, in the case of derivatives, a trading desk's financial position will be the residual risks of the trading desk's open positions. For instance, an options desk may have thousands of open trades at any given time, including hedges, but the desk will manage, among other risk factors, the trading desk's portfolio delta, gamma, rho, and volatility.

[728] As discussed in Part VI.A.3.c.3., a banking entity must establish, implement, maintain, and enforce policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell and the products, instruments, or exposures each trading desk may use for risk management purposes. *See* final rule § 75.4(b)(2)(iii).

[729] Other statutory or regulatory requirements, including those based on prudential safety and soundness concerns, may prevent or limit a banking entity from booking hedging positions in a legal entity other than the entity taking the underlying position.

[730] *See infra* Part VI.A.3.c.4.

[731] Under these circumstances, the other organizational unit would also be required to meet the hedging exemption's documentation requirement for the risk-mitigating transaction. *See* final rule § 75.5(c).

13(b)(2)(B) of the BHC Act with records, promptly upon request, that identify any related positions held at an affiliated entity that are being included in the trading desk's financial exposure for purposes of the market-making exemption. Similarly, the supervisors and examiners of any Agency that has supervisory authority over the banking entity that holds financial instruments that are being included in another trading desk's financial exposure for purposes of the market-making exemption must have the same level of access to the records of the trading desk.[732] Banking entities should be prepared to provide all records that identify all positions included in a trading desk's financial exposure and where such positions are held.

As an example of how a trading desk's market-maker inventory and financial exposure will be analyzed under the market-making exemption, assume a trading desk makes a market in a variety of U.S. corporate bonds and hedges its aggregated positions with a combination of exposures to corporate bond indexes and specific name CDS in which the desk does not make a market. To qualify for the market-making exemption, the trading desk would have to demonstrate, among other things, that: (i) The desk routinely stands ready to purchase and sell the U.S. corporate bonds, consistent with the requirement of § 75.4(b)(2)(i) of the final rule, and these instruments (or category of instruments) are identified in the trading desk's compliance program; (ii) the trading desk's market-maker inventory in U.S. corporate bonds is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, consistent with the analysis and limits established by the banking entity for the trading desk; (iii) the trading desk's exposures to corporate bond indexes and single name CDS are designed to mitigate the risk of its financial exposure, are consistent with the products, instruments, or exposures and the techniques and strategies that the trading desk may use to manage its risk effectively (and such use continues to be effective), and do not exceed the trading desk's limits on the amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes; and (iv) the aggregate risks of the trading desk's exposures to U.S. corporate bonds, corporate bond indexes, and single name CDS do not exceed the trading desk's limits on the level of exposures to relevant risk factors arising from its financial exposure.

Our focus on the financial exposure of a trading desk, rather than a trade-by-trade requirement, is designed to give banking entities the flexibility to acquire not only market-maker inventory, but positions that facilitate market making, such as positions that hedge market-maker inventory.[733] As commenters pointed out, a trade-by-trade requirement would view trades in isolation and could fail to recognize that certain trades that are not customer-facing are nevertheless integral to market making and financial intermediation.[734] The Agencies understand that the risk-reducing effects of combining large diverse portfolios could, in certain instances, mask otherwise prohibited proprietary trading.[735] However, the Agencies do not believe that taking a transaction-by-transaction approach is necessary to address this concern. Rather, the Agencies believe that the broader definitions of ''financial exposure'' and ''market-maker inventory'' coupled with the tailored definition of ''trading desk'' facilitates the analysis of aggregate risk exposures and positions in a manner best suited to apply and evaluate the market-making exemption.

In short, this approach is designed to mitigate the costs of a trade-by-trade analysis identified by commenters. The Agencies recognize, however, that this approach is only effective at achieving the goals of the section 13 of the BHC Act—promoting financial intermediation and limiting speculative risks within banking entities—if there are limits on a trading desk's financial exposure. That is, a permissive market-making exemption that gives banking entities maximum discretion in acquiring positions to provide liquidity runs the risk of also allowing banking entities to engage in speculative trades. As discussed more fully in the following Parts of this **SUPPLEMENTARY INFORMATION**, the final market-making exemption provides a number of controls on a trading desk's financial exposure. These controls include, among others, a provision requiring that a trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers and that any other financial instruments managed by the trading desk be designed to mitigate the risk of such desk's market-maker inventory. In addition, the final market-making exemption requires the trading desk's compliance program to include appropriate risk and inventory limits tied to the near term demand requirement, as well as escalation procedures if a trade would exceed such limits. The compliance program, which includes internal controls and independent testing, is designed to prevent instances where transactions not related to providing financial intermediation services are part of a desk's financial exposure.

iii. Routinely Standing Ready To Buy and Sell

The requirement to routinely stand ready to buy and sell a type of financial instrument in the final rule recognizes that market making-related activities differ based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument. For example, a trading desk acting as a market maker in highly liquid markets would engage in more regular quoting activity than a market maker in less liquid markets. Moreover, the Agencies recognize that the maturity and depth of the market also play a role in determining the character of a market maker's activity.

As noted above, the standard of ''routinely'' standing ready to buy and sell will differ across markets and asset classes based on the liquidity, maturity, and depth of the market for the type of financial instrument. For instance, a trading desk that is a market maker in liquid equity securities generally should engage in very regular or continuous quoting and trading activities on both sides of the market. In less liquid markets, a trading desk should engage in regular quoting activity across the relevant type(s) of financial instruments, although such quoting may be less frequent than in liquid equity markets.[736] Consistent with the CFTC's and SEC's interpretation of market making in swaps and security-based swaps for purposes of the definitions of

[732] A banking entity must be able to provide such records when a related position is held at an affiliate, even if the affiliate and the banking entity are not subject to the same Agency's regulatory jurisdiction.

[733] The Agencies believe it is appropriate to apply the requirements of the exemption to the financial exposure of a ''trading desk,'' rather than the portfolio of a higher level of organization, for the reasons discussed above, including our concern that aggregating a large number of disparate positions and exposures across a range of trading desks could increase the risk of evasion. *See supra* Part VI.A.3.c.1.c.i. (discussing the determination to apply requirements at the trading desk level).

[734] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[735] *See, e.g.,* Occupy.

[736] Indeed, in the most specialized situations, such quotations may only be provided upon request. *See infra* note 740 and accompanying text (discussing permissible block positioning).

''swap dealer'' and ''security-based swap dealer,'' ''routinely'' in the swap market context means that the trading desk should stand ready to enter into swaps or security-based swaps at the request or demand of a counterparty more frequently than occasionally.[737] The Agencies note that a trading desk may routinely stand ready to enter into derivatives on both sides of the market, or it may routinely stand ready to enter into derivatives on either side of the market and then enter into one or more offsetting positions in the derivatives market or another market, particularly in the case of relatively less liquid derivatives. While a trading desk may respond to requests to trade certain products, such as custom swaps, even if it does not normally quote in the particular product, the trading desk should hedge against the resulting exposure in accordance with its financial exposure and hedging limits.[738] Further, the Agencies continue to recognize that market makers in highly illiquid markets may trade only intermittently or at the request of particular customers, which is sometimes referred to as trading by appointment.[739] A trading desk's block positioning activity would also meet the terms of this requirement provided that, from time to time, the desk engages in block trades (*i.e.,* trades of a large quantity or with a high dollar value) with customers.[740]

Regardless of the liquidity, maturity, and depth of the market for a particular type of financial instrument, a trading desk should have a pattern of providing price indications on either side of the market and a pattern of trading with customers on each side of the market. In particular, in the case of relatively illiquid derivatives or structured instruments, it would not be sufficient to demonstrate that a trading desk on occasion creates a customized instrument or provides a price quote in response to a customer request. Instead, the trading desk would need to be able to demonstrate a pattern of taking these actions in response to demand from multiple customers with respect to both long and short risk exposures in identified types of instruments.

This requirement of the final rule applies to a trading desk's activity in one or more ''types'' of financial instruments.[741] The Agencies recognize that, in some markets, such as the corporate bond market, a market maker may regularly quote a subset of instruments (generally the more liquid instruments), but may not provide regular quotes in other related but less liquid instruments that the market maker is willing and available to trade. Instead, the market maker would provide a price for those instruments upon request.[742] The trading desk's activity, in the aggregate for a particular type of financial instrument, indicates whether it is engaged in activity that is consistent with § 75.4(b)(2)(i) of the final rule.

Notably, this requirement provides that the types of financial instruments for which the trading desk routinely stands ready to purchase and sell must be related to its authorized market-maker inventory and it authorized financial exposure. Thus, the types of financial instruments for which the desk routinely stands ready to buy and sell should compose a significant portion of its overall financial exposure. The only other financial instruments contributing to the trading desk's overall financial exposure should be those designed to hedge or mitigate the risk of the financial instruments for which the trading desk is making a market. It would not be consistent with the market-making exemption for a trading desk to hold only positions in, or be exposed to, financial instruments for which the trading desk is not a market maker.[743]

[737] The Agencies will consider factors similar to those identified by the CFTC and SEC in connection with this standard. *See* Further Definition of ''Swap Dealer,'' ''Security-Based Swap Dealer,'' ''Major Swap Participant,'' ''Major Security-Based Swap Participant'' and ''Eligible Contract Participant'', 77 FR 30596, 30609 (May 23, 2012)

[738] The Agencies recognize that, as noted by commenters, preventing a banking entity from conducting customized transactions with customers may impact customers' risk exposures or transaction costs. *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies are not prohibiting this activity under the final rule, as discussed in this Part.

[739] The Agencies have considered comments on the issue of whether trading by appointment should be permitted under the final market-making exemption. The Agencies believe it is appropriate to permit trading by appointment to the extent that there is customer demand for liquidity in the relevant products.

[740] As noted in the preamble to the proposed rule, the size of a block will vary among different asset classes. The Agencies also stated in the proposal that the SEC's definition of ''qualified block positioner'' in Rule 3b–8(c) under the Exchange Act may serve as guidance for determining whether block positioning activity qualifies for the market-making exemption. In referencing that rule as guidance, the Agencies did not intend to imply that a banking entity engaged in block positioning activity would be required to meet all terms of the ''qualified block positioner'' definition at all times. Nonetheless, a number of commenters indicated that it was unclear when a banking entity would need to act as a qualified block positioner in accordance with Rule 3b–8(c) and expressed concern that uncertainty could have a chilling effect on a banking entity's willingness to facilitate customer block trades. *See, e.g.,* RBC; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading). For example, a few commenters stated that certain requirements in Rule 3b–8(c) could cause fire sales or general market uncertainty. *See id.* After considering comments, the Agencies have decided that the reference to Rule 3b–8(c) is unnecessary for purposes of the final rule. In particular, the Agencies believe that the requirements in the market-making exemption provide sufficient safeguards, and the additional requirements of the ''qualified block positioner'' definition may present unnecessary burdens or redundancies with the rule, as adopted. For example, the Agencies believe that there is some overlap between § 75.4(b)(2)(ii) of the exemption, which provides that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and Rule 3b–8(c)(iii), which requires the sale of the shares comprising the block as rapidly as possible commensurate with the circumstances. In other words, the market-making exemption would require a banking entity to appropriately manage its inventory when engaged in block positioning activity, but would not speak directly to the timing element given the diversity of markets to which the exemption applies.

As noted above, one commenter analyzed the potential market impact of a complete restriction on a market maker's ability to provide direct liquidity to help a customer execute a large block trade. *See supra* note 687 and accompanying text. Because the Agencies are not restricting a banking entity's ability to engage in block positioning in the manner suggested by this commenter, the Agencies do not believe that the final rule will cause the cited market impact of incremental transaction costs between $1.7 and $3.4 billion per year. The Agencies address this commenter's concern about the impact of inventory metrics on a banking entity's willingness to engage in block trading in Part VI.C.3. (discussing the metrics requirement in the final rule and noting that metrics will not be used to determine compliance with the rule but, rather, will be monitored for patterns over time to identify activities that may warrant further review).

One commenter appeared to request that block trading activity not be subject to all requirements of the market-making exemption. *See* SIFMA (Asset Mgmt.) (Feb. 2012). Any activity conducted in reliance on the market-making exemption, including block trading activity, must meet the requirements of the market-making exemption. The Agencies believe the requirements in the final rule are workable for block positioning activity and do not believe it would be appropriate to subject block positioning to lesser requirements than general market-making activity. For example, trading in large block sizes can expose a trading desk to greater risk than market making in smaller sizes, particularly absent risk management requirements. Thus, the Agencies believe it is important for block positioning activity to be subject to the same requirements, including the requirements to establish risk limits and risk management procedures, as general market-making activity.

[741] This approach is generally consistent with commenters' requested clarification that a trading desk's quoting activity will not be assessed on an instrument-by-instrument basis, but rather across a range of similar instruments for which the trading desk acts as a market maker. *See, e.g.,* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); CIEBA; Goldman (Prop. Trading).

[742] *See, e.g.,* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[743] The Agencies recognize that there could be limited circumstances under which a trading desk's financial exposure does not relate to the types of financial instruments that it is standing ready to buy and sell for a short period of time. However, the Agencies would expect for such occurrences to be minimal. For example, this scenario could occur if a trading desk unwinds a hedge position after the

A trading desk's routine presence in the market for a particular type of financial instrument would not, on its own, be sufficient grounds for relying on the market-making exemption. This is because the frequency at which a trading desk is active in a particular market would not, on its own, distinguish between permitted market making-related activity and impermissible proprietary trading. In response to comments, the final rule provides that a trading desk also must be willing and available to quote, buy and sell, or otherwise enter into long and short positions in the relevant type(s) of financial instruments for its own account in commercially reasonable amounts and throughout market cycles.[744] Importantly, a trading desk would not meet the terms of this requirement if it provides wide quotations relative to prevailing market conditions and is not engaged in other activity that evidences a willingness or availability to provide intermediation services.[745] Under these circumstances, a trading desk would not be standing ready to purchase and sell because it is not genuinely quoting or trading with customers.

In the context of this requirement, ''commercially reasonable amounts'' means that the desk generally must be willing to quote and trade in sizes requested by other market participants.[746] For trading desks that engage in block trading, this would include block trades requested by customers, and this language is not meant to restrict a trading desk from acting as a block positioner. Further, a trading desk must act as a market maker on an appropriate basis throughout market cycles and not only when it is most favorable for it to do so.[747] For example, a trading desk should be facilitating customer needs in both upward and downward moving markets.

As discussed further in Part VI.A.3.c.3., the financial instruments the trading desk stands ready to buy and sell must be identified in the trading desk's compliance program.[748] Certain requirements in the final exemption apply to the amount, types, and risks of these financial instruments that a trading desk can hold in its market-maker inventory, including the near term customer demand requirement[749] and the need to have certain risk and inventory limits.[750]

In response to the proposed requirement that a trading desk or other organizational unit hold itself out, some commenters requested that the Agencies limit the availability of the market-making exemption to trading in particular asset classes or trading on particular venues (*e.g.,* organized trading platforms). The Agencies are not limiting the availability of the market-making exemption in the manner requested by these commenters.[751] Provided there is customer demand for liquidity in a type of financial instrument, the Agencies do not believe the availability of the market-making exemption should depend on the liquidity of that type of financial instrument or the ability to trade such instruments on an organized trading platform. The Agencies see no basis in the statutory text for either approach and believe that the likely harms to investors seeking to trade affected instruments (*e.g.,* reduced ability to purchase or sell a particular instrument, potentially higher transaction costs) and market quality (*e.g.,* reduced liquidity) that would arise under such an approach would not be justified,[752] particularly in light of the minimal benefits that might result from restricting or eliminating a banking entity's ability to hold less liquid assets in connection with its market making-related activities. The Agencies believe these commenters' concerns are adequately addressed by the final rule's requirements in the market-making exemption that are designed to ensure that a trading desk cannot hold risk in excess of what is appropriate to provide intermediation services designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties.

In response to comments on the proposed interpretation regarding anticipatory position-taking,[753] the Agencies note that the near term demand requirement in the final rule addresses when a trading desk may take positions in anticipation of reasonably expected near term customer demand.[754] The Agencies believe this approach is generally consistent with the comments the Agencies received on this issue.[755] In addition, the Agencies note that modifications to the proposed near term demand requirement in the final rule also address commenters concerns on this issue.[756]

market-making position has already been unwound or if a trading desk acquires an anticipatory hedge position prior to acquiring a market-making position. As discussed more thoroughly in Part VI.A.3.c.3., a banking entity must establish written policies and procedures, internal controls, analysis, and independent testing that establish appropriate parameters around such activities.

[744] *See, e.g.,* Occupy; Better Markets (Feb. 2012).

[745] One commenter expressed concern that a banking entity may be able to rely on the market-making exemption when it is providing only wide, out of context quotes. *See* Occupy.

[746] As discussed below, this may include providing quotes in the interdealer trading market.

[747] Algorithmic trading strategies that only trade when market factors are favorable to the strategy's objectives or that otherwise frequently exit the market would not be considered to be standing ready to purchase or sell a type of financial instrument throughout market cycles and, thus, would not qualify for the market-making exemption. The Agencies believe this addresses commenters' concerns about high-frequency trading activities that are only active in the market when it is believed to be profitable, rather than to facilitate customers. *See, e.g.,* Better Markets (Feb. 2012). The Agencies are not, however, prohibiting all high-frequency trading activities under the final rule or otherwise limiting high-frequency trading by banking entities by imposing a resting period on their orders, as requested by certain commenters. *See, e.g.,* Better Markets (Feb. 2012); Occupy; Public Citizen.

[748] *See* final rule § 75.4(b)(2)(iii)(A).

[749] *See* final rule § 75.4(b)(2)(ii).

[750] *See* final rule § 75.4(b)(2)(iii)(C).

[751] For example, a few commenters requested that the rule prohibit banking entities from market making in assets classified as Level 3 under FAS 157. *See supra* note 656 and accompanying text. The Agencies continue to believe that it would be inappropriate to incorporate accounting standards in the rule because accounting standards could change in the future without consideration of the potential impact on the final rule. *See* Joint Proposal, 76 FR at 68859 n.101 (explaining why the Agencies declined to incorporate certain accounting standards in the proposed rule); CFTC Proposal, 77 FR at 8344 n.107.

Further, a few commenters suggested that the exemption should only be available for trading on an organized trading facility. This type of limitation would require significant and widespread market structure changes (with associated systems and infrastructure costs) in a relatively short period of time, as market making in certain assets is primarily or wholly conducted in the OTC market, and organized trading platforms may not currently exist for these assets. The Agencies do not believe that the costs of such market structure changes would be warranted for purposes of this rule.

[752] As discussed above, a number of commenters expressed concern about the potential market impacts of the perceived restrictions on market making under the proposed rule, particularly with respect to less liquid markets, such as the corporate bond market. *See, e.g.,* Prof. Duffie; Wellington; BlackRock; ICI.

[753] Joint Proposal, 76 FR at 68871 (stating that ''*bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties''); CFTC Proposal, 77 FR at 8356–8357; *see also* Morgan Stanley (requesting certain revisions to more closely track the statute); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[754] *See* final rule § 75.4(b)(2)(ii); *infra* Part VI.A.3.c.2.c.

[755] *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; SIFMA (Asset Mgmt.) (Feb. 2012).

[756] For example, some commenters suggested that the final rule allow market makers to make individualized assessments of anticipated customer demand, based on their expertise and experience, and account for differences between liquid and less liquid markets. *See* Chamber (Feb. 2012); ISDA (Feb. 2012). The final rule allows such assessments,

Continued

2. Near Term Customer Demand Requirement

a. Proposed Near Term Customer Demand Requirement

Consistent with the statute, the proposed rule required that the trading desk or other organizational unit's market making-related activities be, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.[757] This requirement is intended to prevent a trading desk from taking a speculative proprietary position that is unrelated to customer needs as part of the desk's purported market making-related activities.[758]

In the proposal, the Agencies stated that a banking entity's expectations of near term customer demand should generally be based on the unique customer base of the banking entity's specific market-making business lines and the near term demand of those customers based on particular factors, beyond a general expectation of price appreciation. The Agencies further stated that they would not expect the activities of a trading desk or other organizational unit to qualify for the market-making exemption if the trading desk or other organizational unit is engaged wholly or principally in trading that is not in response to, or driven by, customer demands, regardless of whether those activities promote price transparency or liquidity. The proposal stated that, for example, a trading desk or other organizational unit of a banking entity that is engaged wholly or principally in arbitrage trading with non-customers would not meet the terms of the proposed rule's market-making exemption.[759]

With respect to market making in a security that is executed on an exchange or other organized trading facility, the proposal provided that a market maker's activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy and the market maker is registered, if the exchange or organized trading facility registers market makers. Under the proposal, activities on an exchange or other organized trading facility that primarily take liquidity, rather than provide liquidity, would not qualify for the market-making exemption, even if conducted by a registered market maker.[760]

b. Comments Regarding the Proposed Near Term Customer Demand Requirement

As noted above, the proposed near term customer demand requirement would implement language found in the statute's market-making exemption.[761] Some commenters expressed general support for this requirement.[762] For example, these commenters emphasized that the proposed near term demand requirement is an important component that restricts disguised position-taking or market making in illiquid markets.[763] Several other commenters expressed concern that the proposed requirement is too restrictive[764] because, for example, it may impede a market maker's ability to build or retain inventory[765] or may impact a market maker's willingness to engage in block trading.[766] Comments on particular aspects of this proposed requirement are discussed below, including the proposed interpretation of this requirement in the proposal, the requirement's potential impact on market maker inventory, potential differences in this standard across asset classes, whether it is possible to predict near term customer demand, and whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined for purposes of the exemption.

i. The Proposed Guidance for Determining Compliance With the Near Term Customer Demand Requirement

As discussed in more detail above, the proposal set forth proposed guidance on how a banking entity may comply with the proposed near term customer demand requirement.[767] With respect to the language indicating that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation), one commenter stated that it is unclear how a banking entity would be able to make such determinations in markets where trades occur infrequently and customer demand is hard to predict.[768]

Several commenters expressed concern about the proposal's statement that a trading desk or other organizational unit engaged wholly or principally in trading that is not in response to, or driven by, customer demands (*e.g.,* arbitrage trading with non-customers) would not qualify for the exemption, regardless of whether the activities promote price transparency or liquidity.[769] In particular, commenters stated that it would be difficult for a market-making business to try to divide its activities that are in response to customer demand (*e.g.,* customer intermediation and hedging) from activities that promote price transparency and liquidity (*e.g.,* interdealer trading to test market depth or arbitrage trading) in order to determine their proportionality.[770] Another commenter stated that, as a matter of organizational efficiency, firms will often restrict arbitrage trading

based on historical customer demand and other relevant factors, and recognizes that near term demand may differ based on the liquidity, maturity, and depth of the market for a particular type of financial instrument. *See infra* Part VI.A.3.c.2.c.iii.

[757] *See* proposed rule § 75.4(b)(2)(iii).

[758] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8357.

[759] *See id.*

[760] *See* Joint Proposal, 76 FR at 68871–68872; CFTC Proposal, 77 FR at 8357.

[761] *See supra* Part VI.A.3.c.2.a.

[762] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Flynn & Fusselman; Better Markets (Feb. 2012).

[763] *See* Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[764] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); T. Rowe Price; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation; CIEBA; Credit Suisse (Seidel); SSgA (Feb. 2012); IAA (stating that the proposed requirement is too subjective and would be difficult to administer in a range of scenarios); Barclays; Prof. Duffie.

[765] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). The Agencies respond to these comments in Part VI.A.3.c.2.c., *infra.* For a discussion of comments regarding inventory management activity conducted in connection with market making, see Part VI.A.3.c.2.b.vi., *infra.*

[766] *See, e.g.,* ACLI (Feb. 2012); MetLife; Comm. on Capital Markets Regulation (noting that a market maker may need to hold significant inventory to accommodate potential block trade requests). Two of these commenters stated that a market maker may provide a worse price or may be unwilling to intermediate a large customer position if the market maker has to determine whether holding such position will meet the near term demand requirement, particularly if the market maker would be required to sell the block position over a short period of time. *See* ACLI (Feb. 2012); MetLife. These comments are addressed in Part VI.A.3.c.2.c.iii., *infra.*

[767] *See supra* Part VI.A.3.c.2.a.

[768] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). Another commenter suggested that the Agencies ''establish clear criteria that reflect appropriate revenue from changes in the bid-ask spread,'' noting that a legitimate market maker should be both selling and buying in a rising market (or, likewise, in a declining market). Public Citizen.

[769] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (Feb. 2012); ICI Global; Vanguard; SSgA (Feb. 2012); *see also infra* Part VI.A.3.c.2.b.viii. (discussing comments on whether arbitrage trading should be permitted under the market-making exemption under certain circumstances).

[770] *See* Goldman (Prop. Trading); RBC. One of these commenters agreed, however, that a trading desk that is ''wholly'' engaged in trading that is unrelated to customer demand should not qualify for the proposed market-making exemption. *See* Goldman (Prop. Trading).

strategies to certain specific individual traders within the market-making organization, who may sometimes be referred to as a ''desk,'' and expressed concern that this would be prohibited under the rule.[771]

In response to the proposed interpretation regarding market making on an exchange or other organized trading facility (and certain similar language in proposed Appendix B),[772] several commenters indicated that the reference to passive submission of resting orders may be too restrictive and provided examples of scenarios where market makers may need to use market or marketable limit orders.[773] For example, many of these commenters stated that market makers may need to enter market or marketable limit orders to: (i) Build or reduce inventory;[774] (ii) address order imbalances on an exchange by, for example, using market orders to lessen volatility and restore pricing equilibrium; (iii) hedge market-making positions; (iv) create markets;[775] (v) test the depth of the markets; (vi) ensure that ETFs, American depositary receipts (''ADRs''), options, and other instruments remain appropriately priced;[776] and (vii) respond to movements in prices in the markets.[777] Two commenters noted that distinctions between limit and market or marketable limit orders may not be workable in the international context, where exchanges may not use the same order types as U.S. trading facilities.[778]

A few commenters also addressed the proposed use of a market maker's exchange registration status as part of the analysis.[779] Two commenters stated that the proposed rule should not require a market maker to be registered with an exchange to qualify for the proposed market-making exemption. According to these commenters, there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices. These commenters indicated that any restrictions or burdens on such trading may decrease liquidity or make it harder to provide customers with the best price for their trade.[780] One commenter, however, stated that the exchange registration requirement is reasonable and further supported adding a requirement that traders demonstrate adherence to the same or commensurate standards in markets where registration is not possible.[781]

Some commenters recommended certain modifications to the proposed analysis. For example, a few commenters requested that the rule presume that a trading unit is engaged in permitted market making-related activity if it is registered as a market maker on a particular exchange or organized trading facility.[782] In support of this recommendation, one commenter represented that it would be warranted because registered market makers directly contribute to maintaining liquid and orderly markets and are subject to extensive regulatory requirements in that capacity.[783] Another commenter suggested that the Agencies instead use metrics to compare, in the aggregate and over time, the liquidity that a market maker makes rather than takes as part of a broader consideration of the market-making character of the relevant trading activity.[784]

ii. Potential Inventory Restrictions and Differences Across Asset Classes

A number of commenters expressed concern that the proposed requirement may unduly restrict a market maker's ability to manage its inventory.[785] Several of these commenters stated that limitations on inventory would be especially problematic for market making in less liquid markets, like the fixed-income market, where customer demand is more intermittent and positions may need to be held for a longer period of time.[786] Some commenters stated that the Agencies' proposed interpretation of this requirement would restrict a market maker's inventory in a manner that is inconsistent with the statute. These commenters indicated that the ''designed'' and ''reasonably expected'' language of the statute seem to recognize that market makers must anticipate customer requests and accumulate sufficient inventory to meet those reasonably expected demands.[787] In addition, one commenter represented that a market maker must have wide latitude and incentives for initiating trades, rather than merely reacting to customer requests for quotes, to properly risk manage its positions or to prepare for anticipated customer demand or supply.[788] Many commenters requested certain modifications to the proposed requirement to limit its impact on

[771] *See* JPMC.

[772] *See* Joint Proposal, 76 FR at 68871–68,872; CFTC Proposal, 77 FR at 8357.

[773] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); RBC. Comments on proposed Appendix B are discussed further in Part VI.A.3.c.8.b., *infra.* This issue is addressed in note 944 and its accompanying text, *infra.*

[774] Some commenters stated that market makers may need to use market or marketable limit orders to build inventory in anticipation of customer demand or in connection with positioning a block trade for a customer. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). Two of these commenters noted that these order types may be needed to dispose of positions taken into inventory as part of market making. *See* RBC; Goldman (Prop. Trading).

[775] *See* NYSE Euronext.

[776] *See* Goldman (Prop. Trading).

[777] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[778] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading).

[779] *See* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Occupy. *See also infra* notes 945 to 946 and accompanying text (addressing these comments).

[780] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that trading units may currently register as market makers with particular, primary exchanges on which they trade, but will serve in a market-making capacity on other trading venues from time to time); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

[781] *See* Occupy. In the alternative, this commenter would require all market making to be performed on an exchange or organized trading facility. *See id.*

[782] *See* NYSE Euronext (recognizing that registration status is not necessarily conclusive of engaging in market making-related activities); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that to the extent a trading unit is registered on a particular exchange or organized trading facility for any type of financial instrument, all of its activities on that exchange or organized trading facility should be presumed to be market making); Goldman (Prop. Trading). *See also infra* note 945 (responding to these comments). Two commenters noted that certain exchange rules may require market makers to deal for their own account under certain circumstances in order to maintain fair and orderly markets. *See* NYSE Euronext (discussing NYSE rules); Goldman (Prop. Trading) (discussing NYSE and CBOE rules). For example, according to these commenters, NYSE Rule 104(f)(ii) requires a market maker to maintain fair and orderly markets, which may involve dealing for their own account when there is a lack of price continuity, lack of depth, or if a disparity between supply and demand exists or is reasonably anticipated. *See id.*

[783] *See* Goldman (Prop. Trading). This commenter further stated that trading activities of exchange market makers may be particularly difficult to evaluate with customer-facing metrics (because ''specialist'' market makers may not have ''customers''), so conferring a positive presumption of compliance on such market makers would ensure that they can continue to contribute to liquidity, which benefits customers. This commenter noted that, for example, NYSE designated market makers (''DMMs'') are generally prohibited from dealing with customers and companies must ''wall off'' any trading units that act as DMMs. *See id.* (citing NYSE Rule 98).

[784] *See id.* (stating that spread-related metrics, such as Spread Profit and Loss, may be useful for this purpose).

[785] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); T. Rowe Price; CIEBA; Credit Suisse (Seidel); Barclays; Wellington; MetLife; Chamber (Feb. 2012); RBC; Prof. Duffie; ICI (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012). These concerns are addressed in Part VI.A.3.c.2.c., *infra.*

[786] *See, e.g.,* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012); RBC.

[787] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[788] *See* Prof. Duffie. However, another commenter stated that a legitimate market maker should respond to customer demand rather than initiate transactions, which is indicative of prohibited proprietary trading. *See* Public Citizen.

market maker inventory.[789] Commenters' views on the importance of permitting inventory management activity in connection with market making are discussed below in Part VI.A.3.c.2.b.vi.

Several commenters requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes and implement this requirement flexibly.[790] In particular, many of these commenters emphasized that the concept of ''near term demand'' should be different for less liquid markets, where transactions may occur infrequently, and for liquid markets, where transactions occur more often.[791] One commenter requested that the Agencies add the phrase ''based on the characteristics of the relevant market and asset class'' to the end of the requirement to explicitly acknowledge these differences.[792]

iii. Predicting Near Term Customer Demand

Commenters provided views on whether and, if so how, a banking entity may be able to predict near term customer demand for purposes of the proposed requirement.[793] For example, two commenters suggested ways in which a banking entity could predict near term customer demand.[794] One of these commenters indicated that banking entities should be able to utilize current risk management tools to predict near term customer demand, although these tools may need to be adapted to comply with the rule's requirements. According to this commenter, dealers commonly assess the following factors across product lines, which can relate to expected customer demand: (i) Recent volumes and customer trends; (ii) trading patterns of specific customers; (iii) analysis of whether the firm has an ability to win new customer business; (iv) comparison of the current market conditions to prior similar periods; (v) liquidity of large investors; and (vi) the schedule of maturities in customers' existing positions.[795] Another commenter stated that the reasonableness of a market maker's inventory can be measured by looking to the specifics of the particular market, the size of the customer base being served, and expected customer demand, which banking entities should be required to take into account in both their inventory practices and policies and their actual inventories. This commenter recommended that the rule permit a banking entity to assume a position under the market-making exemption if it can demonstrate a track record or reasonable expectation that it can dispose of a position in the near term.[796]

Some commenters, however, emphasized that reasonably expected near term customer demand cannot always be accurately predicted.[797] Several of these commenters requested the Agencies clarify that banking entities will not be subject to regulatory sanctions if reasonably anticipated near term customer demand does not materialize.[798] One commenter further noted that a banking entity entering a new market, or gaining or losing customers, may need greater flexibility in applying the near term demand requirement because its anticipated demand may fluctuate.[799]

iv. Potential Definitions of ''Client,'' ''Customer,'' or ''Counterparty''

Appendix B of the proposal discussed the proposed meaning of the term ''customer'' in the context of permitted market making-related activity.[800] In addition, the proposal inquired whether the terms ''client,'' ''customer,'' or ''counterparty'' should be defined in the rule for purposes of the market-making exemption.[801] Commenters expressed varying views on the proposed interpretations in the proposal and on whether these terms should be defined in the final rule.[802]

With respect to the proposed interpretations of the term ''customer'' in Appendix B, one commenter agreed with the proposed interpretations and expressed the belief that the interpretations will allow interdealer market making where brokers or other dealers act as customers. However, this commenter also requested that the Agencies expressly incorporate

[789] *See* Credit Suisse (Seidel) (suggesting that the rule allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand); Barclays (recommending the rule require that ''the market making-related activity is conducted by each trading unit such that its activities (including the maintenance of inventory) are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties consistent with the market and trading patterns of the relevant product, and consistent with the reasonable judgment of the banking entity where such demand cannot be determined with reasonable accuracy''); CIEBA. In addition, some commenters suggested an interpretation that would provide greater discretion to market makers to enter into trades based on factors such as experience and expertise dealing in the market and market exigencies. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012). Two commenters suggested that the proposed requirement should be interpreted to permit market-making activity as it currently exists. *See* MetLife; ACLI (Feb. 2012). One commenter requested that the proposed requirement be moved to Appendix B of the rule to provide greater flexibility to consider facts and circumstances of a particular activity. *See* JPMC.

[790] *See* CIEBA; Morgan Stanley; RBC; ICI (Feb. 2012); ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock. The Agencies respond to these comments in Part VI.A.3.c.2.c.ii., *infra.*

[791] *See* ICI (Feb. 2012); CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); RBC.

[792] *See* Morgan Stanley.

[793] *See* Wellington; MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Chamber (Feb. 2012); FTN; RBC; Alfred Brock. These comments are addressed in Part VI.A.3.c.2.c.iii., *infra.*

[794] *See* Sens. Merkley & Levin (Feb. 2012); FTN.

[795] *See* FTN. The commenter further indicated that errors in estimating customer demand are managed through kick-out rules and oversight by risk managers and committees, with latitude in decisions being closely related to expected or empirical costs of hedging positions until they result in trading with counterparties. *See id.*

[796] *See* Sens. Merkley & Levin (Feb. 2012) (stating that banking entities should be required to collect inventory data, evaluate the data, develop policies on how to handle particular positions, and make regular adjustments to ensure a turnover of assets commensurate with near term demand of customers). This commenter also suggested that the rule specify the types of inventory metrics that should be collected and suggested that the rate of inventory turnover would be helpful. *See id.*

[797] *See* MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012); Alfred Brock. This issue is addressed in Part VI.A.3.c.2.c.iii., *infra.*

[798] *See* ICI (Feb. 2012); CIEBA; RBC; Wellington; Invesco.

[799] *See* CIEBA.

[800] *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439. More specifically, Appendix B stated: ''In the context of market making in a security that is executed on an organized trading facility or an exchange, a 'customer' is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a [financial instrument] in an OTC market, a 'customer' generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services.'' *Id.* On this last point, the proposal elaborated that in certain cases, depending on the conventions of the relevant market (*e.g.,* the OTC derivatives market), such a ''customer'' may consider itself or refer to itself more generally as a ''counterparty.'' *See* Joint Proposal, 76 FR at 68960 n.2; CFTC Proposal, 77 FR at 8439 n.2.

[801] *See* Joint Proposal, 76 FR at 68874; CFTC Proposal, 77 FR at 8359. In particular, Question 99 states: ''Should the terms 'client,' 'customer,' or 'counterparty' be defined for purposes of the market making exemption? If so, how should these terms be defined? For example, would an appropriate definition of 'customer' be: (i) A continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction; (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction; (iii) a relationship initiated by the banking entity to a prospective customer to induce transactions; or (iv) a relationship initiated by the prospective customer with a view to engaging in transactions?'' *Id.*

[802] Comments on this issue are addressed in Part VI.A.3.c.2.c.i., *infra.*

providing liquidity to other brokers and dealers into the rule text.[803] Another commenter similarly stated that instead of focusing solely on customer demand, the rule should be clarified to reflect that demand can come from other dealers or future customers.[804]

In response to the proposal's question about whether the terms ''client,'' ''customer,'' and ''counterparty'' should be further defined, a few commenters stated that that the terms should not be defined in the rule.[805] Other commenters indicated that further definition of these terms would be appropriate.[806] Some of these commenters suggested that there should be greater limitations on who can be considered a ''customer'' under the rule.[807] These commenters generally indicated that a ''customer'' should be a person or institution with whom the banking entity has a continuing, or a direct and substantive, relationship prior to the time of the transaction.[808] In the case of a new customer, some of these commenters suggested requiring a relationship initiated by the prospective customer with a view to engaging in transactions.[809] A few commenters indicated that a party should not be considered a client, customer, or counterparty if the banking entity: (i) Originates a financial product and then finds a counterparty to take the other side of the transaction;[810] or (ii) engages in transactions driven by algorithmic trading strategies.[811] Three commenters requested more permissive definitions of these terms.[812] According to one of these commenters, because these terms are listed in the disjunctive in the statute, the broadest term—a ''counterparty''—should prevail.[813]

v. Interdealer Trading and Trading for Price Discovery or To Test Market Depth

With respect to interdealer trading, many commenters expressed concern that the proposed rule could be interpreted to restrict a market maker's ability to engage in interdealer trading.[814] As a general matter, commenters attributed these concerns to statements in proposed Appendix B[815] or to the Customer-Facing Trade Ratio metric in proposed Appendix A.[816] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity[817] and suggested ways in which this could be accomplished (*e.g.,* through a definition of ''customer'' or ''counterparty'').[818]

Commenters emphasized that interdealer trading provides certain market benefits, including increased market liquidity;[819] more efficient matching of customer order flow;[820] greater hedging options to reduce risks;[821] enhanced ability to accumulate inventory for current or near term customer demand, work down concentrated positions arising from a customer trade, or otherwise exit a position acquired from a customer;[822] and general price discovery among dealers.[823] Regarding the impact of interdealer trading on a market maker's ability to intermediate customer needs, one commenter studied the potential impact of interdealer trading limits—in combination with inventory limits—on trading in the U.S. corporate bond market. According to this commenter, if interdealer trading had been prohibited

[803] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Credit Suisse (Seidel); RBC (requesting that the Agencies recognize ''wholesale'' market making as permissible and representing that ''[i]t is irrelevant to an investor whether market liquidity is provided by a broker-dealer with whom the investor maintains a customer account, or whether that broker-dealer looks to another dealer for market liquidity'').

[804] *See* Comm. on Capital Markets Regulation.

[805] *See* FTN; ISDA (Feb. 2012); Alfred Brock.

[806] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[807] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. One of these commenters also requested that the Agencies remove the terms ''client'' and ''counterparty'' from the proposed near term demand requirement. *See* Occupy.

[808] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. These commenters stated that other banking entities should never be ''customers'' under the rule. *See id.* In addition, one of these commenters would further prevent a banking entity's employees and covered funds from being ''customers'' under the rule. *See* AFR *et al.* (Feb. 2012).

[809] *See* AFR *et al.* (Feb. 2012) (providing a similar definition for the term ''client'' as well); Public Citizen.

[810] *See* AFR *et al.* (Feb. 2012); Public Citizen. *See also* Sens. Merkley & Levin (Feb. 2012) (stating that a banking entity's activities that involve attempting to sell clients financial instruments that it originated, rather than facilitating a secondary market for client trades in previously existing financial products, should be analyzed under the underwriting exemption, not the market-making exemption; in addition, compiling inventory of financial instruments that the bank originated should be viewed as proprietary trading).

[811] *See* AFR *et al.* (Feb. 2012).

[812] *See* Credit Suisse (Seidel) (stating that ''customer'' should be explicitly defined to include any counterparty to whom a banking entity is providing liquidity); ISDA (Feb. 2012) (recommending that, if the Agencies decide to define these terms, a ''counterparty'' should be defined as the entity on the other side of a transaction, and the terms ''client'' and ''customer'' should not be interpreted to require a relationship beyond the isolated provision of a transaction); Japanese Bankers Ass'n. (requesting that it be clearly noted that interbank participants can be customers for interbank market makers).

[813] *See* ISDA (Feb. 2012). This commenter's primary position was that further definitions are not required and could create additional and unnecessary complexity. *See id.*

[814] *See, e.g.,* JPMC; Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012); MetLife; Credit Suisse (Seidel); BoA; ACLI (Feb. 2012); RBC; AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012). A few commenters noted that the proposed rule would permit a certain amount of interdealer trading. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (citing statements in the proposal providing that a market maker's ''customers'' vary depending on the asset class and market in which intermediation services are provided and interpreting such statements as allowing interdealer market making where brokers or other dealers act as ''customers'' within the proposed construct); Goldman (Prop. Trading) (stating that interdealer trading related to hedging or exiting a customer position would be permitted, but expressing concern that requiring each banking entity to justify each of its interdealer trades as being related to one of its own customers would be burdensome and would reduce the effectiveness of the interdealer market). Commenters' concerns regarding interdealer trading are addressed in Part VI.A.3.c.2.c.i., *infra.*

[815] *See infra* Part VI.A.3.c.8.

[816] *See, e.g.,* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Oliver Wyman (Feb. 2012) (recognizing that the proposed rule did not include specific limits on interdealer trading, but expressing concern that explicit or implicit limits could be established by supervisors during or after the conformance period).

[817] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012).

[818] *See* RBC (suggesting that explicitly incorporating liquidity provision to other brokers and dealers in the market-making exemption would be consistent with the statute's reference to meeting the needs of ''counterparties,'' in addition to the needs of clients and customers); AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction); Goldman (Prop. Trading) (representing that the Agencies could evaluate and monitor the amount of interdealer trading that is consistent with a particular trading unit's market making-related or hedging activity through the customer-facing activity category of metrics); Oliver Wyman (Feb. 2012) (recommending removal or modification of any metrics or principles that would indicate that interdealer trading is not permitted).

[819] *See* Prof. Duffie; MetLife; ACLI (Feb. 2012); BDA (Feb. 2012).

[820] *See* Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012); MetLife; ACLI (Feb. 2012). *See also* Thakor Study (stating that, when a market maker provides immediacy to a customer, it relies on being able to unwind its positions at opportune times by trading with other market makers, who may have knowledge about impending orders from their own customers that may induce them to trade with the market maker).

[821] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[822] *See* Goldman (Prop. Trading); Chamber (Feb. 2012). *See also* Prof. Duffie (stating that a market maker acquiring a position from a customer may wish to rebalance its inventory relatively quickly through the interdealer network, which is often more efficient than requesting immediacy from another customer or waiting for another customer who wants to take the opposite side of the trade).

[823] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

and a market maker's inventory had been limited to the average daily volume of the market as a whole, 69 percent of customer trades would have been prevented.[824] Some commenters stated that a banking entity would be less able or willing to provide market-making services to customers if it could not engage in interdealer trading.[825]

As noted above, a few commenters stated that market makers may use interdealer trading for price discovery purposes.[826] Some commenters separately discussed the importance of this activity and requested that, when conducted in connection with market-making activity, trading for price discovery be considered permitted market making-related activity under the rule.[827] Commenters indicated that price discovery-related trading results in certain market benefits, including enhancing the accuracy of prices for customers,[828] increasing price efficiency, preventing market instability,[829] improving market liquidity, and reducing overall costs for market participants.[830] As a converse, one of these commenters stated that restrictions on such activity could result in market makers setting their prices too high, exposing them to significant risk and causing a reduction of market-making activity or widening of spreads to offset the risk.[831] One commenter further requested that trading to test market depth likewise be permitted under the market-making exemption.[832] This commenter represented that the Agencies would be able to evaluate the extent to which trading for price discovery and market depth are consistent with market making-related activities for a particular market through a combination of customer-facing activity metrics, including the Inventory Risk Turnover metric, and knowledge of a banking entity's trading business developed by regulators as part of the supervisory process.[833]

vi. Inventory Management

Several commenters requested that the rule provide banking entities with greater discretion to manage their inventories in connection with market making-related activity, including acquiring or disposing of positions in anticipation of customer demand.[834] Commenters represented that market makers need to be able to build, manage, and maintain inventories to facilitate customer demand. These commenters further stated that the rule needs to provide some degree of flexibility for inventory management activities, as inventory needs may differ based on market conditions or the characteristics of a particular instrument.[835] A few commenters cited legislative history in support of allowing banking entities to hold and manage inventory in connection with market making-related activities.[836] Several commenters noted benefits that are associated with a market maker's ability to appropriately manage its inventory, including being able to meet reasonably anticipated future client, customer, or counterparty demand;[837] accommodating customer transactions more quickly and at favorable prices; reducing near term price volatility (in the case of selling a customer block position);[838] helping maintain an orderly market and provide the best price to customers (in the case of accumulating long or short positions in anticipation of a large customer sale or purchase);[839] ensuring that markets continue to have sufficient liquidity;[840] fostering a two-way market; and establishing a market-making presence.[841] Some commenters noted that market makers may need to accumulate inventory to meet customer demand for certain products or under certain trading scenarios, such as to create units of structured products (*e.g.,* ETFs and asset-backed securities)[842] and in anticipation of an index rebalance.[843]

Commenters also expressed views with respect to how much discretion a banking entity should have to manage its inventory under the exemption and how to best monitor inventory levels. For example, one commenter recommended that the rule allow market makers to build inventory in products where they believe customer

[824] *See* Oliver Wyman (Feb. 2012) (basing its finding on data from 2009). This commenter also represented that the natural level of interdealer volume in the U.S. corporate bond market made up 16 percent of total trading volume in 2010. *See id.*

[825] *See* Goldman (Prop. Trading); Morgan Stanley. *See also* BDA (Feb. 2012) (stating that if dealers in the fixed-income market are not able to trade with other dealers to ''cooperate with each other to provide adequate liquidity to the market as a whole,'' an essential source of liquidity will be eliminated from the market and existing values of fixed income securities will decline and become volatile, harming both investors who currently hold such positions and issuers, who will experience increased interest costs).

[826] *See* Chamber (Feb. 2012); Goldman (Prop. Trading).

[827] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012); Goldman (Prop. Trading). One commenter provided the following example of such activity: if Security A and Security B have some price correlation but neither trades regularly, then a trader may execute a trade in Security A for price discovery purposes, using the price of Security A to make an informed bid-ask market to a customer in Security B. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[828] *See* Goldman (Prop. Trading); Chamber (Feb. 2012) (stating that this type of trading is necessary in more illiquid markets); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[829] *See* Goldman (Prop. Trading).

[830] *See* Chamber (Feb. 2012).

[831] *See id.*

[832] *See* Goldman (Prop. Trading). This commenter represented that market makers often make trades with other dealers to test the depth of the markets at particular price points and to understand where supply and demand exist (although such trading is not conducted exclusively with other dealers). This commenter stated that testing the depth of the market is necessary to provide accurate prices to customers, particularly when customers seeks to enter trades in amounts larger than the amounts offered by dealers who have sent indications to inter-dealer brokers. *See id.*

[833] *See id.*

[834] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC. Inventory management is addressed in Part VI.A.3.c.2.c., *infra.*

[835] *See, e.g.,* MFA (stating that it is critical for banking entities to continue to be able to maintain sufficient levels of inventory, which is dynamic in nature and requires some degree of flexibility in application); RBC (requesting that the Agencies explicitly acknowledge that, depending on market conditions or the characteristics of a particular security, it may be appropriate or necessary for a firm to maintain inventories over extended periods of time in the course of market making-related activities).

[836] *See, e.g.,* RBC; NYSE Euronext; Fidelity. These commenters cited a colloquy in the Congressional Record between Senator Bayh and Senator Dodd, in which Senator Bayh stated: ''With respect to [section 13 of the BHC Act], the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market-making activities, provided that activity does not exceed the reasonably expected near-term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market-making function. Without that flexibility, market makers would not be able to provide liquidity to markets.'' 156 Cong. Rec. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh).

[837] *See, e.g.,* RBC.

[838] *See* Goldman (Prop. Trading).

[839] *See id.*

[840] *See* MFA.

[841] *See* RBC.

[842] *See* Goldman (Prop. Trading); BoA.

[843] *See* Oliver Wyman (Feb. 2012). As this commenter explained, some mutual funds and ETFs track major equity indices and, when the composition of an index changes (*e.g.,* due to the addition or removal of a security or to rising or falling values of listed shares), an announcement is made and all funds tracking the index need to rebalance their portfolios. According to the commenter, banking entities may need to step in to provide liquidity for rebalances of less liquid indices because trades executed on the open market would substantially affect share prices. The commenter estimated that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year. This commenter identified the proposed inventory metrics in Appendix A as potentially limiting a banking entity's willingness or ability to facilitate index rebalance trades. *See id.* Two other commenters also discussed the index rebalancing scenario. *See* Prof. Duffie; Thakor Study. Index rebalancing is addressed in note 931, *infra.*

demand will exist, regardless of whether the inventory can be tied to a particular customer in the near term or to historical trends in customer demand.[844] A few commenters suggested that the Agencies provide banking entities with greater discretion to accumulate inventory, but discourage market makers from holding inventory for long periods of time by imposing increasingly higher capital requirements on aged inventory.[845] One commenter represented that a trading unit's inventory management practices could be monitored with the Inventory Risk Turnover metric, in conjunction with other metrics.[846]

vii. Acting as an Authorized Participant or Market Maker in Exchange-Traded Funds

With respect to ETF trading, commenters generally requested clarification that a banking entity can serve as an authorized participant (''AP'') to an ETF issuer or can engage in ETF market making under the proposed exemption.[847] According to commenters, APs may engage in the following types of activities with respect to ETFs: (i) Trading directly with the ETF issuer to create or redeem ETF shares, which involves trading in ETF shares and the underlying components;[848] (ii) trading to maintain price alignment between the ETF shares and the underlying components;[849] (iii) traditional market-making activity;[850] (iv) ''seeding'' a new ETF by entering into several initial creation transactions with an ETF issuer and holding the ETF shares, possibly for an extended period of time, until the ETF establishes regular trading and liquidity in the secondary markets;[851] (v) ''create to lend'' transactions, where an AP enters a creation transaction with the ETF issuer and lends the ETF shares to an investor;[852] and (vi) hedging.[853] A few commenters noted that an AP may not engage in traditional market-making activity in the relevant ETF and expressed concern that the proposed rule may limit a banking entity's ability to act in an AP capacity.[854] One commenter estimated that APs that are banking entities make up between 20 percent to 100 percent of creation and redemption activity for individual ETFs, with an average of approximately 35 percent of creation and redemption activity across all ETFs attributed to banking entities. This commenter expressed the view that, if the rule limits banking entities' ability to serve as APs, then individual investors' investments in ETFs will become more expensive due to higher premiums and discounts versus the ETF's NAV.[855]

A number of commenters stated that certain requirements of the proposed exemption may limit a banking entity's ability to serve as AP to an ETF, including the proposed near term customer demand requirement,[856] the proposed source of revenue requirement,[857] and language in the proposal regarding arbitrage trading.[858] With respect to the proposed near term customer demand requirement, a few commenters noted that this requirement could prevent an AP from building inventory to assemble creation units.[859] Two other commenters expressed the view that the ETF issuer would be the banking entity's ''counterparty'' when the banking entity trades directly with the ETF issuer, so this trading and inventory accumulation would meet the terms of the proposed requirement.[860] To permit banking entities to act as APs, two commenters suggested that trading in the capacity of an AP should be deemed permitted market making-related activity, regardless of whether the AP is acting as a traditional market maker.[861]

viii. Arbitrage or Other Activities That Promote Price Transparency and Liquidity

In response to a question in the proposal,[862] a number of commenters

[844] *See* Credit Suisse (Seidel).

[845] *See* CalPERS; Vanguard. These commenters represented that placing increasing capital requirements on aged inventory would ease the rule's impact on investor liquidity, allow banking entities to internalize the cost of continuing to hold a position at the expense of its ability to take on new positions, and potentially decrease the possibility of a firm realizing a loss on a position by decreasing the time such position is held. *See id.* One commenter noted that some banking entities already use this approach to manage risk on their market-making desks. *See* Vanguard. *See also* Capital Group (suggesting that one way to implement the statutory exemption would be to charge a trader or a trading desk for positions held on its balance sheet beyond set time periods and to increase the charge at set intervals). These comments are addressed in note 923, *infra.*

[846] *See* Goldman (Prop. Trading) (representing that the Inventory Risk Turnover metric will allow the Agencies to evaluate the length of time that a trading unit tends to hold risk positions in inventory and whether that holding time is consistent with market making-related activities in the relevant market).

[847] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); BoA; ICI (stating that an AP may trade with the ETF issuer in different capacities—in connection with traditional market-making activity, on behalf of customers, or for the AP's own account); ICI Global (discussing non-U.S. ETFs specifically); Vanguard; SSgA (Feb. 2012). One commenter represented that an AP's transactions in ETFs do not create risks associated with proprietary trading because, when an AP trades with an ETF issuer for its own account, the AP typically enters into an offsetting transaction in the underlying portfolio of securities, which cancels out investment risk and limits the AP's exposure to the difference between the market price for ETF shares and the ETF's net asset value (''NAV''). *See* Vanguard.

With respect to market-making activity in an ETF, several commenters noted that market makers play an important role in maintaining price alignment by engaging in arbitrage transactions between the ETF shares and the shares of the underlying components. *See, e.g.,* JPMC; Goldman (Prop. Trading) (making similar statement with respect to ADRs as well); SSgA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC. AP and market maker activity in ETFs are addressed in Part VI.A.3.c.2.c.i., *infra.*

[848] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA; ICI (Feb. 2012) ICI Global; Vanguard; SSgA (Feb. 2012).

[849] *See* JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); ICI (Feb. 2012) ICI Global.

[850] *See* ICI Global; ICI (Feb. 2012) SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[851] *See* BoA; ICI (Feb. 2012); ICI Global.

[852] *See* BoA (stating that lending the ETF shares to an investor gives the investor a more efficient way to hedge its exposure to assets correlated with those underlying the ETF).

[853] *See* ICI Global; ICI (Feb. 2012).

[854] *See, e.g.,* Vanguard (noting that APs may not engage in market-making activity in the ETF and expressing concern that if AP activities are not separately permitted, banking entities may exit or not enter the ETF market); SSgA (Feb. 2012) (stating that APs are under no obligation to make markets in ETF shares and requiring such an obligation would discourage banking entities from acting as APs); ICI (Feb. 2012).

[855] *See* SSgA (Feb. 2012). This commenter further stated that as of 2011, an estimated 3.5 million—or 3 percent—of U.S. households owned ETFs and, as of September 2011, ETFs represented assets of approximately $951 billion. *See id.*

[856] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[857] *See* BoA. This commenter noted that the proposed source of revenue requirement could be interpreted to prevent a banking entity acting as AP from entering into creation and redemption transactions, ''seeding'' an ETF, engaging in ''create to lend'' transactions, and performing secondary market making in an ETF because all of these activities require an AP to build an inventory—either in ETF shares or the underlying components—which often result in revenue attributable to price movements. *See id.*

[858] Commenters noted that this language would restrict an AP from engaging in price arbitrage to maintain efficient markets in ETFs. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See supra* Part VI.A.3.c.2.a. (discussing the proposal's proposed interpretation regarding arbitrage trading).

[859] *See* BoA; Vanguard (stating that this determination may be particularly difficult in the case of a new ETF).

[860] *See* ICI Global; ICI (Feb. 2012).

[861] *See* ICI (Feb. 2012) ICI Global. These commenters provided suggested rule text on this issue and suggested that the Agencies could require a banking entity's compliance policies and internal controls to take a comprehensive approach to the entirety of an AP's trading activity, which would facilitate easy monitoring of the activity to ensure compliance. *See id.*

[862] *See* Joint Proposal, 76 FR at 68873 (question 91) (inquiring whether the proposed exemption should be modified to permit certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency but do not

Continued

stated that certain types of arbitrage activity should be permitted under the market-making exemption.[863] For example, some commenters stated that a banking entity's arbitrage activity should be considered market making to the extent the activity is driven by creating markets for customers tied to the price differential (*e.g.,* ''box'' strategies, ''calendar spreads,'' merger arbitrage, ''Cash and Carry,'' or basis trading)[864] or to the extent that demand is predicated on specific price relationships between instruments (*e.g.,* ETFs, ADRs) that market makers must maintain.[865] Similarly, another commenter suggested that arbitrage activity that aligns prices should be permitted, such as index arbitrage, ETF arbitrage, and event arbitrage.[866] One commenter noted that many markets, such as futures and options markets, rely on arbitrage activities of market makers for liquidity purposes and to maintain convergence with underlying instruments for cash-settled options, futures, and index-based products.[867] Commenters stated that arbitrage trading provides certain market benefits, including enhanced price transparency,[868] increased market efficiency,[869] greater market liquidity,[870] and general benefits to customers.[871] A few commenters noted that certain types of hedging activity may appear to have characteristics of arbitrage trading.[872]

Commenters suggested certain methods for permitting and monitoring arbitrage trading under the exemption. For example, one commenter suggested a framework for permitting certain arbitrage within the market-making exemption, with requirements such as: (i) Common personnel with market-making activity; (ii) policies that cover the timing and appropriateness of arbitrage positions; (iii) time limits on arbitrage positions; and (iv) compensation that does not reward successful arbitrage, but instead pools any such revenues with market-making profits and losses.[873] A few commenters represented that, if permitted under the rule, the Agencies would be able to monitor arbitrage activities for patterns of impermissible proprietary trading through the use of metrics, as well as compliance and examination tools.[874]

Other commenters stated that the exemption should not permit certain types of arbitrage. One commenter stated that the rule should ensure that relative value and complex arbitrage strategies cannot be conducted.[875] Another commenter expressed the view that the market-making exemption should not permit any type of arbitrage transactions. This commenter stated that, in the event that liquidity or transparency is inhibited by a lack of arbitrage trading, a market maker should be able to find a customer who would seek to benefit from it.[876]

ix. Primary Dealer Activities

A number of commenters requested that the market-making exemption permit banking entities to meet their primary dealer obligations in foreign jurisdictions, particularly if trading in foreign sovereign debt is not separately exempted in the final rule.[877] According to commenters, a banking entity may be obligated to perform the following activities in its capacity as a primary dealer: undertaking to maintain an orderly market, preventing or correcting any price dislocations,[878] and bidding on each issuance of the relevant jurisdiction's sovereign debt.[879] Commenters expressed concern that a banking entity's trading activity as primary dealer may not comply with the proposed near term customer demand requirement[880] or the proposed source of revenue requirement.[881] To address the first issue, one commenter stated that the final rule should clarify that a banking entity acting as a primary dealer of foreign sovereign debt is engaged in primary dealer activity in response to the near term demands of the sovereign, which should be considered a client, customer, or counterparty of the banking entity.[882] Another commenter suggested that the Agencies permit primary dealer activities through commentary stating that fulfilling primary dealer obligations will not be included in determinations of whether the market-making exemption applies to a trading unit.[883]

x. New or Bespoke Products or Customized Hedging Contracts

Several commenters indicated that the proposed exemption does not adequately address market making in new or bespoke products, including structured, customer-driven transactions, and requested that the rule be modified to clearly permit such activity.[884] Many of these commenters

service client, customer, or counterparty demand); CFTC Proposal, 77 FR at 8359.

[863] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); FTN; RBC; ISDA (Feb. 2012). Arbitrage trading is further discussed in Part VI.A.3.c.2.c.i., *infra.*

[864] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[865] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[866] *See* Credit Suisse (Seidel).

[867] *See* RBC.

[868] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[869] *See* Credit Suisse (Seidel); RBC.

[870] *See* RBC.

[871] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; FTN; ISDA (Feb. 2012) (stating that arbitrage activities often yield positions that are ultimately put to use in serving customer demand and representing that the process of consistently trading makes a dealer ready and available to serve customers on a competitive basis).

[872] *See* JPMC (stating that firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and transferred by means of internal transactions to a single utility desk (which hedges all of the risks in the aggregate), and this may optically bear some characteristics of arbitrage, although the commenter requested that such activity be recognized as permitted market making-related activity under the rule); ISDA (Feb. 2012) (stating that in some swaps markets, dealers hedge through multiple instruments, which can give an impression of arbitrage in a function that is risk reducing; for example, a dealer in a broad index equity swap may simultaneously hedge in baskets of stocks, futures, and ETFs). *But see* Sens. Merkley & Levin (Feb. 2012) (''When banks use complex hedging techniques or otherwise engage in trading that is suggestive of arbitrage, regulators should require them to provide evidence and analysis demonstrating what risk is being reduced.'').

[873] *See* FTN.

[874] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Goldman (Prop. Trading). One of these commenters stated that the customer-facing activity category of metrics, as well as other metrics, would be available to evaluate whether the trading unit is engaged in a directly customer-facing business and the extent to which its activities are consistent with the market-making exemption. *See* Goldman (Prop. Trading).

[875] *See* Johnson & Prof. Stiglitz. *See also* AFR *et al.* (Feb. 2012) (noting that arbitrage, spread, or carry trades are a classic type of proprietary trade).

[876] *See* Occupy.

[877] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. *See infra* notes 905 to 906 and accompanying text (addressing these comments).

[878] *See* Goldman (Prop. Trading).

[879] *See* Banco de México.

[880] *See* JPMC; Banco de México. These commenters stated that a primary dealer is required to assume positions in foreign sovereign debt even when near term customer demand is unpredictable. *See id.*

[881] *See* Banco de México (stating that primary dealers need to be able to profit from their positions in sovereign debt, including by holding significant positions in anticipation of future price movements, so that the primary dealer business is financially attractive); IIB/EBF (stating that primary dealers may actively seek to profit from price and interest rate movements based on their debt holdings, which governments support as providing much-needed liquidity for securities that are otherwise purchased largely pursuant to buy-and-hold strategies of institutional investors and other entities seeking safe returns and liquidity buffers).

[882] *See* Goldman (Prop. Trading).

[883] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[884] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); JPMC; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). This issue is addressed in Part VI.A.3.c.1.c.iii., *supra,* and Part VI.A.3.c.2.c.iii., *infra.*

emphasized the role such transactions play in helping customers hedge the unique risks they face.[885] Commenters stated that, as a result, limiting a banking entity's ability to conduct such transactions would subject customers to increased risks and greater transaction costs.[886] One commenter suggested that the Agencies explicitly state that a banking entity's general willingness to engage in bespoke transactions is sufficient to make it a market maker in unique products for purposes of the rule.[887]

Other commenters stated that banking entities should be limited in their ability to rely on the market-making exemption to conduct transactions in bespoke or customized derivatives.[888] For example, one commenter suggested that a banking entity be required to disaggregate such derivatives into liquid risk elements and illiquid risk elements, with liquid risk elements qualifying for the market-making exemption and illiquid risk elements having to be conducted on a riskless principal basis under § 75.6(b)(1)(ii) of the proposed rule. According to this commenter, such an approach would not impact the end user customer.[889] Another commenter stated that a banking entity making a market in bespoke instruments should be required both to hold itself out in accordance with § 75.4(b)(2)(ii) of the proposed rule and to demonstrate the purchase and the sale of such an instrument.[890]

c. Final Near Term Customer Demand Requirement

Consistent with the statute, § 75.4(b)(2)(ii) of the final rule's market-making exemption requires that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on certain market factors and analysis.[891] As discussed above in Part VI.A.3.c.1.c.ii., the trading desk's market-maker inventory consists of positions in financial instruments in which the trading desk stands ready to purchase and sell consistent with the final rule.[892] The final rule requires the financial instruments to be identified in the trading desk's compliance program. Thus, this requirement focuses on a trading desk's positions in financial instruments for which it acts as market maker. These positions of a trading desk are more directly related to the demands of customers than positions in financial instruments used for risk management purposes, but in which the trading desk does not make a market. As noted above, a position or exposure that is included in a trading desk's market-maker inventory will remain in its market-maker inventory for as long as the position or exposure is managed by the trading desk. As a result, the trading desk must continue to account for that position or exposure, together with other positions and exposures in its market-maker inventory, in determining whether the amount, types, and risks of its market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

While the near term customer demand requirement directly applies only to the trading desk's market-maker inventory, this does not mean a trading desk may establish other positions, outside its market-maker inventory, that exceed what is needed to manage the risks of the trading desk's market making-related activities and inventory. Instead, a trading desk must have limits on its market-maker inventory, the products, instruments, and exposures the trading desk may use for risk management purposes, and its aggregate financial exposure that are based on the factors set forth in the near term customer demand requirement, as well as other relevant considerations regarding the nature and amount of the trading desk's market making-related activities. A banking entity must establish, implement, maintain, and enforce a limit structure, as well as other compliance program elements (*e.g.,* those specifying the instruments a trading desk trades as a market maker or may use for risk management purposes and providing for specific risk management procedures), for each trading desk that are designed to prevent the trading desk from engaging in trading activity that is unrelated to making a market in a particular type of financial instrument or managing the risks associated with making a market in that type of financial instrument.[893]

To clarify the application of this standard in response to comments,[894] the final rule provides two factors for assessing whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties. Specifically, the following must be considered under the revised standard: (i) The liquidity, maturity, and depth of the market for the relevant type of financial instrument(s),[895] and (ii) demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments in which the trading desk makes a market, including through block trades. Under the final rule, a banking entity must account for these considerations when establishing risk and inventory limits for each trading desk.[896]

For purposes of this provision, ''demonstrable analysis'' means that the analysis for determining the amount, types, and risks of financial instruments a trading desk may manage in its market-maker inventory, in accordance with the near term demand requirement, must be based on factors that can be demonstrated in a way that makes the analysis reviewable. This may include, among other things, the normal trading records of the trading desk and market information that is readily available and retrievable. If the analysis cannot be supported by the banking entity's books and records and available market data, on their own, then the other factors utilized must be identified and documented and the analysis of those factors together with the facts gathered from the trading and market records must be identified in a way that makes it possible to test the analysis.

[885] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[886] *See* Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[887] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[888] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[889] *See* AFR *et al.* (Feb. 2012).

[890] *See* Public Citizen.

[891] The final rule includes certain refinements to the proposed standard, which would have required that the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the financial instrument, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. *See* proposed rule § 75.4(b)(2)(iii).

[892] *See supra* Part VI.A.3.c.1.c.ii.; final rule § 75.4(b)(5).

[893] *See infra* Part VI.A.3.c.3. (discussing the compliance program requirements); final rule § 75.4(b)(2)(iii).

[894] *See supra* Part VI.A.3.c.2.b.i.

[895] This language has been added to the final rule to respond to commenters' concerns that the proposed near term demand requirement would be unworkable in less liquid markets or would otherwise restrict a market maker's ability to hold and manage its inventory in less liquid markets. *See supra* Part VI.A.3.c.2.b.ii. In addition, this provision is substantially similar to one commenter's suggested approach of adding the phrase ''based on the characteristics of the relevant market and asset class'' to the proposed requirement, but the Agencies have added more specificity about the relevant characteristics that should be taken into consideration. *See* Morgan Stanley.

[896] *See infra* Part VI.A.3.c.3.

Importantly, a determination of whether a trading desk's market-maker inventory is appropriate under this requirement will take into account reasonably expected near term customer demand, including historical levels of customer demand, expectations based on market factors, and current demand. For example, at any particular time, a trading desk may acquire a position in a financial instrument in response to a customer's request to sell the financial instrument or in response to reasonably expected customer buying interest for such instrument in the near term.[897] In addition, as discussed below, this requirement is not intended to impede a trading desk's ability to engage in certain market making-related activities that are consistent with and needed to facilitate permissible trading with its clients, customers, or counterparties, such as inventory management and interdealer trading. These activities must, however, be consistent with the analysis conducted under the final rule and the trading desk's limits discussed below.[898] Moreover, as explained below, the banking entity must also have in place escalation procedures to address, analyze, and document trades made in response to customer requests that would exceed one of a trading desk's limits.

The near term demand requirement is an ongoing requirement that applies to the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory. For instance, a trading desk may acquire exposures as a result of entering into market-making transactions with customers that are within the desk's market-marker inventory and financial exposure limits. Even if the trading desk is appropriately managing the risks of its market-maker inventory, its market-maker inventory still must be consistent with the analysis of the reasonably expected near term demands of clients, customers, and counterparties and the liquidity, maturity and depth of the market for the relevant instruments in the inventory. Moreover, the trading desk must take action to ensure that its financial exposure does not exceed its financial exposure limits.[899] A trading desk may not maintain an exposure in its market-maker inventory, irrespective of customer demand, simply because the exposure is hedged and the resulting financial exposure is below the desk's financial exposure limit. In addition, the amount, types, and risks of financial instruments in a trading desk's market-maker inventory would not be consistent with permitted market-making activities if, for example, the trading desk has a pattern or practice of retaining exposures in its market-maker inventory, while refusing to engage in customer transactions when there is customer demand for those exposures at commercially reasonable prices.

The following is an example of the interplay between a trading desk's market-maker inventory and financial exposure. An airline company customer may seek to hedge its long-term exposure to price fluctuations in jet fuel by asking a banking entity to create a structured ten-year, $1 billion jet fuel swap for which there is no liquid market. A trading desk that makes a market in energy swaps may service its customer's needs by executing a custom jet fuel swap with the customer and holding the swap in its market-maker inventory, if the resulting transaction does not cause the trading desk to exceed its market-maker inventory limit on the applicable class of instrument, or the trading desk has received approval to increase the limit in accordance with the authorization and escalation procedures under paragraph (b)(2)(iii)(E). In keeping with the market-making exemption as provided in the final rule, the trading desk would be required to hedge the risk from this swap, either individually or as part of a set of aggregated positions, if the trade would result in a financial exposure that exceeds the desk's financial exposure limits. The trading desk may hedge the risk of the swap, for example, by entering into one or more futures or swap positions that are identified as permissible hedging products, instruments, or exposures in the trading desk's compliance program and that analysis, including correlation analysis as appropriate, indicates would demonstrably reduce or otherwise significantly mitigate risks associated with the financial exposure from its market-making activities. Alternatively, if the trading desk also acts as a market maker in crude oil futures, then the desk's exposures arising from its market-making activities may naturally hedge the jet fuel swap (*i.e.,* it may reduce its financial exposure levels resulting from such instruments).[900] The trading desk must continue to appropriately manage risks of its financial exposure over time in accordance with its financial exposure limits.

As discussed above, several commenters expressed concern that the near-term customer demand requirement is too restrictive and that it could impede a market maker's ability to build or retain inventory, particularly in less liquid markets where demand is intermittent.[901] Because customer demand in illiquid markets can be difficult to predict with precision, market-maker inventory may not closely track customer order flow. The Agencies acknowledge that market makers will face costs associated with demonstrating that market-maker inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers, as required by the statute and the final rule because this is an analysis that banking entities may not currently undertake. However, the final rule includes certain modifications to the proposed rule that are intended to reduce the negative impacts cited by commenters, such as limitations on inventory management activity and potential restrictions on market making in less liquid instruments, which the Agencies believe should reduce the perceived burdens of the proposed near term demand requirement. For example, the final rule recognizes that liquidity, maturity, and depth of the market vary across asset classes. The Agencies expect that the express recognition of these differences in the rule should avoid unduly impeding a market maker's ability to build or retain inventory. More specifically, the Agencies recognize the relationship between market-maker inventory and customer order flow can vary across asset classes and that an inflexible standard for demonstrating that inventory does not exceed reasonably expected near term demand could provide an incentive to stop making markets in illiquid asset classes.

i. Definition of ''client,'' ''customer,'' and ''counterparty''

In response to comments requesting further definition of the terms ''client,'' ''customer,'' and ''counterparty'' for purposes of this standard,[902] the Agencies have defined these terms in the final rule. In particular, the final

[897] As discussed further below, acquiring a position in a financial instrument in response to reasonably expected customer demand would not include creating a structured product for which there is no current customer demand and, instead, soliciting customer demand during or after its creation. *See infra* note 938 and accompanying text; Sens. Merkley & Levin (Feb. 2012).

[898] The formation of structured finance products and securitizations is discussed in detail in Part VI.B.2.b. of this **SUPPLEMENTARY INFORMATION**.

[899] *See* final rule § 75.4(b)(2)(iii)(B), (C).

[900] This natural hedge with futures would introduce basis risk which, like other risks of the trading desk, must be managed within the desk's limits.

[901] *See* SIFMA (Asset Mgmt.) (Feb. 2012); T. Rowe Price; CIEBA; ICI (Feb. 2012) RBC.

[902] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

rule defines ''client,'' ''customer,'' and ''counterparty'' as, on a collective or individual basis, ''market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services.'' [903] However, for purposes of the analysis supporting the market-maker inventory held to meet the reasonably expected near-term demands of clients, customer and counterparties, a client, customer, or counterparty of the trading desk does not include a trading desk or other organizational unit of another entity if that entity has $50 billion or more in total trading assets and liabilities, measured in accordance with § 75.20(d)(1),[904] unless the trading desk documents how and why such trading desk or other organizational unit should be treated as a customer or the transactions are conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.[905]

The Agencies believe this definition is generally consistent with the proposed interpretation of ''customer'' in the proposal. The proposal generally provided that, for purposes of market making on an exchange or other organized trading facility, a customer is any person on behalf of whom a buy or sell order has been submitted. In the context of the over-the-counter market, a customer was generally considered to be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship for such services.[906] The definition of client, customer, and counterparty in the final rule recognizes that, in the context of market making in a financial instrument that is executed on an exchange or other organized trading facility, a client, customer, or counterparty would be any person whose buy or sell order executes against the banking entity's quotation posted on the exchange or other organized trading facility.[907] Under these circumstances, the person would be trading with the banking entity in response to the banking entity's quotations and obtaining the banking entity's market making-related services. In the context of market making in a financial instrument in the OTC market, a client, customer, or counterparty generally would be a person that makes use of the banking entity's intermediation services, either by requesting such services (possibly via a request-for-quote on an established trading facility) or entering into a continuing relationship with the banking entity with respect to such services. For purposes of determining the reasonably expected near-term demands of customers, a client, customer, or counterparty generally would not include a trading desk or other organizational unit of another entity that has $50 billion or more in total trading assets except if the trading desk has a documented reason for treating the trading desk or other organizational unit of such entity as a customer or the trading desk's transactions are executed anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants. The Agencies believe that this exclusion balances commenters' suggested alternatives of either defining as a client, customer, or counterparty anyone who is on the other side of a market maker's trade [908] or preventing any banking entity from being a client, customer, or counterparty.[909] The Agencies believe that the first alternative is overly broad and would not meaningfully distinguish between permitted market making-related activity and impermissible proprietary trading. For example, the Agencies are concerned that such an approach would allow a trading desk to maintain an outsized inventory and to justify such inventory levels as being tangentially related to expected market-wide demand. On the other hand, preventing any banking entity from being a client, customer, or counterparty under the final rule would result in an overly narrow definition that would significantly impact banking entities' ability to provide and access market making-related services. For example, most banks look to market makers to provide liquidity in connection with their investment portfolios.

The Agencies further note that, with respect to a banking entity that acts as a primary dealer (or functional equivalent) for a sovereign government, the sovereign government and its central bank are each a client, customer, or counterparty for purposes of the market-making exemption as well as the underwriting exemption.[910] The Agencies believe this interpretation, together with the modifications in the rule that eliminate the requirement to distinguish between revenues from spreads and price appreciation and the recognition that the market-making exemption extends to market making-related activities appropriately captures the unique relationship between a primary dealer and the sovereign government. Thus, generally a banking entity may rely on the market-making exemption for its activities as primary dealer (or functional equivalent) to the extent those activities are outside of the underwriting exemption.[911]

[903] Final rule § 75.4(b)(3).

[904] *See* final rule § 75.4(b)(3)(i). The Agencies are using a $50 billion threshold for these purposes in recognition that firms engaged in substantial trading activity do not typically act as customers to other market makers, while smaller regional firms may seek liquidity from larger firms as part of their market making-related activities.

[905] *See* final rule § 75.4(b)(3)(i)(A), (B). In Appendix C of the proposed rule, a trading unit engaged in market making-related activities would have been required to describe how it identifies its customers for purposes of the Customer-Facing Trading Ratio, if applicable, including documentation explaining when, how, and why a broker-dealer, swap dealer, security-based swap dealer, or any other entity engaged in market making-related activities, or any affiliate thereof, is considered to be a customer of the trading unit. *See* Joint Proposal, 76 FR at 68964. While the proposed approach would not have necessarily prevented any of these entities from being considered a customer of the trading desk, it would have required enhanced documentation and justification for treating any of these entities as a customer. The final rule's exclusion from the definition of client, customer, and counterparty is similar to the proposed approach, but is more narrowly focused on firms that have $50 billion or more trading assets and liabilities because, as noted above, the Agencies believe firms engaged in such substantial trading activity are less likely to act as customers to market makers than smaller regional firms.

[906] *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439.

[907] *See, e.g.,* Goldman (Prop. Trading) (explaining generally how exchange-based market makers operate).

[908] *See* ISDA (Feb. 2012). In addition, a number of commenters suggested that the rule should not limit broker-dealers from being customers of a market maker. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); RBC; Comm. on Capital Markets Regulation.

[909] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[910] A primary dealer is a firm that trades a sovereign government's obligations directly with the sovereign (in many cases, with the sovereign's central bank) as well as with other customers through market making. The sovereign government may impose conditions on a primary dealer or require that it engage in certain trading in the relevant government obligations (*e.g.,* participate in auctions for the government obligation or maintain a liquid secondary market in the government obligations). Further, a sovereign government may limit the number of primary dealers that are authorized to trade with the sovereign. A number of countries use a primary dealer system, including Australia, Brazil, Canada, China-Hong Kong, France, Germany, Greece, India, Indonesia, Ireland, Italy, Japan, Mexico, Netherlands, Portugal, South Africa, South Korea, Spain, Turkey, the U.K., and the U.S. *See, e.g.,* Oliver Wyman (Feb. 2012). The Agencies note that this standard would similarly apply to the relationship between a banking entity and a sovereign that does not have a formal primary dealer system, provided the sovereign's process functions like a primary dealer framework.

[911] *See* Goldman (Prop. Trading). *See also supra* Part VI.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity). Each suggestion regarding the treatment of primary dealer activity has not been incorporated into the

Continued

For exchange-traded funds (''ETFs'') (and related structures), Authorized Participants (''APs'') are generally the conduit for market participants seeking to create or redeem shares of the fund (or equivalent structure).[912] For example, an AP may buy ETF shares from market participants who would like to redeem those shares for cash or a basket of instruments upon which the ETF is based. To provide this service, the AP may in turn redeem these shares from the ETF itself. Similarly, an AP may receive cash or financial instruments from a market participant seeking to purchase ETF shares, in which case the AP may use that cash or set of financial instruments to create shares from the ETF. In either case, for the purpose of the market-making exemption, such market participants as well as the ETF itself would be considered clients, customers, or counterparties of the AP.[913] The inventory of ETF shares or underlying instruments held by the AP can therefore be evaluated under the criteria of the market-making exemption, such as how these holdings relate to reasonably expected near term customer demand.[914] These criteria can be similarly applied to other activities of the AP, such as building inventory to ''seed'' a new ETF or engaging in ETF-loan related transactions.[915] The Agencies recognize that banking entities currently conduct a substantial amount of AP creation and redemption activity in the ETF market and, thus, if the rule were to prevent or restrict a banking entity from acting as an AP for an ETF, then the rule would impact the functioning of the ETF market.[916]

Some firms, whether or not an AP in a given ETF, may also actively engage in buying and selling shares of an ETF and its underlying instruments in the market to maintain price continuity between the ETF and its underlying instruments, which are exchangeable for one another. Sometimes these firms will register as market makers on an exchange for a given ETF, but other times they may not register as market maker. Regardless of whether or not the firm is registered as a market maker on any given exchange, this activity not only provides liquidity for ETFs, but also, and very importantly, helps keep the market price of an ETF in line with the NAV of the fund. The market-making exemption can be used to evaluate trading that is intended to maintain price continuity between these exchangeable instruments by considering how the firm quotes, maintains risk and exposure limits, manages its inventory and risk, and, in the case of APs, exercises its ability to create and redeem shares from the fund. Because customers take positions in ETFs with an expectation that the price relationship will be maintained, such trading can be considered to be market making-related activity.[917]

After considering comments, the Agencies continue to take the view that a trading desk would not qualify for the market-making exemption if it is wholly or principally engaged in arbitrage trading or other trading that is not in response to, or driven by, the demands of clients, customers, or counterparties.[918] The Agencies believe this activity, which is not in response to or driven by customer demand, is inconsistent with the Congressional intent that market making-related activity be designed not to exceed the reasonably expected near term demands

rule. Specifically, the exemption for market making as applied to a primary dealer does not extend without limitation to primary dealer activities that are not conducted under the conditions of one of the exemptions. These interpretations would be inconsistent with Congressional intent for the statute, to limit permissible market- making activity through the statute's near term demand requirement and, thus, does not permit trading without limitation. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that permitted activities should include trading necessary to meet the relevant jurisdiction's primary dealer and other requirements); JPMC (indicating that the exemption should cover all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities); Goldman (Prop. Trading); Banco de México; IIB/EBF. Rather, recognizing that market making by primary dealers is a key function, the limits and other conditions of the rule are flexible enough to permit necessary market making-related activities.

[912] ETF sponsors enter into relationships with one or more financial institutions that become APs for the ETF. Only APs are permitted to purchase and redeem shares directly from the ETF, and they can do so only in large aggregations or blocks that are commonly called ''creation units.'' In response to a question in the proposal, a number of commenters expressed concern that the proposed market-making exemption may not permit certain AP and market maker activities in ETFs and requested clarification that these activities would be permitted under the market-making exemption. *See* Joint Proposal, 76 FR at 68873 (question 91) (''Do particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed in the proposal? If so, how could the proposal better address those instruments, markets or market features?''); CFTC Proposal, 77 FR at 8359 (question 91); *supra* Part VI.A.3.c.2.b.vii. (discussing comments on this issue).

[913] This is consistent with two commenters' request that an ETF issuer be considered a ''counterparty'' of the banking entity when it trades directly with the ETF issuer as an AP. *See* ICI Global; ICI (Feb. 2012). Further, this approach is intended to address commenters' concerns that the near term demand requirement may limit a banking entity's ability to act as AP for an ETF. *See* BoA; Vanguard. The Agencies believe that one commenter's concern about the impact of the proposed source of revenue requirement on AP activity should be addressed by the replacement of this proposed requirement with a metric-based focus on when a trading desk generates revenue from its trading activity. *See* BoA; *infra* Part VI.A.3.c.7.c. (discussing the new approach to assessing a trading desk's pattern of profit and loss).

[914] This does not imply that the AP must perfectly predict future customer demand, but rather that there is a demonstrable, statistical, or historical basis for the size of the inventory held, as more fully discussed below. Consider, for example, a fixed-income ETF with $500 million in assets. If, on a typical day, an AP generates requests for $10 to $20 million of creations or redemptions, then an inventory of $10 to $20 million in bonds upon which the ETF is based (or some small multiple thereof) could be construed as consistent with reasonably expected near term customer demand. On the other hand, if under the same circumstances an AP holds $1 billion of these bonds solely in its capacity as an AP for this ETF, it would be more difficult to justify this as needed for reasonably expected near term customer demand and may be indicative of an AP engaging in prohibited proprietary trading.

[915] In ETF loan transactions (also referred to as ''create-to-lend'' transactions), an AP borrows the underlying instruments that form the creation basket of an ETF, submits the borrowed instruments to the ETF agent in exchange for a creation unit of ETF shares, and lends the resulting ETF shares to a customer that wants to borrow the ETF. At the end of the ETF loan, the borrower returns the ETF shares to the AP, and the AP redeems the ETF shares with the ETF agent in exchange for the underlying instruments that form the creation basket. The AP may return the underlying instruments to the parties from whom it borrowed them or may use them for another loan, as long as the AP is not obligated to return them at that time. For the term of the ETF loan transaction, the AP hedges against market risk arising from any rebalancing of the ETF, which would change the amount or type of underlying instruments the AP would receive in exchange for the ETF compared to the underlying instruments the AP borrowed and submitted to the ETF agent to create the ETF shares. *See* David J. Abner, ''The ETF Handbook,'' Ch. 12 (2010); Jean M. McLoughlin, Davis Polk & Wardwell LLP, to Division of Corporation Finance, U.S. Securities and Exchange Commission, dated Jan. 23, 2013, available at *http://www.sec.gov/divisions/corpfin/cf-noaction/2013/davis-polk-wardwell-llp-012813-16a.pdf.*

[916] *See* SSgA (Feb. 2012).

[917] A number of commenters expressed concern that the proposed rule would limit market making or AP activity in ETFs because market makers and APs engage in trading to maintain a price relationship between ETFs and their underlying components, which promotes ETF market efficiency. *See* Vanguard; RBC; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012); Credit Suisse (Prop. Trading).

[918] Some commenters suggested that a range of arbitrage trading should be permitted under the market-making exemption. *See, e.g.,* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC. Other commenters, however, stated that arbitrage trading should be prohibited under the final rule. *See* AFR *et al.* (Feb. 2012); Volcker; Occupy. In response to commenters representing that it would be difficult to comply with this standard because it requires a trading desk to determine the proportionality of its activities in response to customer demand compared to its activities that are not in response to customer demand, the Agencies believe that the statute requires a banking entity to distinguish between market making-related activities that are designed not to exceed the reasonably expected near term demands of customers and impermissible proprietary trading. *See* Goldman (Prop. Trading); RBC.

of clients, customers, or counterparties. For example, a trading desk would not be permitted to engage in general statistical arbitrage trading between instruments that have some degree of correlation but where neither instrument has the capability of being exchanged, converted, or exercised for or into the other instrument. A trading desk may, however, act as market maker to a customer engaged in a statistical arbitrage trading strategy. Furthermore as suggested by some commenters,[919] trading activity used by a market maker to maintain a price relationship that is expected and relied upon by clients, customers, and counterparties is permitted as it is related to the demands of clients, customers, or counterparties because the relevant instrument has the capability of being exchanged, converted, or exercised for or into another instrument.[920]

The Agencies recognize that a trading desk, in anticipating and responding to customer needs, may engage in interdealer trading as part of its inventory management activities and that interdealer trading provides certain market benefits, such as more efficient matching of customer order flow, greater hedging options to reduce risk, and enhanced ability to accumulate or exit customer-related positions.[921] The final rule does not prohibit a trading desk from using the market-making exemption to engage in interdealer trading that is consistent with and related to facilitating permissible trading with the trading desk's clients, customers, or counterparties.[922] However, in determining the reasonably expected near term demands of clients, customers, or counterparties, a trading desk generally may not account for the expected trading interests of a trading desk or other organizational unit of an entity with aggregate trading assets and liabilities of $50 billion or greater (except if the trading desk documents why and how a particular trading desk or other organizational unit at such a firm should be considered a customer or the trading desk or conduct market-making activity anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants).[923]

A trading desk may engage in interdealer trading to: Establish or acquire a position to meet the reasonably expected near term demands of its clients, customers, or counterparties, including current demand; unwind or sell positions acquired from clients, customers, or counterparties; or engage in risk-mitigating or inventory management transactions.[924] The Agencies believe that allowing a trading desk to continue to engage in customer-related interdealer trading is appropriate because it can help a trading desk appropriately manage its inventory and risk levels and can effectively allow clients, customers, or counterparties to access a larger pool of liquidity. While the Agencies recognize that effective intermediation of client, customer, or counterparty trading may require a trading desk to engage in a certain amount of interdealer trading, this is an activity that will bear some scrutiny by the Agencies and should be monitored by banking entities to ensure it reflects market-making activities and not impermissible proprietary trading.

ii. Impact of the Liquidity, Maturity, and Depth of the Market on the Analysis

Several commenters expressed concern about the potential impact of the proposed near term demand requirement on market making in less liquid markets and requested that the Agencies recognize that near term customer demand may vary across different markets and asset classes.[925] The Agencies understand that reasonably expected near term customer demand may vary based on the liquidity, maturity, and depth of the market for the relevant type of financial instrument(s) in which the trading desk acts as market maker.[926] As a result, the final rule recognizes that these factors impact the analysis of reasonably expected near term demands of clients, customers, or counterparties and the amount, types, and risks of market-maker inventory needed to meet such demand.[927] In particular, customer demand is likely to be more frequent in more liquid markets than in less liquid or illiquid markets. As a result, market makers in more liquid cash-based markets, such as liquid equity securities, should generally have higher rates of inventory turnover and less aged inventory than market makers in less liquid or illiquid markets.[928] Market makers in less liquid cash-based markets are more likely to hold a particular position for a longer period of time due to intermittent customer demand. In the derivatives markets, market makers carry open positions and manage various risk factors, such as exposure to different points on a yield curve. These exposures are analogous to inventory in the cash-based markets. Further, it may be more difficult to reasonably predict near term customer demand in less mature markets due to,

[919] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[920] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Credit Suisse (Seidel). For example, customers have an expectation of general price alignment under these circumstances, both at the time they decide to invest in the instrument and for the remaining time they hold the instrument. To the contrary, general statistical arbitrage does not maintain a price relationship between related instruments that is expected and relied upon by customers and, thus, is not permitted under the market-making exemption. Firms engage in general statistical arbitrage to profit from differences in market prices between instruments, assets, or price or risk elements associated with instruments or assets that are thought to be statistically related, but which do not have a direct relationship of being exchangeable, convertible, or exercisable for the other.

[921] *See* MetLife; ACLI (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; Chamber (Feb. 2012); Prof. Duffie; Oliver Wyman (Dec. 2011); Oliver Wyman (Feb. 2012).

[922] A number of commenters requested that the rule be modified to clearly recognize interdealer trading as a component of permitted market making-related activity. *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; Credit Suisse (Seidel); JPMC; BoA; ACLI (Feb. 2012); AFR *et al.* (Feb. 2012); ISDA (Feb. 2012); Goldman (Prop. Trading); Oliver Wyman (Feb. 2012). One of these commenters analyzed the potential market impact of preventing interdealer trading, combined with inventory limits. *See* Oliver Wyman (Feb. 2012). Because the final rule does not prohibit interdealer trading or limit inventory in the manner this commenter assumed for purposes of its analysis, the Agencies do not believe the final rule will have the market impact cited by this commenter.

[923] *See* AFR *et al.* (Feb. 2012) (recognizing that the ability to manage inventory through interdealer transactions should be accommodated in the rule, but recommending that this activity be conditioned on a market maker having an appropriate level of inventory after an interdealer transaction).

[924] Provided it is consistent with the requirements of the market-making exemption, including the near term customer demand requirement, a trading desk may trade for purposes of determining how to price a financial instrument a customer seeks to trade with the trading desk or to determine the depth of the market for a financial instrument a customer seeks to trade with the trading desk. *See* Goldman (Prop. Trading).

[925] *See* CIEBA (stating that, absent a different interpretation for illiquid instruments, market makers will err on the side of holding less inventory to avoid sanctions for violating the rule); Morgan Stanley; RBC; ICI (Feb. 2012) ISDA (Feb. 2012); Comm. on Capital Markets Regulation; Alfred Brock.

[926] *See supra* Part VI.A.3.c.2.b.ii. (discussing comments on this issue).

[927] *See* final rule § 75.4(b)(2)(ii)(A).

[928] The final rule does not impose additional capital requirements on aged inventory to discourage a trading desk from retaining positions in inventory, as suggested by some commenters. *See* CalPERS; Vanguard. The Agencies believe the final rule already limit a trading desk's ability to hold inventory over an extended period and do not see a need at this time to include additional capital requirements in the final rule. For example, a trading desk must have written policies and procedures relating to its inventory and must be able to demonstrate, as needed, its analysis of why the levels of its market-maker inventory are necessary to meet, or is a result of meeting, customer demand. *See* final rule § 75.4(b)(2)(ii), (iii)(C).

among other things, a lack of historical experience with client, customer, or counterparty demands for the relevant product. Under these circumstances, the Agencies encourage banking entities to consider their experience with similar products or other relevant factors.[929]

iii. Demonstrable Analysis of Certain Factors

In the proposal, the Agencies stated that permitted market making includes taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.[930] A number of commenters expressed concern about this proposed interpretation's impact on market makers' inventory management activity and represented that it was inconsistent with the statute's near term demand standard, which permits market-making activity that is ''designed'' not to exceed the ''reasonably expected'' near term demands of customers.[931] In response to comments, the Agencies are permitting a trading desk to take positions in reasonable expectation of customer demand in the near term based on a demonstrable analysis that the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of customers.

The proposal also stated that a banking entity's determination of near term customer demand should generally be based on the unique customer base of a specific market-making business line (and not merely an expectation of future price appreciation). Several commenters stated that it was unclear how such determinations should be made and expressed concern that near term customer demand cannot always be accurately predicted,[932] particularly in markets where trades occur infrequently and customer demand is hard to predict[933] or when a banking entity is entering a new market.[934] To address these comments, the Agencies are providing additional information about how a banking entity can comply with the statute's near term customer demand requirement, including a new requirement that a banking entity conduct a demonstrable assessment of reasonably expected near term customer demand and several examples of factors that may be relevant for conducting such an assessment. The Agencies believe it is important to require such demonstrable analysis to allow determinations of reasonably expected near term demand and associated inventory levels to be monitored and tested to ensure compliance with the statute and the final rule.

The final rule provides that, to help determine the appropriate amount, types, and risks of the financial instruments in the trading desk's market-maker inventory and to ensure that such inventory is designed not to exceed, on an ongoing basis, the reasonably expected near term demands of client, customers, or counterparties, a banking entity must conduct demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with financial instruments in which the trading desk makes a market, including through block trades. This analysis should not be static or fixed solely on current market or other factors. Instead, an appropriately conducted analysis under this provision will be both backward- and forward-looking by taking into account relevant historical trends in customer demand[935] and any events that are reasonably expected to occur in the near term that would likely impact demand.[936] Depending on the facts and circumstances, it may be proper for a banking entity to weigh these factors differently when conducting an analysis under this provision. For example, historical trends in customer demand may be less relevant when a trading desk is experiencing or expects to experience a change in the pattern of customer needs (*e.g.,* requests for block positioning), adjustments to its business model (*e.g.,* efforts to expand or contract its market shares), or changes in market conditions.[937] On the other hand, absent these types of current or anticipated events, the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory should be relatively consistent with such trading desk's historical profile of market-maker inventory.[938]

Moreover, the demonstrable analysis required under § 75.4(b)(2)(ii)(B) should account for, among other things, how the market factors discussed in § 75.4(b)(2)(ii)(A) impact the amount, types, and risks of market-maker inventory the trading desk may need to facilitate reasonably expected near term demands of clients, customers, or counterparties.[939] Other potential

[929] The Agencies agree, as suggested by one commenter, it may be appropriate for a market maker in a new asset class or market to look to reasonably expected future developments on the basis of the trading desk's customer relationships. *See* Morgan Stanley. As discussed further below, the Agencies recognize that a trading desk could encounter similar issues if it is a new entrant in an existing market.

[930] *See* Joint Proposal, 76 FR at 68871; CFTC Proposal, 77 FR at 8356–8357.

[931] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Chamber (Feb. 2012); Comm. on Capital Markets Regulation. *See also* Morgan Stanley; SIFMA (Asset Mgmt.) (Feb. 2012).

[932] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); MetLife; Chamber (Feb. 2012); RBC; CIEBA; Wellington; ICI (Feb. 2012) Alfred Brock.

[933] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[934] *See* CIEBA.

[935] To determine an appropriate historical dataset, a banking entity should assess the relation between current or reasonably expected near term conditions and demand and those of prior market cycles.

[936] This analysis may, where appropriate, take into account prior and/or anticipated cyclicality to the demands of clients, customers, or counterparties, which may cause variations in the amounts, types, and risks of financial instruments needed to provide intermediation services at different points in a cycle. For example, the final rule recognizes that a trading desk may need to accumulate a larger-than-average amount of inventory in anticipation of an index rebalance. *See supra* note 843 (discussing a comment on this issue). The Agencies are aware that a trading desk engaged in block positioning activity may have a less consistent pattern of inventory because of the need to take on large block positions at the request of customers. *See supra* note 761 and accompanying text (discussing comments on this issue).

Because the final rule does not prevent banking entities from providing direct liquidity for rebalance trades, the Agencies do not believe that the final rule will cause the market impacts that one commenter predicted would occur were such a restriction adopted. *See* Oliver Wyman (Feb. 2012) (estimating that if market makers are not able to provide direct liquidity for rebalance trades, investors tracking these indices could potentially pay incremental costs of $600 million to $1.8 billion every year).

[937] In addition, the Agencies recognize that a new entrant to a particular market or asset class may not have knowledge of historical customer demand in that market or asset class at the outset. *See supra* note 924 and accompanying text (discussing factors that may be relevant to new market entrants for purposes of determining the reasonably expected near term demands of clients, customers, or counterparties).

[938] One commenter suggested an approach that would allow market makers to build inventory in products where they believe customer demand will exist, regardless of whether inventory can be tied to a particular customer in the near term or to historical trends in customer demand. *See* Credit Suisse (Seidel). The Agencies believe an approach that does not provide for any consideration of historical trends could result in a heightened risk of evasion. At the same time, as discussed above, the Agencies recognize that historical trends may not always determine the amount of inventory a trading desk may need to meet reasonably expected near term demand and it may under certain circumstances be appropriate to build inventory in anticipation of a reasonably expected near term event that would likely impact customer demand. While the Agencies are not requiring that market-maker inventory be tied to a particular customer, the Agencies are requiring that a banking entity analyze and support its expectations for near term customer demand.

[939] The Agencies recognize that a trading desk could acquire either a long or short position in

factors that could be used to assess reasonably expected near term customer demand and the appropriate amount, types, and risks of financial instruments in the trading desk's market-maker inventory include, among others: (i) Recent trading volumes and customer trends; (ii) trading patterns of specific customers or other observable customer demand patterns; (iii) analysis of the banking entity's business plan and ability to win new customer business; (iv) evaluation of expected demand under current market conditions compared to prior similar periods; (v) schedule of maturities in customers' existing portfolios; and (vi) expected market events, such as an index rebalancing, and announcements. The Agencies believe that some banking entities already analyze these and other relevant factors as part of their overall risk management processes.[940]

With respect to the creation and distribution of complex structured products, a trading desk may be able to use the market-making exemption to acquire some or all of the risk exposures associated with the product if the trading desk has evidence of customer demand for each of the significant risks associated with the product.[941] To have evidence of customer demand under these circumstances, there must be prior express interest from customers in the specific risk exposures of the product. Without such express interest, a trading desk would not have sufficient information to support the required demonstrable analysis (*e.g.,* information about historical customer demand or other relevant factors).[942] The Agencies are concerned that, absent express interest in each significant risk associated with the product, a trading desk could evade the market-making exemption by structuring a deal with certain risk exposures, or amounts of risk exposures, for which there is no customer demand and that would be retained in the trading desk's inventory, potentially for speculative purposes. Thus, a trading desk would not be engaged in permitted market making-related activity if, for example, it structured a product solely to acquire a desired exposure and not to respond to customer demand.[943] When a trading desk acquires risk exposures in these circumstances, the trading desk would be expected to enter into appropriate hedging transactions or otherwise mitigate the risks of these exposures, consistent with its hedging policies and procedures and risk limits.

With regard to a trading desk that conducts its market-making activities on an exchange or other similar anonymous trading facility, the Agencies continue to believe that market-making activities are generally consistent with reasonably expected near term customer demand when such activities involve passively providing liquidity by submitting resting orders that interact with the orders of others in a non-directional or market-neutral trading strategy or by regularly responding to requests for quotes in markets where resting orders are not generally provided. This ensures that the trading desk has a pattern of providing, rather than taking, liquidity. However, this does not mean that a trading desk acting as a market maker on an exchange or other similar anonymous trading facility is only permitted to use these types of orders in connection with its market making-related activities. The Agencies recognize that it may be appropriate for a trading desk to enter market or marketable limit orders on an exchange or other similar anonymous trading facility, or to request quotes from other market participants, in connection with its market making-related activities for a variety of purposes including, among others, inventory management, addressing order imbalances on an exchange, and hedging.[944] In response to comments, the Agencies are not requiring a banking entity to be registered as a market maker on an exchange or other similar anonymous trading facility, if the exchange or other similar anonymous trading facility registers market makers, for purposes of the final rule.[945] The Agencies recognize, as noted by commenters, that there are a large number of exchanges and organized trading facilities on which market makers may need to trade to maintain liquidity across the markets and to provide customers with favorable prices and that requiring registration with each exchange or other trading facility may unnecessarily restrict or impose burdens on exchange market-making activities.[946]

A banking entity is not required to conduct the demonstrable analysis under § 75.4(b)(2)(B) of the final rule on an instrument-by-instrument basis. The Agencies recognize that, in certain cases, customer demand may be for a particular type of exposure, and a customer may be willing to trade any one of a number of instruments that would provide the demanded exposure. Thus, an assessment of the amount, types, and risks of financial instruments that the trading desk may hold in market-maker inventory and that would be designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties does not need to be made for each financial instrument in which the trading desk acts as market maker. Instead, the amount and types of financial instruments in the trading desk's market-maker inventory should be

reasonable anticipation of near term demands of clients, customers, or counterparties. In particular, if it is expected that customers will want to buy an instrument in the near term, it may be appropriate for the desk to acquire a long position in such instrument. If it is expected that customers will want to sell the instrument, acquiring a short position may be appropriate under certain circumstances.

[940] *See supra* Part VI.A.3.c.2.b.iii. *See* FTN; Morgan Stanley (suggesting a standard that would require a position to be ''reasonably consistent with observable customer demand patterns'').

[941] Complex structured products can contain a combination of several different types of risks, including, among others, market risk, credit risk, volatility risk, and prepayment risk.

[942] In contrast, a trading desk may respond to requests for customized transactions, such as custom swaps, provided that the trading desk is a market maker in the risk exposures underlying the swap or can hedge the underlying risk exposures, consistent with its financial exposure and hedging limits, and otherwise meets the requirements of the market-making exemption. For example, a trading desk may routinely make markets in underlying exposures and, thus, would meet the requirements for engaging in transactions in derivatives that reflect the same exposures. Alternatively, a trading desk might meet the requirements by routinely trading in the derivative and hedging in the underlying exposures. *See supra* Part VI.A.3.c.1.c.iii.

[943] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012).

[944] The Agencies are clarifying this point in response to commenters who expressed concern that the proposal would prevent an exchange market maker from using market or marketable limit orders under these circumstances. *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); RBC.

[945] *See supra* notes 774 to 779 and accompanying text (discussing commenters' response to statements in the proposal requiring exchange registration as a market maker under certain circumstances). Similarly, the final rule does not establish a presumption of compliance with the market-making exemption based on registration as a market maker with an exchange, as requested by a few commenters. *See supra* note 777 and accompanying text. As noted above, activity that is considered market making for purposes of this rule may not be considered market making for purposes of other rules, including self-regulatory organization rules, and vice versa. In addition, exchange requirements for registered market makers are subject to change without consideration of the impact on this rule. Although a banking entity is not required to be an exchange-registered market maker under the final rule, a banking entity must be licensed or registered to engage in market making-related activities in accordance with applicable law. For example, a banking entity would be required to be an SEC-registered broker-dealer to engage in market making-related activities in securities in the U.S. unless the banking entity is exempt from registration or excluded from regulation as a dealer under the Exchange Act. *See infra* Part VI.A.3.c.6.; final rule § 75.4(b)(2)(vi).

[946] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading) (noting that there are more than 12 exchanges and 40 alternative trading systems currently trading U.S. equities).

consistent with the types of financial instruments in which the desk makes a market and the amount and types of such instruments that the desk's customers are reasonably expected to be interested in trading.

In response to commenters' concern that banking entities may be subject to regulatory sanctions if reasonably expected customer demand does not materialize,[947] the Agencies recognize that predicting the reasonably expected near term demands of clients, customers, or counterparties is inherently subject to changes based on market and other factors that are difficult to predict with certainty. Thus, there may at times be differences between predicted demand and actual demand from clients, customers, or counterparties. However, assessments of expected near term demand may not be reasonable if, in the aggregate and over longer periods of time, a trading desk exhibits a repeated pattern or practice of significant variation in the amount, types, and risks of financial instruments in its market-maker inventory in excess of what is needed to facilitate near term customer demand.

iv. Relationship to Required Limits

As discussed further below, a banking entity must establish limits for each trading desk on the amount, types, and risks of its market-maker inventory, level of exposures to relevant risk factors arising from its financial exposure, and period of time a financial instrument may be held by a trading desk. These limits must be reasonably designed to ensure compliance with the market-making exemption, including the near term customer demand requirement, and must take into account the nature and amount of the trading desk's market making-related activities. Thus, the limits should account for and generally be consistent with the historical near term demands of the desk's clients, customers, or counterparties and the amount, types, and risks of financial instruments that the trading desk has historically held in market-maker inventory to meet such demands. In addition to the limits that a trading desk selects in managing its positions to ensure compliance with the market-making exemption set out in § 75.4(b), the Agencies are requiring, for banking entities that must report metrics in Appendix A, such limits include, at a minimum, ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics as limits, except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.[948] The Agencies believe that these metrics can be useful for measuring and managing many types of positions and trading activities and therefore can be useful in establishing a minimum set of metrics for which limits should be applied.[949]

As this requirement applies on an ongoing basis, a trade in excess of one or more limits set for a trading desk should not be permitted simply because it responds to customer demand. Rather, a banking entity's compliance program must include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the requirements of this near term demand requirement and with the prudent management of risk by the banking entity, and independent review of such demonstrable analysis and approval.[950] The Agencies expect that a trading desk's escalation procedures will generally explain the circumstances under which a trading desk's limits can be increased, either temporarily or permanently, and that such increases must be consistent with reasonably expected near term demands of the desk's clients, customers, or counterparties and the amount and type of risks to which the trading desk is authorized to be exposed.

3. Compliance Program Requirement

a. Proposed Compliance Program Requirement

To ensure that a banking entity relying on the market-making exemption had an appropriate framework in place to support its compliance with the exemption, § 75.4(b)(2)(i) of the proposed rule required a banking entity to establish an internal compliance program, as required by subpart D of the proposal, designed to ensure compliance with the requirements of the market-making exemption.[951]

b. Comments on the Proposed Compliance Program Requirement

A few commenters supported the proposed requirement that a banking entity establish a compliance program under § 75.20 of the proposed rule as effective.[952] For example, one commenter stated that the requirement ''keeps a strong focus on the bank's own workings and allows banks to self-monitor.'' [953] One commenter indicated that a comprehensive compliance program is a ''cornerstone of effective corporate governance,'' but cautioned against placing ''undue reliance'' on compliance programs.[954] As discussed further below in Parts VI.C.1. and VI.C.3., many commenters expressed concern about the potential burdens of the proposed rule's compliance program requirement, as well as the proposed requirement regarding quantitative measurements. According to one commenter, the compliance burdens associated with these requirements may dissuade a banking entity from attempting to comply with the market-making exemption.[955]

c. Final Compliance Program Requirement

Similar to the proposed exemption, the market-making exemption adopted in the final rule requires that a banking entity establish and implement, maintain, and enforce an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing.[956] This provision further requires that the compliance program include particular written policies and procedures, internal controls, analysis, and independent testing identifying and addressing:

- The financial instruments each trading desk stands ready to purchase and sell as a market maker;
- The actions the trading desk will take to demonstrably reduce or

[947] *See* RBC; CIEBA; Wellington; ICI (Feb. 2012) Invesco.

[948] *See* Appendix A.

[949] The Agencies recognize that for some types of positions or trading strategies, the use of ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics may be ineffective and accordingly limits do not need to be set for those metrics if such ineffectiveness is demonstrated by the banking entity.

[950] *See* final rule § 75.4(b)(2)(iii); *infra* Part VI.A.3.c.3.c. (discussing the meaning of ''independent'' review for purposes of this requirement).

[951] *See* proposed rule § 75.4(b)(2)(i); Joint Proposal, 76 FR at 68870; CFTC Proposal, 77 FR at 8355.

[952] *See* Flynn & Fusselman; Morgan Stanley.

[953] *See* Flynn & Fusselman.

[954] *See* Occupy.

[955] *See* ICI (Feb. 2012).

[956] The independent testing standard is discussed in more detail in Part VI.C., which discusses the compliance program requirement in § 75.20 of the final rule.

otherwise significantly mitigate promptly the risks of its financial exposure consistent with the required limits; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

- Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by the near term customer demand requirement of the final rule, on:
  - The amount, types, and risks of its market-maker inventory;
  - The amount, types, and risks of the products, instruments, and exposures the trading desk uses for risk management purposes;
  - Level of exposures to relevant risk factors arising from its financial exposure; and
  - Period of time a financial instrument may be held;
- Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its required limits; and
- Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of § 75.4(b)(2)(ii) of the final rule, and independent review (*i.e.,* by risk managers and compliance officers at the appropriate level independent of the trading desk) of such demonstrable analysis and approval.[957]

The compliance program requirement in the proposed market-making exemption did not include specific references to all the compliance program elements now listed in the final rule. Instead, these elements were generally included in the compliance requirements of Appendix C of the proposed rule. The Agencies are moving certain of these requirements into the market-making exemption to ensure that critical components are made part of the compliance program for market making-related activities. Further, placing these requirements within the market-making exemption emphasizes the important role they play in overall compliance with the exemption.[958] Banking entities should note that these compliance procedures must be established, implemented, maintained, and enforced for each trading desk engaged in market making-related activities under the final rule. Each of the requirements in paragraphs (b)(2)(iii)(A) through (E) must be appropriately tailored to the individual trading activities and strategies of each trading desk on an ongoing basis.

As a threshold issue, the compliance program must identify the products, instruments, and exposures the trading desk may trade as market maker or for risk management purposes.[959] Identifying the relevant instruments in which a trading desk is permitted to trade will facilitate monitoring and oversight of compliance with the exemption by preventing an individual trader on a market-making desk from establishing positions in instruments that are unrelated to the desk's market-making function. Further, this identification of instruments helps form the basis for the specific types of inventory and risk limits that the banking entity must establish and is relevant to considerations throughout the exemption regarding the liquidity, depth, and maturity of the market for the relevant type of financial instrument. The Agencies note that a banking entity should be able to demonstrate the relationship between the instruments in which a trading desk may act as market maker and the instruments the desk may use to manage the risk of its market making-related activities and inventory and why the instruments the desk may use to manage its risk appropriately and effectively mitigate the risk of its market making-related activities without generating an entirely new set of risks that outweigh the risks that are being hedged.

The final rule provides that a banking entity must establish an appropriate risk management framework for each of its trading desks that rely on the market-making exemption.[960] This includes not only the techniques and strategies that a trading desk may use to manage its risk exposures, but also the actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposures consistent with its required limits, which are discussed in more detail below. While the Agencies do not expect a trading desk to hedge all of the risks that arise from its market

[957] *See* final rule § 75.4(b)(2)(iii).

[958] The Agencies note that a number of commenters requested that the Agencies place a greater emphasis on inventory limits and risk limits in the final exemption. *See, e.g.,* Citigroup (suggesting that the market-making exemption utilize risk limits that would be set for each trading unit based on expected levels of customer trading—estimated by looking to historical results, target product and customer lists, and target market share—and an appropriate amount of required inventory to support that level of customer trading); Prof. Colesanti *et al.* (suggesting that the exemption include, among other things, a bright-line threshold of the amount of risk that can be retained (which cannot be in excess of the size and type required for market making), positions limits, and limits on holding periods); Sens. Merkley & Levin (Feb. 2012) (suggesting the use of specific parameters for inventory levels, along with a number of other criteria, to establish a safe harbor); SIFMA *et al.* (Prop. Trading) (Feb. 2012) (recommending the use of risk limits in combination with a guidance-based approach); Japanese Bankers Ass'n. (suggesting that the rule set risk allowances for market making-related activities based on required capital for such activities). The Agencies are not establishing specific limits in the final rule, as some commenters appeared to recommend, in recognition of the fact that appropriate limits will differ based on a number of factors, including the size of the market-making operation and the liquidity, depth, and maturity of the market for the particular type(s) of financial instruments in which the trading desk is permitted to trade. *See* Sens. Merkley & Levin (Feb. 2012); Prof. Colesanti *et al.* However, banking entities relying on the market-making exemption must set limits and demonstrate how the specific limits and limit methodologies they have chosen are reasonably designed to limit the amount, types, and risks of the financial instruments in a trading desk's market-maker inventory consistent with the reasonably expected near term demands of the banking entity's clients, customers, and counterparties, subject to the market and conditions discussed above, and to commensurately control the desk's overall financial exposure.

[959] *See* final rule § 75.4(b)(2)(iii)(A) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the financial instruments each trading desk stands ready to purchase and sell in accordance with § 75.4(b)(2)(i) of the final rule); final rule § 75.4(b)(2)(iii)(B) (requiring written policies and procedures, internal controls, analysis, and independent testing regarding the products, instruments, or exposures each trading desk may use for risk management purposes).

[960] This standard addresses issues raised by commenters concerning: certain language in proposed Appendix B regarding market making-related risk management; the market making-related hedging provision in § 75.4(b)(3) of the proposed rule; and, to some extent, the proposed source of revenue requirement in § 75.4(b)(2)(v) of the proposed rule. *See* Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8439–8440; proposed rule § 75.4(b)(3); Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358; Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco; Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); FTN; RBC; NYSE Euronext; MFA. As discussed in more detail above, a number of commenters emphasized that market making-related activities necessarily involve a certain amount of risk-taking to provide ''immediacy'' to customers. *See, e.g.,* Prof. Duffie; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Commenters also represented that the amount of risk a market maker needs to retain may differ across asset classes and markets. *See, e.g.,* Morgan Stanley; Credit Suisse (Seidel). The Agencies believe that the requirement we are adopting better recognizes that appropriate risk management will tailor acceptable position, risk and inventory limits based on the type(s) of financial instruments in which the trading desk is permitted to trade and the liquidity, maturity, and depth of the market for the relevant type of financial instrument.

making-related activities, the Agencies do expect each trading desk to take appropriate steps consistent with market-making activities to contain and limit risk exposures (such as by unwinding unneeded positions) and to follow reasonable procedures to monitor the trading desk's risk exposures (*i.e.,* its financial exposure) and hedge risks of its financial exposure to remain within its relevant risk limits.[961]

As discussed in Part VI.A.3.c.4.c., managing the risks associated with maintaining a market-maker inventory that is appropriate to meet the reasonably expected near-term demands of customers is an important part of market making.[962] The Agencies understand that, in the context of market-making activities, inventory management includes adjustment of the amount and types of market-maker inventory to meet the reasonably expected near term demands of customers.[963] Adjustments of the size and types of a financial exposure are also made to reduce or mitigate the risks associated with financial instruments held as part of a trading desk's market-maker inventory. A common strategy in market making is to establish market-maker inventory in anticipation of reasonably expected customer needs and then to reduce that market-maker inventory over time as customer demand materializes.[964] If customer demand does not materialize, the market maker addresses the risks associated with its market-maker inventory by adjusting the amount or types of financial instruments in its inventory as well as taking steps otherwise to mitigate the risk associated with its inventory.

The Agencies recognize that, to provide effective intermediation services, a trading desk engaged in permitted market making-related activities retains a certain amount of risk arising from the positions it holds in inventory and may hedge certain aspects of that risk. The requirements in the final rule establish controls around a trading desk's risk management activities, yet still recognize that a trading desk engaged in market making-related activities may retain a certain amount of risk in meeting the reasonably expected near term demands of clients, customers, or counterparties. As the Agencies noted in the proposal, where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act.[965] The Agencies emphasize that the only risk management activities that qualify for the market-making exemption—and that are not subject to the hedging exemption—are risk management activities conducted or directed by the trading desk in connection with its market making-related activities and in conformance with the trading desk's risk management policies and procedures.[966] A trading desk engaged in market making-related activities would be required to comply with the hedging exemption or another available exemption for any risk management or other activity that is not in conformance with the trading desk's required market-making risk management policies and procedures.

A banking entity's written policies and procedures, internal controls, analysis, and independent testing identifying and addressing the products, instruments, or exposures and the techniques and strategies that may be used by each trading desk to manage the risks of its market making-related activities and inventory must cover both how the trading desk may establish hedges and how such hedges are removed once the risk they were mitigating is unwound. With respect to establishing positions that hedge or otherwise mitigate the risk(s) of market making-related positions held by the trading desk, the written policies and procedures may consider the natural hedging and diversification that occurs in an aggregation of long and short positions in financial instruments for which the trading desk is a market maker,[967] as it documents its specific risk-mitigating strategies that use instruments for which the desk is a market maker or instruments for which the desk is not a market maker. Further, the written policies and procedures identifying and addressing permissible hedging techniques and strategies must address the circumstances under which the trading desk may be permitted to engage in anticipatory hedging. Like the proposed rule's hedging exemption, a trading desk may establish an anticipatory hedge position before it becomes exposed to a risk that it is highly likely to become exposed to, provided there is a sound risk management rationale for establishing such an anticipatory hedge position.[968] For example, a trading desk may hedge against specific positions promised to customers, such as volume-weighted average price (''VWAP'') orders or large block trades, to facilitate the customer trade.[969] The amount of time that an anticipatory hedge may precede the establishment of the position to be hedged will depend on market factors,

[961] It may be more efficient for a banking entity to manage some risks at a higher organizational level than the trading desk level. As a result, a banking entity's written policies and procedures may delegate the responsibility to mitigate specific risks of the trading desk's financial exposure to an entity other than the trading desk, including another organizational unit of the banking entity or of an affiliate, provided that such organizational unit of the banking entity or of an affiliate is identified in the banking entity's written policies and procedures. Under these circumstances, the other organizational unit of the banking entity or of an affiliate must conduct such hedging activity in accordance with the requirements of the hedging exemption in § 75.5 of the final rule, including the documentation requirement in § 75.5(c). As recognized in Part VI.A.4.d.4., hedging activity conducted by a different organizational unit than the unit responsible for the positions being hedged presents a greater risk of evasion. Further, the risks being managed by a higher organizational level than the trading desk may be generated by trading desks engaged in market making-related activity or by trading desks engaged in other permitted activities. Thus, it would be inappropriate for such hedging activity to be conducted in reliance on the market-making exemption.

[962] *See supra* Part VI.A.3.c.2.c. (discussing the final near term demand requirement).

[963] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Goldman (Prop. Trading); MFA; RBC.

[964] *See, e.g.,* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Chamber (Feb. 2012).

[965] *See* Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[966] As discussed above, if a trading desk operating under the market-making exemption directs a different organizational unit of the banking entity or an affiliate to establish a hedge position on the desk's behalf, then the other organizational unit may rely on the market-making exemption to establish the hedge position as long as: (i) The other organizational unit's hedging activity is consistent with the trading desk's risk management policies and procedures (*e.g.,* the hedge instrument, technique, and strategy are consistent with those identified in the trading desk's policies and procedures); and (ii) the hedge position is attributed to the financial exposure of the trading desk and is included in the trading desk's daily profit and loss. If a different organizational unit of the banking entity or of an affiliate establishes a hedge for the trading desk's financial exposure based on its own determination, or if such position was not established in accordance with the trading desk's required procedures or was included in that other organizational unit's financial exposure and/or daily profit and loss, then that hedge position must be established in compliance with the hedging exemption in § 75.5 of the rule, including the documentation requirement in § 75.5(c). *See supra* Part VI.A.3.c.1.c.ii.

[967] For example, this may occur if a U.S. corporate bond trading desk acquires a $100 million long position in the corporate bonds of one issuer from clients, customers, or counterparties and separately acquires a $50 million short position in another issuer in the same market sector in reasonable expectation of near term demand of clients, customers, or counterparties. Although both positions were acquired to facilitate customer demand, the positions may also naturally hedge each other, to some extent.

[968] *See* Joint Proposal, 76 FR at 68875; CFTC Proposal, 77 FR at 8361.

[969] Two commenters recommended that banking entities be permitted to establish hedges prior to acquiring the underlying risk exposure under these circumstances. *See* Credit Suisse (Seidel); BoA.

such as the liquidity of the hedging position.

Written policies and procedures, internal controls, analysis, and independent testing established pursuant to the final rule identifying and addressing permissible hedging techniques and strategies should be designed to prevent a trading desk from over-hedging its market-maker inventory or financial exposure. Over-hedging would occur if, for example, a trading desk established a position in a financial instrument for the purported purpose of reducing a risk associated with one or more market-making positions when, in fact, that risk had already been mitigated to the full extent possible. Over-hedging results in a new risk exposure that is unrelated to market-making activities and, thus, is not permitted under the market-making exemption.

A trading desk's financial exposure generally would not be considered to be consistent with market making-related activities to the extent the trading desk is engaged in hedging activities that are inconsistent with the management of identifiable risks in its market-maker inventory or maintains significant hedge positions after the underlying risk(s) of the market-maker inventory have been unwound. A banking entity's written policies and procedures, internal controls, analysis, and independent testing regarding the trading desk's permissible hedging techniques and strategies must be designed to prevent a trading desk from engaging in over-hedging or maintaining hedge positions after they are no longer needed.[970] Further, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities are and continue to be effective, which would include monitoring for and addressing any scenarios where a trading desk may be engaged in over-hedging or maintaining unnecessary hedge positions or new significant risks have been introduced by the hedging activity.

As a result of these limitations, the size and risks of the trading desk's hedging positions are naturally constrained by the size and risks of its market-maker inventory, which must be designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, as well as by the risk limits and controls established under the final rule. This ultimately constrains a trading desk's overall financial exposure since such position can only contain positions, risks, and exposures related to the market-maker inventory that are designed to meet current or near term customer demand and positions, risks and exposures designed to mitigate the risks in accordance with the limits previously established for the trading desk.

The written policies and procedures identifying and addressing a trading desk's hedging techniques and strategies also must describe how and under what timeframe a trading desk must remove hedge positions once the underlying risk exposure is unwound. Similarly, the compliance program established by the banking entity to specify and control the trading desk's hedging activities in accordance with the final rule must be designed to prevent a trading desk from purposefully or inadvertently transforming its positions taken to manage the risk of its market-maker inventory under the exemption into what would otherwise be considered prohibited proprietary trading.

Moreover, the compliance program must provide for the process and personnel responsible for ensuring that the actions taken by the trading desk to mitigate the risks of its market making-related activities and inventory—including the instruments, techniques, and strategies used for risk management purposes—are and continue to be effective. This includes ensuring that hedges taken in the context of market making-related activities continue to be effective and that positions taken to manage the risks of the trading desk's market-maker inventory are not purposefully or inadvertently transformed into what would otherwise be considered prohibited proprietary trading. If a banking entity's monitoring procedures find that a trading desk's risk management procedures are not effective, such deficiencies must be promptly escalated and remedied in accordance with the banking entity's escalation procedures. A banking entity's written policies and procedures must set forth the process for determining the circumstances under which a trading desk's risk management strategies may be modified. In addition, risk management techniques and strategies developed and used by a trading desk must be independently tested or verified by management separate from the trading desk.

To control and limit the amount and types of financial instruments and risks that a trading desk may hold in connection with its market making-related activities, a banking entity must establish, implement, maintain, and enforce reasonably designed written policies and procedures, internal controls, analysis, and independent testing identifying and addressing specific limits on a trading desk's market-maker inventory, risk management positions, and financial exposure. In particular, the compliance program must establish limits for each trading desk, based on the nature and amount of its market making-related activities (including the factors prescribed by the near term customer demand requirement), on the amount, types, and risks of its market-maker inventory, the amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes, the level of exposures to relevant risk factors arising from its financial exposure, and the period of time a financial instrument may be held.[971] The limits would be set, as appropriate, and supported by an analysis for specific types of financial instruments, levels of risk, and duration of holdings, which would also be required by the compliance appendix. This approach will build on existing risk management infrastructure for market-making activities that subject traders to a variety of internal, predefined limits.[972] Each of these limits is independent of the others, and a trading desk must maintain its aggregated market-making position within each of these limits, including by taking action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded.[973] For example, if changing market conditions cause an increase in one or more risks within the trading desk's financial exposure and that increased risk causes the desk to exceed one or more of its limits, the trading desk must take prompt action to reduce its risk exposure (either by hedging the risk or unwinding its existing positions) or receive approval of a temporary or permanent increase to its limit through the required escalation procedures.

The Agencies recognize that trading desks' limits will differ across asset classes and acknowledge that trading desks engaged in market making-related activities in less liquid asset classes, such as corporate bonds, certain derivatives, and securitized products, may require different inventory, risk exposure, and holding period limits than trading desks engaged in market

[970] *See* final rule § 75.4(b)(2)(iii)(B).

[971] *See* final rule § 75.4(b)(2)(iii)(C).

[972] *See, e.g.,* Citigroup (Feb. 2012) (noting that its suggested approach to implementing the market-making exemption, which would focus on risk limits and risk architecture, would build on existing risk limits and risk management systems already present in institutions).

[973] *See* final rule § 75.4(b)(2)(iv).

making-related activities in more liquid financial instruments, such as certain listed equity securities. Moreover, the types of risk factors for which limits are established should not be limited solely to market risk factors. Instead, such limits should also account for all risk factors that arise from the types of financial instruments in which the trading desk is permitted to trade. In addition, these limits should be sufficiently granular and focused on the particular types of financial instruments in which the desk may trade. For example, a trading desk that makes a market in derivatives would have exposures to counterparty risk, among others, and would need to have appropriate limits on such risk. Other types of limits that may be relevant for a trading desk include, among others, position limits, sector limits, and geographic limits.

A banking entity must have a reasonable basis for the limits it establishes for a trading desk and must have a robust procedure for analyzing, establishing, and monitoring limits, as well as appropriate escalation procedures.[974] Among other things, the banking entity's compliance program must provide for: (i) Written policies and procedures and internal controls establishing and monitoring specific limits for each trading desk; and (ii) analysis regarding how and why these limits are determined to be appropriate and consistent with the nature and amount of the desk's market making-related activities, including considerations related to the near term customer demand requirement. In making these determinations, a banking entity should take into account and be consistent with the type(s) of financial instruments the desk is permitted to trade, the desk's trading and risk management activities and strategies, the history and experience of the desk, and the historical profile of the desk's near term customer demand and market and other factors that may impact the reasonably expected near term demands of customers.

The limits established by a banking entity should generally reflect the amount and types of inventory and risk that a trading desk holds to meet the reasonably expected near term demands of clients, customers, or counterparties. As discussed above, while the trading desk's market-maker inventory is directly limited by the reasonably expected near term demands of customers, the positions managed by the trading desk outside of its market-maker inventory are similarly constrained by the near term demand requirement because they must be designed to manage the risks of the market-maker inventory in accordance with the desk's risk management procedures. As a result, the trading desk's risk management positions and aggregate financial exposure are also limited by the current and reasonably expected near term demands of customers. A trading desk's market-maker inventory, risk management positions, or financial exposure would not, however, be permissible under the market-making exemption merely because the market-maker inventory, risk management positions, or financial exposure happens to be within the desk's prescribed limits.[975]

In addition, a banking entity must establish internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits, including the frequency, nature, and extent of a trading desk exceeding its limits and patterns regarding the portions of the trading desk's limits that are accounted for by the trading desk's activity.[976] This may include the use of management and exception reports. Moreover, the compliance program must set forth a process for determining the circumstances under which a trading desk's limits may be modified on a temporary or permanent basis (*e.g.,* due to market changes or modifications to the trading desk's strategy).[977] This process must cover potential scenarios when a trading desk's limits should be raised, as well as potential scenarios when a trading desk's limits should be lowered. For example, if a trading desk experiences reduced customer demand over a period of time, that trading desk's limits should be decreased to address the factors prescribed by the near term demand requirement.

A banking entity's compliance program must also include escalation procedures that require review and approval of any trade that would exceed one or more of a trading desk's limits, demonstrable analysis that the basis for any temporary or permanent increase to one or more of a trading desk's limits is consistent with the near term customer demand requirement, and independent review of such demonstrable analysis and approval of any increase to one or more of a trading desk's limits.[978] Thus, in order to increase a limit of a trading desk—on either a temporary or permanent basis—there must be an analysis of why such increase would be appropriate based on the reasonably expected near term demands of clients, customers, or counterparties, including the factors identified in § 75.4(b)(2)(ii) of the final rule, which must be independently reviewed. A banking entity also must maintain documentation and records with respect to these elements, consistent with the requirement of § 75.20(b)(6).

As already discussed, commenters have represented that the compliance costs associated with the proposed rule, including the compliance program and metrics requirements, may be significant and ''may dissuade a banking entity from attempting to comply with the market making-related activities exemption.'' [979] The Agencies believe that a robust compliance program is necessary to ensure adherence to the rule and to prevent evasion, although, as discussed in Part VI.C.3., the Agencies are adopting a more tailored set of quantitative measurements to better focus on those that are most germane to evaluating market making-related activity. The Agencies acknowledge that the compliance program requirements for the market-making exemption, including reasonably designed written policies and procedures, internal controls, analysis, and independent testing, represent a new regulatory requirement for banking entities and the Agencies have thus been mindful that it may impose significant costs and may cause a banking entity to reconsider whether to conduct market making-related activities. Despite the potential costs of the compliance program, the Agencies believe they are warranted to ensure that the goals of the rule and statute will be met, such as promoting

[974] *See* final rule § 75.4(b)(2)(iii)(C).

[975] For example, if a U.S. corporate bond trading desk has a prescribed limit of $200 million net exposure to any single sector of related issuers, the desk's limits may permit it to acquire a net economic exposure of $400 million long to issuer ABC and a net economic exposure of $300 million short to issuer XYZ, where ABC and XYZ are in the same sector. This is because the trading desk's net exposure to the sector would only be $100 million, which is within its limits. Even though the net exposure to this sector is within the trading desk's prescribed limits, the desk would still need to be able to demonstrate how its net exposure of $400 million long to issuer ABC and $300 million short to issuer XYZ is related to customer demand.

[976] *See* final rule § 75.4(b)(2)(iii)(D).

[977] For example, a banking entity may determine to permit temporary, short-term increases to a trading desk's risk limits due to an increase in short-term credit spreads or in response to volatility in instruments in which the trading desk makes a market, provided the increased limit is consistent with the reasonably expected near term demands of clients, customers, or counterparties. As noted above, other potential circumstances that could warrant changes to a trading desk's limits include: A change in the pattern of customer needs, adjustments to the market maker's business model (*e.g.,* new entrants or existing market makers trying to expand or contract their market share), or changes in market conditions. *See supra* note 937 and accompanying text.

[978] *See* final rule § 75.4(b)(2)(iii)(E).

[979] *See* ICI (Feb. 2012).

the safety and soundness of banking entities and the financial stability of the United States.

4. Market Making-Related Hedging

a. Proposed Treatment of Market Making-Related Hedging

In the proposal, certain hedging transactions related to market making were considered to be made in connection with a banking entity's market making-related activity for purposes of the market-making exemption. The Agencies explained that where the purpose of a transaction is to hedge a market making-related position, it would appear to be market making-related activity of the type described in section 13(d)(1)(B) of the BHC Act.[980] To qualify for the market-making exemption, a hedging transaction would have been required to meet certain requirements under § 75.4(b)(3) of the proposed rule. This provision required that the purchase or sale of a financial instrument: (i) Be conducted to reduce the specific risks to the banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to the market-making exemption; and (ii) meet the criteria specified in § 75.5(b) of the proposed hedging exemption and, where applicable, § 75.5(c) of the proposal.[981] In the proposal, the Agencies noted that a market maker may often make a market in one type of financial instrument and hedge its activities using different financial instruments in which it does not make a market. The Agencies stated that this type of hedging transaction would meet the terms of the market-making exemption if the hedging transaction met the requirements of § 75.4(b)(3) of the proposed rule.[982]

b. Comments on the Proposed Treatment of Market Making-Related Hedging

Several commenters recommended that the proposed market-making exemption be modified to establish a more permissive standard for market maker hedging.[983] A few of these commenters stated that, rather than applying the standards of the risk-mitigating hedging exemption to market maker hedging, a market maker's hedge position should be permitted as long as it is designed to mitigate the risk associated with positions acquired through permitted market making-related activities.[984] Other commenters emphasized the need for flexibility to permit a market maker to choose the most effective hedge.[985] In general, these commenters expressed concern that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers.[986] For example, one commenter stated that ''[t]he ability of market makers to freely offset or hedge positions is what, in most cases, makes them willing to buy and sell [financial instruments] to and from customers, clients or counterparties,'' so ''[a]ny impediment to hedging market making-related positions will decrease the willingness of banking entities to make markets and, accordingly, reduce liquidity in the marketplace.'' [987]

In addition, some commenters expressed concern that certain requirements in the proposed hedging exemption may result in a reduction in market-making activities under certain circumstances.[988] For example, one commenter expressed concern that the proposed hedging exemption would require a banking entity to identify and tag hedging transactions when hedges in a particular asset class take place alongside a trading desk's customer flow trading and inventory management in that same asset class.[989] Further, a few commenters represented that the proposed reasonable correlation requirement in the hedging exemption could impact market making by discouraging market makers from entering into customer transactions that do not have a direct hedge [990] or making it more difficult for market makers to cost-effectively hedge the fixed income securities they hold in inventory, including hedging such inventory positions on a portfolio basis.[991]

One commenter, however, stated that the proposed approach is effective.[992] Another commenter indicated that it is confusing to include hedging within the market-making exemption and suggested that a market maker be required to rely on the hedging exemption under § 75.5 of the proposed rule for its hedging activity.[993]

As noted above in the discussion of comments on the proposed source of revenue requirement, a number of commenters expressed concern that the proposed rule assumed that there are effective, or perfect, hedges for all market making-related positions.[994] Another commenter stated that market makers should be required to hedge whenever an inventory imbalance arises, and the absence of a hedge in such circumstances may evidence prohibited proprietary trading.[995]

c. Treatment of Market Making-Related Hedging in the Final Rule

Unlike the proposed rule, the final rule does not require that market making-related hedging activities separately comply with the requirements found in the risk-mitigating hedging exemption if conducted or directed by the same trading desk conducting the market-making activity. Instead, the Agencies are including requirements for market making-related hedging activities within the market-making exemption in response to comments.[996] As discussed above, a trading desk's compliance program must include written policies and procedures, internal controls, independent testing and analysis identifying and addressing the products, instruments, exposures, techniques, and strategies a trading desk may use to manage the risks of its market making-related activities, as well as the actions the trading desk will take to demonstrably reduce or otherwise significant mitigate the risks of its financial exposure consistent with its required limits.[997] The Agencies believe this approach addresses commenters' concerns that limitations on hedging market making-related positions may cause a reduction in liquidity, wider spreads, or increased risk and trading costs for market makers because it allows banking entities to determine

[980] *See* Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[981] *See* proposed rule § 75.4(b)(3); Joint Proposal, 76 FR at 68873; CFTC Proposal, 77 FR at 8358.

[982] *See* Joint Proposal, 76 FR at 68870 n.146; CFTC Proposal, 77 FR at 8356 n.152.

[983] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA. These comments are addressed in Part VI.A.3.c.4.c., *infra.*

[984] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC. *See also* FTN (stating that the principal requirement for such hedges should be that they reduce the risk of market making).

[985] *See* NYSE Euronext (stating that the best hedge sometimes involves a variety of complex and dynamic transactions over the time in which an asset is held, which may fall outside the parameters of the exemption); MFA; JPMC.

[986] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[987] RBC.

[988] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012).

[989] *See* Goldman (Prop. Trading).

[990] *See* BoA.

[991] *See* SIFMA (Asset Mgmt.) (Feb. 2012).

[992] *See* Alfred Brock.

[993] *See* Occupy.

[994] *See infra* notes 1073 to 1075 and accompanying text.

[995] *See* Public Citizen.

[996] *See, e.g.,* Japanese Bankers Ass'n.; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); FTN; RBC; NYSE Euronext; MFA.

[997] *See* final rule § 75.4(b)(2)(iii)(B); *supra* Part VI.A.3.c.3.c.

how best to manage the risks of trading desks' market making-related activities through reasonable policies and procedures, internal controls, independent testing, and analysis, rather than requiring compliance with the specific requirements of the hedging exemption.[998] Further, this approach addresses commenters' concerns about the impact of certain requirements of the hedging exemption on market making-related activities.[999]

The Agencies believe it is consistent with the statute's reference to ''market making-related'' activities to permit market making-related hedging activities under this exemption. In addition, the Agencies believe it is appropriate to require a trading desk to appropriately manage its risks, consistent with its risk management procedures and limits, because management of risk is a key factor that distinguishes permitted market making-related activity from impermissible proprietary trading. As noted in the proposal, while ''a market maker attempts to eliminate some [of the risks arising from] its retained principal positions and risks by hedging or otherwise managing those risks [ ], a proprietary trader seeks to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains.'' [1000]

The Agencies recognize that some banking entities may manage the risks associated with market making at a different level than the individual trading desk.[1001] While this risk management activity is not permitted under the market-making exemption, it may be permitted under the hedging exemption, provided the requirements of that exemption are met. Thus, the Agencies believe banking entities will continue to have options available that allow them to efficiently hedge the risks arising from their market-making operations. Nevertheless, the Agencies understand that this rule will result in additional documentation or other potential burdens for market making-related hedging activity that is not conducted by the trading desk responsible for the market-making positions being hedged.[1002] As discussed in Part VI.A.4.d.4., hedging conducted by a different organizational unit than the trading desk that is responsible for the underlying positions presents an increased risk of evasion, so the Agencies believe it is appropriate for such hedging activity to be required to comply with the hedging exemption, including the associated documentation requirement.

5. Compensation Requirement

a. Proposed Compensation Requirement

Section 75.4(b)(2)(vii) of the proposed market-making exemption would have required that the compensation arrangements of persons performing market making-related activities at the banking entity be designed not to reward proprietary risk-taking.[1003] In the proposal, the Agencies noted that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a financial instrument position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, would be inconsistent with the proposed market-making exemption.

The Agencies stated that under the proposed rule, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking. However, the Agencies noted that a banking entity relying on the proposed market-making exemption would be able to appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained.[1004]

b. Comments Regarding the Proposed Compensation Requirement

Several commenters recommended certain revisions to the proposed compensation requirement.[1005] Two commenters stated that the proposed requirement is effective,[1006] while one commenter stated that it should be removed from the rule.[1007] Moreover, in addressing this proposed requirement, commenters provided views on: identifiable characteristics of compensation arrangements that incentivize prohibited proprietary trading,[1008] methods of monitoring compliance with this requirement,[1009] and potential negative incentives or outcomes this requirement could cause.[1010]

With respect to suggested modifications to this requirement, a few commenters suggested that a market maker's compensation should be subject to additional limitations.[1011] For example, two commenters stated that compensation should be restricted to particular sources, such as fees, commissions, and spreads.[1012] One commenter suggested that compensation should not be symmetrical between gains and losses and, further, that trading gains reflecting an unusually high variance in position values should either not be reflected in compensation and bonuses or should be less reflected than other gains and losses.[1013] Another commenter recommended that the Agencies remove ''designed'' from the rule text and provide greater clarity about how a banking entity's compensation regime must be structured.[1014] Moreover, a number of commenters stated that compensation should be vested for a period of time, such as until the trader's market making positions have been fully unwound and are no longer in the banking entity's inventory.[1015] As one commenter explained, such a requirement would discourage traders from carrying inventory and encourage them to get out of positions as soon as possible.[1016] Some commenters also recommended that compensation be risk adjusted.[1017]

[998] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); NYSE Euronext; MFA; Japanese Bankers Ass'n.; RBC.

[999] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012); Goldman (Prop. Trading).

[1000] *See* Joint Proposal, 76 FR at 68961.

[1001] *See, e.g.,* letter from JPMC (stating that, to minimize risk management costs, firms commonly organize their market-making activities so that risks delivered to client-facing desks are aggregated and passed by means of internal transactions to a single utility desk and suggesting this be recognized as permitted market making-related behavior).

[1002] *See* final rule § 75.5(c).

[1003] *See* proposed rule § 75.4(b)(2)(vii).

[1004] *See* Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8358.

[1005] *See* Prof. Duffie; SIFMA *et al.* (Prop. Trading) (Feb. 2012); John Reed; Credit Suisse (Seidel); JPMC; Morgan Stanley; Better Markets (Feb. 2012); Johnson & Prof. Stiglitz; Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[1006] *See* FTN; Alfred Brock.

[1007] *See* Japanese Bankers Ass'n.

[1008] *See* Occupy.

[1009] *See* Occupy; Goldman (Prop. Trading).

[1010] *See* AllianceBernstein; Prof. Duffie; Investure; STANY; Chamber (Dec. 2011).

[1011] *See* Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Occupy; John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012). These comments are addressed in note 1032, *infra.*

[1012] *See* Better Markets (Feb. 2012); Public Citizen.

[1013] *See* AFR *et al.* (Feb. 2012)

[1014] *See* Occupy.

[1015] *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie (''A trader's incentives for risk taking can be held in check by vesting incentive-based compensation over a substantial period of time. Pending compensation can thus be forfeited if a trader's negligence causes substantial losses or if his or her employer fails.''); Sens. Merkley & Levin (Feb. 2012).

[1016] *See* John Reed.

[1017] *See* Johnson & Prof. Stiglitz; John Reed; Sens. Merkley & Levin (Feb. 2012).

A few commenters indicated that the proposed approach may be too restrictive.[1018] Two of these commenters stated that the compensation requirement should instead be set forth as guidance in Appendix B.[1019] In addition, two commenters requested that the Agencies clarify that compensation arrangements must be designed not to reward prohibited proprietary risk-taking. These commenters were concerned the proposed approach may restrict a banking entity's ability to provide compensation for permitted activities, which also involve proprietary trading.[1020]

Two commenters discussed identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading.[1021] For example, one commenter stated that rewarding pure profit and loss, without consideration for the risk that was assumed to capture it, is an identifiable characteristic of an arrangement that incentivizes proprietary risk-taking.[1022] For purposes of monitoring and ensuring compliance with this requirement, one commenter noted that existing Board regulations for systemically important banking entities require comprehensive firm-wide policies that determine compensation. This commenter stated that those regulations, along with appropriately calibrated metrics, should ensure that compensation arrangements are not designed to reward prohibited proprietary risk-taking.[1023] For similar purposes, another commenter suggested that compensation incentives should be based on a metric that meaningfully accounts for the risk underlying profitability.[1024]

Certain commenters expressed concern that the proposed compensation requirement could incentivize market makers to act in a way that would not be beneficial to customers or market liquidity.[1025] For example, two commenters expressed concern that the requirement could cause market makers to widen their spreads or charge higher fees because their personal compensation depends on these factors.[1026] One commenter stated that the proposed requirement could dampen traders' incentives and discretion and may make market makers less likely to accept trades involving significant increases in risk or profit.[1027] Another commenter expressed the view that profitability-based compensation arrangements encourage traders to exercise due care because such arrangements create incentives to avoid losses.[1028] Finally, one commenter stated that compliance with the proposed requirement may be difficult or impossible if the Agencies do not take into account the incentive-based compensation rulemaking.[1029]

c. Final Compensation Requirement

Similar to the proposed rule, the market-making exemption requires that the compensation arrangements of persons performing the banking entity's market making-related activities, as described in the exemption, are designed not to reward or incentivize prohibited proprietary trading.[1030] The language of the final compensation requirement has been modified in response to comments expressing concern about the proposed language regarding ''proprietary risk-taking.''[1031] The Agencies note that the Agencies do not intend to preclude an employee of a market-making desk from being compensated for successful market making, which involves some risk-taking.

The Agencies continue to hold the view that activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a position held in inventory, rather than use of that inventory to successfully provide effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed retained principal risk, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not prohibited proprietary trading.[1032] For example, a compensation plan based purely on net profit and loss with no consideration for inventory control or risk undertaken to achieve those profits would not be consistent with the market-making exemption.

6. Registration Requirement

a. Proposed Registration Requirement

Under § 75.4(b)(2)(iv) of the proposed rule, a banking entity relying on the market-making exemption with respect to trading in securities or certain derivatives would be required to be appropriately registered as a securities dealer, swap dealer, or security-based swap dealer, or exempt from registration or excluded from regulation as such type of dealer, under applicable securities or commodities laws. Further, if the banking entity was engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States in a manner for which no U.S. registration is required, the banking entity would be required to be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located.[1033]

b. Comments on the Proposed Registration Requirement

A few commenters stated that the proposed dealer registration requirement is effective.[1034] However, a number of commenters opposed the proposed dealer registration requirement in whole or in part.[1035]

[1018] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Morgan Stanley.

[1019] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1020] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies respond to these comments in note 1026 and its accompanying text, *infra.*

[1021] *See* Occupy; Alfred Brock.

[1022] *See* Occupy. The Agencies respond to this comment in Part VI.A.3.c.5.c., *infra.*

[1023] *See* Goldman (Prop. Trading).

[1024] *See* Occupy.

[1025] *See* AllianceBernstein; Investure; Prof. Duffie; STANY. This issue is addressed in note 1032, *infra.*

[1026] *See* AllianceBernstein; Investure.

[1027] *See* Prof. Duffie.

[1028] *See* STANY.

[1029] *See* Chamber (Dec. 2011).

[1030] *See* final rule § 75.4(b)(2)(v).

[1031] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1032] Because the Agencies are not limiting a market maker's compensation to specific sources, such as fees, commissions, and bid-ask spreads, as recommended by a few commenters, the Agencies do not believe the compensation requirement in the final rule will incentivize market makers to widen their quoted spreads or charge higher fees and commissions, as suggested by certain other commenters. *See* Better Markets (Feb. 2012); Public Citizen; AllianceBernstein; Investure. In addition, the Agencies note that an approach requiring revenue from fees, commissions, and bid-ask spreads to be fully distinguished from revenue from price appreciation can raise certain practical difficulties, as discussed in Part VI.A.3.c.7. The Agencies also are not requiring compensation to be vested for a period of time, as recommended by some commenters to reduce traders' incentives for undue risk-taking. The Agencies believe the final rule includes sufficient controls around risk-taking activity without a compensation vesting requirement. *See* John Reed; AFR *et al.* (Feb. 2012); Johnson & Prof. Stiglitz; Prof. Duffie; Sens. Merkley & Levin (Feb. 2012).

[1033] *See* proposed rule § 75.4(b)(2)(iv); Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8357–8358.

[1034] *See* Occupy; Alfred Brock.

[1035] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that if the requirement is not removed from

Continued

Commenters' primary concern with the requirement appeared to be its application to market making-related activities outside of the United States for which no U.S. registration is required.[1036] For example, several commenters stated that many non-U.S. markets do not provide substantive regulation of dealers for all asset classes.[1037] In addition, two commenters stated that booking entities may be able to rely on intra-group exemptions under local law rather than carrying dealer registrations, or a banking entity may execute customer trades through an international dealer but book the position in a non-dealer entity for capital adequacy and risk management purposes.[1038] Several of these commenters requested, at a minimum, that the dealer registration requirement not apply to dealers in non-U.S. jurisdictions.[1039]

In addition, with respect to the provisions that would generally require a banking entity to be a form of SEC- or CFTC-registered dealer for market-making activities in securities or derivatives in the United States, a few commenters stated that these provisions should be removed from the rule.[1040] These commenters represented that removing these provisions would be appropriate for several reasons. For example, one commenter stated that dealer registration does not help distinguish between market making and speculative trading.[1041] Another commenter indicated that effective market making often requires a banking entity to trade on several exchange and platforms in a variety of markets, including through legal entities other than SEC- or CFTC-registered dealer entities.[1042] One commenter expressed general concern that the proposed requirement may result in the market-making exemption being unavailable for market making in exchange-traded futures and options because those markets do not have a corollary to dealer registration requirements in securities, swaps, and security-based swaps markets.[1043]

Some commenters expressed particular concern about the provisions that would generally require registration as a swap dealer or a security-based swap dealer.[1044] For example, one commenter expressed concern that these provisions may require banking regulators to redundantly enforce CFTC and SEC registration requirements. Moreover, according to this commenter, the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' do not focus on the market making core of the swap dealing business.[1045] Another commenter stated that incorporating the proposed definitions of ''swap dealer'' and ''security-based swap dealer'' is contrary to the Administrative Procedure Act.[1046]

c. Final Registration Requirement

The final requirement of the market-making exemption provides that the banking entity must be licensed or registered to engage in market making-related activity in accordance with applicable law.[1047] The Agencies have considered comments regarding the dealer registration requirement in the proposed rule.[1048] In response to comments, the Agencies have narrowed the scope of the proposed requirement's application to banking entities engaged in market making-related activity in foreign jurisdictions.[1049] Rather than requiring these banking entities to be subject to substantive regulation of their dealing business in the relevant foreign jurisdiction, the final rule only require a banking entity to be a registered dealer in a foreign jurisdiction to the extent required by applicable foreign law. The Agencies have also simplified the language of the proposed requirement, although the Agencies have not modified the scope of the requirement with respect to U.S. dealer registration requirements.

This provision is not intended to expand the scope of licensing or registration requirements under relevant U.S. or foreign law that are applicable to a banking entity engaged in market-making activities. Instead, this provision recognizes that compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.[1050] For example, a U.S. banking entity would be expected to be an SEC-registered dealer to rely on the market-making exemption for trading in securities—other than exempted securities, security-based swaps, commercial paper, bankers acceptances, or commercial bills—unless the banking entity is exempt from registration or excluded from regulation as a dealer.[1051] Similarly, a U.S. banking entity is expected to be a CFTC-registered swap dealer or SEC-registered security-based swap dealer to rely on the market-making exemption for trading in swaps or security-based swaps, respectively,[1052] unless the

the rule, then it should only be an indicative factor of market making); Morgan Stanley; Goldman (Prop. Trading); ISDA (Feb. 2012).

[1036] *See* Goldman (Prop. Trading); Morgan Stanley; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Feb. 2012); JPMC. This issue is addressed in note 1044 and its accompanying text, *infra.*

[1037] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1038] *See* JPMC; Goldman (Prop. Trading).

[1039] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). *See also* Morgan Stanley (requesting the addition of the phrase ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions).

[1040] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). Rather than remove the requirement entirely, one commenter recommended that the Agencies move the dealer registration requirement to proposed Appendix B, which would allow the Agencies to take into account the facts and circumstances of a particular trading activity. *See* JPMC.

[1041] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1042] *See* Goldman (Prop. Trading).

[1043] *See* CME Group.

[1044] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1045] *See* ISDA (Feb. 2012).

[1046] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1047] *See* final rule § 75.4(b)(2)(vi).

[1048] *See supra* Part VI.A.3.c.5.b. One commenter expressed concern that the instruments listed in § 75.4(b)(2)(iv) of the proposed rule could be interpreted as limiting the availability of the market-making exemption to other instruments, such as exchange-traded futures and options. In response to this comment, the Agencies note that the reference to particular instruments in § 75.4(b)(2)(iv) was intended to reflect that trading in certain types of instruments gives rise to dealer registration requirements. This provision was not intended to limit the availability of the market-making exemption to certain types of financial instruments. *See* CME Group.

[1049] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley.

[1050] In response to commenters who stated that the dealer registration requirement should be removed from the rule because, among other things, registration as a dealer does not distinguish between permitted market making and impermissible proprietary trading, the Agencies recognize that acting as a registered dealer does not ensure that a banking entity is engaged in permitted market making-related activity. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Morgan Stanley; ISDA (Feb. 2012). However, this requirement recognizes that registration as a dealer is an indicator of market making-related activities in the circumstances in which a person is legally obligated to be a registered dealer to act as a market maker.

[1051] A banking entity relying on the market-making exemption for transactions in security-based swaps would generally be required to be a registered security-based swap dealer and would not be required to be a registered securities dealer. However, a banking entity may be required to be a registered securities dealer if it engages in market-making transactions involving security-based swaps with persons that are not eligible contract participants. The definition of ''dealer'' in section 3(a)(5) of the Exchange Act generally includes ''any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants), for such person's own account.'' 15 U.S.C. 78c(a)(5).

To the extent, if any, that a banking entity relies on the market-making exemption for its trading in municipal securities or government securities, rather than the exemption in § 75.6(a) of the final rule, this provision may require the banking entity to be registered or licensed as a municipal securities dealer or government securities dealer.

[1052] As noted above, under certain circumstances, a banking entity acting as market maker in security-

banking entity is exempt from registration or excluded from regulation as a swap dealer or security-based swap dealer.[1053] In response to comments on whether this provision should generally require registration as a swap dealer or security-based swap dealer to make a market in swaps or security-based swaps,[1054] the Agencies continue to believe that this requirement is appropriate. In general, a person that is engaged in making a market in swaps or security-based swaps or other activity causing oneself to be commonly known in the trade as a market maker in swaps or security-based swaps is required to be a registered swap dealer or registered security-based swap dealer, unless exempt from registration or excluded from regulation as such.[1055] As noted above, compliance with applicable law is an essential indicator that a banking entity is engaged in market-making activities.

As noted above, the Agencies have determined that, rather than require a banking entity engaged in the business of a securities dealer, swap dealer, or security-based swap dealer outside the United States to be subject to substantive regulation of its dealing business in the foreign jurisdiction in which the business is located, a banking entity's dealing activity outside the U.S. should only be subject to licensing or registration requirements under applicable foreign law (provided no U.S. registration or licensing requirements apply to the banking entity's activities). As a result, this requirement will not impact a banking entity's ability to engage in permitted market making-related activities in a foreign jurisdiction that does not provide for substantive regulation of dealers.[1056]

7. Source of Revenue Analysis

a. Proposed Source of Revenue Requirement

To qualify for the market-making exemption, the proposed rule required that the market making-related activities of the trading desk or other organizational unit be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of financial instrument positions it holds in trading accounts or the hedging of such positions.[1057] This proposed requirement was intended to ensure that activities conducted in reliance on the market-making exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the intermediation and liquidity services a market maker provides to its customers, rather than changes in the market value of the positions or risks held in inventory.[1058]

b. Comments Regarding the Proposed Source of Revenue Requirement

As discussed in more detail below, many commenters expressed concern about the proposed source of revenue requirement. These commenters raised a number of concerns including, among others, the proposed requirement's potential impact on a market maker's inventory or on costs to customers, the difficulty of differentiating revenues from spreads and revenues from price appreciation in certain markets, and the need for market makers to be compensated for providing intermediation services.[1059] Several of these commenters requested that the proposed source of revenue requirement be removed from the rule or modified in certain ways. Some commenters, however, expressed support for the proposed requirement or requested that the Agencies place greater restrictions on a banking entity's permissible sources of revenue under the market-making exemption.[1060]

i. Potential Restrictions on Inventory, Increased Costs for Customers, and Other Changes to Market-Making Services

Many commenters stated that the proposed source of revenue requirement may limit a market maker's ability to hold sufficient inventory to facilitate customer demand.[1061] Several of these commenters expressed particular concern about applying this requirement to less liquid markets or to facilitating large customer positions, where a market maker is more likely to hold inventory for a longer period of time and has increased risk of potential price appreciation (or depreciation).[1062] Further, another commenter questioned how the proposed requirement would apply when unforeseen market pressure or disappearance of customer demand results in a market maker holding a particular position in inventory for longer than expected.[1063] In response to this proposed requirement, a few commenters stated that it is important for market makers to be able to hold a certain amount of inventory to: provide liquidity (particularly in the face of order imbalances and market volatility),[1064] facilitate large trades, and hedge positions acquired in the course of market making.[1065]

Several commenters expressed concern that the proposed source of revenue requirement may incentivize a market maker to widen its quoted spreads or otherwise impose higher fees to the detriment of its customers.[1066] For example, some commenters stated that the proposed requirement could result in a market maker having to sell a position in its inventory within an artificially prescribed period of time and, as a result, the market maker would pay less to initially acquire the position from a customer.[1067] Other commenters represented that the proposed source of revenue requirement would compel market makers to hedge their exposure

based swaps may be required to be a registered securities dealer. *See supra* note 1051.

[1053] For example, a banking entity meeting the conditions of the *de minimis* exception in SEC Rule 3a71–2 under the Exchange Act would not need to be a registered security-based swap dealer to act as a market maker in security-based swaps. *See* 17 CFR 240.3a71–2.

[1054] *See* ISDA (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1055] *See* 7 U.S.C. 1a(49)(A); 15 U.S.C. 78c(a)(71)(A).

[1056] *See* Goldman (Prop. Trading); RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley. This is consistent with one commenter's suggestion that the Agencies add ''to the extent it is legally required to be subject to such regulation'' to the non-U.S. dealer provisions. *See* Morgan Stanley.

[1057] *See* proposed rule § 75.4(b)(2)(v).

[1058] *See* Joint Proposal, 76 FR at 68872; CFTC Proposal, 77 FR at 8358.

[1059] These concerns are addressed in Part VI.A.3.c.7.c., *infra.*

[1060] *See infra* note 1103 (responding to these comments).

[1061] *See, e.g.,* NYSE Euronext; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); STANY; BlackRock; SIFMA (Asset Mgmt.) (Feb. 2012); ACLI (Feb. 2012); T. Rowe Price; PUC Texas; SSgA (Feb. 2012); ICI (Feb. 2012) Invesco; MetLife; MFA.

[1062] *See, e.g.,* Morgan Stanley; BoA; BlackRock; T. Rowe Price; Goldman (Prop. Trading); NYSE Euronext (suggesting that principal trading by market makers in large sizes is essential in some securities, such as an AP's trading in ETFs); Prof. Duffie; SSgA (Feb. 2012); CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); MFA. To explain its concern, one commenter stated that bid-ask spreads are useful to capture the concept of market-making revenues when a market maker is intermediating on a close to real-time basis between balanced customer buying and selling interest for the same instrument, but such close-in-time intermediation does not occur in many large or illiquid assets, where demand gaps may be present for days, weeks, or months. *See* Morgan Stanley.

[1063] *See* Capital Group.

[1064] *See* NYSE Euronext; CIEBA (stating that if the rule discourages market makers from holding inventory, there will be reduced liquidity for investors and issuers).

[1065] *See* NYSE Euronext. For a more in-depth discussion of comments regarding the benefits of permitting market makers to hold and manage inventory, see Part VI.A.3.c.2.b.vi., *infra.*

[1066] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA.

[1067] *See* MetLife; ACLI (Feb. 2012); ICI (Feb. 2012) SSgA (Feb. 2012).

to price movements, which would likely increase the cost of intermediation.[1068]

Some commenters stated that the proposed source of revenue requirement may make a banking entity less willing to make markets in instruments that it may not be able to resell immediately or in the short term.[1069] One commenter indicated that this concern may be heightened in times of market stress.[1070] Further, a few commenters expressed the view that the proposed requirement would cause banking entities to exit the market-making business due to restrictions on their ability to make a profit from market-making activities.[1071] Moreover, in one commenter's opinion, the proposed requirement would effectively compel market makers to trade on an agency basis.[1072]

ii. Certain Price Appreciation-Related Profits Are an Inevitable or Important Component of Market Making

A number of commenters indicated that market makers will inevitably make some profit from price appreciation of certain inventory positions because changes in market values cannot be precisely predicted or hedged.[1073] In particular, several commenters emphasized that matched or perfect hedges are generally unavailable for most types of positions.[1074] According to one commenter, a provision that effectively requires a market-making business to hedge all of its principal positions would discourage essential market-making activity. The commenter explained that effective hedges may be unavailable in less liquid markets and hedging can be costly, especially in relation to the relative risk of a trade and hedge effectiveness.[1075] A few commenters further indicated that making some profit from price appreciation is a natural part of market making or is necessary to compensate a market maker for its willingness to take a position, and its associated risk (*e.g.,* the risk of market changes or decreased value), from a customer.[1076]

iii. Concerns Regarding the Workability of the Proposed Standard in Certain Markets or Asset Classes

Some commenters represented that it would be difficult or burdensome to identify revenue attributable to the bid-ask spread versus revenue arising from price appreciation, either as a general matter or for specific markets.[1077] For example, one commenter expressed the opinion that the difference between the bid-ask spread and price appreciation is ''metaphysical'' in some sense,[1078] while another stated that it is almost impossible to objectively identify a bid-ask spread or to capture profit and loss solely from a bid-ask spread in most markets.[1079] Other commenters represented that it is particularly difficult to make this distinction when trades occur infrequently or where prices are not transparent, such as in the fixed-income market where no spread is published.[1080]

Many commenters expressed particular concern about the proposed requirement's application to specific markets, including: The fixed-income markets;[1081] the markets for commodities, derivatives, securitized products, and emerging market securities;[1082] equity and physical commodity derivatives markets;[1083] and customized swaps used by customers of banking entities for hedging purposes.[1084] Another commenter expressed general concern about extremely volatile markets, where market makers often see large upward or downward price swings over time.[1085]

Two commenters emphasized that the revenues a market maker generates from hedging the positions it holds in inventory are equivalent to spreads in many markets. These commenters explained that, under these circumstances, a market maker generates revenue from the difference between the customer price for the position and the banking entity's price for the hedge. The commenters noted that proposed Appendix B expressly recognizes this in the case of derivatives and recommended that Appendix B's

[1068] *See* SSgA (Feb. 2012); PUC Texas.

[1069] *See* ICI (Feb. 2012) SSgA (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); BoA.

[1070] *See* CIEBA (arguing that banking entities may be reluctant to provide liquidity when markets are declining and there are more sellers than buyers because it would be necessary to hold positions in inventory to avoid losses).

[1071] *See* Credit Suisse (Seidel) (arguing that banking entities are likely to cease being market makers if they are: (i) Unable to take into account the likely direction of a financial instrument, or (ii) forced to take losses if a financial instrument moves against them, but cannot take gains if the instrument's price moves in their favor); STANY (contending that banking entities cannot afford to maintain unprofitable or marginally profitable operations in highly competitive markets, so this requirement would cause banking entities to eliminate a majority of their market-making functions).

[1072] *See* IR&M (arguing that domestic corporate and securitized credit markets are too large and heterogeneous to be served appropriately by a primarily agency-based trading model).

[1073] *See* Wellington; Credit Suisse (Seidel); Morgan Stanley; PUC Texas (contending that it is impossible to predict the behavior of even the most highly correlated hedge in comparison to the underlying position); CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco.

[1074] *See* Morgan Stanley; Credit Suisse (Seidel); SSgA (Feb. 2012); PUC Texas; Wellington; AllianceBernstein; Investure.

[1075] *See* Wellington. Moreover, one commenter stated that, as a general matter, market makers need to be compensated for bearing risk related to providing immediacy to a customer. This commenter stated that ''[t]he greater the inventory risk faced by the market maker, the higher the expected return (compensation) that the market maker needs,'' to compensate the market maker for bearing the risk and reward its specialization skills in that market (*e.g.,* its knowledge about market conditions and early indicators that may imply future price movements in a particular direction). This commenter did not, however, discuss the source of revenue requirement in the proposed rule. *See* Thakor Study.

[1076] *See* Capital Group; Prof. Duffie; Investure; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; SIFMA (Asset Mgmt.) (Feb. 2012); RBC; PNC.

[1077] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group.

[1078] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1079] *See* Citigroup (Feb. 2012). *See also* Barclays (arguing that a bid-ask spread cannot be defined on a consistent basis with respect to many instruments).

[1080] *See* Goldman (Prop. Trading); BoA; Morgan Stanley (''Observable, actionable, bid/ask spreads exist in only a small subset of institutional products and markets. Indicative bid/ask spreads may be observable for certain products, but this pricing would typically be specific to small size standard lot trades and would not represent a spread applicable to larger and/or more illiquid trades. End-of-day valuations for assets are calculated, but they are not an effective proxy for real-time bid/ask spreads because of intra-day price movements.''); RBC; Capital Group (arguing that bid-ask spreads in fixed-income markets are not always quantifiable or well defined and can fluctuate widely within a trading day because of small or odd lot trades, price discovery activity, a lack of availability to cover shorts, or external factors not directly related to the security being traded).

[1081] *See* Capital Group; CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SSgA (Feb. 2012). These commenters stated that the requirement may be problematic for the fixed-income markets because, for example, market makers must hold inventory in these markets for a longer period of time than in more liquid markets. *See id.*

[1082] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012) (stating that these markets are characterized by even less liquidity and less frequent trading than the U.S. corporate bond market). This commenter also stated that in markets where trades are large and less frequent, such as the market for customized securitized products, appreciation in price of one position may be a predominate contributor to the overall profit and loss of the trading unit. *See id.*

[1083] *See* BoA. According to this commenter, the distinction between capturing a spread and price appreciation is fundamentally flawed in some markets, like equity derivatives, because the market does not trade based on movements of a particular security or underlying instrument. This commenter indicated that expected returns are instead based on the bid-ask spread the market maker charges for implied volatility as reflected in options premiums and hedging of the positions. *See id.*

[1084] *See* CIEBA (stating that because it would be difficult for a market maker to enter promptly into an offsetting swap, the market maker would not be able to generate income from the spread).

[1085] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). This commenter questioned whether proposed Appendix B's reference to ''unexpected market disruptions'' as an explanatory fact and circumstance was intended to permit such market making. *See id.*

guidance on this point apply equally to certain non-derivative positions.[1086]

A few commenters questioned how this requirement would work in the context of block trading or otherwise facilitating large trades, where a market maker may charge a premium or discount for taking on a large position to provide ''immediacy'' to its customer.[1087] One commenter further explained that explicitly quoted bid-ask spreads are only valid for indicated trade sizes that are modest enough to have negligible market impact, and such spreads cannot be used for purposes of a significantly larger trade.[1088]

iv. Suggested Modifications to the Proposed Requirement

To address some or all of the concerns discussed above, many commenters recommended that the source of revenue requirement be modified [1089] or removed from the rule entirely.[1090] With respect to suggested changes, some commenters stated that the Agencies should modify the rule text,[1091] use a metrics-based approach to focus on customer revenues,[1092] or replace the proposed requirement with guidance.[1093] Some commenters requested that the Agencies modify the focus of the requirement so that, for example, dealers' market-making activities in illiquid securities can function as close to normal as possible [1094] or market makers can take short-term positions that may ultimately result in a profit or loss.[1095] As discussed below, some commenters stated that the Agencies should modify the proposed requirement to place greater restrictions on market maker revenue.

v. General Support for the Proposed Requirement or for Placing Greater Restrictions on a Market Maker's Sources of Revenue

Some commenters expressed support for the proposed source of revenue requirement or stated that the requirement should be more restrictive.[1096] For example, one of these commenters stated that a real market maker's trading book should be fully hedged, so it should not generate profits in excess of fees and commissions except in times of rare and extraordinary market conditions.[1097] According to another commenter, the final rule should make it clear that banking entities seeking to rely on the market-making exemption may not generally seek to profit from price movements in their inventories, although their activities may give rise to modest and relatively stable profits arising from their limited inventory.[1098] One commenter recommended that the proposed requirement be interpreted to limit market making in illiquid positions because a banking entity cannot have the required revenue motivation when it enters into a position for which there is no readily discernible exit price.[1099]

Further, some commenters suggested that the Agencies remove the word ''primarily'' from the provision to limit banking entities to specified sources of revenue.[1100] In addition, one of these commenters requested that the Agencies restrict a market maker's revenue to fees and commissions and remove the allowance for revenue from bid-ask spreads because generating bid-ask revenues relies exclusively on changes in market values of positions held in inventory.[1101] For enforcement purposes, a few commenters suggested that the Agencies require banking entities to disgorge any profit obtained from price appreciation.[1102]

c. Final Rule's Approach To Assessing Revenues

Unlike the proposed rule, the final rule does not include a requirement that a trading desk's market making-related activity be designed to generate revenue primarily from fees, commissions, bid-ask spreads, or other income not attributable to appreciation in the value of a financial instrument or hedging.[1103] The revenue requirement was one of the most commented upon aspects of the market-making exemption in the proposal.[1104]

The Agencies believe that an analysis of patterns of revenue generation and profitability can help inform a judgment regarding whether trading activity is consistent with the intermediation and liquidity services that a market maker provides to its customers in the context of the liquidity, maturity, and depth of the relevant market, as opposed to prohibited proprietary trading activities. To facilitate this type of analysis, the Agencies have included a metrics data reporting requirement that is refined from the proposed metric regarding profits and losses. The Comprehensive Profit and Loss Attribution metric collects information regarding the daily fluctuation in the value of a trading desk's positions to various sources, along with its volatility, including: (i)

[1086] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). In its discussion of ''customer revenues,'' Appendix B states: ''In the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract.'' Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8440. *See also* RBC (requesting clarification on how the proposed standard would apply if a market maker took an offsetting position in a different instrument (*e.g.,* a different bond) and inquiring whether, if the trader took the offsetting position, its revenue gain is attributable to price appreciation of the two offsetting positions or from the bid-ask spread in the respective bonds).

[1087] *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading). *See also* Thakor Study (discussing market makers' role of providing ''immediacy'' in general).

[1088] *See* CIEBA.

[1089] *See, e.g.,* JPMC; Barclays; Goldman (Prop. Trading); BoA; CFA Inst.; ICI (Feb. 2012) Flynn & Fusselman.

[1090] *See, e.g.,* CIEBA; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Goldman (Prop. Trading); Capital Group; RBC. In addition to the concerns discussed above, one commenter stated that the proposed requirement may set limits on the values of certain metrics, and it would be inappropriate to prejudge the appropriate results of such metrics at this time. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1091] *See, e.g.,* Barclays. This commenter provided alternative rule text stating that ''market making-related activity is conducted by each trading unit such that its activities are reasonably designed to generate revenues primarily from fees, commissions, bid-ask spreads, or other income attributable to satisfying reasonably expected customer demand.'' *See id.*

[1092] *See* Goldman (Prop. Trading) (suggesting that the Agencies use a metrics-based approach to focus on customer revenues, as measured by Spread Profit and Loss (when it is feasible to calculate) or other metrics, especially because a proprietary trading desk would not be expected to earn any revenues this way). This commenter also indicated that the ''primarily'' standard in the proposed rule is problematic and can be read to mean ''more than 50%,'' which is different from Appendix B's acknowledgment that the proportion of customer revenues relative to total revenues will vary by asset class. *See id.*

[1093] *See* BoA (recommending that the guidance state that the Agencies would consider the design and mix of such revenues as an indicator of potentially prohibited proprietary trading, but only for those markets for which revenues are quantifiable based on publicly available data, such as segments of certain highly liquid equity markets).

[1094] *See* CFA Inst.

[1095] *See* ICI (Feb. 2012).

[1096] *See* Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); FTN; Public Citizen; Occupy; Alfred Brock.

[1097] *See* Better Markets (Feb. 2012). *See also* Public Citizen (arguing that the imperfection of a hedge should signal potential disqualification of the underlying position from the market-making exemption).

[1098] *See* Sens. Merkley & Levin (Feb. 2012). This commenter further suggested that the rule identify certain red flags and metrics that could be used to monitor this requirement, such as: (i) Failure to obtain relatively low ratios of revenue-to-risk, low volatility, and relatively high turnover; (ii) significant revenues from price appreciation relative to the value of securities being traded; (iii) volatile revenues from price appreciation; or (iv) revenue from price appreciation growing out of proportion to the risk undertaken with the security. *See id.*

[1099] *See* AFR *et al.* (Feb. 2012).

[1100] *See* Occupy; Better Markets (Feb. 2012). *See supra* note 1108 (addressing these comments).

[1101] *See* Occupy.

[1102] *See* Occupy; Public Citizen.

[1103] *See* proposed rule § 75.4(b)(2)(v).

[1104] *See infra* Part VI.A.3.c.7.b.

Profit and loss attributable to current positions that were also held by the banking entity as of the end of the prior day (''existing positions); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions.[1105]

This quantitative measurement has certain conceptual similarities to the proposed source of revenue requirement in § 75.4(b)(2)(v) of the proposed rule and certain of the proposed quantitative measurements.[1106] However, in response to comments on those provisions, the Agencies have determined to modify the focus from particular revenue sources (*e.g.,* fees, commissions, bid-ask spreads, and price appreciation) to when the trading desk generates revenue from its positions. The Agencies recognize that when the trading desk is engaged in market making-related activities, the day one profit and loss component of the Comprehensive Profit and Loss Attribution metric may reflect customer-generated revenues, like fees, commissions, and spreads (including embedded premiums or discounts), as well as that day's changes in market value. Thereafter, profit and loss associated with the position carried in the trading desk's book may reflect changes in market price until the position is sold or unwound. The Agencies also recognize that the metric contains a residual component for profit and loss that cannot be specifically attributed to existing positions or new positions.

The Agencies believe that evaluation of the Comprehensive Profit and Loss Attribution metric could provide valuable information regarding patterns of revenue generation by market-making trading desks involved in market-making activities that may warrant further review of the desk's activities, while eliminating the requirement from the proposal that the trading desk demonstrate that its primary source of revenue, under all circumstances, is fees, commissions and bid/ask spreads. This modified focus will reduce the burden associated with the proposed source of revenue requirement and better account for the varying depth and liquidity of markets.[1107] In addition, the Agencies believe these modifications appropriately address commenters' concerns about the proposed source of revenue requirement and reduce the potential for negative market impacts of the proposed requirement cited by commenters, such as incentives to widen spreads or disincentives to engage in market making in less liquid markets.[1108]

The Agencies recognize that this analysis is only informative over time, and should not be determinative of an analysis of whether the amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. The Agencies believe this quantitative measurement provides appropriate flexibility to obtain information on market-maker revenues, which is designed to address commenters' concerns about the proposal's source of revenue requirement (*e.g.,* the burdens associated with differentiating spread revenue from price appreciation revenue) while also helping assess patterns of revenue generation that may be informative over time about whether a market maker's activities are designed to facilitate and provide customer intermediation.

8. Appendix B of the Proposed Rule

a. Proposed Appendix B Requirement

The proposed market-making exemption would have required that the market making-related activities of the trading desk or other organizational unit of the banking entity be consistent with the commentary in proposed Appendix B.[1109] In this proposed Appendix, the Agencies provided overviews of permitted market making-related activity and prohibited proprietary trading activity.[1110]

The proposed Appendix also set forth various factors that the Agencies proposed to use to help distinguish prohibited proprietary trading from permitted market making-related activity. More specifically, proposed Appendix B set forth six factors that, absent explanatory facts and circumstances, would cause particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity. The proposed factors focused on: (i) Retaining risk in excess of the size and type required to provide intermediation services to customers (''risk management factor''); (ii) primarily generating revenues from price movements of retained principal positions and risks, rather than customer revenues (''source of revenues factor''); (iii) generating only very small

[1105] *See* Appendix A of the final rule (describing the Comprehensive Profit and Loss Attribution metric). This approach is generally consistent with one commenter's suggested metrics-based approach to focus on customer-related revenues. *See* Goldman (Prop. Trading); *see also* Sens. Merkley & Levin (Feb. 2012) (suggesting the use of metrics to monitor a firm's source of revenue); proposed Appendix A.

[1106] *See supra* Part VI.A.3.c.7. and *infra* Part VI.C.3.

[1107] The Agencies understand that some commenters interpreted the proposed requirement as requiring that both the bid-ask spread for a financial instrument and the revenue a market maker acquired from such bid-ask spread through a customer trade be identifiable on a close-to-real-time basis and readily distinguishable from any additional revenue gained from price appreciation (both on the day of the transaction and for the rest of the holding period). *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA; Citigroup (Feb. 2012); Japanese Bankers Ass'n.; Sumitomo Trust; Morgan Stanley; Barclays; RBC; Capital Group. We recognize that such a requirement would be unduly burdensome. In fact, the proposal noted that bid-ask spreads or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable in certain asset classes for purposes of the proposed Spread Profit and Loss metric in Appendix A of the proposal. *See* Joint Proposal, 76 FR at 68958–68959; CFTC Proposal, 77 FR at 8438. Moreover, the burden associated with the proposed requirement should be further reduced because we are not adopting a stand-alone requirement regarding a trading desk's source of revenue. Instead, when and how a trading desk generates profit and loss from its trading activities is a factor that must be considered for purposes of the near term customer demand requirement. It is not a dispositive factor for determining compliance with the exemption.

Further, some commenters expressed concern that the proposed requirement suggested market makers were not permitted to profit from price appreciation, but rather only from observable spreads or explicit fees or commissions. *See, e.g.,* Wellington, Credit Suisse (Seidel); Morgan Stanley; PUC Texas; CIEBA; SSgA (Feb. 2012); AllianceBernstein; Investure; Invesco. The Agencies confirm that the intent of the market-making exemption is not to preclude a trading desk from generating any revenue from price appreciation. Because this approach clarifies that a trading desk's source of revenue is not limited to its quoted spread, the Agencies believe this quantitative measurement will address commenters concerns that the proposed source of revenue requirement could create incentives for market makers to widen their spreads, result in higher transaction costs, require market makers to hedge any exposure to price movements, or discourage a trading desk from making a market in instruments that it may not be able to sell immediately. *See* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA; SIFMA (Asset Mgmt.) (Feb. 2012). The modifications to this provision are designed to better reflect when, on average and across many transactions, profits are gained rather than how they are gained, similar to the way some firms measure their profit and loss today. *See, e.g.,* Goldman (Prop. Trading).

[1108] *See, e.g.,* Wellington; CIEBA; MetLife; ACLI (Feb. 2012); SSgA (Feb. 2012); PUC Texas; ICI (Feb. 2012) BoA. The Agencies are not adopting an approach that limits a market maker to specified revenue sources (*e.g.,* fees, commissions, and spreads), as suggested by some commenters, due to the considerations discussed above. *See* Occupy; Better Markets (Feb. 2012). In response to the proposed source of revenue requirement, some commenters noted that a market maker may charge a premium or discount for taking on a large position from a customer. *See* Prof. Duffie; NYSE Euronext; Capital Group; RBC; Goldman (Prop. Trading).

[1109] *See* proposed rule § 75.4(b)(2)(vi).

[1110] *See* Joint Proposal, 76 FR at 68873, 68960–68961; CFTC Proposal, 77 FR at 8358, 8439–8440.

or very large amounts of revenue per unit of risk, not demonstrating consistent profitability, or demonstrating high earnings volatility (''revenues relative to risk factor''); (iv) not trading through a trading system that interacts with orders of others or primarily with customers of the banking entity's market-making desk to provide liquidity services, or retaining principal positions in excess of reasonably expected near term customer demands (''customer-facing activity factor''); (v) routinely paying rather than earning fees, commissions, or spreads (''payment of fees, commissions, and spreads factor''); and (vi) providing compensation incentives to employees that primarily reward proprietary risk-taking (''compensation incentives factor'').[1111]

b. Comments on Proposed Appendix B

Commenters expressed differing views about the accuracy of the commentary in proposed Appendix B and the appropriateness of including such commentary in the rule. For example, some commenters stated that the description of market making-related activity in the proposed appendix is accurate [1112] or appropriately accounts for differences among asset classes.[1113] Other commenters indicated that the appendix is too strict or narrow.[1114] Some commenters recommended that the Agencies revise proposed Appendix B's approach by, for example, placing greater focus on what market making is rather than what it is not,[1115] providing presumptions of activity that will be treated as permitted market making-related activity,[1116] re-formulating the appendix as nonbinding guidance,[1117] or moving certain requirements of the proposed exemption to the appendix.[1118] One commenter suggested the Agencies remove Appendix B from the rule and instead use the conformance period to analyze and develop a body of supervisory guidance that appropriately characterizes the nature of market making-related activity.[1119]

A few commenters expressed concern about the appendix's facts-and-circumstances-based approach to distinguishing between prohibited proprietary trading and permitted market making-related activity and stated that such an approach will make it more difficult or burdensome for banking entities to comply with the proposed rule [1120] or will generate regulatory uncertainty.[1121] As discussed below, other commenters opposed proposed Appendix B because of its level of granularity [1122] or due to perceived restrictions on interdealer trading or generating revenue from retained principal positions or risks in the proposed appendix.[1123] A number of commenters expressed concern about the complexity or prescriptiveness of the six proposed factors for distinguishing permitted market making-related activity from prohibited proprietary trading.[1124]

With respect to the level of granularity of proposed Appendix B, a number of commenters expressed concern that the reference to a ''single significant transaction'' indicated that the Agencies will review compliance with the proposed market-making exemption on a trade-by-trade basis and stated that assessing compliance at the level of individual transactions would be unworkable.[1125] One of these commenters further stated that assessing compliance at this level of granularity would reduce a market maker's willingness to execute a customer sell order as principal due to concern that the market maker may not be able to immediately resell such position. The commenter noted that this chilling effect would be heightened in declining markets.[1126]

A few commenters interpreted certain statements in proposed Appendix B as limiting interdealer trading and expressed concerns regarding potential limitations on this activity.[1127] These commenters emphasized that market makers may need to trade with non-customers to: (i) Provide liquidity to other dealers and, indirectly, their customers, or to otherwise allow customers to access a larger pool of liquidity; [1128] (ii) conduct price discovery to inform the prices a market maker can offer to customers; [1129] (iii) unwind or sell positions acquired from

[1111] *See* Joint Proposal, 76 FR at 68873, 68961–68963; CFTC Proposal, 77 FR at 8358, 8440–8442.

[1112] *See* MetLife; ACLI (Feb. 2012).

[1113] *See* Alfred Brock. *But see, e.g.,* Occupy (stating that the proposed commentary only accounts for the most liquid and transparent markets and fails to accurately describe market making in most illiquid or OTC markets).

[1114] *See* Morgan Stanley; IIF; Sumitomo Trust; ISDA (Apr. 2012); BDA (Feb. 2012) (Oct. 2012) (stating that proposed Appendix B places too great of a focus on derivatives trading and does not reflect how principal trading operations in equity and fixed income markets are structured). One of these commenters requested that the appendix be modified to account for certain activities conducted in connection with market making in swaps. This commenter indicated that a swap dealer may not regularly enjoy a dominant flow of customer revenues and may consistently need to make revenue from its book management. In addition, the commenter stated that the appendix should recognize that making a two-way market may be a dominant theme, but there are certain to be frequent occasions when, as a matter of market or internal circumstances, a market maker is unavailable to trade. *See* ISDA (Apr. 2012).

[1115] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1116] *See* Sens. Merkley & Levin (Feb. 2012). This commenter stated that, for example, Appendix B could deem market making involving widely-traded stocks and bonds issued by well-established corporations, government securities, or highly liquid asset-backed securities as the type of plain vanilla, low risk capital activities that are presumptively permitted, provided the activity is within certain, specified parameters for inventory levels, revenue-to-risk metrics, volatility, and hedging. *See id.*

[1117] *See* Morgan Stanley; Flynn & Fusselman.

[1118] *See* JPMC. In support of such an approach, the commenter argued that sometimes proposed § 75.4(b) and Appendix B addressed the same topic and, when this occurs, it is unclear whether compliance with Appendix B constitutes compliance with § 75.4(b) or if additional compliance steps are required. *See id.*

[1119] *See* Morgan Stanley.

[1120] *See* NYSE Euronext; Morgan Stanley.

[1121] *See* IAA.

[1122] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012).

[1123] *See* Morgan Stanley; Chamber (Feb. 2012); Goldman (Prop. Trading).

[1124] *See* Japanese Bankers Ass'n.; Credit Suisse (Seidel); Chamber (Feb. 2012); ICFR; Morgan Stanley; Goldman (Prop. Trading); Occupy; Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011); Public Citizen; NYSE Euronext. *But see* Alfred Brock (stating that the proposed factors are effective).

[1125] *See* Wellington; Goldman (Prop. Trading); SIFMA (Asset Mgmt.) (Feb. 2012). In particular, proposed Appendix B provided that ''The particular types of trading activity described in this appendix may involve the aggregate trading activities of a single trading unit, a significant number or series of transactions occurring at one or more trading units, or a single significant transaction, among other potential scenarios.'' Joint Proposal, 76 FR at 68961; CFTC Proposal, 77 FR at 8441. The Agencies address commenters' trade-by-trade concerns in Part VI.A.3.c.1.c.ii., *infra.*

[1126] *See* Goldman (Prop. Trading).

[1127] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012). Specifically, commenters cited statements in proposed Appendix B indicating that market makers ''typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions.'' On this issue, the appendix further stated that ''a market maker generally only transacts with non-customers to the extent necessary to hedge or otherwise manage the risks of its market making-related activities, including managing its risk with respect to movements of the price of retained principal positions and risks, to acquire positions in amounts consistent with reasonably expected near term demand of its customers, or to sell positions acquired from its customers.'' The appendix recognized, however, that the ''appropriate proportion of a market maker's transactions that are with customers versus non-customers varies depending on the type of positions involved and the extent to which the positions are typically hedged in non-customer transactions.'' Joint Proposal, 76 FR at 68961; CFTC Proposal, 77 FR at 8440. Commenters' concerns regarding interdealer trading are addressed in Part VI.A.3.c.2.c.i., *infra.*

[1128] *See* Morgan Stanley; Goldman (Prop. Trading).

[1129] *See* Morgan Stanley; Goldman (Prop. Trading); Chamber (Feb. 2012).

customers;[1130] (iv) establish or acquire positions to meet reasonably expected near term customer demand;[1131] (v) hedge;[1132] and (vi) sell a financial instrument when there are more buyers than sellers for the instrument at that time.[1133] Further, one of these commenters expressed the view that the proposed appendix's statements are inconsistent with the statutory market-making exemption's reference to ''counterparties.''[1134]

In addition, a few commenters expressed concern about statements in proposed Appendix B about a market maker's source of revenue.[1135] According to one commenter, the statement that profit and loss generated by inventory appreciation or depreciation must be ''incidental'' to customer revenues is inconsistent with market making-related activity in less liquid assets and larger transactions because market makers often must retain principal positions for longer periods of time in such circumstances and are unable to perfectly hedge these positions.[1136] As discussed above with respect to the source of revenue requirement in § 75.4(b)(v) of the proposed rule, a few commenters requested that Appendix B's discussion of ''customer revenues'' be modified to state that revenues from hedging will be considered to be customer revenues in certain contexts beyond derivatives contracts.[1137]

A number of commenters discussed the six proposed factors in Appendix B that, absent explanatory facts and circumstances, would have caused a particular trading activity to be considered prohibited proprietary trading activity and not permitted market making-related activity.[1138] With respect to the proposed factors, one commenter indicated that they are appropriate,[1139] while another commenter stated that they are complex and their effectiveness is uncertain.[1140] Another commenter expressed the view that ''[w]hile each of the selected factors provides evidence of 'proprietary trading,' warrants regulatory attention, and justifies a shift in the burden of proof, some require subjective judgments, are subject to gaming or data manipulation, and invite excessive reliance on circumstantial evidence and lawyers' opinions.''[1141]

In response to the proposed risk management factor,[1142] one commenter expressed concern that it could prevent a market maker from warehousing positions in anticipation of predictable but unrealized customer demands and, further, could penalize a market maker that misestimated expected demand. This commenter expressed the view that such an outcome would be contrary to the statute and would harm market liquidity.[1143] Another commenter requested that this presumption be removed because in less liquid markets, such as markets for corporate bonds, equity derivatives, securitized products, emerging markets, foreign exchange forwards, and fund-linked products, a market maker needs to act as principal to facilitate client requests and, as a result, will be exposed to risk.[1144]

Two commenters expressed concern about the proposed source of revenue factor.[1145] One commenter stated that this factor does not accurately reflect how market making occurs in a majority of markets and asset classes.[1146] The other commenter expressed concern that this factor shifted the emphasis of § 75.4(b)(v) of the proposed rule, which required that market making-related activities be ''designed'' to generate revenue primarily from certain sources, to the actual outcome of activities.[1147]

With respect to the proposed revenues relative to risk factor, one commenter supported this aspect of the proposal.[1148] Some commenters, however, expressed concern about using these factors to differentiate permitted market making-related activity from prohibited proprietary trading.[1149] These commenters stated that volatile risk-taking and revenue can be a natural result of principal market-making activity.[1150] One commenter noted that customer flows are often ''lumpy'' due to, for example, a market maker's facilitation of large trades.[1151]

A few commenters indicated that the analysis in the proposed customer-facing activity factor may not accurately reflect how market making occurs in certain markets and asset classes due to potential limitations on interdealer trading.[1152] According to another commenter, however, a banking entity's non-customer facing trades should be required to be matched with existing customer counterparties.[1153] With respect to the near term customer demand component of this factor, one commenter expressed concern that it goes farther than the statute's activity-based ''design'' test by analyzing whether a trading unit's inventory has exceeded reasonably expected near term customer demand at any particular point in time.[1154]

Some commenters expressed concern about the payment of fees, commissions,

[1130] *See* Morgan Stanley; Chamber (Feb. 2012) (stating that market makers in the corporate bond, interest rate derivative, and natural gas derivative markets frequently trade with other dealers to work down a concentrated position originating with a customer trade).

[1131] *See* Morgan Stanley; Chamber (Feb. 2012).

[1132] *See* Goldman (Prop. Trading).

[1133] *See* Chamber (Feb. 2012).

[1134] *See* Goldman (Prop. Trading).

[1135] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading). On this issue, Appendix B stated that certain types of ''customer revenues'' provide the primary source of a market maker's profitability and, while a market maker also incurs losses or generates profits as price movements occur in its retained principal positions and risks, ''such losses or profits are incidental to customer revenues and significantly limited by the banking entity's hedging activities.'' Joint Proposal, 76 FR at 68960; CFTC Proposal, 77 FR at 8440. The Agencies address commenters' concerns about proposed requirements regarding a market maker's source of revenue in Part VI.A.3.c.7.c., *infra.*

[1136] *See* Morgan Stanley.

[1137] *See supra* note 1086 and accompanying text.

[1138] *See supra* note 1111 and accompanying text.

[1139] *See* Alfred Brock.

[1140] *See* Japanese Bankers Ass'n.

[1141] Sens. Merkley & Levin (Feb. 2012).

[1142] The proposed appendix stated that the Agencies would use certain quantitative measurements required in proposed Appendix A to help assess the extent to which a trading unit's risks are potentially being retained in excess amounts, including VaR, Stress VaR, VaR Exceedance, and Risk Factor Sensitivities. *See* Joint Proposal, 76 FR at 68961–68962; CFTC Proposal, 77 FR at 8441. One commenter questioned whether, assuming such metrics are effective and the activity does not exceed the banking entity's expressed risk appetite, it is necessary to place greater restrictions on risk-taking, based on the Agencies' judgment of the level of risk necessary for *bona fide* market making. *See* ICFR.

[1143] *See* Chamber (Feb. 2012).

[1144] *See* Credit Suisse (Seidel).

[1145] *See* Goldman (Prop. Trading); Morgan Stanley.

[1146] *See* Morgan Stanley.

[1147] *See* Goldman (Prop. Trading). This commenter suggested that the Agencies remove any negative presumptions based on revenues and instead use revenue metrics, such as Spread Profit and Loss (when it is feasible to calculate) or other metrics for purposes of monitoring a banking entity's trading activity. *See id.*

[1148] *See* Occupy (stating that these factors are important and will provide invaluable information about the nature of the banking entity's trading activity).

[1149] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1150] *See* Morgan Stanley; Credit Suisse (Seidel); Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011). For example, one commenter stated that because markets and trading volumes are volatile, consistent profitability and low earnings volatility are outside a market maker's control. In support of this statement, the commenter indicated that: (i) Customer trading activity varies significantly with market conditions, which results in volatility in a market maker's earnings and profitability; and (ii) a market maker will experience volatility associated with changes in the value of its inventory positions, and principal risk is a necessary feature of market making. *See* Morgan Stanley.

[1151] *See* Oliver Wyman (Feb. 2012); Oliver Wyman (Dec. 2011).

[1152] *See* Morgan Stanley; Goldman (Prop. Trading).

[1153] *See* Public Citizen.

[1154] *See* Oliver Wyman (Feb. 2012).

and spreads factor.[1155] One commenter appeared to support this proposed factor.[1156] According to one commenter, this factor fails to recognize that market makers routinely pay a variety of fees in connection with their market making-related activity, including, for example, fees to access liquidity on another market to satisfy customer demand, transaction fees as a matter of course, and fees in connection with hedging transactions. This commenter also indicated that, because spreads in current, rapidly-moving markets are volatile, short-term measurements of profit compared to spread revenue is problematic, particularly for less liquid stocks.[1157] Another commenter stated that this factor reflects a bias toward agency trading and principal market making in highly liquid, exchange-traded markets and does not reflect the nature of principal market making in most markets.[1158] One commenter recommended that the rule require that a trader who pays a fee be prepared to document the chain of custody to show that the instrument is shortly re-sold to an interested customer.[1159]

Regarding the proposed compensation incentives factor, one commenter requested that the Agencies make clear that explanatory facts and circumstances cannot justify a trading unit providing compensation incentives that primarily reward proprietary risk-taking to employees engaged in market making. In addition, the commenter recommended that the Agencies delete the word ''primarily'' from this factor.[1160]

c. Determination to Not Adopt Proposed Appendix B

To improve clarity, the final rule establishes particular criteria for the exemption and does not incorporate the commentary in proposed Appendix B regarding the identification of permitted market making-related activities. This **SUPPLEMENTARY INFORMATION** provides guidance on the standards for compliance with the market-making exemption.

9. Use of Quantitative Measurements

Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review.[1161] The Agencies will not use quantitative measurements as a dispositive tool for differentiating between permitted market making-related activities and prohibited proprietary trading. Like the framework the Agencies have developed for the market-making exemption, the Agencies recognize that there may be differences in the quantitative measurements across markets and asset classes.

4. Section 75.5: Permitted Risk-Mitigating Hedging Activities

Section 75.5 of the proposed rule implemented section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on proprietary trading for certain risk-mitigating hedging activities.[1162] Section 13(d)(1)(C) provides an exemption for risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings (the ''hedging exemption''). Section 75.5 of the final rule implements the hedging exemption with a number of modifications from the proposed rule to respond to commenters' concerns as described more fully below.

a. Summary of Proposal's Approach To Implementing the Hedging Exemption

The proposed rule would have required seven criteria to be met in order for a banking entity's activity to qualify for the hedging exemption. First, §§ 75.5(b)(1) and 75.5(b)(2)(i) of the proposed rule generally required that the banking entity establish an internal compliance program that is designed to ensure the banking entity's compliance with the requirements of the hedging limitations, including reasonably designed written policies and procedures, internal controls, and independent testing, and that a transaction for which the banking entity is relying on the hedging exemption be made in accordance with the compliance program established under § 75.5(b)(1). Next, § 75.5(b)(2)(ii) of the proposed rule required that the transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity. Moreover, § 75.5(b)(2)(iii) of the proposed rule required that the transaction be reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate. Furthermore, § 75.5(b)(2)(iv) of the proposed rule required that the hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction. Section 75.5(b)(2)(v) of the proposed rule required that any hedge position established in reliance on the hedging exemption be subject to continuing review, monitoring and management. Finally, § 75.5(b)(2)(vi) of the proposed rule required that the compensation arrangements of persons performing the risk-mitigating hedging activities be designed not to reward proprietary risk-taking. Additionally, § 75.5(c) of the proposed rule required the banking entity to document certain hedging transactions at the time the hedge is established.

b. Manner of Evaluating Compliance With the Hedging Exemption

A number of commenters expressed concern that the final rule required application of the hedging exemption on a trade-by-trade basis.[1163] One commenter argued that the text of the proposed rule seemed to require a trade-by-trade analysis because each ''purchase or sale'' or ''hedge'' was subject to the requirements.[1164] The final rule modifies the proposal by generally replacing references to a ''purchase or sale'' in the § 75.5(b) requirements with ''risk-mitigating hedging activity.'' The Agencies believe this approach is consistent with the statute, which refers to ''risk-mitigating hedging activity.''[1165]

[1155] *See* NYSE Euronext; Morgan Stanley.

[1156] *See* Public Citizen.

[1157] *See* NYSE Euronext.

[1158] *See* Morgan Stanley.

[1159] *See* Public Citizen.

[1160] *See* Occupy. This commenter also stated that the commentary in Appendix B stating that a banking entity may give some consideration of profitable hedging activities in determining compensation would provide inappropriate incentives. *See id.*

[1161] *See infra* Part VI.C.3.; final rule Appendix A.

[1162] *See* 12 U.S.C. 1851(d)(1)(C); proposed rule § 75.5.

[1163] *See* Ass'n. of Institutional Investors (Feb. 2012); *see also* Barclays; ICI (Feb. 2012); Investure; MetLife; RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley; Fixed Income Forum/Credit Roundtable; Fidelity; FTN.

[1164] *See* Barclays.

[1165] *See* 12 U.S.C. 1851(d)(1)(C) (stating that ''risk-mitigating hedging activities'' are permitted under certain circumstances).

Section 13(d)(1)(C) of the BHC Act specifically authorizes risk-mitigating hedging activities in connection with and related to ''individual or aggregated positions, contracts or other holdings.'' [1166] Thus, the statute does not require that exempt hedging be conducted on a trade-by-trade basis, and permits hedging of aggregated positions. The Agencies recognized this in the proposed rule, and the final rule continues to permit hedging activities in connection with and related to individual or aggregated positions.

The statute also requires that, to be exempt under section 13(d)(1)(C), hedging activities be risk-mitigating. The final rule incorporates this statutory requirement. As explained in more detail below, the final rule requires that, in order to qualify for the exemption for risk-mitigating hedging activities: The banking entity implement, maintain, and enforce an internal compliance program, including policies and procedures that govern and control these hedging activities; the hedging activity be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates specific, identifiable risks; the hedging activity not give rise to significant new risks that are left unhedged; the hedging activity be subject to continuing review, monitoring and management to address risk that might develop over time; and the compensation arrangements for persons performing risk-mitigating hedging activities be designed not to reward or incentivize prohibited proprietary trading. These requirements are designed to focus the exemption on hedging activities that are designed to reduce risk and that also demonstrably reduce risk, in accordance with the requirement under section 13(d)(1)(C) that hedging activities be risk-mitigating to be exempt. Additionally, the final rule imposes a documentation requirement on certain types of hedges.

Consistent with the other exemptions from the ban on proprietary trading for market-making and underwriting, the Agencies intend to evaluate whether an activity complies with the hedging exemption under the final rule based on the totality of circumstances involving the products, techniques, and strategies used by a banking entity as part of its hedging activity.[1167]

c. Comments on the Proposed Rule and Approach To Implementing the Hedging Exemption

Commenters expressed a variety of views on the proposal's hedging exemption. A few commenters offered specific suggestions described more fully below regarding how, in their view, the hedging exemption should be strengthened to ensure proper oversight of hedging activities.[1168] These commenters expressed concern that the proposal's exemption was too broad and argued that all proprietary trading could be designated as a hedge under the proposal and thereby evade the prohibition of section 13.[1169]

By contrast, a number of other commenters argued that the proposal imposed burdensome requirements that were not required by statute, would limit the ability of banking entities to hedge in a prudent and cost-effective manner, and would reduce market liquidity.[1170] These commenters argued that implementation of the requirements of the proposal would decrease safety and soundness of banking entities and the financial system by reducing cost-effective risk management options. Some commenters emphasized that the ability of banking entities to hedge their positions and manage risks taken in connection with their permissible activities is a critical element of liquid and efficient markets, and that the cumulative impact of the proposal would inhibit this risk-mitigation by raising transaction costs and suppressing essential and beneficial hedging activities.[1171]

A number of commenters expressed concern that the proposal's hedging exemption did not permit the full breadth of transactions in which banking entities engage to hedge or mitigate risks, such as portfolio hedging,[1172] dynamic hedging,[1173] anticipatory hedging,[1174] or scenario hedging.[1175] Some commenters stated that restrictions on a banking entity's ability to hedge may have a chilling effect on its willingness to engage in other permitted activities, such as market making.[1176] In addition, many of these commenters stated that, if a banking entity is limited in its ability to hedge its market-making inventory, it may be less willing or able to assume risk on behalf of customers or provide financial products to customers that are used for hedging purposes. As a result, according to these commenters, it will be more difficult for customers to hedge their risks and customers may be forced to retain risk.[1177]

Another commenter contended that the proposal represented an inappropriate ''one-size-fits-all'' approach to hedging that did not properly take into account the way banking entities and especially market intermediaries operate, particularly in less-liquid markets.[1178] Two commenters requested that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of the proposed exemption and, in particular, that a banking entity is not obligated to choose the ''best hedge'' and may use the cheapest instrument available.[1179] One commenter suggested uncertainty about the permissibility of a situation where gains on a hedge position exceed losses on the underlying position. The commenter suggested that uncertainty may lead banking entities to not use the most cost-effective hedge, which would make hedging less efficient and raise costs for banking entities and customers.[1180] However, another commenter expressed concern about banking entities relying on the cheapest satisfactory hedge. The commenter explained that such hedges lead to more complicated risk profiles and require banking entities to engage in additional transactions to hedge the

[1166] *See* 12 U.S.C. 1851(d)(1)(C).

[1167] *See* Part VI.A.4.b., *infra.*

[1168] *See, e.g.,* AFR *et al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1169] *See, e.g.,* Occupy.

[1170] *See, e.g.,* Australian Bankers' Ass'n (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1171] *See* Credit Suisse (Seidel); ICI (Feb. 2012); Wells Fargo (Prop. Trading); *see also* Banco de México; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); BoA.

[1172] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA; HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1173] *See* Goldman (Prop. Trading); BoA.

[1174] *See* Barclays; State Street (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1175] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Markets Regulation. Each of these types of activities is discussed further below. *See infra* Part VI.A.4.d.2.

[1176] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1177] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Goldman (Prop. Trading); Credit Suisse (Seidel).

[1178] *See* Barclays.

[1179] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel).

[1180] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

exposures resulting from the imperfect, cheapest hedge.[1181]

A few commenters suggested the hedging exemption be modified in favor of a simpler requirement that banking entities adopt risk limits and policies and procedures commensurate with qualitative guidance issued by the Agencies.[1182] Many of these commenters also expressed concerns that the proposed rule's hedging exemption would not allow so-called asset-liability management (''ALM'') activities.[1183] Some commenters proposed that the risk-mitigating hedging exemption reference a set of relevant descriptive factors rather than specific prescriptive requirements.[1184] Other alternative frameworks suggested by commenters include: (i) Reformulating the proposed requirements as supervisory guidance; [1185] (ii) establishing a safe harbor,[1186] presumption of compliance,[1187] or bright line test; [1188] or (iii) a principles-based approach that would require a banking entity to document its risk-mitigating hedging strategies for submission to its regulator.[1189]

d. Final Rule

The final rule provides a multi-faceted approach to implementing the hedging exemption that seeks to ensure that hedging activity is designed to be risk-reducing in nature and not designed to mask prohibited proprietary trading.[1190] The final rule includes a number of modifications in response to comments.

This multi-faceted approach is intended to permit hedging activities that are risk-mitigating and to limit potential abuse of the hedging exemption while not unduly constraining the important risk-management function that is served by a banking entity's hedging activities. This approach is also intended to ensure that any banking entity relying on the hedging exemption has in place appropriate internal control processes to support its compliance with the terms of the exemption. While commenters proposed a number of alternative frameworks for the hedging exemption, the Agencies believe the final rule's multi-faceted approach most effectively balances commenter concerns with statutory purpose. In response to commenter requests to reformulate the proposed rule as supervisory guidance,[1191] including the suggestion that the Agencies simply require banking entities to adopt risk limits and policies and procedures commensurate with qualitative Agency guidance,[1192] the Agencies believe that such an approach would provide less clarity than the adopted approach. Although a purely guidance-based approach could provide greater flexibility, it would also provide less specificity, which could make it difficult for banking entity personnel and the Agencies to determine whether an activity complies with the rule and could lead to an increased risk of evasion of the statutory requirements. Further, while a bright-line or safe harbor approach to the hedging exemption would generally provide a high degree of certainty about whether an activity qualifies for the exemption, it would also provide less flexibility to recognize the differences in hedging activity across markets and asset classes.[1193] In addition, the use of any bright-line approach would more likely be subject to gaming and avoidance as new products and types of trading activities are developed than other approaches to implementing the hedging exemption. Similarly, the Agencies decline to establish a presumption of compliance because, in light of the constant innovation of trading activities and the differences in hedging activity across markets and asset classes, establishing appropriate parameters for a presumption of compliance with the hedging exemption would potentially be less capable of recognizing these legitimate differences than our current approach.[1194] Moreover, the Agencies decline to follow a principles-based approach requiring a banking entity to document its hedging strategies for submission to its regulator.[1195] The Agencies believe that evaluating each banking entity's trading activity based on an individualized set of documented hedging strategies could be unnecessarily burdensome and result in unintended competitive impacts since banking entities would not be subject to one uniform rule. The Agencies believe the multi-faceted approach adopted in the final rule establishes a consistent framework applicable to all banking entities that will reduce the potential for such adverse impacts.

Further, the Agencies believe the scope of the final hedging exemption is appropriate because it permits risk-mitigating hedging activities, as mandated by section 13 of the BHC Act,[1196] while requiring a robust compliance program and other internal controls to help ensure that only genuine risk-mitigating hedges can be used in reliance on the exemption.[1197] In response to concerns that the proposed hedging exemption would reduce legitimate hedging activity and thus impact market liquidity and the banking entity's willingness to engage in permissible customer-related activity,[1198] the Agencies note that the requirements of the final hedging exemption are designed to permit banking entities to properly mitigate specific risk exposures, consistent with the statute. In addition, hedging related to market-making activity conducted by a market-making desk is subject to the requirements of the market-making exemption, which are designed to permit banking entities to continue providing valuable intermediation and liquidity services, including related risk-management activity.[1199] Thus, the final hedging exemption will not negatively impact the safety and soundness of banking entities or the

[1181] *See* Occupy.

[1182] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1183] A detailed discussion of ALM activities is provided in Part VI.A.1.d.2 of this **SUPPLEMENTARY INFORMATION** relating to the definition of trading account. As explained in that part, the final rule does not allow use of the hedging exemption for ALM activities that are outside of the hedging activities specifically permitted by the final rule.

[1184] *See* BoA; JPMC; Morgan Stanley.

[1185] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI.

[1186] *See* Prof. Richardson; ABA (Keating).

[1187] *See* Barclays; BoA; ISDA (Feb. 2012).

[1188] *See* Johnson & Prof. Stiglitz.

[1189] *See* HSBC.

[1190] *See* final rule § 75.5.

[1191] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; PNC *et al.;* ICI (Feb. 2012); BoA; Morgan Stanley.

[1192] *See* BoA; Barclays; CH/ABASA; Credit Suisse (Seidel); HSBC; ICI (Feb. 2012); ISDA (Apr. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Stephen Roach.

[1193] Some commenters requested that the Agencies establish a safe harbor. *See* Prof. Richardson; ABA (Keating). One commenter requested that the Agencies adopt a bright-line test. *See* Johnson & Prof. Stiglitz.

[1194] A few commenters requested that the Agencies establish a presumption of compliance. *See* Barclays; BoA; ISDA (Feb. 2012).

[1195] One commenter suggested this principles-based approach. *See* HSBC.

[1196] Section 13(d)(1)(C) of the BHC Act permits ''risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.'' 12 U.S.C. 1851(d)(1)(C).

[1197] Some commenters were concerned that the proposed hedging exemption was too broad and that all proprietary trading could be designated as a hedge. *See, e.g.,* Occupy.

[1198] *See, e.g.,* Australian Bankers Ass'n. (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Chamber (Feb. 2012); Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1199] *See supra* Part VI.A.3.c.4.

financial system or have a chilling effect on a banking entity's willingness to engage in other permitted activities, such as market making.[1200]

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

1. Compliance Program Requirement

The first criterion of the proposed hedging exemption required a banking entity to establish an internal compliance program designed to ensure the banking entity's compliance with the requirements of the hedging exemption and conduct its hedging activities in compliance with that program. While the compliance program under the proposal was expected to be appropriate for the size, scope, and complexity of each banking entity's activities and structure, the proposal would have required each banking entity with significant trading activities to implement robust, detailed hedging policies and procedures and related internal controls and independent testing designed to prevent prohibited proprietary trading in the context of permitted hedging activity.[1201] These enhanced programs for banking entities with large trading activity were expected to include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader designed to ensure that hedging strategies mitigated risk and were not for the purpose of engaging in prohibited proprietary trading.

Commenters, including industry groups, generally expressed support for requiring policies and procedures to monitor the safety and soundness, as well as appropriateness, of hedging activity.[1202] Some of these commenters advocated that the final rule presume that a banking entity is in compliance with the hedging exemption if the banking entity's hedging activity is done in accordance with the written policies and procedures required under its compliance program.[1203] One commenter represented that the proposed compliance framework was burdensome and complex.[1204]

Other commenters expressed concerns that the hedging exemption would be too limiting and burdensome for community and regional banks.[1205] Some commenters argued that foreign banking entities should not be subject to the requirements of the hedging exemption for transactions that do not introduce risk into the U.S. financial system.[1206] Other commenters stated that coordinated hedging through and by affiliates should qualify as permitted risk-mitigating hedging activity.[1207]

Some commenters urged the Agencies to adopt detailed limitations on hedging activities. For example, one commenter urged that all hedging trades be labeled as such at the inception of the trade and detailed information regarding the trader, manager, and supervisor authorizing the trade be kept and reviewed.[1208] Another commenter suggested that the hedging exemption contain a requirement that the banking entity employee who approves a hedge affirmatively certify that the hedge conforms to the requirements of the rule and has not been put in place for the direct or indirect purpose or effect of generating speculative profits.[1209] A few commenters requested limitations on instruments that can be used for hedging purposes.[1210]

The final rule retains the proposal's requirement that a banking entity establish an internal compliance program that is designed to ensure the banking entity limits its hedging activities to hedging that is risk-mitigating.[1211] The final rule largely retains the proposal's approach to the compliance program requirement, except to the extent that, as requested by some commenters,[1212] the final rule modifies the proposal to provide additional detail regarding the elements that must be included in a compliance program. Similar to the proposal, the final rule contemplates that the scope and detail of a compliance program will reflect the size, activities, and complexity of banking entities in order to ensure that banking entities engaged in more active trading have enhanced compliance programs without imposing undue burden on smaller organizations and entities that engage in little or no trading activity.[1213] The final rule also requires, like the proposal, that the banking entity implement, maintain, and enforce the program.[1214]

In response to commenter concerns about ensuring the appropriate level of senior management involvement in establishing these policies,[1215] the final rule requires that the written policies and procedures be developed and implemented by a banking entity at the appropriate level of organization and expressly address the banking entity's requirements for escalation procedures, supervision, and governance related to hedging activities.[1216]

[1200] Some commenters believed that restrictions on hedging would have a chilling effect on banking entities' willingness to engage in market making, and may result in customers experiencing difficulty in hedging their risks or force customers to retain risk. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA; IHS.

[1201] These aspects of the compliance program requirement are described in further detail in Part VI.C. of this **SUPPLEMENTARY INFORMATION.**

[1202] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1203] *See* BoA; Barclays; HSBC; JPMC; Morgan Stanley; *see also* Goldman (Prop. Trading); RBC; Barclays; ICI (Feb. 2012); ISDA (Apr. 2012); PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012). See the discussion of why the Agencies decline to take a presumption of compliance approach above.

[1204] *See* Barclays.

[1205] *See* ICBA; M&T Bank.

[1206] *See, e.g.,* Bank of Canada; Allen & Overy (on behalf of Canadian Banks). Additionally, foreign banking entities engaged in hedging activity may be able to rely on the exemption for trading activity conducted by foreign banking entities in lieu of the hedging exemption, provided they meet the requirements of the exemption for trading by foreign banking entities under § 75.6(e) of the final rule. *See infra* Part VI.A.8.

[1207] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

[1208] *See* Sens. Merkley & Levin (Feb. 2012).

[1209] *See* Better Markets (Feb. 2012).

[1210] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras.

[1211] *See* final rule § 75.5(b)(1). The final rule retains the proposal's requirement that the compliance program include, among other things, written hedging policies.

[1212] *See, e.g.,* BoA; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1213] *See* final rule § 75.20(a) (stating that ''[t]he terms, scope and detail of [the] compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity''). The Agencies believe this helps address some commenters' concern that the hedging exemption would be too limiting and burdensome for community and regional banks. *See* ICBA; M&T Bank.

[1214] Many of these policies and procedures were contained as part of the proposed rule's compliance program requirements under Appendix C. They have been moved, and in some cases modified, in order to more clearly demonstrate how they are incorporated into the requirements of the hedging exemption.

[1215] *See* Better Markets (Feb. 2012). The final rule does not require affirmative certification of each hedge, as suggested by this commenter, because the Agencies believe it would unnecessarily slow legitimate transactions. The Agencies believe the final rule's required management framework and escalation procedures achieve the same objective as the commenter's suggested approach, while imposing fewer burdens on legitimate risk-mitigating hedging activity.

[1216] *See* final rule §§ 75.20(b), 75.5(b). This approach builds on the proposal's requirement that senior management and intermediate managers be accountable for the effective implementation of the compliance program.

Like the proposal, the final rule specifies that a banking entity's compliance regime must include reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a trading desk may use in its risk-mitigating hedging activities.[1217] The focus on policies and procedures governing risk identification and mitigation, analysis and testing of position limits and hedging strategies, and internal controls and ongoing monitoring is expected to limit use of the hedging exception to risk-mitigating hedging. The final rule adds to the proposed compliance program approach by requiring that the banking entity's written policies and procedures include position and aging limits with respect to such positions, contracts, or other holdings.[1218] The final rule, similar to the proposed rule, also requires that the compliance program contain internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures.[1219] Further, the final rule retains the proposed requirement that the compliance program provide for the conduct of analysis and independent testing designed to ensure that the positions, techniques, and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks being hedged.[1220]

The final rule also adds that correlation analysis be undertaken as part of the analysis of the hedging positions, techniques, and strategies that may be used. This provision effectively changes the requirement in the proposed rule that the hedge must maintain correlation into a requirement that correlation be analyzed as part of the compliance program before a hedging activity is undertaken. This provision incorporates the concept in the proposed rule that a hedge should be correlated (negatively, when sign is considered) to the risk being hedged. However, the Agencies recognize that some effective hedging activities, such as deep out-of-the-money puts and calls, may not be exhibit a strong linear correlation to the risks being hedged and also that correlation over a period of time between two financial positions does not necessarily mean one position will in fact reduce or mitigate a risk of the other. Rather, the Agencies expect the banking entity to undertake a correlation analysis that will, in many but not all instances, provide a strong indication of whether a potential hedging position, strategy, or technique will or will not demonstrably reduce the risk it is designed to reduce. It is important to recognize that the rule does not require the banking entity to prove correlation mathematically or by other specific methods. Rather, the nature and extent of the correlation analysis undertaken would be dependent on the facts and circumstances of the hedge and the underlying risks targeted. If correlation cannot be demonstrated, then the Agencies would expect that such analysis would explain why not and also how the proposed hedging position, technique, or strategy is designed to reduce or significantly mitigate risk and how that reduction or mitigation can be demonstrated without correlation.

Moreover, the final rule requires hedging activity conducted in reliance on the hedging exemption be subject to continuing review, monitoring, and management that is consistent with the banking entity's written hedging policies and procedures and is designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, the specific, identifiable risks that develop over time from hedging activity and underlying positions.[1221] This ongoing review should consider market developments, changes in positions or the configuration of aggregated positions, changes in counterparty risk, and other facts and circumstances related to the risks associated with the underlying and hedging positions, contracts, or other holdings.

The Agencies believe that requiring banking entities to develop and follow detailed compliance policies and procedures related to risk-mitigating hedging activity will help both banking entities and examiners understand the risks to which banking entities are exposed and how these risks are managed in a safe and sound manner. With this increased understanding, banking entities and examiners will be better able to evaluate whether banking entities are engaged in legitimate, risk-reducing hedging activity, rather than impermissible proprietary trading. While the Agencies recognize there are certain costs associated with this compliance program requirement,[1222] we believe this provision is necessary to ensure compliance with the statute and the final rule. As discussed in Part VI.C.1., the Agencies have modified the proposed compliance program structure to reduce burdens on small banking entities.[1223]

The Agencies note that hedging may occur across affiliates under the hedging exemption.[1224] To ensure that hedging across trading desks or hedging done at a level of the organization outside of the trading desk does not result in prohibited proprietary trading, the final rule imposes enhanced documentation requirements on these activities, which are discussed more fully below. The Agencies also note that nothing in the final rule limits or restricts the ability of the appropriate supervisory agency of a banking entity to place limits on interaffiliate hedging in a manner consistent with their safety and soundness authority to the extent the

[1217] This approach is generally consistent with some commenters' suggested approach of limiting the instruments that can be used for hedging purposes; although the final rules provide banking entities with discretion to determine the types of positions, contracts, or other holdings that will mitigate specific risks of individual or aggregated holdings and thus may be used for risk-mitigating hedging activity. *See* Sens. Merkley & Levin (Feb. 2012); Occupy; Andrea Psoras. In response to one commenter's request that the final rule require all hedges to be labeled at inception and certain detailed information be documented for each hedge, the Agencies note that the final rules continue to require detailed documentation for hedging activity that presents a heightened risk of evasion. *See* Sens. Merkley & Levin (Feb. 2012); final rule § 75.5(c); *infra* Part VI.A.4.d.4. The Agencies believe a documentation requirement targeted at these scenarios balances the need to prevent evasion of the general prohibition on proprietary trading with the concern that documentation requirements can slow or impede legitimate risk-mitigating activity in the normal course.

[1218] *See* final rule § 75.5(b)(1)(i). Some commenters expressed support for the use of risk limits in determining whether trading activity qualifies for the hedging exemption. *See, e.g.,* Barclays; Credit Suisse (Seidel); ICI (Feb. 2012); Morgan Stanley.

[1219] *See* final rule § 75.5(b)(1)(ii).

[1220] *See* final rule § 75.5(b)(1)(iii). The final rule's requirement to demonstrably reduce or otherwise significantly mitigate is discussed in greater detail below.

[1221] The proposal also contained a continuing review, monitoring, and management requirement. *See* proposed rule § 75.5(b)(2)(v). The final rule modifies the proposed requirement, however, by removing the ''reasonable correlation'' requirement and instead requiring that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks. Correlation analysis is, however, a necessary component of the analysis element in the compliance program requirement of the hedging exemption in the final rule. *See* final rule § 75.5(b). This change is discussed below.

[1222] *See* Barclays.

[1223] *See infra* Part VI.C.1. Some commenters expressed concern that the compliance program requirement would place undue burden on regional or community banks. *See* ICBA; M&T Bank.

[1224] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC.

agency has such authority.[1225] Additionally, nothing in the final rule limits or modifies the applicability of CFTC regulations with respect to the clearing of interaffiliate swaps.[1226]

2. Hedging of Specific Risks and Demonstrable Reduction of Risk

Section 75.5(b)(2)(ii) of the proposed rule required that a qualifying transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity.[1227] This criterion implemented the essential element of the hedging exemption that the transaction be risk-mitigating.

Some commenters expressed support for this provision, particularly the requirement that a banking entity be able to tie a hedge to a specific risk.[1228] One of these commenters stated that a demonstrated reduction in risk should be a key indicator of whether a hedge is in fact permitted.[1229] However, some commenters argued that the list of risks eligible to be hedged under the proposed rule, which included risks arising from aggregated positions, could justify transactions that should be viewed as prohibited proprietary trading.[1230] Another commenter contended that the term ''basis risk'' was undefined and could heighten the potential that this exemption would be used to evade the prohibition on proprietary trading.[1231]

Other commenters argued that requiring a banking entity to specify the particular risk being hedged discourages effective hedging and increases the risk at banking entities. These commenters contended that hedging activities must address constantly changing positions and market conditions.[1232] Another commenter argued that this requirement could render a banking entity's hedges impermissible if those hedges do not succeed in fully hedging or mitigating an identified risk as determined by a post hoc analysis and could prevent banking entities from entering into hedging transactions in anticipation of risks that the banking entity expects will arise (or increase).[1233] Certain commenters requested that the hedging exemption provide a safe harbor for positions that satisfy FASB ASC Topic 815 (formerly FAS 133) hedging accounting standards, which provides that an entity recognize derivative instruments, including certain derivative instruments embedded in other contracts, as assets or liabilities in the statement of financial position and measure them at fair value.[1234] Another commenter suggested that scenario hedges could be identifiable and subject to review by the Agencies using VaR, Stress VaR, and VaR Exceedance, as well as revenue metrics.[1235]

The Agencies have considered these comments carefully in light of the statute. Section 13(d)(1)(C) of the BHC Act provides an exemption from the prohibition on proprietary trading only for hedging activity that is ''designed to reduce the specific risks to the banking entity in connection with and related to'' individual or aggregated positions, contracts, or other holdings of the banking entity.[1236] Thus, while the statute permits hedging of individual or aggregated positions (as discussed more fully below), the statute requires that, to be exempt from the prohibition on proprietary trading, hedging transactions be designed to reduce specific risks.[1237] Moreover, it requires that these specific risks be in connection with or related to the individual or aggregated positions, contracts, or other holdings of the banking entity.

The final rule implements these requirements. To ensure that exempt hedging activities are designed to reduce specific risks, the final rule requires that the hedging activity at inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, be designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified individual or aggregated positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1238] Hedging activities and limits should be based on analysis conducted by the banking entity of the appropriateness of hedging instruments, strategies, techniques, and limits. As discussed above, this analysis must include analysis of correlation between the hedge and the specific identifiable risk or risks that the hedge is designed to reduce or significantly mitigate.[1239]

This language retains the focus of the statute and the proposed rule on reducing or mitigating specific and identified risks.[1240] As discussed more fully above, banking entities are required to describe in their compliance policies and procedures the types of strategies, techniques, and positions that may be used for hedging.

The final rule does not prescribe the hedging strategy that a banking entity must employ. While one commenter urged that the final rule require each banking entity to adopt the ''best hedge'' for every transaction,[1241] the Agencies believe that the complexity of positions, market conditions at the time of a transaction, availability of hedging

[1225] In addition, section 608 of the Dodd-Frank Act added credit exposure arising from securities borrowing and lending or a derivative transaction with an affiliate to the list of covered transactions subject to the restrictions of section 23A of the FR Act, in each case to the extent that such transaction causes a bank to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7) and (8). As a consequence, interaffiliate hedging activity within a banking entity may be subject to limitation or restriction under section 23A of the FR Act.

[1226] *See* 17 CFR 50.52.

[1227] *See* proposed rule § 75.5(b)(2)(ii); *see also* Joint Proposal, 76 FR at 68875.

[1228] *See* AFR (June 2013); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1229] *See* Sens. Merkley & Levin (Feb. 2012).

[1230] *See* Public Citizen; *see also* Occupy.

[1231] *See* Occupy.

[1232] *See, e.g.,* Japanese Bankers Ass'n.

[1233] *See* Barclays.

[1234] *See* ABA (Keating); Wells Fargo (Prop. Trading). Although certain accounting standards, such as FASB ASC Topic 815 hedge accounting standards, address circumstances in which a transaction may be considered a hedge of another transaction, the final rule does not refer to or expressly rely on these accounting standards because such standards: (i) are designed for financial statement purposes, not to identify proprietary trading; and (ii) change often and are likely to change in the future without consideration of the potential impact on section 13 of the BHC Act.

[1235] *See* JPMC.

[1236] 12 U.S.C. 1851(d)(1)(C).

[1237] Some commenters expressed support for the requirement that a banking entity tie a hedge to a specific risk. *See* AFR (June 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Johnson & Prof. Stiglitz.

[1238] *See* final rule § 75.5(b)(2)(ii).

[1239] *See* final rule § 75.5(b)(1)(iii).

[1240] Some commenters represented that the proposed list of risks eligible to be hedged could justify transactions that should be considered proprietary trading. *See* Public Citizen; Occupy. One commenter was concerned about the proposed inclusion of ''basis risk'' in this list. *See* Occupy. As noted in the proposal, the Agencies believe the inclusion of a list of eligible risks, including basis risk, helps implement the essential element of the statutory hedging exemption—*i.e.,* that the transaction is risk-reducing in connection with a specific risk. *See* Joint Proposal, 76 FR at 68875. *See also* 12 U.S.C. 1851(d)(1)(C). Further, the Agencies believe the other requirements of the final hedging exemption, including requirements regarding internal controls and a compliance program, help to ensure that only legitimate hedging activity qualifies for the exemption.

[1241] *See, e.g.,* Occupy.

transactions, costs of hedging, and other circumstances at the time of the transaction make a requirement that a banking entity always adopt the ''best hedge'' impractical, unworkable, and subjective.

Nonetheless, the statute requires that, to be exempt under section 13(d)(1)(C), hedging activity must be risk-mitigating. To ensure that only risk-mitigating hedging is permitted under this exemption, the final rule requires that in its written policies and procedures the banking entity identify the instruments and positions that may be used in hedging, the techniques and strategies the banking entity deems appropriate for its hedging activities, as well as position limits and aging limits on hedging positions. These written policies and procedures also must specify the escalation and approval procedures that apply if a trader seeks to conduct hedging activities beyond the limits, position types, strategies, or techniques authorized for the trader's activities.[1242]

As noted above, commenters were concerned that risks associated with permitted activities and holdings change over time, making a determination regarding the effectiveness of hedging activities in reducing risk dependent on the time when risk is measured. To address this, the final rule requires that the exempt hedging activity be designed to reduce or otherwise significantly mitigate, and demonstrably reduces or otherwise significantly mitigates, risk at the inception of the hedge. As explained more fully below, because risks and the effectiveness of a hedging strategy may change over time, the final rule also requires the banking entity to implement a program to review, monitor, and manage its hedging activity over the period of time the hedging activity occurs in a manner designed to reduce or significantly mitigate and demonstrably reduce or otherwise significantly mitigate new or changing risks that may develop over time from both the banking entity's hedging activities and the underlying positions. Many commenters expressed concern that the proposed ongoing review, monitoring, and management requirement would limit a banking entity's ability to engage in aggregated position hedging.[1243] One commenter stated that because aggregated position hedging may result in modification of hedging exposures across a variety of underlying risks, even as the overall risk profile of a banking entity is reduced, it would become impossible to subsequently review, monitor, and manage individual hedging transactions for compliance.[1244] The Agencies note that the final rule, like the statute, requires that the hedging activity relate to individual or aggregated positions, contracts or other holdings being hedged, and accordingly, the review, monitoring and management requirement would not limit the extent of permitted hedging provided for in section 13(d)(1)(C) as implied by some commenters. Further, the final rule recognizes that the determination of whether hedging activity demonstrably reduces or otherwise significantly mitigates risks that may develop over time should be ''based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the banking entity and the risks and liquidity thereof.'' [1245]

A number of other commenters argued that a legitimate risk-reducing hedge may introduce new risks at inception.[1246] A few commenters contended that a requirement that no new risks be associated with a hedge would be inconsistent with prudent risk management and greatly reduce the ability of banking entities to reduce overall risk through hedging.[1247] A few commenters stated that the proposed requirement does not recognize that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner.[1248] With respect to the timing of the initial hedge and any additional transactions necessary to reduce significant exposures arising from it, one of these commenters represented that requiring contemporaneous hedges is impracticable, would raise transaction costs, and would make hedging uneconomic.[1249] Another commenter stated that this requirement could have a chilling effect on risk managers' willingness to engage in otherwise permitted hedging activity.[1250]

Other commenters stated that a position that does not fully offset the risk of an underlying position is not in fact a hedge.[1251] These commenters believed that the introduction of new risks at inception of a transaction indicated that the transaction was impermissible proprietary trading and not a hedge.[1252]

The Agencies recognize that prudent risk-reducing hedging activities by banking entities are important to the efficiency of the financial system.[1253] The Agencies further recognize that hedges are generally imperfect; consequently, hedging activities can introduce new and sometimes significant risks, such as credit risk, basis risk, or new market risk, especially when hedging illiquid positions.[1254] However, the Agencies also recognize that hedging activities present an opportunity to engage in impermissible proprietary trading designed to profit from exposure to these types of risks.

To address these competing concerns, the final rule substantially retains the proposed requirement that, at the inception of the hedging activity, the risk-reducing hedging activity does not give rise to significant new or additional risk that is not itself contemporaneously hedged. This approach is designed to allow banking entities to continue to engage in prudent risk-mitigating activities while ensuring that the hedging exemption is not used to engage in prohibited proprietary trading by taking on prohibited short-term exposures under the guise of hedging.[1255] As noted in the proposal,

[1242] A banking entity must satisfy the enhanced documentation requirements of § 75.5(c) if it engages in hedging activity utilizing positions, contracts, or holdings that were not identified in its written policies and procedures.

[1243] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1244] *See* Barclays.

[1245] Final rule § 75.5(b)(2)(iv)(B). The Agencies believe this provision addresses some commenters' concern that the ongoing review, monitoring, and management requirement would limit hedging of aggregated positions, and that such ongoing review of individual hedge transactions with a variety of underlying risks would be impossible. *See* SIFMA (Prop. Trading) (Feb. 2012); Barclays; ICI (Feb. 2012); Morgan Stanley.

[1246] *See* ABA (Keating); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* AFR *et al.* (Feb. 2012).

[1247] *See* Credit Suisse (Seidel); Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1248] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays.

[1249] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1250] *See* BoA.

[1251] *See* Sens. Merkley & Levin (Feb. 2012); Public Citizen; AFR (Nov. 2012).

[1252] *See* Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012).

[1253] *See* FSOC study (stating that ''[p]rudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability'').

[1254] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1255] Some commenters stated that it is not always possible to hedge a new risk exposure arising from a hedge in a cost-effective manner, and requiring contemporaneous hedges would raise transaction costs and the potential for hedges to become uneconomical. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Barclays. As noted in the proposal, the Agencies believe that requiring a contemporaneous hedge of any significant new risk that arises at the inception of a hedge is appropriate because a transaction that creates significant new risk exposure that is not itself hedged at the same time would appear to be indicative of prohibited proprietary trading. *See* Joint Proposal, 76 FR at 68876. Thus, the Agencies believe this requirement is necessary to prevent evasion of the general prohibition on proprietary trading. In response to

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however, the Agencies recognize that exposure to new risks may result from legitimate hedging transactions;[1256] this provision only prohibits the introduction of additional significant exposures through the hedging transaction unless those additional exposures are contemporaneously hedged.

As noted above, the final rule recognizes that whether hedging activity will demonstrably reduce risk must be based upon the facts and circumstances of the individual or aggregated underlying and hedging positions, contracts, or other holdings of the banking entity and the risks and liquidity thereof.[1257] The Agencies believe this approach balances commenters' request that the Agencies clarify that a banking entity may use its discretion to choose any hedging strategy that meets the requirements of the proposed exemption[1258] with concerns that allowing banking entities to rely on the cheapest satisfactory hedge will lead to additional hedging transactions.[1259] The Agencies expect that hedging strategies and techniques, as well as assessments of risk, will vary across positions, markets, activities and banking entities, and that a ''one-size-fits-all'' approach would not accommodate all types of appropriate hedging activity.[1260]

By its terms, section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .''[1261] The preamble to the proposed rule made clear that, consistent with the statutory reference to mitigating risks of individual or aggregated positions, this criterion permits hedging of risks associated with aggregated positions.[1262] This approach is consistent with prudent risk-management and safe and sound banking practice.[1263]

The proposed rule explained that, to be exempt under this provision, hedging activities must reduce risk with respect to ''positions, contracts, or other holdings of the banking entity.'' The proposal also required that a banking entity relying on the exemption be prepared to identify the specific position or risks associated with aggregated positions being hedged and demonstrate that the hedging transaction was risk-reducing in the aggregate, as measured by appropriate risk management tools.

Some commenters were of the view that the hedging exemption applied to aggregated positions or portfolio hedging and was consistent with prudent risk-management practices. These commenters argued that permitting a banking entity to hedge aggregate positions and risks arising from a portfolio of assets would be more efficient from both a procedural and business standpoint.[1264]

By contrast, other commenters argued that portfolio-based hedging could be used to mask prohibited proprietary trading.[1265] One commenter contended that the statute provides no basis for portfolio hedging, and another commenter similarly suggested that portfolio hedging should be prohibited.[1266] Another commenter suggested adopting limits that would prevent the use of the hedging exemption to conduct proprietary activity at one desk as a theoretical ''hedge for proprietary trading at another desk.''[1267] Among the limits suggested by these commenters were a requirement that a banking entity have a well-defined compliance program, the formation of central ''risk management'' groups to perform and monitor hedges of aggregated positions, and a requirement that the banking entity demonstrate the capacity to measure aggregate risk across the institution with precision using proven models.[1268] A few commenters suggested that the presence of portfolio hedging should be viewed as an indicator of imperfections in hedging at the desk level and be a flag used by examiners to identify and review the integrity of specific hedges.[1269]

The final rule, like the proposed rule, implements the statutory language providing for risk-mitigating hedging activities related to individual or aggregated positions. For example, activity permitted under the hedging exemption would include the hedging of one or more specific risks arising from identified positions, contracts, or other holdings, such as the hedging of the aggregate risk of identified positions of one or more trading desks. Further, the final rule requires that these hedging activities be risk-reducing with respect to the identified positions, contracts, or other holdings being hedged and that the risk reduction be demonstrable. Specifically, the final rule requires, among other things: That the banking entity has a robust compliance program reasonably designed to ensure compliance with the exemption; that each hedge is subject to continuing review, monitoring and management designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks that develop over time related to the hedging activity and the underlying positions, contracts, or other holdings of the banking entity; and that the banking entity meet a documentation requirement for hedges not established by the trading desk responsible for the underlying position or for hedges effected through a financial instrument, technique or strategy that is not specifically identified in the trading desk's written policies and procedures. The Agencies believe this approach addresses concerns that a banking entity could use the hedging exemption to conduct proprietary activity at one desk as a theoretical hedge for proprietary trading at another desk in a manner consistent with the statute.[1270] Further, the Agencies believe the adopted exemption allows banking entities to engage in hedging of aggregated positions[1271] while helping to ensure that such hedging activities are truly risk-mitigating.[1272]

commenters' concerns about transaction costs and uneconomical hedging, the Agencies note that this provision only requires additional hedging of ''significant'' new or additional risk and does not apply to any risk exposure arising from a hedge.

[1256] *See* Joint Proposal, 76 FR at 68876.

[1257] *See* final rule § 75.5(b)(2)(ii).

[1258] *See* SIFMA (Prop. Trading) (Feb. 2012); Credit Suisse (Seidel); Barclays; Goldman (Prop. Trading); BoA.

[1259] *See* Occupy.

[1260] *See* Barclays.

[1261] 12 U.S.C. 1851(d)(1)(C).

[1262] *See* Joint Proposal, 76 FR at 68875.

[1263] *See, e.g.,* Australian Bankers' Ass'n. (Feb. 2012); BoA; Barclays; Credit Suisse (Seidel); Goldman (Prop. Trading); HSBC; ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading); Rep. Bachus *et al.;* RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1264] *See, e.g.* ABA (Keating); Ass'n. of Institutional Investors (Sept. 2012); BoA; *see also* Barclays (expressing concern that the proposed rule could result in regulatory review of individual hedging trades for compliance on a *post hoc* basis); HSBC; ISDA (Apr. 2012); ICI (Feb. 2012); PNC; MetLife; RBC; SIFMA (Prop. Trading) (Feb. 2012).

[1265] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen; Johnson & Prof. Stiglitz.

[1266] *See* Sens. Merkley & Levin (Feb. 2012) (commenting that the use of the term ''aggregate'' positions was intended to note that firms do not have to hedge on a trade-by-trade basis but could not hedge on a portfolio basis); Johnson & Prof. Stiglitz.

[1267] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1268] *See, e.g.,* Occupy; Public Citizen.

[1269] *See* Public Citizen; Occupy; AFR *et al.* (Feb. 2012).

[1270] *See* AFR *et al.* (Feb. 2012) (citing 156 Cong. Rec. S5898 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[1271] *See* MetLife; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); HSBC; Fixed Income Forum/Credit Roundtable; ICI (Feb. 2012); ISDA (Feb. 2012).

[1272] The Agencies believe certain limits suggested by commenters, such as the formation of central

As noted above, several commenters questioned whether the hedging exemption should apply to ''portfolio'' hedging and whether portfolio hedging may create the potential for abuse of the hedging exemption. The term ''portfolio hedging'' is not used in the statute. The language of section 13(d)(1)(C) of the BHC Act permits a banking entity to engage in risk-mitigating hedging activity ''in connection with and related to individual or aggregated positions . . . .'' [1273] After consideration of the comments regarding portfolio hedging, and in light of the statutory language, the Agencies are of the view that the statutory language is clear on its face that a banking entity may engage in risk-mitigating hedging in connection with aggregated positions of the banking entity. The permitted hedging activity, when involving more than one position, contract, or other holding, must be in connection with or related to aggregated positions of the banking entity.

Moreover, hedging of aggregated positions under this exemption must be related to identifiable risks related to specific positions, contracts, or other holdings of the banking entity. Hedging activity must mitigate one or more specific risks arising from an identified position or aggregation of positions. The risks in this context are not intended to be more generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modeling or other considerations. For example, the hedging activity cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.[1274] Rather, the hedging exemption permits the banking entity to engage in trading activity designed to reduce or otherwise mitigate specific identifiable risks related to identified individual or aggregated positions that the banking entity is otherwise lawfully permitted to have.

When undertaking a hedge to mitigate the risk of an aggregation of positions, the banking entity must be able to specifically identify the risk factors arising from this set of positions. In identifying the aggregate set of positions that is being hedged for purposes of § 75.5(b)(2)(ii) and, where applicable, § 75.5(c)(2)(i), the banking entity needs to identify the positions being hedged with sufficient specificity so that at any point in time, the specific financial instrument positions or components of financial instrument positions held by the banking entity that comprise the set of positions being hedged can be clearly identified.

The proposal would have permitted a series of hedging transactions designed to rebalance hedging position(s) based on changes resulting from permissible activities or from a change in the price or other characteristic of the individual or aggregated positions, contracts, or other holdings being hedged.[1275] The Agencies recognized that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.[1276]

Some commenters questioned the risk-mitigating nature of a hedge if, at inception, that hedge contained component risks that must be dynamically managed throughout the life of the hedge. These commenters stated that hedges that do not continuously match the risk of underlying positions are not in fact risk-mitigating hedges in the first place.[1277]

On the other hand, other commenters argued that banking entities must be permitted to engage in dynamic hedging activity, such as in response to market conditions which are unforeseeable or out of the control of the banking entity,[1278] and expressed concern that the limitations of the proposed rule, especially the requirement that hedging transactions ''maintain a reasonable level of correlation,'' might impede truly risk-reducing hedging activity.[1279]

A number of commenters asserted that there could be confusion over the meaning of ''reasonable correlation,'' which was used in the proposal as part of explaining what type of activity would qualify for the hedging exemption. Some commenters urged requiring that there be a ''high'' or ''strong'' correlation between the hedge and the risk of the underlying asset.[1280]

Other commenters indicated that uncertainty about the meaning of reasonable correlation could limit valid risk-mitigating hedging activities because the level of correlation between a hedge and the risk of the position or aggregated positions being hedged changes over time as a result of changes in market factors and conditions.[1281] Some commenters represented that the proposed provision would cause certain administrative burdens [1282] or may result in a reduction in market-making activities in certain asset classes.[1283] A few commenters expressed concern that the reasonable correlation requirement could render a banking entity's hedges impermissible if they do not succeed in being reasonably correlated to the relevant risk or risks based on an after-the-fact analysis that incorporates market developments that could not have been foreseen at the time the hedge was placed. These commenters tended to favor a different approach or a type of safe harbor based on an initial determination of correlation.[1284] Some commenters argued the focus of the hedging exemption should be on risk reduction and not on reasonable

''risk management'' groups to monitor hedges of aggregated positions, are unnecessary given the aforementioned limits in the final rule. *See* Occupy; Public Citizen.

[1273] *See* 12 U.S.C. 1851(d)(1)(C).

[1274] The Agencies believe that it would be inconsistent with Congressional intent to permit some or all of these activities under the hedging exemption, regardless of whether certain metrics could be useful for monitoring such activity. *See* JPMC.

[1275] *See* proposed rule § 75.5(b)(2)(ii) (requiring that the hedging transaction ''hedges or otherwise mitigates one or more specific risks . . . arising in connection with and related to individual or aggregated positions, contracts, or other holdings of [the] banking entity''). The proposal noted that this requirement would include, for example, dynamic hedging. *See* Joint Proposal, 76 FR at 68875.

[1276] The proposal noted that this corresponding modification to the hedge should also be reasonably correlated to the material changes in risk that are intended to be hedged or otherwise mitigated, as required by § 75.5(b)(2)(iii) of the proposed rule.

[1277] *See* AFR *et al.* (Feb. 2012); Public Citizen; *see also* Better Markets (Feb. 2012), Sens. Merkley & Levin (Feb. 2012).

[1278] *See* Japanese Bankers Ass'n.

[1279] *See, e.g.,* BoA; Barclays; ISDA (Apr. 2012); PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1280] *See, e.g.,* Occupy; Public Citizen; AFR *et. al.* (Feb. 2012); AFR (June 2013); Better Markets (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1281] *See* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY; *see also* Chamber (Feb. 2012).

[1282] *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1283] *See* BoA; SIFMA (Asset Mgmt.) (Feb. 2012). As discussed above, market-maker hedging at the trading desk level is no longer subject to the hedging exemption and is instead subject to the requirements of the market-making exemption, which is designed to permit banking entities to continue providing legitimate market-making services, including managing the risk of market-making activity. *See also supra* Part VI.A.3.c.4. of this **SUPPLEMENTARY INFORMATION.**

[1284] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* FTN; BoA.

correlation.[1285] One commenter suggested that risk management metrics such as VaR and risk factor sensitivities could be the focus for permitted hedging instead of requirements like reasonable correlation under the proposal.[1286]

In consideration of commenter concerns about the proposed reasonable correlation requirement, the final rule modifies the proposal in the following key respects. First, the final rule modifies the requirement of ''reasonable correlation'' by providing that the hedge demonstrably reduce or otherwise significantly mitigate specific identifiable risks.[1287] This change is designed to reinforce that hedging activity should be demonstrably risk reducing or mitigating rather than simply correlated to risk. This change acknowledges that hedges need not simply be correlated to underlying positions, and that hedging activities should be consciously designed to reduce or mitigate identifiable risks, not simply the result of pairing correlated positions, as some commenters suggested.[1288] As discussed above, the Agencies do, however, recognize that correlation is often a critical element of demonstrating that a hedging activity reduces the risks it is designed to address. Accordingly, the final rule requires that banking entities conduct correlation analysis as part of the required compliance program in order to utilize the hedging exemption.[1289] The Agencies believe this change better allows consideration of the facts and circumstances of the particular hedging activity as part of the correlation analysis and therefore addresses commenters' concerns that the proposed reasonable correlation requirement could cause administrative burdens, impede legitimate hedging activity,[1290] and require an after-the-fact analysis.[1291]

Second, the final rule provides that the determination of whether an activity or strategy is risk-reducing or mitigating must, in the first instance, be made at the inception of the hedging activity. A trade that is not risk-reducing at its inception is not viewed as a hedge for purposes of the exemption in § 75.5.[1292]

Third, the final rule requires that the banking entity conduct analysis and independent testing designed to ensure that the positions, techniques, and strategies used for hedging are reasonably designed to reduce or otherwise mitigate the risk being hedged. As noted above, such analysis and testing must include correlation analysis. Evidence of negative correlation may be a strong indicator that a given hedging position or strategy is risk-reducing. Moreover, positive correlation, in some instances, may be an indicator that a hedging position or strategy is not designed to be risk-mitigating. The type of analysis and factors considered in the analysis should take account of the facts and circumstances, including type of position being hedged, market conditions, depth and liquidity of the market for the underlying and hedging position, and type of risk being hedged.

The Agencies recognize that markets and risks are dynamic and that the risks from a permissible position or aggregated positions may change over time, new risks may emerge in the positions underlying the hedge and in the hedging position, new risks may emerge from the hedging strategy over time, and hedges may become less effective over time in addressing the related risk.[1293] The final rule, like the proposal, continues to allow dynamic hedging. Additionally, the final rule requires the banking entity to engage in ongoing review, monitoring, and management of its positions and related hedging activity to reduce or otherwise significantly mitigate the risks that develop over time. This ongoing hedging activity must be designed to reduce or otherwise significantly mitigate, and must demonstrably reduce or otherwise significantly mitigate, the material changes in risk that develop over time from the positions, contracts, or other holdings intended to be hedged or otherwise mitigated in the same way, as required for the initial hedging activity. Moreover, the banking entity is required under the final rule to support its decisions regarding appropriate hedging positions, strategies and techniques for its ongoing hedging activity in the same manner as for its initial hedging activities. In this manner, the final rule permits a banking entity to engage in effective management of its risks throughout changing market conditions[1294] while also seeking to prohibit the banking entity from taking large proprietary positions through action or inaction related to an otherwise permissible hedge.[1295]

As explained above, the final rule requires a banking entity relying on the hedging exemption to be able to demonstrate that the banking entity is exposed to the specific risks being hedged at the inception of the hedge and any adjustments thereto. However, in the proposal, the Agencies requested comment on whether the hedging exemption should be available in certain cases where hedging activity begins before the banking entity becomes exposed to the underlying risk. The Agencies proposed that the hedging exemption would be available in certain cases where the hedge is established ''slightly'' before the banking entity becomes exposed to the underlying risk if such anticipatory hedging activity: (i) Was consistent with appropriate risk management practices; (ii) otherwise met the terms of the hedging exemption; and (iii) did not involve the potential for speculative profit. For example, a banking entity that was contractually obligated or otherwise highly likely to

[1285] *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *see also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1286] *See* Goldman (Prop. Trading). Consistent with the FSOC study and the proposal, the Agencies continue to believe that quantitative measurements can be useful to banking entities and the Agencies to help assess the profile of a trading desk's trading activity and to help identify trading activity that may warrant a more in-depth review. *See infra* Part VI.C.3.; final rule Appendix A. The Agencies do not intend to use quantitative measurements as a dispositive tool for differentiating between permitted hedging activities and prohibited proprietary trading.

[1287] Some commenters stated that the hedging exemption should focus on risk reduction, not reasonable correlation. *See, e.g.,* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); Sens. Merkley & Levin (Feb. 2012); Occupy. One of these commenters noted that demonstrated risk reduction should be a key requirement. *See* Sens. Merkley & Levin (Feb. 2012).

[1288] *See* FTN; Goldman (Prop. Trading); ISDA (Apr. 2012); *see also* Sens. Merkley & Levin (Feb. 2012); Occupy.

[1289] *See* final rule § 75.5(b)(1)(iii).

[1290] Some commenters expressed concern that the proposed ''reasonable correlation'' requirement might impede truly risk-reducing activity. *See, e.g.,* BoA; Barclays; Comm. on Capital Markets Regulation; Credit Suisse (Seidel); FTN; Goldman (Prop. Trading); ICI (Feb. 2012); ISDA (Apr. 2012); Japanese Bankers Ass'n.; JPMC; Morgan Stanley; PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012); STANY. Some of these commenters stated that the proposed requirement would cause administrative burdens. *See* Japanese Bankers Ass'n.; Goldman (Prop. Trading); BoA.

[1291] *See* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012; *see also* FTN.

[1292] By contrast, the proposed requirement did not specify that the hedging activity reduce risk ''at the inception of the hedge.'' *See* proposed rule § 75.5(b)(2)(ii).

[1293] Some commenters noted that hedging activities must address constantly changing positions and market conditions and expressed concern about requiring a banking entity to identify the particular risk being hedged. *See* Japanese Bankers Ass'n.; Barclays.

[1294] A few commenters expressed concern that the proposed ''reasonable correlation'' requirement would render hedges impermissible if not reasonably correlated to the relevant risk(s) based on a *post hoc* analysis. *See, e.g.,* Barclays; Goldman (Prop. Trading); Chamber (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1295] Some commenters questioned the risk-mitigating nature of a hedge if, at inception, it contained risks that must be dynamically managed throughout the life of the hedge. *See, e.g.,* AFR *et al.* (Feb. 2012); Public Citizen.

become exposed to a particular risk could engage in hedging that risk in advance of actual exposure.[1296]

A number of commenters argued that anticipatory hedging is a necessary and prudent activity and that the final rule should permit anticipatory hedging more broadly than did the proposed rule.[1297] In particular, commenters were concerned that permitting hedging activity only if it occurs ''slightly'' before a risk is taken could limit hedging activities that are crucial to risk management.[1298] Commenters expressed concern that the proposed approach would, among other things, make it difficult for banking entities to accommodate customer requests for transactions with specific price or size executions [1299] and limit dynamic hedging activities that are important to sound risk management.[1300] In addition, a number of commenters requested that the rule permit banking entities to engage in scenario hedging, a form of anticipatory hedging that addresses potential exposures to ''tail risks.'' [1301]

Some commenters expressed concern about the proposed criterion that the hedging activity not involve the potential for speculative profit.[1302] These commenters argued that the proper focus of the hedging exemption should be on the purpose of the transaction, and whether the hedge is correlated to the underlying risks being hedged (in other words, whether the hedge is effective in mitigating risk).[1303] By contrast, another commenter urged the Agencies to adopt a specific metric to track realized profits on hedging activities as an indicator of prohibited arbitrage trading.[1304]

Like the proposal, the final rule does not prohibit anticipatory hedging. However, in response to commenter concerns that the proposal would limit a banking entity's ability to respond to customer requests and engage in prudent risk management, the final rule does not retain the proposed requirement discussed above that an anticipatory hedge be established ''slightly'' before the banking entity becomes exposed to the underlying risk and meet certain conditions. To address commenter concerns with the statutory mandate, several parts of the final rule are designed to ensure that all hedging activities, including anticipatory hedging activities, are designed to be risk reducing and not impermissible proprietary trading activities. For example, the final rule retains the proposed requirement that a banking entity have reasonably designed policies and procedures indicating the positions, techniques and strategies that each trading desk may use for hedging. These policies and procedures should specifically address when anticipatory hedging is appropriate and what policies and procedures apply to anticipatory hedging.

The final rule also requires that a banking entity relying on the hedging exemption be able to demonstrate that the hedging activity is designed to reduce or significantly mitigate, and does demonstrably reduce or otherwise significantly mitigate, specific, identifiable risks in connection with individual or aggregated positions of the banking entity.[1305] Importantly, to use the hedging exemption, the final rule requires that the banking entity subject its hedging activity to continuing review, monitoring, and management that is designed to reduce or significantly mitigate specific, identifiable risks, and that demonstrably reduces or otherwise significantly mitigates identifiable risks, in connection with individual or aggregated positions of the banking entity.[1306] The final rule also requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in § 75.5(b)(2) and is not prohibited proprietary trading. If an anticipated risk does not materialize within a limited time period contemplated when the hedge is entered into, under these provisions, the banking entity would be required to extinguish the anticipatory hedge or otherwise demonstrably reduce the risk associated with that position as soon as reasonably practicable after it is determined that the anticipated risk will not materialize. This requirement focuses on the purpose of the hedge as a trade designed to reduce anticipated risk and not for other purposes. The Agencies will (and expect that banking entities also will) monitor the activities of banking entities to identify prohibited trading activity that is disguised as anticipatory hedging.

As noted above, one commenter suggested the Agencies adopt a metric to monitor the profitability of a banking entity's hedging activity.[1307] We are not adopting such a metric because we do not believe it would be useful to monitor the profit and loss associated with hedging activity in isolation without considering the profit and loss associated with the individual or aggregated positions being hedged. For example, the commenter's suggested metric would not appear to provide information about whether the gains arising from hedging positions offset or mitigate losses from individual or aggregated positions being hedged.

3. Compensation

The proposed rule required that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward proprietary risk-taking.[1308] In the proposal, the Agencies stated that hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing

[1296] *See* Joint Proposal, 76 FR at 68875.

[1297] *See, e.g.,* Barclays; SIFMA *et al.* (Prop. Trading); Japanese Bankers Ass'n.; Credit Suisse (Seidel); BoA; PNC *et al.;* ISDA (Feb. 2012).

[1298] *See* BoA; Credit Suisse (Seidel); ISDA (Feb. 2012); JPMC; Morgan Stanley; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1299] *See* Credit Suisse (Seidel); BoA.

[1300] *See* PNC *et al.*

[1301] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Goldman (Prop. Trading); BoA; Comm. on Capital Market Regulation. As discussed above, hedging activity relying on this exemption cannot be designed to: Reduce risks associated with the banking entity's assets and/or liabilities generally, general market movements or broad economic conditions; profit in the case of a general economic downturn; counterbalance revenue declines generally; or otherwise arbitrage market imbalances unrelated to the risks resulting from the positions lawfully held by the banking entity.

[1302] *See* ABA (Keating); CH/ABASA; *see also* Credit Suisse (Seidel); PNC; PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012). One commenter argued that anticipatory hedging should not be permitted because it represents illegal front running. *See* Occupy. The Agencies note that not all anticipatory hedging would constitute illegal front running. Any activity that is illegal under another provision of law, such as front running under section 10(b) of the Exchange Act, remains illegal; and section 13 of the BHC Act and any implementing rules thereunder do not represent a grant of authority to engage in any such activity. *See* 15 U.S.C. 78j.

[1303] As discussed above, the final hedging exemption replaces the ''reasonable correlation'' concept with the requirement that hedging activity ''demonstrably reduce or otherwise significantly mitigate'' specific, identifiable risks.

[1304] *See* AFR *et al.* (Feb. 2012); *see also* Part VI.C.3.d., *infra.*

[1305] This requirement modifies proposed rule § 75.5(b)(2)(ii) and (iii). As discussed above, the addition of ''demonstrably reduces or significantly mitigates'' language replaces the proposed ''reasonable correlation'' requirement.

[1306] The proposed rule contained a similar provision, except that the proposed provision also required that the continuing review maintain a reasonable level of correlation between the hedge transaction and the risk being hedged. *See* proposed rule § 75.5(b)(2)(v). As discussed above, the proposed ''reasonable correlation'' requirement was removed from that provision and instead a requirement has been added to the compliance program provision that correlation analysis be undertaken when analyzing hedging positions, techniques, and strategies before they are implemented.

[1307] *See* AFR *et al.* (Feb. 2012).

[1308] *See* proposed rule § 75.5(b)(2)(vi).

risk, are inconsistent with permitted risk-mitigating hedging activities.[1309]

Commenters generally supported this requirement and indicated that its inclusion was very important and valuable.[1310] Some commenters argued that the final rule should limit compensation based on profits derived from hedging transactions, even if those hedging transactions were in fact risk-mitigating hedges, and urged that employees be compensated instead based on success in risk mitigation at the end of the life of the hedge.[1311] In contrast, other commenters argued that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking.[1312]

After considering comments received on the compensation requirements of the proposed hedging exemption, the final rule substantially retains the proposed requirement that the compensation arrangements of persons performing risk-mitigating hedging activities be designed not to reward prohibited proprietary trading. The final rule is also modified to make clear that rewarding or incentivizing profit making from prohibited proprietary trading is not permitted.[1313]

The Agencies recognize that compensation, especially incentive compensation, may be both an important motivator for employees as well as a useful indicator of the type of activity that an employee or trading desk is engaged in. For instance, an incentive compensation plan that rewards an employee engaged in activities under the hedging exemption based primarily on whether that employee's positions appreciate in value instead of whether such positions reduce or mitigate risk would appear to be designed to reward prohibited proprietary trading rather than risk-reducing hedging activities.[1314] Similarly, a compensation arrangement that is designed to incentivize an employee to exceed the potential losses associated with the risks of the underlying position rather than reduce risks of underlying positions would appear to reward prohibited proprietary trading rather than risk-mitigating hedging activities. The banking entity should review its compensation arrangements in light of the guidance and rules imposed by the appropriate Federal supervisor for the entity regarding compensation.[1315]

4. Documentation Requirement

Section 75.5(c) of the proposed rule would have imposed a documentation requirement on certain types of hedging transactions. Specifically, for any transaction that a banking entity conducts in reliance on the hedging exemption that involved a hedge established at a level of organization different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the hedging transaction is designed to reduce, the banking entity was required, at a minimum, to document: The risk-mitigating purpose of the transaction; the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce; and the level of organization that is establishing the hedge.[1316] Such documentation was required to be established at the time the hedging transaction is effected. The Agencies expressed concern in the proposal that hedging transactions established at a different level of organization than the positions being hedged may present or reflect heightened potential for prohibited proprietary trading, either at the trading desk level or at the level instituting the hedging transaction. In other words, the further removed hedging activities are from the specific positions, contracts, or other holdings the banking entity intends to hedge, the greater the danger that such activity is not limited to hedging specific risks of individual or aggregated positions, contracts, or other holdings of the banking entity, as required by the rule.

Some commenters argued that the final rule should require comprehensive documentation for all activity conducted pursuant to the hedging exemption, regardless of where it occurs in an organization.[1317] One of these commenters stated that such documentation can be easily and quickly produced by traders and noted that traders already record execution details of every trade.[1318] Several commenters argued that the rule should impose a requirement that banks label all hedges at their inception and provide information regarding the specific risk being offset, the expected duration of the hedge, how it will be monitored, how it will be wound down, and the names of the trader, manager, and supervisor approving the hedge.[1319]

Some commenters requested that the documentation requirement be applied at a higher level of organization,[1320] and some commenters noted that policies and procedures alone would be sufficient to address hedging activity, wherever conducted within the organization.[1321] Two commenters indicated that making the documentation requirement narrower is necessary to avoid impacts or delays in daily trading operations that could lead to a banking entity being exposed to greater risks.[1322] A number of commenters stated that any enhanced documentation requirement would be burdensome and costly, and would impede rapid and effective risk mitigation, whether done at a trading desk or elsewhere in the banking entity.[1323]

At least one commenter also argued that a banking entity should be permitted to consolidate some or all of its hedging activity into a trading desk that is not responsible for the underlying positions without triggering a requirement that all hedges undertaken by a trading desk be documented solely because the hedges are not undertaken by the trading desk that originated the underlying position.[1324]

The final rule substantially retains the proposed requirement for enhanced documentation for hedging activity

[1309] *See* Joint Proposal, 76 FR at 68868.

[1310] *See, e.g.,* AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen.

[1311] *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1312] *See* Morgan Stanley.

[1313] One commenter stated that the compensation requirement should restrict only compensation arrangements that incentivize employees to engage in prohibited proprietary risk-taking, rather than apply to hedging activities. *See* Morgan Stanley.

[1314] Thus, the Agencies agree with one commenter who stated that compensation for hedging should not be based purely on profits derived from hedging. However, the final rule does not require compensation vesting, as suggested by this commenter, because the Agencies believe the final hedging exemption includes sufficient requirements to ensure that only risk-mitigating hedging is permitted under the exemption without a compensation vesting provision. *See* AFR *et al.* (Feb. 2012); AFR (June 2013).

[1315] *See* 12 U.S.C. 5641.

[1316] For example, as explained under the proposal, a hedge would be established at a different level of organization of the banking entity if multiple market-making desks were exposed to similar risks and, to hedge such risks, a hedge was established at the direction of a supervisor or risk manager responsible for more than one desk rather than at each of the market-making desks that established the initial positions, contracts, or other holdings. *See* Joint Proposal, 76 FR at 68876 n.161.

[1317] *See* AFR (June 2013); Occupy.

[1318] *See* Occupy.

[1319] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR (June 2013).

[1320] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; *see also* Japanese Bankers Ass'n.

[1321] *See* JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1322] *See* JPMC; Barclays.

[1323] *See* Barclays; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Japanese Bankers Ass'n.

[1324] *See* JPMC.

conducted under the hedging exemption if the hedging is not conducted by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings, the risks of which the hedging activity is designed to reduce. The final rule clarifies that a banking entity must prepare enhanced documentation if a trading desk establishes a hedging position and is not the trading desk that established the underlying positions, contracts, or other holdings. The final rule also requires enhanced documentation for hedges established to hedge aggregated positions across two or more desks. This change in the final rule clarifies that the level of the organization at which the trading desk exists is important for determining whether the trading desk established or is responsible for the underlying positions, contracts, or other holdings. The final rule recognizes that a trading desk may be responsible for hedging aggregated positions of that desk and other desks, business units, or affiliates. In that case, the trading desk putting on the hedge is at least one step removed from some of the positions being hedged. Accordingly, the final rule provides that the documentation requirements in § 75.5 apply if a trading desk is hedging aggregated positions that include positions from more than one trading desk.

The final rule adds to the proposal by requiring enhanced documentation for hedges established by the specific trading desk establishing or directly responsible for the underlying positions, contracts, or other holdings, the risks of which the purchases or sales are designed to reduce, if the hedge is effected through a financial instrument, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures as a product, instrument, exposure, technique, or strategy that the trading desk may use for hedging.[1325] The Agencies note that this documentation requirement does not apply to hedging activity conducted by a trading desk in connection with the market making-related activities of that desk or by a trading desk that conducts hedging activities related to the other permissible trading activities of that desk so long as the hedging activity is conducted in accordance with the compliance program for that trading desk.

The Agencies continue to believe that, for the reasons stated in the proposal, it is appropriate to retain documentation of hedging transactions conducted by those other than the traders responsible for the underlying position in order to permit evaluation of the activity. In order to reduce the burden of the documentation requirement while still giving effect to the rule's purpose, the final rule requires limited documentation for hedging activity that is subject to a documentation requirement, consisting of: (1) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings that the purchase or sale is designed to reduce; (2) the specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and (3) the trading desk or other business unit that is establishing and responsible for the hedge transaction. As in the proposal, this documentation must be established contemporaneously with the hedging transaction. Documentation would be contemporaneous if it is completed reasonably promptly after a trade is executed. The banking entity is required to retain records for no less than 5 years (or such longer period as may be required under other law) in a form that allows the banking entity to promptly produce such records to the Agency on request.[1326] While the Agencies recognize this documentation requirement may result in certain costs, the Agencies believe this requirement is necessary to prevent evasion of the statute and final rule.

5. Section 75.6(a)–(b): Permitted Trading in Certain Government and Municipal Obligations

Section 75.6 of the proposed rule permitted a banking entity to engage in trading activities that were authorized by section 13(d)(1) of the BHC Act,[1327] including trading in certain government obligations, trading on behalf of customers, trading by insurance companies, and trading outside of the United States by certain foreign banking entities.[1328] Section 75.6 of the final rule generally incorporates these same statutory exemptions. However, the final rule has been modified in some ways in response to comments received on the proposal.

a. Permitted Trading in U.S. Government Obligations

Section 13(d)(1)(A) permits trading in various U.S. government, U.S. agency and municipal securities.[1329] Section 75.6(a) of the proposed rule, which implemented section 13(d)(1)(A) of the BHC Act, permitted the purchase or sale of a financial instrument that is an obligation of the United States or any agency thereof or an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*).[1330] The proposal did not contain an exemption for trading in derivatives referencing exempt U.S. government and agency securities, but requested comment on whether the final rule should contain an exemption for proprietary trading in options or other derivatives referencing an exempt government obligation.[1331]

Commenters were generally supportive of the manner in which the proposal implemented the exemption for permitted trading in U.S. government and U.S. agency obligations.[1332] Many commenters argued that the exemption for permissible proprietary trading in government obligations should be expanded, however, to include trading in derivatives on government obligations.[1333] These commenters asserted that failure to provide an exemption would adversely impact liquidity in the underlying government obligations themselves and increase

[1325] One commenter suggested that the rule require documentation when a banking entity needs to engage in new types of hedging transactions that are not covered by its hedging policies, although this commenter's suggested approach would only apply when a hedge is conducted two levels above the level at which the risk arose. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies agree that documentation is needed when a trading desk is acting outside of its hedging policies and procedures. However, the final rule does not limit this documentation requirement to circumstances when the hedge is conducted two organizational levels above the trading desk. Such an approach would be less effective than the adopted approach at addressing evasion concerns.

[1326] *See* final rule § 75.5(c)(3).

[1327] *See* proposed rule § 75.6.

[1328] *See* 12 U.S.C. 1851(d)(1)(A), (C), (F), and (H).

[1329] 12 U.S.C. 1851(d)(1)(A).

[1330] The Agencies proposed that United States ''agencies'' for this purpose would include those agencies described in section 201.108(b) of the Board's Regulation A. *See* 12 CFR 201.108(b). The Agencies also noted that the terms of the exemption would encompass the purchase or sale of enumerated government obligations on a forward basis (*e.g.,* in a to-be-announced market). In addition, this would include pass-through or participation certificates that are issued and guaranteed by a government-sponsored entity (*e.g.,* the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with its securitization activities.

[1331] *See* Joint Proposal, 76 FR at 68878.

[1332] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1333] *See* BoA; CalPERS; Credit Suisse (Seidel); CME Group; Fixed Income Forum/Credit Roundtable; FIA; JPMC; Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

borrowing costs to governments.[1334] Several commenters asserted that U.S. government and agency obligations and derivatives on those instruments are substitutes and pose the same investment risks and opportunities.[1335] According to some commenters, the significant connections between these markets and the interchangeable nature of these instruments significantly contribute to price discovery, in particular, in the cash market for U.S. Treasury obligations.[1336] Commenters also argued that trading in Treasury futures and options improves liquidity in Treasury securities markets by providing an outlet to relieve any supply and demand imbalances in spot obligations. Many commenters argued that the authority to engage in trading in derivatives on U.S. government, agency, and municipal obligations is inherent in the statutory exceptions granted by section 13(d)(1)(A) to trade in the underlying obligation.[1337] To the extent there is any doubt about the scope of those exemptions, commenters urged the Agencies to use the exemptive authority under section 13(d)(1)(J) if necessary to permit proprietary trading in derivatives on government obligations.[1338] Two commenters opposed providing an exemption for proprietary trading in derivatives on exempt government obligations.[1339]

The final rule has not been modified to permit a banking entity to engage in proprietary trading of derivatives on U.S. government and agency obligations.

The Agencies note that the cash market for exempt government obligations is already one of the most liquid markets in the world, and the final rule will permit banking entities to participate fully in these cash markets. In addition, the final rule permits banking entities to make a market in U.S. government securities and in derivatives on those securities. Moreover, the final rule allows banking entities to continue to use U.S. government obligations and derivatives on those obligations in risk-mitigating hedging activities permitted by the rule. Further, proprietary trading in derivatives on such obligations will continue by entities other than banking entities.

Proprietary trading of derivatives on U.S. government obligations is not necessary to promote and protect the safety and soundness of a banking entity or the financial stability of the United States. Commenters offered no compelling reasons why derivatives on exempt government obligations pose little or no risk to the financial system as compared to derivatives on other financial products for which proprietary trading is generally prohibited and did not indicate how proprietary trading in derivatives of U.S. government and agency obligations by banking entities would promote the safety and soundness of those entities or the financial stability of the United States. For these reasons, the Agencies have not determined to provide an exemption for proprietary trading in derivatives on exempt government obligations.

The Agencies believe banking entities will continue to provide significant support and liquidity to the U.S. government and agency security markets through permitted trading in the cash exempt government obligations markets, making markets in government obligation derivatives and through derivatives trading for hedging purposes. The final rule adopts the same approach as the proposed rule for the exemption for permitted trading in U.S. government and U.S. agency obligations. In response to commenters, the Agencies are clarifying how banking entities would be permitted to use Treasury derivatives on Treasury securities when relying on the exemptions for market-making related activities and risk-mitigating hedging activities. The Agencies agree with commenters that some Treasury derivatives are close economic substitutes for Treasury securities and provide many of the same economic exposures.[1340] The Agencies also understand that the markets for Treasury securities and Treasury futures are fully integrated, and that trading in these derivative instruments is essential to ensuring the continued smooth functioning of market-making related activities in Treasury securities. Treasury derivatives are frequently used by market makers to hedge their market-making related positions across many different types of fixed-income securities. Under the final rule, market makers will generally be able to continue their practice of using Treasury futures to hedge their activities as block positioners off exchanges. Additionally, when engaging in permitted market-making related or risk-mitigating hedging activities in accordance with the requirements in §§ 75.4(b) or 75.(5), the final rule permits banking entities to acquire a short or long position in Treasury futures through manual trading or automated processes. For example, a banking entity would be permitted to use Treasury futures to hedge the duration risk (*i.e.,* the measure of a bond's price sensitivity to interest rates movements) associated with the banking entity's market-making in Treasury securities or other fixed-income products, provided that the banking entity complies with the market-making requirements in § 75.4(b). In their market making, banking entities also frequently trade Treasury futures (and acquire a corresponding long or short position) in reasonable anticipation of the near-term demands of their clients, customers, and counterparties. For example, banking entities may acquire a long or short position in Treasury futures to hedge anticipated market risk when they reasonably expect clients, customers, or counterparties will seek to establish long or short positions in on- or off-the-run Treasury securities. Similarly, banking entities could acquire a long or short position in the ''Treasury basis'' to hedge the anticipated basis risk associated with making markets for clients, customers, or counterparties that are reasonably expected to engage in basis trading of the price spread between Treasury futures and Treasury securities. A banking entity can also use Treasury futures (or other derivatives on exempt government obligations) to hedge other risks such as the aggregated interest rate risk for specifically identified loans as well as other financial instruments such as asset-backed securities, corporate bonds, and interest rate swaps. Therefore, depending on the relevant facts and circumstances, banking entities would be permitted to acquire a very large long or short position in Treasury derivatives provided that they comply with the requirements in §§ 75.4(b) or 75.(5). The Agencies also understand that banking entities that have been designated as ''primary dealers'' by the Federal Reserve Bank of New York are required to underwrite issuances of Treasury securities. This necessitates the banking entities to frequently establish very large short positions in Treasury futures to order to hedge the duration risk associated with potentially owning a large volume of Treasury securities. As described below,[1341] the Agencies note that, with

[1334] *See* BoA; FIA; HSBC; JPMC; Morgan Stanley; Wells Fargo (Prop. Trading).

[1335] *See* Barclays; Credit Suisse (Seidel); Fixed Income Forum/Credit Roundtable; FIA.

[1336] *See* Barclays; CME Group; Fixed Income Forum/Credit Roundtable; *see also* UBS.

[1337] *See* CME Group; *see also* Morgan Stanley; PNC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1338] *See* Barclays; CME Group; JPMC.

[1339] *See* Occupy; Alfred Brock.

[1340] *See supra* note 1335.

[1341] *See infra* Part VI.A.3.c.2.c.i.

respect to a banking entity that acts as a primary dealer for Treasury securities, the U.S. government will be considered a client, customer, or counterparty of the banking entity for purposes of the market-making exemption.[1342] We believe this interpretation appropriately captures the unique relationship between a primary dealer and the government. Moreover, this interpretation clarifies that a banking entity may rely on the market-making exemption for its activities as primary dealer to the extent those activities are outside the scope of the underwriting exemption.[1343]

The final rule also includes an exemption for obligations of or guaranteed by the United States or an agency of the United States. An obligation guaranteed by the U.S. or an agency of the U.S. is, in effect, an obligation of the U.S. or that agency.

The final rule also includes an exemption for an obligation of the FDIC, or any entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act (''FDI Act'') or Title II of the Dodd-Frank Act.[1344] These FDIC receivership and conservatorship operations are authorized under the FDI Act and Title II of the Dodd-Frank Act and are designed to lower the FDIC's resolution costs. The Agencies believe that an exemption for these types of obligations would promote and protect the safety and soundness of banking entities and the financial stability of the United States because they facilitate the FDIC's ability to conduct receivership and conservatorship operations in an orderly manner, thereby limiting risks to the financial system generally that might otherwise occur if the FDIC was restricted in its ability to conduct these operations.

b. Permitted Trading in Foreign Government Obligations

The proposed rule did not contain an exemption for trading in obligations of foreign sovereign entities. As part of the proposal, however, the Agencies specifically requested comment on whether proprietary trading in the obligations of foreign governments would promote and protect the safety and soundness of banking entities and the financial stability of the United States under section 13(d)(1)(J) of the BHC Act.[1345]

The treatment of proprietary trading in foreign sovereign obligations prompted a significant number of comments. Many commenters, including foreign governments, foreign and domestic banking entities, and various trade groups, argued that the final rule should permit trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments.[1346] Representatives from foreign governments such as Canada, Germany, Luxembourg, Japan, Australia, and Mexico specifically requested an exemption for trading in obligations of their governments and argued that an exemption was necessary and appropriate to maintain and promote financial stability in their markets.[1347] Some commenters also requested an exemption for trading in obligations of multinational central banks, such as Eurobonds issued or guaranteed by the European Central Bank.[1348]

Many commenters argued that the same rationale for the statutory exemption for proprietary trading in U.S. government obligations supported exempting proprietary trading in foreign sovereign debt and related obligations.[1349] Commenters contended that lack of an express exemption for trading in foreign sovereign obligations could critically impact the functioning of money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations.[1350] These commenters also contended that an exemption for proprietary trading in foreign sovereign debt would promote and protect the safety and soundness and the financial stability of the United States by avoiding the possible negative effects of a contraction of government bond market liquidity.[1351]

Commenters also contended that in some foreign markets, local regulations or market practice require U.S. banking entities operating in those jurisdictions to hold, trade or support government issuance of local sovereign securities. They also indicated that these instruments are traded in the United States or on U.S. markets.[1352] In addition, a number of commenters contended that U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the United States by U.S. primary dealers and alleged that restricting these trading activities would have a significant negative impact on the ability of foreign governments to implement their monetary policy and on liquidity for such securities in many foreign markets.[1353] A few commenters further argued that banking entities use foreign sovereign debt, particularly debt of their home country and of the country in which they are operating, to manage their risk by posting sovereign securities as collateral in foreign jurisdictions, to manage international rate and foreign exchange risk (particularly in local operations), and for liquidity and asset-liability management purposes in different

[1342] *See supra* note 910 (explaining the functions of primary dealers).

[1343] *See supra* Part VI.A.3.c.2.b.ix. (discussing commenters' concerns regarding primary dealer activity, as well as one commenter's request for such an interpretation).

[1344] *See* final rule § 75.6(a)(4).

[1345] *See* Joint Proposal, 76 FR at 68878.

[1346] *See, e.g.,* Allen & Overy (Gov't Obligations); Allen & Overy (Canadian Banks); BoA; Australian Bankers Ass'n. (Feb. 2012); AFMA; Banco de México; Bank of Canada; Ass'n of German Banks; BAROC; Barclays; BEC (citing the National Institute of Banking and Finance); British Bankers' Ass'n.; BaFin/Deutsche Bundesbank; Chamber (Feb. 2012); Mexican Banking Comm'n.; French Treasury *et al.;* EFAMA; ECOFIN; EBF; French Banking Fed'n.; FSA (Apr. 2012); FIA; Goldman (Prop. Trading); HSBC; Hong Kong Inv. Funds Association; IIB/EBF; ICFR; ICSA; IRSG; Japanese Bankers Ass'n.; Ass'n. of Banks in Malaysia; OSFI; British Columbia; Québec; Sumitomo Trust; TMA Hong Kong; UBS; Union Asset.

[1347] *See, e.g.,* Allen & Overy (Gov't Obligations); Bank of Canada; British Columbia; Ontario; IIAC; Quebec; IRSG; IIB/EBF; Mitsubishi; Gov't of Japan/ Bank of Japan; Australian Bankers Ass'n (Feb. 2012); AFMA; Banco de México; Ass'n. of German Banks; ALFI; Embassy of Switzerland.

[1348] *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't Obligations).

[1349] *See* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; BaFIN/Deutsche Bundesbank; EFAMA; Union Asset; TMA Hong Kong; ICI (Feb. 2012) (arguing that such an exemption would be consistent with Congressional intent to limit the extra-territorial application of U.S. law).

[1350] *See* Banco de México; Barclays; BoA; Gov't of Japan/Bank of Japan; IIAC; OSFI.

[1351] *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Banco de México; Ass'n. of German Banks; Barclays; Mexican Banking Comm'n.; EFAMA; EBF; French Banking Fed'n.; Goldman (Prop. Trading); HSBC; IIB/EBF; HSBC; ICSA; T. Rowe Price; UBS; Union Asset; IRSG; EBF; Mitsubishi (citing Japanese Bankers Ass'n. and IIB); Wells Fargo (Prop. Trading); ICI Global.

[1352] *See* Allen & Overy (Gov't. Obligations) (contending that ''even if not primary dealers, banking entities or their branches or agencies acting in certain foreign jurisdictions, such as Singapore and India, are still required to hold or transact in local sovereign debt under local law''); BoA; Barclays; Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1353] *See* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup; Goldman (Prop. Trading); IIB/EBF; *see also* JPMC (suggesting that, at a minimum, the Agencies should make clear that all of a firm's activities that are necessary or reasonably incidental to its acting as a primary dealer in a foreign government's debt securities are protected by the market-making-related permitted activity); SIFMA *et al.* (Prop. Trading) (Feb. 2012). As discussed in Parts VI.A.2.c.2.c. and VI.A.2.c.2.b.ix of this **SUPPLEMENTARY INFORMATION**, the Agencies believe primary dealing activities would generally qualify under the scope of the market-making or underwriting exemption.

countries.[1354] Similarly, commenters expressed concern that the lack of an exemption for trading in foreign government obligations could adversely interact with other banking regulations, such as liquidity requirements under the Basel III capital rules that encourage financial institutions to hold large concentrations of sovereign bonds to match foreign currency denominated obligations.[1355] Commenters also expressed particular concern that the limitations and obligations of section 13 of the BHC Act would likely be problematic and unduly burdensome if banking entities were able to trade in foreign sovereign obligations only under the market making or other proposed exemptions from the proprietary trading prohibition.[1356] One commenter expressed the view that lack of an exemption for proprietary trading in foreign government obligations together with the proposed exemption for trading that occurs solely outside the U.S. may cause foreign banks to close their U.S. branches to avoid being subject to section 13 of the BHC Act and any final rule thereunder.[1357]

According to some commenters, providing an exemption only for proprietary trading in U.S. government obligations, without a similar exemption for foreign government obligations, would be discriminatory and inconsistent with longstanding principles of national treatment and with U.S. treaty obligations, such as obligations under the World Trade Organization framework or bilateral trade agreements.[1358] In addition, several commenters argued that not exempting proprietary trading of foreign sovereign debt may encourage foreign regulators to enact similar regulations to the detriment of U.S. financial institutions operating abroad.[1359] However, another commenter disagreed that the failure to exempt trading in foreign government obligations would violate trade agreements or that the proposal discriminated in any way against foreign banking entities' ability to compete with U.S. banking entities in the U.S.[1360]

Based on these concerns, some commenters suggested that the Agencies exempt proprietary trading by foreign banking entities in obligations of their home or host country.[1361] Other commenters suggested allowing trading in foreign government obligations that meet some condition on quality (*e.g.,* OECD-member country obligations, government bonds eligible as collateral for Federal Reserve advances, sovereign bonds issued by G–20 countries, or other highly liquid or rated instruments).[1362] One commenter indicated that in their view, provided appropriate risk-management procedures are followed, investing in non-U.S. government securities is as low risk as investing in U.S. government securities despite current price volatility in certain types of sovereign debt.[1363] Some commenters also suggested the final rule give deference to home country regulation and permit foreign banking entities to engage in proprietary trading in any government obligation to the extent that such trading is permitted by the entity's primary regulator.[1364]

By contrast, other commenters argued that proprietary trading in foreign sovereign obligations represents a risky activity and that there is no effective way to draw the line between safe and unsafe foreign debt.[1365] Two of these commenters pointed to several publicly reported instances where proprietary trading in foreign sovereign obligations resulted in significant losses to certain firms. These commenters argued that restricting proprietary trading in foreign sovereign debt would not cause reduced liquidity in government bond markets since banking entities would still be permitted to make a market in and underwrite foreign government obligations.[1366] A few commenters suggested that, if the final rule exempted proprietary trading in foreign sovereign debt, foreign governments should commit to pay for any damage to the U.S. financial system related to proprietary trading in their obligations pursuant to such exemption.[1367]

The Agencies carefully considered all the comments related to proprietary trading in foreign sovereign debt in light of the language, purpose and standards for exempting activity contained in section 13 of the BHC Act. Under section 13(d)(1)(J), the Agencies may grant an exemption from the prohibitions of the section for any activity that the Agencies determine would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The Agencies note as an initial matter that section 13 permits banking entities—both inside the United States and outside the United States—to make markets in and to underwrite all types of securities, including all types of foreign sovereign debt. The final rule implements the statutory market-making and underwriting exemptions, and thus, the key role of banking entities in facilitating trading and liquidity in foreign government debt through market-making and underwriting is maintained. This includes underwriting and marketmaking as a primary dealer in foreign sovereign obligations. Banking entities may also hold foreign sovereign debt in their long-term investment book. In addition, the final rule does not prevent foreign banking entities from engaging in proprietary trading outside of the United States in any type of sovereign debt.[1368] Moreover, the Agencies continue to believe that positions, including positions in foreign government obligations, acquired or taken for the *bona fide* purpose of liquidity management and in accordance with a documented liquidity management plan that is consistent with the relevant Agency's supervisory requirements, guidance and expectations regarding liquidity management are not covered by the prohibitions in section 13.[1369] The final rule continues to incorporate this view.[1370]

The issue raised by commenters, therefore, is the extent to which proprietary trading in foreign sovereign obligations by U.S. banking entities anywhere in the world and by foreign banking entities in the United States is consistent with promoting and protecting the safety and soundness of the banking entity and the financial stability of the United States. Taking

[1354] *See* Citigroup; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1355] *See* Allen & Overy (Gov't. Obligations); BoA.

[1356] *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1357] *See* Comm. on Capital Markets Regulation.

[1358] *See* Allen & Overy (Gov't. Obligations); Banco de México; IIB/EBF; Ass'n. of Banks in Malaysia.

[1359] *See* Sumitomo Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Allen & Overy (Govt. Obligations); BoA; ICI Global; RBC; ICFR; ICI (Feb. 2012); Bank of Canada; Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); Chamber (Feb. 2012); BAROC. *See also* IIB/EBF.

[1360] *See* Sens. Merkley & Levin (Feb. 2012).

[1361] *See* Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS; *see also* BAROC.

[1362] *See* BoA; Cadwalader (on behalf of Singapore Banks); IIB/EBF; Norinchukin; OSFI; Cadwalader (on behalf of Thai Banks); Ass'n. of Banks in Malaysia; UBS; *see also* BAROC; ICFR; Japanese Bankers Ass'n.; JPMC; Québec.

[1363] *See, e.g.,* Allen & Overy (Gov't Obligations).

[1364] *See* Allen & Overy (Gov't. Obligations); HSBC.

[1365] *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1366] *See* Prof. Johnson; Better Markets (Feb. 2012).

[1367] *See* Better Markets (Feb. 2012); *see also* Prof. Johnson.

[1368] *See* final rule § 75.6(e).

[1369] *See* Joint Proposal, 76 FR at 68862.

[1370] *See* final rule § 75.3(d)(3).

into account the information provided by commenters, the Agencies' understanding of market operations, and the purpose and language of section 13, the Agencies have determined to grant a limited exemption to the prohibition on proprietary trading for trading in foreign sovereign obligations under certain circumstances.

This exemption, which is contained in § 75.6(b) of the final rule, permits the U.S. operations of foreign banking entities to engage in proprietary trading in the United States in the foreign sovereign debt of the foreign sovereign under whose laws the banking entity—or the banking entity that controls it—is organized (hereinafter, the ''home country''), and any multinational central bank of which the foreign sovereign is a member so long as the purchase or sale as principal is not made by an insured depository institution.[1371] Similar to the exemption for proprietary trading in U.S. government obligations, the permitted trading activity in the U.S. by the eligible U.S. operations of a foreign banking entity would extend to obligations of political subdivisions of the foreign banking entity's home country.[1372]

Permitting the eligible U.S. operations of a foreign banking entity to engage in proprietary trading in the United States in the foreign sovereign obligations of the foreign entity's home country allows these U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations.[1373] At the same time, the risk of these trading activities is largely determined by the foreign sovereign that charters the foreign bank. By not permitting proprietary trading in foreign sovereign debt in insured depository institutions (other than in accordance with the limitations in other exemptions), the exemption limits the direct risks of these activities to insured depository institutions in keeping with the statute.[1374] Thus, the Agencies have determined that this limited exemption for proprietary trading in foreign sovereign obligations promotes and protects the safety and soundness of banking entities and also promotes and protects the financial stability of the United States.

The Agencies have also determined to permit a foreign bank or foreign broker-dealer regulated as a securities dealer and controlled by a U.S. banking entity to engage in proprietary trading in the obligations of the foreign sovereign under whose laws the foreign entity is organized (hereinafter, the ''home country''), including obligations of an agency or political subdivision of that foreign sovereign.[1375] This limited exemption is necessary to allow U.S. banking organizations to continue to own and acquire foreign banking organizations and broker-dealers without requiring those foreign banking organizations and broker-dealers to discontinue proprietary trading in the sovereign debt of the foreign banking entity's home country.[1376] The Agencies have determined that this limited exemption will promote the safety and soundness of banking entities and the financial stability of the United States by allowing U.S. banking entities to continue to be affiliated with and operate foreign banking entities and benefit from international diversification and participation in global financial markets.[1377] However, the Agencies intend to monitor activity of banking entities under this exemption to ensure that U.S. banking entities are not seeking to evade the restrictions of section 13 by using an affiliated foreign bank or broker-dealer to engage in proprietary trading in foreign sovereign debt on behalf of or for the benefit of other parts of the U.S. banking entity.

Apart from this limited exemption, the Agencies have not extended this exemption to proprietary trading in foreign sovereign debt by U.S. banking entities for several reasons. First, section 13 was primarily concerned with the risks posed to the U.S. financial system by proprietary trading activities. This risk is most directly transmitted by U.S. banking entities, and while commenters alleged that prohibiting U.S. banking entities from engaging in proprietary trading in debt of foreign sovereigns would harm liquidity in those markets, the evidence provided by commenters did not sufficiently indicate that permitting U.S. banking entities to engage in proprietary trading (as opposed to market-making or underwriting) in debt of foreign sovereigns contributed in any significant degree to the liquidity of markets in foreign sovereign instruments.[1378] Thus, expanding the exemption to permit U.S. banking entities to engage in proprietary trading in debt of foreign sovereigns would likely increase the risks to these entities and the U.S. financial system without a significant concomitant and offsetting benefit. As explained above, these U.S.

[1371] *See* final rule § 75.6(b). Some commenters requested an exemption for trading in obligations of multinational central banks. *See* Ass'n. of German Banks; Goldman (Prop. Trading); IIB/EBF; ICFR; FIA; Mitsubishi; Sumitomo Trust; Allen & Overy (Gov't. Obligations). In the case of a foreign banking entity that is owned or controlled by a second foreign banking entity domiciled in a country other than the home country of the first foreign banking entity, the final rule would permit the eligible U.S. operations of the first foreign banking entity to engage in proprietary trading only in the sovereign debt of the first foreign banking entity's home country, and would permit the U.S. operations of the second foreign banking entity to engage in proprietary trading only in the sovereign debt of the home country of the second foreign banking entity. As noted earlier, other provisions of the final rule make clear that the rule does not restrict the proprietary trading outside of the United States of either foreign banking organization in debt of any foreign sovereign.

[1372] *See* Part VI.A.5.c., *infra*. Many commenters requested an exemption for trading in foreign sovereign debt, including obligations issued by political subdivisions of foreign governments. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Bank of Canada; Ass'n. of German Banks; BAROC; Barclays.

[1373] As part of this exemption, for example, the U.S. operations of a European bank would be able to trade in obligations issued by the European Central Bank. Many commenters represented that the same rationale for exempting trading in U.S. government obligations supports exempting trading in foreign sovereign debt. *See, e.g.,* Allen & Overy (Gov't. Obligations); Banco de México; Barclays; EFAMA; ICI (Feb. 2012).

[1374] The Agencies believe this approach appropriately balances commenter concerns that proprietary trading in foreign sovereign obligations represents a risky activity and the interest in preserving the ability of U.S. operations of foreign banking entities to continue to support the smooth functioning of markets in foreign sovereign obligations in the same manner as U.S. banking entities are permitted to support the smooth functioning of markets in U.S. government and agency obligations. *See* Better Markets (Feb. 2012); Occupy; Prof. Johnson; Sens. Merkley & Levin (Feb. 2012).

[1375] *See* final rule § 75.6(c). Many commenters requested an exemption for trading in foreign sovereign debt, and some commenters suggested exempting proprietary trading by foreign banking entities in obligations of their home country. *See, e.g.,* Allen & Overy (Gov't. Obligations); BoA; FSA (Apr. 2012); Cadwalader (on behalf of Thai Banks); IIB/EBF; Ass'n. of Banks in Malaysia; UBS.

[1376] Commenters argued that in some foreign markets, U.S. banks operating in those jurisdictions are required by local regulation or market practice to trade in local sovereign securities. *See, e.g.,* Allen & Overy (Gov't. Obligations); AFMA; Ass'n. of German Banks; Barclays; EBF; Goldman (Prop. Trading); UBS.

[1377] Some commenters represented that the limitations and obligations of section 13 would be problematic and unduly burdensome on banking entities because they would only be able to trade in foreign sovereign obligations under existing exemptions, such as the market-making exemption. *See* Barclays; IIAC; UBS; Ass'n. of Banks in Malaysia; IIB/EBF.

[1378] *See, e.g.,* BoA; Citigroup; Goldman (Prop. Trading); IIB/EBF; Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012).; Banco de México; Barclays. The Agencies recognize some commenters' representation that restricting trading in foreign sovereign debt would not necessarily cause reduced liquidity in government bond markets because banking entities would still be able to make a market in and underwrite foreign government obligations. *See* Prof. Johnson; Better Markets (Feb. 2012).

entities are permitted by the final rule to continue to engage fully in market-making in and underwriting of debt of foreign sovereigns anywhere in the world. The only restriction placed on these entities is on the otherwise impermissible proprietary trading in these instruments for the purpose of selling in the near term or otherwise with the intent to resell in order to profit from short-term price movements.

The Agencies recognize that, depending on the extent to which banking entities subject to the rule have contributed to the liquidity of trading markets for foreign sovereign debt, the lack of an exemption for proprietary trading in foreign sovereign debt could result in certain negative impacts on the markets for such debt. In general, the Agencies believe these concerns should be mitigated somewhat by the refined exemptions for market making, underwriting and permitted trading activity of foreign banking entities; however, those exemptions do not address certain of the collateral, capital, and other operational issues identified by commenters.[1379] Foreign sovereign debt of home and host countries generally serves these purposes. Due to the relationships among global financial markets, permitting trading that supports these essential functions promotes the financial stability and the safety and soundness of banking entities.[1380] In contrast, a broad exemption for proprietary trading in all foreign sovereign debt without the limitations contained in the underwriting, market making and hedging exemptions could lead to more complicated risk profiles and significant unhedged risk exposures that section 13 of the BHC Act is designed to address. Thus, the Agencies believe use of section 13(d)(1)(J) exemptive authority to permit proprietary trading in foreign government obligations in certain limited circumstances is appropriate.

The Agencies decline to follow commenters' suggested alternative of allowing trading in foreign government obligations if the obligations meet a particular condition on quality, such as obligations of OECD member countries.[1381] The Agencies do not believe such an approach responds to the statutory purpose of limiting risks posed to the U.S. financial system by proprietary trading activities as directly as our current approach, which is structured to limit the exposure of banking entities, including insured depository institutions, to the risks of foreign sovereign debt. Additionally, the Agencies decline to permit proprietary trading in any obligation permitted under the laws of the foreign banking entity's home country,[1382] because such an approach could result in unintended competitive impacts since banking entities would not be subject to one uniform standard inside the United States. Further, unlike some commenters, the Agencies do not believe it is appropriate to require foreign governments to commit to paying for any damage to the U.S. financial system resulting from the foreign sovereign debt exemption.[1383]

The proposal also did not contain an exemption for trading in derivatives on foreign government obligations. Many commenters who recommended providing an exemption for proprietary trading in foreign government obligations also requested that the exemption be extended to derivatives on foreign government obligations.[1384] Two of these commenters urged that trading in derivatives on foreign sovereign obligations should be exempt for the same reason that trading in derivatives on U.S. government obligations is exempt because such trading supports liquidity and price stability in the market for the underlying government obligations.[1385] One commenter recommended that the Agencies use the authority in section 13(d)(1)(J) to grant an exemption for proprietary trading in derivatives on foreign government obligations.[1386]

The final rule has not been modified in § 75.6(b) to permit a banking entity to engage in proprietary trading in derivatives on foreign government obligations. As noted above, the Agencies have determined not to permit proprietary trading in derivatives on U.S. exempt government obligations under section 13(d) and, for the same reasons, have determined not to extend the permitted activities to include proprietary trading in derivatives on foreign government obligations.

c. *Permitted Trading in Municipal Securities*

Section 75.6(a) of the proposed rule implemented an exemption to the prohibition against proprietary trading under section 13(d)(1)(A) of the BHC Act, which permits trading in certain governmental obligations. This exemption permits the purchase or sale of obligations issued by any State or any political subdivision thereof (the ''municipal securities trading exemption''). The proposed rule included both general obligation bonds and limited obligation bonds, such as revenue bonds, within the scope of this municipal securities trading exemption. The proposed rule, however, did not extend to obligations of ''agencies'' of States or political subdivisions thereof.[1387]

Many commenters, including industry participants, trade groups, and Federal and state governmental representatives, argued that the municipal securities trading exemption should be interpreted to permit banking entities to engage in proprietary trading in a broader range of municipal securities, including the

[1379] Representatives from foreign governments stated that an exemption allowing trading in obligations of their governments is necessary to maintain financial stability in their markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Bank of Canada; IRSG; IIB/EBF; Gov't of Japan/Bank of Japan; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Ass'n. of German Banks; ALFI. Commenters argued that exempting trading in foreign sovereign debt would avoid the possible negative impacts of a contraction of government bond market liquidity. *See, e.g.,* BoA; Citigroup; Goldman (Feb. 2012); IIB/EBF. Additionally, commenters suggested that failing to provide an exemption for this activity would impact money market operations of foreign central banks and limit the ability of foreign sovereign governments to conduct monetary policy or finance their operations. *See, e.g.,* Barclays; BoA; Gov't of Japan/Bank of Japan; OSFI. A number of commenters also argued that, since U.S. and foreign banking entities often perform functions for foreign governments similar to those provided in the U.S. by U.S. primary dealers, the lack of an exemption would have a significant, negative impact on the ability of foreign governments to implement monetary policy and on liquidity in many foreign markets. *See, e.g.,* Allen & Overy (Gov't. Obligations); Australian Bankers Ass'n. (Feb. 2012); BoA; Banco de México; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); IIB/EBF. Some commenters argued that banking entities and their customers use foreign sovereign debt to manage their risk by posting collateral in foreign jurisdictions and to manage international rate and foreign exchange risk. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1380] The Agencies generally concur with commenters' concerns that because the lack of an exemption could result in negative consequences—such as harming liquidity in foreign sovereign debt markets, making it more difficult and more costly for foreign governments to fund themselves, or subjecting banking entities to increased concentration risk—systemic risk could increase or there could be spillover effects that would harm global markets, including U.S. markets. *See* IIF; EBF; ICI Global; HSBC; Barclays; ICI (Feb. 2012); IIB/EBF; Union Asset. Additionally, in consideration of one commenter's statements, the Agencies believe that failing to provide this exemption may cause foreign banks to close their U.S. branches, which could harm U.S. markets. *See* Comm. on Capital Markets Regulation.

[1381] *See, e.g.,* BoA; Cadwalader (on behalf of Singapore Banks); IIB/EBF; OSFI; UBS; BAROC; Japanese Bankers Ass'n.; JPMC.

[1382] Some commenters suggested permitting non-U.S. banking entities to trade in any government obligation to the extent that such trading is permitted by the entity's primary regulator. *See* Allen & Overy (Gov't. Obligations); HSBC.

[1383] *See* Better Markets (Feb. 2012); *see also* Prof. Johnson.

[1384] *See* Barclays; Credit Suisse (Seidel); IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; RBC; Sumitomo Trust; UBS.

[1385] *See* Barclays; FIA.

[1386] *See* Barclays.

[1387] *See* Joint Proposal, 76 FR at 68878 n.165.

following: Obligations issued directly by States and political subdivisions thereof; obligations issued by agencies, constituted authorities, and similar governmental entities acting as instrumentalities on behalf of States and political subdivisions thereof; and obligations issued by such governmental entities that are treated as political subdivisions under various more expansive definitions of political subdivisions under Federal and state laws.[1388] These commenters argued that States and municipalities often issue obligations through agencies and instrumentalities and that these obligations generally have the same level of risk as direct obligations of States and political subdivisions.[1389] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the terms and purposes of section 13 and would not adversely affect the safety and soundness of banking entities involved in these transactions or create additional risk to the financial stability of the United States.[1390]

Commenters expressed concerns that the proposed rule would result in a bifurcation of the municipal securities market that would achieve no meaningful benefits to the safety and soundness of banking entities, create administrative burdens for determining whether or not a municipal security qualifies for the exemption, result in inconsistent applications across different States, increase costs, and decrease liquidity in the diverse municipal securities market.[1391] Commenters also argued that the market for securities issued by agencies and instrumentalities of States and political subdivisions thereof would be especially disrupted, and would affect about 40 percent of the municipal securities market.[1392]

Commenters recommended that the final rule provide a broad exemption to the prohibition on proprietary trading for municipal securities, based on the definition of ''municipal securities'' used in section 3(a)(29) of the Exchange Act,[1393] which is understood by market participants and by Congress, and has a well-settled meaning and an established body of law. [1394] Other commenters contended that adopting the same definition of municipal securities as used in the Federal securities laws would reduce regulatory burden, remove uncertainty, and lead to consistent treatment of these securities under the banking and securities laws.[1395] According to some commenters, the terms ''agency'' and ''political subdivision'' are used differently under some State laws, and some State laws identify certain agencies as political subdivisions or define political subdivision to include agencies.[1396] Commenters also noted that a number of Federal statutes and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1397] Commenters suggested that the Agencies interpret the term ''political subdivision'' in section 13 more broadly than in the proposal to include a wider range of State and municipal governmental obligations issued by agencies and instrumentalities or, alternatively, that the Agencies use the exemptive authority in section 13(d)(1)(J) if necessary to permit proprietary trading of a broader array of State and municipal obligations.[1398]

On the other hand, one commenter contended that bonds issued by agencies and instrumentalities of States or municipalities pose risks to the banking system because the commenter believed the market for these bonds has not been properly regulated or controlled.[1399] A few commenters also recommended tightening the proposed municipal securities trading exemption to exclude conduit obligations that benefit private businesses and private organizations.[1400] One commenter suggested that the proposed municipal securities trading exemption should not apply to tax-exempt municipal bonds that benefit private businesses (referred to as ''private activity bonds'' in the Internal Revenue Code [1401]) and that allow private businesses to finance private projects at lower interest rates as

[1388] *See, e.g.,* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); BoA; BDA (Feb. 2012); Capital Group; Chamber (Feb. 2012); Citigroup (Jan. 2012); CHFA; Eaton Vance; Fidelity; Fixed Income Forum/Credit Roundtable; HSBC; MEFA; Nuveen Asset Mgmt.; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* MSRB; Fidelity; State of New York; STANY; SIFMA (Municipal Securities) (Feb. 2012); State Street (Feb. 2012); North Carolina; T. Rowe Price; Sumitomo Trust; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1389] *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* North Carolina; Washington State Treasurer; *see also* NABL; Ashurst; BDA (Feb. 2012); Chamber (Feb. 2012); Eaton Vance; Fidelity; MEFA; MSRB; Am. Pub. Power *et al.;* Nuveen Asset Mgmt.; PNC; SIFMA (Municipal Securities) (Feb. 2012); UBS.

[1390] *See* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; Wells Fargo (Prop. Trading); *see also* Capital Group (arguing that municipal securities are not generally used as a profit making strategy and thus, including all municipal securities in the exemption by itself should not adversely affect the safety and soundness of banking entities); PNC (arguing that the safe and sound nature of trading in State and municipal agency obligations was ''a fact recognized by Congress in 1999 when it authorized well capitalized national banks to underwrite and deal in, without limit, general obligation, limited obligation and revenue bonds issued by or on behalf of any State, or any public agency or authority of any State or political subdivision of a State''); Sens. Merkley & Levin (Feb. 2012).

[1391] *See, e.g.,* MSRB; City of New York; Am. Pub. Power *et al.;* Wells Fargo; State of New York; Washington State Treasurer; ABA (Keating); Capital Group; North Carolina; Eaton Vance; Port Authority; Connecticut; Citigroup (Jan. 2012); Ashurst; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 2012).

[1392] *See, e.g.,* MSRB (stating that, based on data from Thomson Reuters, 41.4 percent of the municipal securities issued in FY 2011 were issued by agencies and authorities).

[1393] *See* 15 U.S.C. 78c(a)(29).

[1394] *See* ABA (Keating); Ashurst; BoA; Capital Group; Chamber (Feb. 2012); Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); Eaton Vance; Fidelity; MEFA; MTA–NY; MSRB; Am. Pub. Power *et al.;* NABL; NCSL; State of New York; Nuveen Asset Mgmt.; Port Authority; PNC; SIFMA (Municipal Securities) (Feb. 2012); North Carolina; T. Rowe Price; UBS; Washington State Treasurer; Wells Fargo (Prop. Trading).

[1395] *See* Ashurst; Citigroup (Jan. 2012) (noting that the National Bank Act explicitly lists State agencies and authorities as examples of political subdivisions); MSRB.

[1396] *See, e.g.,* Citigroup (Jan. 2012).

[1397] *See, e.g.,* MSRB; Citigroup (Jan. 2012). In addition to the Federal securities laws, the National Bank Act explicitly includes agencies and authorities as examples of political subdivisions. *See* 12 U.S.C. 24(seventh) (permitting investments in securities ''issued by or on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality of 1 or more States, or any public agency or authority of any State or political subdivision of a State . . . .''). In addition, a number of banking regulations also include agencies as examples of political subdivisions or define political subdivision to include municipal agencies, authorities, districts, municipal corporations and similar entities. *See, e.g.,* 12 CFR 1.2; 12 CFR 160.30; 12 CFR 161.38; 12 CFR 330.15. Further, for purposes of the tax-exempt bond provisions in the Internal Revenue Code, Treasury regulations treat obligations issued by or ''on behalf of'' States or political subdivisions by ''constituted authorities'' as obligations of such States or political subdivisions, and the Treasury regulations define the term ''political subdivision'' to mean ''any division of any State or local governmental unit which is a municipal corporation or which has been delegated the right to exercise part of the sovereign power of the unit. . . .'' *See* 26 CFR 1.103–1(b).

[1398] *See* ABA (Keating); Ashurst; Ass'n. of Institutional Investors (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation; Sens. Merkley & Levin (Feb. 2012); MSRB; Wells Fargo (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1399] *See* Occupy.

[1400] *See* AFR *et al.* (Feb. 2012); Occupy.

[1401] *See* 26 U.S.C. 141. In general, the rules applicable to the issuance of tax-exempt private activity bonds under the Internal Revenue Code of 1986, as amended (the ''Code'') are more restrictive than those applicable to traditional governmental bonds issued by States or political subdivisions thereof. Section 146 of the Code imposes an annual State bond volume cap on most tax-exempt private activity bonds that is tied to measures of State populations. Sections 141–150 of the Code impose other additional restrictions on tax-exempt private activity bonds, including, among others, eligible project and use restrictions, bond maturity restrictions, land and existing property financing restrictions, an advance refunding prohibition, and a public approval requirement.

a result of the exemption from Federal income taxation for the interest received by investors.[1402]

The final rule includes the statutory exemption for proprietary trading of obligations of any State or political subdivision thereof.[1403] In response to the public comments and for the reasons discussed below, this exemption uses the definition of the term ''municipal security'' modeled after the definition of ''municipal securities'' under section 3(a)(29) of the Exchange Act,[1404] but with simplifications.[1405] The final rule defines the term ''municipal security'' to mean ''a security which is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.''

The final rule modifies the proposal to permit proprietary trading in obligations issued by agencies and instrumentalities acting on behalf of States and municipalities (*e.g.,* port authority bonds and bonds issued by municipal agencies or corporations).[1406] As noted by commenters, many States and municipalities rely on securities issued by agencies and instrumentalities to fund essential activities, including utility systems, infrastructure projects, affordable housing, hospitals, universities, and other nonprofit institutions.[1407] Both obligations issued directly by States and political subdivisions thereof and obligations issued by an agency or instrumentality of such a State or local governmental entity are ultimately obligations of the State or local governmental entity on whose behalf they act. Moreover, exempting obligations issued by State and municipal agencies and instrumentalities in the same manner as the direct obligations of States and municipalities lessens potential inconsistent treatment of government obligations across States and municipalities that use different funding methods for government projects.[1408]

The Agencies believe that interpreting the language of section 13(d)(1)(A) of the BHC Act to provide an exemption to the prohibition on proprietary trading for obligations issued by States and municipal agencies and instrumentalities as described above is consistent with the terms and purposes of section 13 of the BHC Act.[1409] The Agencies recognize that state and political subdivision agency obligations generally present the same level of risk as direct obligations of States and political subdivisions.[1410] Moreover, the Agencies recognize that other Federal laws and regulations define the term ''political subdivision'' to include municipal agencies and instrumentalities.[1411] The Agencies decline to exclude from this exemption conduit obligations that benefit private entities, as suggested by some commenters.[1412]

The proposal did not exempt proprietary trading of derivatives on obligations of States and political subdivisions. The proposal solicited comment on whether exempting proprietary trading in options or other derivatives referencing an obligation of a State or political subdivision thereof was consistent with the terms and purpose of the statute.[1413] The Agencies did not receive persuasive information on this topic and, for the same reasons discussed above related to derivatives on U.S. government securities, the Agencies have determined not to provide an exemption for proprietary trading in municipal securities, beyond the underwriting, market-making, hedging and other exemptions provided generally in the rule. The Agencies note that banking entities may trade derivatives on municipal securities under any other available exemption to the prohibition on proprietary trading,

[1402] *See* AFR *et al.* (Feb. 2012).

[1403] *See* final rule § 75.6(a)(3).

[1404] Many commenters requested that the final rule use the definition of ''municipal securities'' used in the Federal securities laws because, among other reasons, the industry is familiar with that definition and such an approach would promote consistent treatment of these securities under banking and securities laws. *See, e.g.,* ABA (Keating); Ashurst; BoA; Comm. on Capital Markets Regulation; Citigroup (Jan. 2012); NCSL; Port Authority; SIFMA (Municipal Securities) (Feb. 2012); MSRB. Section 3(a)(29) of the Exchange Act defines the term ''municipal securities'' to mean ''securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.'' *See* 15 U.S.C. 78c(a)(29).

[1405] The definition of municipal securities in section 3(a)(29) of the Exchange Act has outdated tax references to the prior law under the former Internal Revenue Code of 1954, including particularly references to certain provisions involving the concept of ''industrial development bonds.'' The successor current Internal Revenue Code of 1986, as amended, replaces the prior definition of ''industrial development bonds'' with a revised, more restrictive successor definition of ''private activity bonds'' and related definitions of ''exempt facility bonds'' and ''small issue bonds.'' In recognition of the numerous tax law changes since the last statutory revision of section 3(a)(29) of the Exchange Act in 1970 and the potential attendant confusion, the Agencies determined to use a simpler, streamlined, independent definition of municipal securities for purposes of the municipal securities trading exception. This revised definition is intended to encompass, among others, any securities that are covered by the definition of the term ''municipal securities'' under section 3(a)(29) of the Exchange Act.

[1406] Many commenters requested that the municipal securities trading exemption be interpreted to include a broader range of State and municipal obligations issued by agencies and instrumentalities. *See, e.g.,* ABA (Keating); Ashurst; BoA; BDA (Feb. 2012); Fixed Income Forum/Credit Roundtable; Sens. Merkley & Levin (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Comm. on Capital Markets Regulation.

[1407] *See, e.g.,* Citigroup (Jan. 2012); Ashurst; SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); Chamber (Dec. 2011); BlackRock; Fixed Income Forum/Credit Roundtable.

[1408] Commenters represented that the proposed rule would result in inconsistent applications of the exemption across States and political subdivisions. The Agencies also recognize, as noted by commenters, that the proposed rule would likely have resulted in a bifurcation of the municipal securities market and associated administrative burdens and disruptions. *See, e.g.,* MSRB; Am. Pub. Power *et al.;* Port Authority; Citigroup (Jan. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012).

[1409] Commenters asserted that permitting trading in a broader group of municipal securities would be consistent with the terms and purposes of section 13. *See, e.g.,* Ashurst; Citigroup (Jan. 2012); Eaton Vance; Am. Pub. Power *et al.;* SIFMA (Municipal Securities) (Feb. 2012).

[1410] Commenters argued that obligations issued by agencies and instrumentalities generally have the same level of risk as direct obligations of States and political subdivisions. *See, e.g.,* CHFA; Sens. Merkley & Levin (Feb. 2012); Am. Pub. Power *et al.;* North Carolina. In response to one commenter's concern that the markets for bonds issued by agencies and instrumentalities are not properly regulated, the Agencies note that all types of municipal securities, as defined under the securities laws to include, among others, State direct obligation bonds and agency or instrumentality bonds, are generally subject to the same regulations under the securities laws. Thus, the Agencies do not believe that obligations of agencies and instrumentalities are subject to less effective regulation than obligations of States and political subdivisions. *See* Occupy.

[1411] Commenters noted that a number of Federal statutes and regulations define ''political subdivision'' to include municipal agencies and instrumentalities. *See, e.g.,* MSRB; Citigroup (Jan. 2012).

[1412] *See* AFR *et al.* (Feb. 2012); Occupy. The Agencies do not believe it is appropriate to exclude conduit obligations, which are tax-exempt municipal bonds, from this exemption because such obligations are used to finance important projects related to, for example, multi-family housing, healthcare (hospitals and nursing homes), colleges and universities, power and energy companies and resource recovery facilities. *See* U.S. Securities & Exchange Comm'n., Report on the Municipal Securities Market 7 (2012), *available at http://www.sec.gov/news/studies/2012/munireport073112.pdf.*

[1413] *See* Joint Proposal, 76 FR at 68878.

providing the requirements of the relevant exemption are met.

d. Determination to Not Exempt Proprietary Trading in Multilateral Development Bank Obligations

The proposal did not exempt proprietary trading in obligations of multilateral banks or derivatives on multilateral development bank obligations but requested comment on this issue.[1414] A number of commenters argued that the final rule should include an exemption for obligations of multilateral development banks.[1415]

The Agencies have not included an exemption to permit banking entities to engage in proprietary trading in obligations of multilateral development banks at this time. The Agencies do not believe that providing an exemption for trading obligations of multilateral development banks will help enhance the markets for these obligations and therefore promote and protect the safety and soundness of banking entities and U.S. financial stability.

6. Section 75.6(c): Permitted Trading on Behalf of Customers

Section 13(d)(1)(D) of the BHC Act provides an exemption from the prohibition on proprietary trading for the purchase, sale, acquisition, or disposition of financial instruments on behalf of customers.[1416] The statute does not define when a transaction or activity is conducted ''on behalf of customers.''

a. Proposed Exemption for Trading on Behalf of Customers

Section 75.6(b) of the proposed rule implemented the exemption for trading on behalf of customers by exempting three types of trading activity. Section 75.6(b)(i) of the proposed rule provided that a purchase or sale of a financial instrument occurred on behalf of customers if the transaction (i) was conducted by a banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of that customer, and (ii) involved solely financial instruments for which the banking entity's customer, and not the banking entity or any affiliate of the banking entity, was the beneficial owner. This exemption was intended to permit trading activity that a banking entity conducts in the context of providing investment advisory, trust, or fiduciary services to customers provided that the banking entity structures the activity so that the customer, and not the banking entity, benefits from any gains and suffers any losses on the traded positions.

Section 75.6(b)(ii) of the proposed rule exempted the purchase or sale of a covered financial position if the banking entity was acting as riskless principal.[1417] Under the proposed rule, a banking entity qualified as a riskless principal if the banking entity, after having received an order to purchase or sell a covered financial position from a customer, purchased or sold the covered financial position for its own account to offset a contemporaneous sale to or purchase from the customer.[1418]

Section 75.6(b)(iii) of the proposed rule permitted trading by a banking entity that was an insurance company for the separate account of insurance policyholders. Under the proposed rule, only a banking entity that is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator was eligible for this prong of the exemption for trading on behalf of customers. Additionally, the purchase or sale of the covered financial position was exempt only if it was solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company under which all profits and losses arising from the purchase or sale of the financial instrument were allocated to the separate account and inured to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity. These types of transactions are customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets even though the banking entity is treated as the owner of those assets for certain purposes.

b. Comments on the Proposed Rule

Several commenters contended that the Agencies construed the statutory exemption too narrowly by limiting permissible proprietary trading on behalf of customers to only three categories of transactions.[1419] Some of these commenters argued the exemption in the proposal was not consistent with the statutory language or Congressional intent to permit all transactions that are ''on behalf of customers.''[1420] One of these commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to permit only customer-driven transactions involving securities and not other financial instruments such as foreign exchange forwards and other derivatives.[1421]

Several commenters urged the Agencies to expand the exemption for trading on behalf of customers to permit other categories of customer-driven transactions in which the banking entity may be acting as principal but that serve legitimate customer needs including capital formation. For example, one commenter urged the Agencies to permit customer-driven transactions in which the banking entity has no ready counterparty but that are undertaken at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions.[1422] Other commenters urged the Agencies to exempt transactions where the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction.[1423] Commenters argued that these kinds of transactions are similar in purpose and level of risk to riskless principal transactions.[1424] Commenters also argued that these transactions could be viewed as market-making related activities, but indicated that the potential uncertainty and costs of making that determination would discourage banking entities from taking principal risks to accommodate customer needs.[1425] Commenters also requested that the Agencies expressly

[1414] *See id.*

[1415] Commenters argued that including obligations of multilateral developments banks in a foreign sovereign debt exemption is necessary to avoid endangering international cooperation in financial regulation and potential retaliatory prohibitions against U.S. government obligations. *See* Ass'n. of German Banks; Sumitomo; SIFMA *et al.* (Prop. Trading) (Feb. 2012). Additionally, some commenters represented that an exemption for obligations of international and multilateral development banks is appropriate for many of the same reasons provided for exempting U.S. government obligations and foreign sovereign debt generally. *See* Ass'n. of German Banks; Barclays; Goldman (Prop. Trading); IIB/EBF; ICFR; ICI Global; FIA; Sumitomo Trust; Allen & Overy (Gov't. Obligations); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1416] 12 U.S.C. 1851(d)(1)(D).

[1417] *See* Joint Proposal, 76 FR at 68879.

[1418] This language generally mirrors that used in the Board's Regulation Y, OCC interpretive letters, and the SEC's Rule 3a5–1 under the Exchange Act. *See* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993).

[1419] *See, e.g.,* Am. Express; BoA; ISDA (Apr. 2012); RBC; SIMFA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[1420] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1421] *See* Am. Express.

[1422] *See* RBC. The Agencies note that acting as a block positioner is expressly contemplated and included as part of the exemption for market making-related activities under the final rule.

[1423] *See* BoA; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1424] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1425] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

permit transactions on behalf of customers to create structured products, as well as for client funding needs, customer clearing, and prime brokerage, if these transactions are included within the trading account.[1426]

In contrast, some commenters supported the proposed approach for implementing the exemption for trading on behalf of customers or urged narrowing the exemption.[1427] One commenter expressed general support for the requirement that all profits (or losses) from the transaction flow to the customer and not the banking entity providing the service for a transaction to be exempt.[1428] One commenter contended that the statute did not permit transactions on behalf of customers to be performed by an investment adviser.[1429] Another commenter argued that the final rule should permit a banking entity to engage in a riskless principal transaction only where the banking entity has already arranged for another customer to be on the other side of the transaction.[1430] Other commenters urged the Agencies to ensure that both parties to the transaction agree beforehand to the time and price of any relevant trade to ensure that the banking entity solely stands in the middle of the transaction and in fact passes on all gains (or losses) from the transaction to the customers.[1431] Commenters also urged the Agencies to define other key terms used in the exemption. For instance, some commenters requested that the final rule define which entities may qualify as a ''customer'' for purposes of the exemption.[1432]

Some commenters urged the Agencies to provide uniform guidance on how the Agencies will interpret the riskless principal exemption.[1433] One commenter urged the Agencies to clarify how the riskless principal exemption would be implemented with respect to transactions in derivatives, including a hedged derivative transaction executed at the request of a customer.[1434]

Several commenters generally expressed support for the exemption for trading for the separate account of insurance policyholders under the proposed rule.[1435] One commenter requested that the final rule more clearly articulate who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure.[1436]

Several commenters argued that certain types of separate account activities, including the allocation of seed money by an insurance company to a separate account or the offering of certain non-variable separate account contracts by the insurance company, would not appear to be permitted under the proposal.[1437] Commenters also expressed concern that these separate account activities might not satisfy the proposed requirement that all profits and losses arising from the purchase or sale of the financial position inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company.[1438] In addition, commenters argued that under the proposed rule, these activities would appear to fall outside of the exemption for activities in the general account of an insurance company because the proposed rule defined a general account as excluding a separate account.[1439] Commenters urged the Agencies to more closely align the exemptions for trading by an insurance company for the general account and separate account.[1440] According to these commenters, this change would permit insurance companies to continue to engage in the business of insurance by offering the full suite of insurance products to their customers.[1441]

c. Final Exemption for Trading on Behalf of Customers

The Agencies have carefully considered the comments and are adopting the exemption for trading on behalf of customers with several modifications. The Agencies believe that the final rule implements the exemption in section 13(d)(1)(D) in a manner consistent with the legislative intent to allow banking entities to use their own funds to purchase or sell financial instruments when acting on behalf of their customers.[1442] At the same time, the limited activities permitted under the final rule limit the potential for abuse.[1443]

The final rule slightly modifies the proposed rule by providing that a banking entity is not prohibited from trading on behalf of customers when that activity is conducted by the banking entity as trustee or in a similar fiduciary capacity for a customer and so long as the transaction is conducted for the account of, or on behalf of the customer and the banking entity does not have or retain a beneficial ownership of the financial instruments. The final rule removes the proposal's express exemption for investment advisers. After further consideration, the Agencies do not believe an express reference to investment advisers is necessary because investment advisers generally act in a fiduciary capacity on behalf of clients in a manner that is separately covered by other exclusions and exemptions in the final rule. Additionally, the final rule deletes the proposal's express exemption for commodity trading advisors because the legal relationship between a commodity trading advisor and its client depends on the facts and circumstances of each relationship. Therefore, the Agencies determined that it was appropriate to limit the discussion to fiduciary obligations generally and to omit any specific discussion of commodity trading advisors. In order to ensure that a banking entity utilizes this exemption to engage only in transactions for customers and not to conduct its own trading activity, the final rule (consistent with the proposed rule) requires that the purchase or sale of financial instruments be conducted for the account of the customer and that it involve solely financial instruments of which the customer, and not the banking entity, is beneficial owner.[1444] The final rule, like the proposed rule, permits transactions in any financial instrument, including derivatives such as foreign exchange forwards, so long as

[1426] *See* SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1427] *See, e.g.,* Alfred Brock; ICBA; Occupy.

[1428] *See* ICBA.

[1429] *See* Occupy.

[1430] *See* Public Citizen.

[1431] *See* Occupy; Alfred Brock.

[1432] *See* Occupy; Public Citizen. Conversely, other commenters supported the approach taken in the proposed rule without requesting such a definition. *See* Alfred Brock.

[1433] *See, e.g.,* Am. Express; SIMFA *et al.* (Prop. Trading) (Feb. 2012).

[1434] *See* Am. Express.

[1435] *See* ACLI; Chris Barnard; NAMIC; Fin. Services Roundtable (Feb. 3, 2012).

[1436] *See* Chris Barnard.

[1437] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1438] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1439] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1440] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1441] *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1442] *See* 156 Cong. Rec. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''this permitted activity is intended to allow financial firms to use firm funds to purchase assets on behalf of their clients, rather than on behalf of themselves.'').

[1443] Some commenters urged narrowing the exemption. *See, e.g.,* Alfred Brock; ICBA; Occupy. The Agencies believe the final rule is appropriately narrow to limit potential abuse.

[1444] *See* final rule § 75.6(c)(1)(ii)–(iii). *See also* proposed rule § 75.6(b)(2)(i)(B)–(C).

those transactions are on behalf of customers.[1445]

While some commenters requested that the final rule define ''customer'' for purposes of this exemption,[1446] the Agencies believe the requirements of this exemption address commenters' underlying concerns about what constitutes a ''customer.'' Specifically, the Agencies believe that requiring a transaction relying on this exemption to be conducted in a fiduciary capacity for a customer, to be conducted for the account of the customer, and to involve solely financial instruments of which the customer is beneficial owner address the underlying concerns that a transaction could qualify for this exemption if done on behalf of an indirect customer or on behalf of a customer not served by the banking entity.

The final rule also provides that a banking entity may act as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset the contemporaneous sale of the financial instrument to (purchase from) the customer.[1447] Any transaction conducted pursuant to the exemption for riskless principal activity must be customer-driven and may not expose the banking entity to gains (or losses) on the value of the traded instruments as principal.[1448] Importantly, the final rule does not permit a banking entity to purchase (or sell) a financial instrument without first having a customer order to buy (sell) the instrument. While some commenters requested that the Agencies modify the final rule to permit activity without a customer order,[1449] the Agencies are concerned that broadening the exemption in this manner would enable banking entities to evade the requirements of section 13 and engage in prohibited proprietary trading under the guise of trading on behalf of customers.

Several commenters requested that the final rule explain how a banking entity may determine when it is acting as riskless principal.[1450] The Agencies note that riskless principal transactions typically are undertaken as an alternative method of executing orders by customers to buy or sell financial instruments on an agency basis. Acting as riskless principal does not include acting as underwriter or market maker in the particular financial instrument and is generally understood to be equivalent to agency or brokerage transactions in which all of the risks associated with ownership of financial instruments are borne by customers. The Agencies have generally equivalent standards for determining when a banking entity acts as riskless principal and require that the banking entity, after receiving an order to buy (or sell) a financial instrument from a customer, buys (or sells) the instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.[1451] The Agencies intend to determine whether a banking entity acts as riskless principal in accordance with and subject to the requirements of these standards.

Some commenters requested that the final rule permit a greater variety of transactions to be conducted on behalf of customers. Many of these transactions, such as transactions that facilitate customer liquidity needs or block positioning transactions [1452] or transactions in which the banking entity acts as principal to accommodate a customer and substantially and promptly hedges the risks of the transaction,[1453] may be permissible under the market-making exemption. To the extent these transactions are conducted by a market maker, the Agencies believe that the restrictions and limits required in connection with market making-related activities are important for limiting the risks to the banking entity from these transactions.[1454] While some commenters requested that clearing and settlement activities and prime brokerage activities be viewed as permitted proprietary trading on behalf of customers,[1455] these transactions are not considered proprietary trading as an initial matter under the final rule.[1456]

Finally, the Agencies have decided to move the exemption for trading activity conducted by an insurance company for a separate account into the provision exempting trading activity in an insurance company's general account in order to better align the two exemptions.[1457] As discussed below in Part VI.A.7., the final rule provides exemptions for trading activity conducted by an insurance company that is a banking entity either in the general account or in a separate account of customers in § 75.6(d). As explained below, the statute specifically exempts trading activity that is conducted by a regulated insurance company engaged in the business of insurance for the general account of the company if conducted in accordance with applicable state law and if not prohibited by the appropriate Federal banking agencies.[1458] Unlike activity for the general account of an insurance company, investments made by regulated insurance companies in separate accounts in accordance with applicable state law are made on behalf of and for the benefit of customers of the insurance company.[1459] Also unlike

[1445] Some commenters expressed concern that the proposed exemption for trading on behalf of customers may be construed to not permit transactions in foreign exchange forwards and other derivatives. *See* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1446] *See* Occupy; Public Citizen.

[1447] *See* final rule § 75.6(c)(2).

[1448] Some commenters urged the Agencies to ensure that the banking entity passes on all gains (or losses) from the transaction to the customers. *See* Occupy; Public Citizen.

[1449] *See* RBC; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1450] *See, e.g.,* Am. Express; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1451] *See, e.g.,* 12 CFR 225.28(b)(7)(ii); 17 CFR 240.3a5–1(b); OCC Interpretive Letter 626 (July 7, 1993). One commenter stated that a banking entity should only be allowed to engage in a riskless principal transaction where the banking entity has already arranged for another customer to be on the other side of the transaction. *See* Public Citizen. The Agencies believe that the contemporaneous requirement in the final rule addresses this comment.

[1452] One commenter requested an exemption for transactions at the instruction or request of a customer or client or in anticipation of such an instruction or request, such as facilitating customer liquidity needs or block positioning transactions. *See* RBC.

[1453] Some commenters requested an exemption for these types of transactions. *See* BoA; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1454] Some commenters stated that the potential uncertainty and costs of determining whether an activity qualifies for the market-making exemption would discourage banking entities from taking principal risks to accommodate customer needs. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies believe that adjustments made to the market-making exemption in the final rule help address this concern. Specifically, the final market-making exemption better accounts for the varying characteristics of market-making across markets and assets classes.

[1455] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1456] *See* final rule § 75.3(d)(4)–(6). *See also infra* Part VI.A.1.d.3–4.

[1457] Some commenters requested that the Agencies more closely align the exemptions for trading by an insurance company for the general account and separate account. *See* ACLI; Sutherland (on behalf of Comm. of Annuity Insurers); Fin. Services Roundtable (Feb. 3, 2012); NAMIC.

[1458] *See* 12 U.S.C. 1851(d)(1)(F).

[1459] One commenter requested clarification on who may qualify as a permissible owner of an insurance policy to whom the profits and losses arising from the purchase or sale of a financial instrument allocated to the separate account may inure. *See* Chris Barnard. The Agencies note that the proposed requirement that all profits and losses arising from the purchase or sale of a financial instrument inure to the benefit or detriment of the ''owners of the insurance policies supported by the separate account'' has been removed. *See* proposed rule § 75.6(b)(2)(iii)(C). Instead, the final rule requires that the income, gains, and losses from assets allocated to a separate account be credited to

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general accounts (which are supported by all of the assets of the insurance company), a separate account is supported only by the assets in that account and does not have call on the other assets of the company. The customer benefits (or loses) based solely on the performance of the assets in the separate account. These arrangements are the equivalent for insurance companies of fiduciary accounts at banks. For these reasons, the final rule recognizes that separate accounts at regulated insurance companies maintained in accordance with applicable state insurance laws are exempt from the prohibitions in section 13 as acquisitions on behalf of customers.

7. Section 75.6(d): Permitted Trading by a Regulated Insurance Company

Section 13(d)(1)(F) permits a banking entity that is a regulated insurance company acting for its general account, or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions (the ''general account exemption'').[1460] Section 13(d)(1)(D) permits a banking entity to purchase or sell a financial instrument on behalf of customers.[1461] In the proposed rule, the Agencies viewed Section 13(d)(1)(D) as permitting an insurance company to purchase or sell a financial instrument for certain separate accounts (the ''separate account exemption''). The proposal implemented both these exemptions with respect to activities of insurance companies, in each case subject to the restrictions discussed below.[1462]

Section 75.6(c) of the proposed rule implemented the general account exemption by generally restating the statutory requirements of the exemption that:

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

The proposed rule defined the term ''general account'' to include all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State law.[1463]

As noted above in Part VI.A.6.a., § 75.6(b)(iii) of the proposed rule provided an exemption for a banking entity that is an insurance company when it acted through a separate account for the benefit of insurance policyholders. The proposed rule defined a ''separate account'' as an account established or maintained by a regulated insurance company subject to regulation by a State insurance regulator or foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[1464]

To limit the potential for abuse of the separate account exemption, the proposed rule included requirements designed to ensure that the separate account trading activity is subject to appropriate regulation and supervision under insurance laws and not structured so as to allow gains or losses from trading activity to inure to the benefit or detriment of the banking entity.[1465] In particular, the proposed rule provided that a purchase or sale of a financial instrument qualified for the separate account exemption only if:

- The banking entity is an insurance company directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;[1466]
- The banking entity purchases or sells the financial instrument solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;
- All profits and losses arising from the purchase or sale of the financial instrument are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the banking entity; and
- The purchase or sale is conducted in compliance with, and subject to, the insurance company investment and other laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.

The proposal explained that the proposed separate account exception represented transactions on behalf of customers because the insurance-related transactions are generally customer-driven and do not expose the banking entity to gains or losses on the value of separate account assets, even though the banking entity may be treated as the owner of those assets for certain purposes.

Commenters generally supported the general account exemption and the separate account exemption for regulated insurance companies as consistent with both the statute and Congressional intent to accommodate the business of insurance.[1467] For instance, commenters argued that the statute was designed to appropriately accommodate the business of insurance, subject to regulation in accordance with relevant insurance company investment laws, in recognition that insurance company investment activities are already subject to comprehensive regulation and oversight.[1468]

A few commenters expressed concerns about the definition of ''general account'' and ''separate

or charged against the account without regard to other income, gains or losses of the insurance company. *See* final rule § 75.2(z) (definition of ''separate account''). Thus, the final rule no longer references ''owners of the insurance policies supported by the separate account.'' The Agencies note, however, that the final rule requires exempted separate account transactions to be ''conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled.'' *See* final rule § 75.6(d)(3).

[1460] *See* 12 U.S.C. 1851(d)(1)(F).

[1461] *See* 12 U.S.C. 1851(d)(1)(D).

[1462] *See* proposed rule §§ 75.6(b)(2)(iii), 75.6(c).

[1463] *See* proposed rule § 75.3(c)(6).

[1464] *See* proposed rule § 75.2(z).

[1465] The Agencies noted in the proposal they would not consider profits to inure to the benefit of the banking entity if the banking entity were solely to receive payment, out of separate account profits, of fees unrelated to the investment performance of the separate account.

[1466] The proposed rule provided definitions of the terms ''State insurance regulator'' and ''foreign insurance regulator.'' *See* proposed rule § 75.3(c)(4), (13).

[1467] *See, e.g.,* Alfred Brock; Chris Barnard; Fin. Services Roundtable (Feb. 3, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); TIAA–CREF; NAMIC.

[1468] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Country Fin. *et al.*; Sutherland (on behalf of Comm. of Annuity Insurers).

account.'' [1469] One commenter argued the definition of general account was unclear.[1470] A few commenters expressed concern that the proposed definition of separate account inappropriately excluded some separate accounts, such as certain insurance company investment activities such as guaranteed investment contracts, which would also not fall within the proposed definition of general account.[1471] Several commenters argued that the final rule should be modified so that all insurance company investment activity permitted under applicable insurance laws would qualify for either the general account exemption or the separate account exemption.[1472]

Some commenters argued that the prohibition in the proposed definition of separate account against any profits or losses from activity in the account inuring to the benefit (or detriment) of the insurance company would exclude some activity permitted by insurance regulation in separate accounts.[1473] For example, commenters contended that an insurer may allocate its own funds to a separate account as ''seed money'' and the profits and losses on those funds inure to the benefit or detriment of the insurance company.[1474]

Some commenters expressed specific concerns about the scope or requirements of the proposal. For instance, one commenter argued that the final rule should provide that a trade is exempt if the trade is made by an affiliate of the insurance company in accordance with state insurance law.[1475] Another commenter urged that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign insurance company was inconsistent with the safety and soundness or financial stability.[1476]

One commenter suggested that insurance company affiliates of banking entities should expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[1477] By contrast, other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities.[1478] These commenters argued that insurance companies are already subject to comprehensive regulation of the kinds and amounts of investments they can make under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits.

After considering the comments received and the language and purpose of the statute, the final rule has been modified to better account for the language of the statute and more appropriately accommodate the business of insurance.

As explained in the proposal, section 13(d)(1)(F) of the BHC Act specifically and broadly exempts the purchase, sale, acquisition, or disposition of securities and other instruments by a regulated insurance company engaged in the business of insurance for the general account of the company (and by an affiliate solely for the general account of the regulated insurance company). Section 13(d)(1)(D) of the statute also specifically exempts the same activity when done on behalf of customers. As explained in the proposal, separate accounts managed and maintained by insurance companies as part of the business of insurance are generally customer-driven and do not expose the banking entity to gains or losses on the value of assets held in the separate account, even though the banking entity may be treated as the owner of the assets for certain purposes. Unlike the general account of the insurance company, separate accounts are managed on behalf of specific customers, much as a bank would manage a trust or fiduciary account.

For these reasons, the final rule retains both the general account exemption and the separate account exemption. The final rule removes any gap between the definition of general account and the definition of separate account by defining the general account to be all of the assets of an insurance company except those allocated to one or more separate accounts.[1479]

The final rule also combines the general account exemption and the separate account exemption into a single section. This makes clear that both exemptions are available only:

- If the insurance company or its affiliate purchases or sells the financial instruments solely for the general account of the insurance company or a separate account of the insurance company;
- The purchases or sales of financial instruments are conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and
- The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance regarding insurance is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[1480]

Like section 13(d)(1)(F) of the BHC Act, the final rule permits an affiliate of an insurance company to purchase and sell financial instruments in reliance on the general account exemption, so long as that activity is for the general account of the insurance company. Similarly, the final rule implements section 13(d)(1)(D) and permits an affiliate of an insurance company to purchase and sell financial instruments for a separate account of the insurance company, so long as the separate account is

[1469] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); Sutherland (on behalf of Comm. of Annuity Insurers).

[1470] *See* Sutherland (on behalf of Comm. of Annuity Insurers).

[1471] *See* ACLI (Jan. 2012); NAMIC.

[1472] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; *see also* Nationwide.

[1473] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* Nationwide.

[1474] *See* Fin. Services Roundtable (Feb. 3, 2012); ACLI (Jan. 2012).

[1475] *See* USAA.

[1476] *See* HSBC Life.

[1477] *See* Sens. Merkley & Levin (Feb. 2012).

[1478] *See* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); Mutual of Omaha; NAMIC.

[1479] *See* final rule § 75.2(p), (bb). Some commenters expressed concerns about the proposed definitions of ''general account'' and ''separate account,'' including that the proposed definition of ''separate account'' excluded some legitimate separate account activities that do not fall within the proposed general account definition. *See, e.g.,* ACLI (Jan. 2012); NAMIC; Sutherland (on behalf of Comm. of Annuity Insurers). *See also* proposed rule §§ 75.2(z), 75.3(c)(5).

[1480] The Federal banking agencies have not at this time determined, as part of the final rule, that the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States. The Federal banking agencies expect to monitor, in conjunction with the FSOC, the insurance company investment laws, regulations, and written guidance of States or jurisdictions to which exempt transactions are subject and make such determinations in the future, where appropriate. The Agencies believe the final approach addresses one commenter's request that the Agencies consult with the foreign insurance supervisor of an insurance company regulated outside of the United States before finding that an insurance activity conducted by the foreign company was inconsistent with the safety and soundness or financial stability. *See* HSBC Life.

established and maintained at the insurance company.

Importantly, the final rule applies only to covered trading activity in a general or separate account of a licensed insurance company engaged in the business of insurance under the supervision of a State or foreign insurance regulator. As in the statute, an affiliate of an insurance company may not rely on this exemption for activity in any account of the affiliate (unless it, too, meets the definition of an insurance company). An affiliate may rely on the exemption to the limited extent that the affiliate is acting solely for the account of the insurance company.[1481]

As noted above, one commenter requested that the final rule impose special data and reporting obligations on insurance companies. Other commenters argued that insurance companies are already subject to comprehensive regulation under insurance laws and regulations and that additional recordkeeping obligations would impose unnecessary compliance burdens on these entities without producing significant offsetting benefits. In accordance with the statute,[1482] the Agencies expect insurance companies to have appropriate compliance programs in place for any activity subject to section 13 of the BHC Act.

The final rule contains a number of other related definitions that are intended to help make clear the limitations of the insurance company exemption, including definitions of foreign insurance regulator and State insurance regulator.

8. Section 75.6(e): Permitted Trading Activities of a Foreign Banking Entity

Section 13(d)(1)(H) of the BHC Act[1483] permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States (the ''foreign trading exemption'').[1484] The statute does not define when a foreign banking entity's trading occurs solely outside of the United States.

The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and activity that constitutes trading solely outside of the United States. The proposed rule effectively precluded a foreign banking entity from engaging in proprietary trading through a transaction that had any connection with the United States, including: Trading with any party located in the United States; allowing U.S. personnel of the foreign banking entity to be involved in the purchase or sale; or executing any transaction in the United States (on an exchange or otherwise).[1485]

In general, commenters emphasized the importance of and supported an exemption for foreign trading activities of foreign banking entities. However, a number of commenters expressed concerns that the proposed foreign trading exemption was too narrow and would not be effective in permitting foreign banking entities to engage in foreign trading activities.[1486] For instance, many commenters stated that the proposal's prohibition on trading activities that have any connection to the U.S. was not consistent with the purpose of section 13 of the BHC Act where the risk of the trading activity is taken or held outside of the United States and does not implicate the U.S. safety net.[1487] These commenters argued that, since one of the principal purposes of section 13 of the BHC Act is to limit the risk posed by prohibited proprietary trading to the Federal safety net, the safety and soundness of U.S. banking entities, and the financial stability of the United States, the exemption for foreign trading activity should similarly focus on whether the trading activity involves principal risk being taken or held by the foreign banking entity inside the United States.[1488]

Many commenters argued that the proposal's transaction-based approach to implementing the foreign trading exemption would harm U.S. markets and U.S. market participants. For example, some commenters argued that the proposed exemption would cause foreign banks to exit U.S. markets or shrink their U.S.-based operations, thereby resulting in less liquidity and greater fragmentation in markets without producing any significant offsetting benefit.[1489] Commenters also asserted that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities and would lead to foreign firms refusing to trade with U.S. counterparties, including the foreign operations of U.S. entities, to avoid compliance costs associated with relying on another exemption under the proposed rule.[1490] Additionally, commenters argued that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[1491]

a. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(H) provides that, in order to be eligible for the foreign trading exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. The proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

Commenters generally supported this aspect of the proposal.[1492] However, some commenters requested that the final rule be modified to allow U.S. banking entities' affiliates or branches that are physically located outside of the United States (''foreign operations of U.S. banking entities'') to engage in proprietary trading outside of the United States pursuant to this

[1481] Although one commenter requested that the final rule exempt a trade as long as the trade is made by an affiliate of the insurance company in accordance with state insurance law, the Agencies believe the final approach properly implements the statute. *See* USAA.

[1482] *See* 12 U.S.C. 1851(e)(1) (requiring that the Agencies issue regulations regarding ''internal controls and recordkeeping, in order to insure compliance with this section'').

[1483] Section 13(d)(1)(H) of the BHC Act provides an exemption to the prohibition on proprietary trading for trading conducted by a foreign banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act, if the trading occurs solely outside of the United States, and the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(H).

[1484] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the rule's implementation of section 13(d)(1)(H) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[1485] *See* proposed rule § 75.6(d).

[1486] *See, e.g.,* IIB/EBF; ICI Global; ICI (Feb. 2012); Wells Fargo (Prop. Trading); BoA.

[1487] *See* IIB/EBF; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Seidel); Cadwalader (on behalf of Thai Banks).

[1488] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1489] *See* ICE; ICI Global; BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; IIB/EBF.

[1490] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA; Citigroup (Feb. 2012). As discussed below in Part VI.C. of this **SUPPLEMENTARY INFORMATION,** other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[1491] *See* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Commissioner Barnier; Ass'n. of German Banks; Société Générale; Chamber (Dec. 2012).

[1492] *See* Sens. Merkley & Levin (Feb. 2012) (arguing that the final rule's foreign trading exemption should not exempt foreign affiliates of U.S. banking entities when they engage in trading activity abroad); *see also* Occupy; Alfred Brock.

exemption.[1493] These commenters argued that, unless foreign operations of U.S. banking entities are provided similar authority to engage in proprietary trading outside of the United States, foreign operations of U.S. banking entities would be at a competitive disadvantage abroad with respect to foreign banking entities. One commenter also asserted that, unless foreign operations of U.S. banking entities were able to effectively access foreign markets, they could be shut out of those markets and would be unable to effectively manage their risks in a safe and sound manner.[1494]

As noted above, section 13(d)(1)(H) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[1495] Because of this express statutory threshold requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its trading activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act.[1496] The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[1497]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[1498] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[1499] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[1500] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[1501] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the exemption for proprietary trading activity of a foreign banking entity.[1502]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not currently subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of this exemption[1503] if the entity, on a fully-consolidated basis, meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[1504] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and section 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States.[1505] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the prohibition on proprietary trading.

b. Permitted Trading Activities of a Foreign Banking Entity

As noted above, the proposed rule laid out a transaction-based approach to

[1493] *See* Citigroup (Feb. 2012); Sen. Carper; IIF; ABA (Keating); Wells Fargo (Prop. Trading); Abbot Labs. *et* al. (Feb. 14, 2012).

[1494] *See* Citigroup (Feb. 2012).

[1495] *See* 12 U.S.C. 1851(d)(1)(H).

[1496] *See* final rule § 75.6(e)(1)(ii).

[1497] Section 75.6(e)(2) addresses only when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(H) of the BHC Act, are unable to rely on the foreign trading exemption.

[1498] *See* 12 U.S.C. 1843(c)(9).

[1499] *See* 12 CFR 211.20 *et seq.*

[1500] Commenters noted that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign trading exemption. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. Accordingly, the final rule does not retain the proposal's requirement that the activity be conducted in compliance with subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the exemption in section 13(d)(1)(H) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[1501] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule referenced only the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[1502] This modification to the definition of foreign banking organization is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State a commonwealth, territory or possession of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, or the United States Virgin Islands.

[1503] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[1504] *See* final rule § 75.6(e)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § 75.6(e)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

[1505] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § 75.6(e)(2)(ii)(B).

implementing the foreign trading exemption and provided that a transaction would be considered to qualify for the exemption only if (i) the transaction was conducted by a banking entity not organized under the laws of the United States or of one or more States; (ii) no party to the transaction was a resident of the United States; (iii) no personnel of the banking entity that was directly involved in the transaction was physically located in the United States; and (iv) the transaction was executed wholly outside the United States.[1506]

Many commenters objected to the proposed exemption, arguing that it was unworkable and would have unintended consequences. For example, commenters argued that prohibiting a foreign banking entity from conducting a proprietary trade with a resident of the United States, including a subsidiary or branch of a U.S. banking entity, wherever located, would likely cause foreign banking entities to be unwilling to enter into permitted trading transactions with foreign subsidiaries or branches of U.S. firms.[1507] In addition, some commenters represented that it would be difficult to determine and track whether a party is a resident of the United States or that this requirement would require non-U.S. banking entities to inefficiently bifurcate their activities into U.S.-facing and non-U.S.-facing trading desks.[1508] For example, one commenter noted that trading on many exchanges and platforms is anonymous (*i.e.,* each party to the trade is unaware of the identity of the other party to the trade), so a foreign banking entity would likely have to avoid U.S. trading platforms and exchanges entirely to avoid transactions with any resident of the United States.[1509] Further, commenters stated that the proposed rule could deter foreign banking entities from conducting business with U.S. parties outside of the United States, which could also incentivize foreign market centers to limit participation by U.S. parties on their markets.[1510]

Commenters also expressed concern about the requirement that transactions be executed wholly outside of the United States in order to qualify for the proposed foreign trading exemption. Commenters represented that foreign banking entities currently use U.S. trading platforms to trade in certain products (such as U.S.-listed securities or a variety of derivatives contracts), to take advantage of robust U.S. infrastructure, and for time zone reasons.[1511] Commenters indicated that the proposed requirement could harm the competitiveness of U.S. trading platforms and the liquidity available on such facilities.[1512] Some commenters stated that this requirement would effectively result in most foreign banking entities moving their trading operations and personnel outside of the United States and executing transactions on exchanges outside of the United States.[1513] These commenters stated that the relocation of these activities would reduce trading activity in the United States that supports the financial stability and efficiency of U.S. markets. Moreover, these commenters argued that, if foreign banking entities relocate their personnel from the United States to overseas, this would diminish U.S. jobs with no concomitant benefit. They also contended that the proposal was at cross purposes with other parts of the Dodd-Frank Act and would hinder growth of market infrastructure being developed under the requirements of Title VII of that Act, including use of swap execution facilities and security-based swap execution facilities to enhance transparency in the swaps markets and use of central clearinghouses to reduce counterparty risk for the parties to a swap transaction.[1514] For example, one commenter represented that the proposed exemption could make it difficult for non-U.S. swap entities to comply with potential mandatory execution requirements under Title VII of the Dodd-Frank Act and could cause market fragmentation across borders through the creation of parallel execution facilities outside of the United States, which would result in less transparency and greater systemic risk.[1515] In addition, another commenter stated that the proposed requirement would force issuers to dually list their securities to permit trading on non-U.S. exchanges and, further, clearing and settlement systems would have to be set up outside of the United States, which would create inefficiencies, operational risks, and potentially systemic risk by adding needless complexity to the financial system.[1516]

Instead of the proposal's transaction-based approach to implementing the foreign trading exemption, many commenters suggested the final rule adopt a risk-based approach.[1517] These commenters noted that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign trading activity of foreign banking entities.[1518] Commenters also noted that foreign trading activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[1519]

The Agencies have carefully considered these comments and have determined to modify the approach in the final rule. The Agencies believe that the revisions mitigate the potential adverse impacts of the proposed approach while still remaining faithful to the overall purpose of section 13(d)(1)(H). Also, the Agencies believe that section 13(d)(1)(J) of the BHC Act, which authorizes the Agencies to provide an exemption from the prohibition on proprietary trading for any activity the Agencies determine by rule ''would promote and protect the safety and soundness of the banking entity and the financial stability of the United States,'' [1520] supports allowing foreign banking entities to use U.S. infrastructure and trade with certain U.S. counterparties in certain circumstances, which will promote and protect the safety and soundness of banking entities and U.S. financial stability.

Overall, the comments illustrated that both the mechanical steps of the specified transactions to purchase or sell various instruments (*e.g.,* execution, clearing), and the identity of the entity for whose trading account the specified trading is conducted are important.[1521] Consistent with the comments described above, the Agencies believe that the

[1506] *See* proposed rule § 75.6(d).

[1507] *See* BoA; Citigroup (Feb. 2012); British Bankers' Ass'n.; Credit Suisse (Seidel); George Osbourne; IIB/EBF.

[1508] *See* Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Cadwalader (on behalf of Thai Banks); IIF; ICE; Banco de México; ICFR; Australian Bankers Ass'n. (Feb. 2012); BAROC.

[1509] *See* ICE.

[1510] *See, e.g.,* RBC.

[1511] *See, e.g.,* IIF; ICE; Société Générale; Mexican Banking Comm'n.; Australian Bankers Ass'n. (Feb. 2012); Banco de México; OSFI. In addition, a few commenters argued that Canadian and Mexican financial firms frequently use U.S. infrastructure to conduct their trading activities in Canada or Mexico. *See, e.g.,* OSFI; Banco de México; Mexican Banking Comm'n.

[1512] *See, e.g.,* ICE; Société Générale (arguing that the requirement would impair capital raising efforts of many U.S. companies); Australian Bankers Ass'n. (Feb. 2012); Canadian Minister of Fin.; Ass'n. of German Banks.

[1513] *See* IIB/EBF.

[1514] *See* Bank of Canada; Banco de México; Allen & Overy (on behalf of Canadian Banks).

[1515] *See* Allen & Overy (on behalf of Candian Banks).

[1516] *See* IIF.

[1517] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Seidel); George Osbourne.

[1518] *See* IIB/EBF.

[1519] *See* IIB/EBF.

[1520] *See* 12 U.S.C. 1851(d)(1)(J).

application of section 13(d)(1)(H) and their exemptive authority under section 13(d)(1)(J) should focus on both how the transaction occurs and which entity will bear the risk of those transactions. Although the statute does not define expressly what it means to act ''as a principal'' (acting as principal ordinarily means acting for one's own account), the combination of references to engaging as principal and to a trading account focuses on an entity's incurring risks of profit and loss through taking ownership of securities and other instruments. Thus, the final rule provides an exemption for trading activities of foreign banking entities that addresses both the location of the facilities that effect the acquisition, holding, and disposition of such positions, and the location of the banking entity that incurs such risks through acquisition, holding, and disposition of such positions.

The Agencies believe this approach is consistent with one of the principal purposes of section 13, which is to limit risks that proprietary trading poses to the U.S. financial system.[1522] Further, the purpose of section 13(d)(1)(H) is to limit the extraterritorial application of section 13 as it applies to foreign banking entities.[1523]

In addition, prohibiting foreign banking entities from using U.S. infrastructure or trading with all U.S. counterparties could cause certain trading activities to move offshore, with corresponding negative impacts on U.S. market participants, including U.S. banking entities. For example, movement of trading activities offshore, particularly in U.S. financial instruments, could result in bifurcated markets for these instruments that are less efficient and less liquid and could reduce transparency for oversight of trading in these instruments. In addition, reducing access to foreign counterparties for U.S. instruments could concentrate risks in the United States and to its financial system. Moreover, the statute provides separate exemptions for U.S. banking entities to engage in underwriting and market making-related activities, subject to certain requirements, and there is no evidence that limiting the range of potential customers for these entities would further the purposes of the statute. In fact, it is possible that limiting the customer bases of U.S. banking entities, as well as other U.S. firms that are not banking entities, could reduce their ability to effectively manage their inventories and risks and could also result in concentration risk.

These potential effects of the approach taken in the proposal appear to be inconsistent with the statute's goals, including the promotion and protection of the safety and soundness of banking entities and U.S. financial stability. To the contrary, the exemptive approach taken in the final rule appears to be more consistent with the goals of the statute and would promote and protect the safety and soundness of banking entities and U.S. financial stability by limiting the risks of foreign banking entities' proprietary trading activities to the U.S. financial system, while also allowing U.S. markets to continue to operate efficiently in conjunction with foreign markets (rather than creating incentives to establish barriers between U.S. and foreign markets).[1524]

Thus, in response to commenter concerns, the final rule has been modified to better reflect the text and achieve the overall purposes of the statute (by ensuring that the principal risks of proprietary trading by foreign banking entities allowed under the foreign trading exemption remain solely outside of the United States) while mitigating potentially adverse effects on competition.[1525] In order to ensure these risks remain largely outside of the United States, and to limit potential risk that could flow to the U.S. financial system through trades by foreign banking entities with or through U.S. entities, the final rule includes several conditions on the availability of the exemption. Specifically, in addition to limiting the exemption to foreign banking entities, the final rule provides that the exemption for the proprietary trading activity of a foreign banking entity is available only if:

- The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;[1526]
- The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;
- The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;
- No financing for the banking entity's purchase or sale is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;[1527]
- The purchase or sale is not conducted with or through any U.S. entity,[1528] other than:
  - A purchase or sale with the foreign operations of a U.S. entity, if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation or execution of such purchase or sale.

The Agencies believe it is appropriate to exercise their exemptive authority under section 13(d)(1)(J) to also allow, under clause (vi) of the final rule, the following types of purchases or sales conducted with a U.S. entity:

- A purchase or sale with an unaffiliated market intermediary acting as principal,[1529] provided the purchase

[1522] *See, e.g.,* 12 U.S.C. 1851(b)(1) (directing the FSOC to study and make recommendations on implementing section 13 so as to, among other things, protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities).

[1523] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (stating that the foreign trading exemption ''recognize[s] rules of international comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law.'').

[1524] 12 U.S.C. 1851(d)(1)(J).

[1525] The proposed rule also contained a definition of ''resident of the United States'' that was designed to capture the scope of U.S. counterparties that, if involved in the transaction, would preclude that transaction from being considered to have occurred solely outside the United States. The final rule addresses this point by including a definition, for purposes of § 75.6(e) only, of the term ''U.S. entity.''

[1526] Personnel that arrange, negotiate, or execute a purchase or sale conducted under the exemption for trading activity of a foreign banking entity must be located outside of the United States. Thus, for example, personnel in the United States cannot solicit or sell to or arrange for trades conducted under this exemption. Personnel in the United States also cannot serve as decision makers in transactions conducted under this exemption. Personnel that engage in back-office functions, such as clearing and settlement of trades, would not be considered to arrange, negotiate, or execute a purchase or sale for purposes of this provision.

[1527] This provision is not intended to restrict the ability of a U.S. branch or affiliate of a foreign banking entity to provide funds collected in the United States to its foreign parent for general purposes.

[1528] ''U.S. entity'' is defined for purposes of this provision as any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State. *See* final rule § 75.6(e)(4).

[1529] This provision would generally allow market intermediaries to engage in market-making, underwriting or similar market intermediation functions.

or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

○ A purchase or sale through an unaffiliated market intermediary, provided the purchase or sale is conducted anonymously (i.e. each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale) on an exchange or similar trading facility and promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

The requirements are designed to ensure that any foreign banking entity engaging in trading activity under this exemption does so in a manner that ensures the risk, decision-making, arrangement, negotiation, execution and financing of the activity resides solely outside the United States and limits the risk to the U.S. financial system from trades by foreign banking entities with or through U.S. entities.

The final rule specifically recognizes that, for purposes of the exemption for trading activity of a foreign banking entity, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[1530] This provision helps give effect to the statutory language limiting the foreign trading exemption to activities of foreign banking entities that occur solely outside of the United States by clarifying that the U.S. operations of foreign banking entities may not conduct proprietary trading based on this exemption.

The Agencies have considered whether the concerns raised by commenters that the foreign operations of U.S. banking entities would be disadvantaged in competing outside the United States warrant an exemption under section 13(d)(1)(J) of the BHC Act that extends to foreign operations of U.S. banking entities. The competitiveness of U.S. banking entities outside the United States often improves the potential for the operations of U.S. firms outside the United States to succeed and be profitable, and thereby, often improves the safety and soundness of the entity and financial stability in the United States.

However, Congress has determined to generally prohibit U.S. banking entities (including foreign branches and subsidiaries thereof) from engaging in proprietary trading because of the perceived risks of those activities to banking entities and the U.S. economy.[1531] Allowing U.S. banking entities to conduct, through branches or subsidiaries that are physically located outside the United States, the same proprietary trading activities those U.S. firms are expressly prohibited from conducting directly through their operations located within the United States would subject U.S. banking entities and the U.S. economy to the very risks section 13 is designed to avoid. The risks of proprietary trading would continue to be borne by the U.S. banking entity whether the activity is conducted by the U.S. banking entity through units physically located inside or outside of the United States. Moreover, the robust trading markets that exist overseas could allow U.S. banking entities to shift their prohibited proprietary trading activities to branches or subsidiaries that are physically located outside the United States under such an exemption, without achieving a meaningful elimination of risk. Accordingly, the Agencies have not exercised their authority under section 13(d)(1)(J) at this time to allow U.S. banking entities to conduct otherwise prohibited proprietary trading activities through operations located outside the United States. As a consequence, and consistent with the statutory language and purpose of section 13(d)(1)(H) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under, or directly or indirectly controlled by a banking entity that is organized under, the laws of the United States or of one or more States.[1532]

As discussed above, many commenters requested that the final rule permit a foreign banking entity to engage in proprietary trading transactions with a greater variety of counterparties, including counterparties that are located in or organized and incorporated under the laws of the United States or of one or more States.[1533] These commenters also requested that the final rule not require that any purchase or sale under the exemption be executed wholly outside of the United States.

As described above and in response to commenters' concerns, the final rule provides that a foreign banking entity generally may engage in trading activity under the exemption with U.S. entities, provided the transaction is with the foreign operations of an unaffiliated U.S. firm (whether or not the U.S. firm is a banking entity subject to section 13 of the BHC Act) and does not involve any personnel of the U.S. entity that are in the United States and involved in the arrangement, negotiation, or execution of the transaction. The Agencies have also exercised their exemptive authority under section 13(d)(1)(J) to allow foreign banking entities to engage in a transaction that is either through an unaffiliated market intermediary and executed anonymously on an exchange or similar trading facility (regardless of whether the ultimate counterparty is a U.S. entity or not) or is executed with a U.S. entity that is an unaffiliated market intermediary acting as principal, provided in either case that the transaction is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty.

For purposes of the final rule, market intermediary is defined as an unaffiliated entity, acting as an intermediary, that is: (i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such; (ii) a swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such; (iii) a security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or (iv) a futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.[1534]

These provisions of the final rule, viewed as a whole, prevent the

[1530] *See* final rule § 75.6(e)(5).

[1531] *See, e.g.,* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (''However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly.'').

[1532] *See* final rule § 75.6(e)(1)(i).

[1533] A number of commenters also requested that the foreign trading exemption permit proprietary trading of foreign sovereign debt or similar obligations of foreign governments. As discussed in Part VI.A.5.b. of this **SUPPLEMENTARY INFORMATION**, the final rule addresses banking entities' ability to engage in transaction in these types of instruments in § 75.6(b).

[1534] *See* final rule § 75.6(e)(5). For example, under this definition, a bank that is exempt from registration as a swap dealer under the de minimis exception to swap dealer registration requirements could be a market intermediary for transactions in swaps. *See* 17 CFR 1.3(ggg)(4).

exemption for trading of foreign banking entities from weakening U.S. trading markets and U.S. firms that are either not subject to the provisions of section 13 or that conduct activities in compliance with other parts of section 13. For instance, the final rule permits a foreign banking entity to trade under the exemption with the foreign operations of a U.S. firm, so long as the purchase or sale does not involve any personnel of the U.S. firm who are located in the United States and involved in arranging, negotiating or executing the trade.[1535] Transactions that occur outside of the United States between foreign operations of U.S. entities and foreign banking entities improve access to and functioning of liquid markets without raising the concerns for increased risk to banking entities in the U.S. that motivated enactment of section 13 of the BHC Act. The final rule permits a foreign banking entity to engage in transactions with the foreign operations of both U.S. non-banking and U.S. banking entities. Among other things, this approach will ensure that the foreign operations of U.S. banking entities continue to be able to access foreign markets.[1536] The language of the exemption expressly requires that trading with the foreign operations of a U.S. entity may not involve the use of personnel of the U.S. entity who are located in the United States for purposes of arranging, negotiating, or executing transactions.

Under the final rule, the exemption in no way exempts the U.S. or foreign operations of the U.S. banking entities from having to comply with the restrictions and limitations of section 13. Thus, the U.S. and foreign operations of a U.S. banking entity that is engaged in permissible market making-related activities or other permitted activities may engage in those transactions with a foreign banking entity that is engaged in proprietary trading in accordance with the exemption under § 75.6(e) of the final rule. Importantly, the final rule does not impose a duty on the foreign banking entity or the U.S. banking entity to ensure that its counterparty is conducting its activity in conformance with section 13 of the BHC Act and the final rule. Rather, that burden is at all times on each party subject to section 13 to ensure that it is conducting its activities in accordance with section 13 and this implementing rule.

The final rule also permits, pursuant to section 13(d)(1)(J), a foreign banking entity to trade through an unaffiliated market intermediary if the trade is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization.[1537] Allowing foreign banking entities to generally conduct anonymous proprietary trades on U.S. exchanges and similar anonymous trading facilities allows these exchanges and facilities—which are generally not subject to section 13 and do not take the risks section 13 is designed to address—to serve the widest possible range of counterparties. This prevents the potential adverse impacts from possible reductions in competitiveness of or liquidity available on these regulated exchanges and facilities, which could also harm other U.S. market participants who trade on these exchanges and facilities. In addition, the Agencies recognize that anonymous trading on exchanges and similar anonymous trading facilities promotes transparency and that prohibiting foreign banking entities from trading on U.S. exchanges and similar anonymous trading facilities under this exemption would likely reduce transparency for trading in U.S. financial instruments. All of these considerations support the Agencies' exercise of their exemptive authority under section 13(d)(1)(J) to allow such trading by foreign banking entities.

The final rule requires that foreign banking entities trade through an unaffiliated market intermediary to access a U.S. exchange or trading facility in recognition that existing laws and regulations generally require this structure.[1538] For purposes of this exemption, an exchange would include, unless the context otherwise requires, any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, and any exchange or security-based swap execution facility, as such terms are defined under the Exchange Act.[1539]

This provision of the final rule requires that foreign banking entities trade anonymously and that the trade be centrally cleared and settled. The Agencies understand that in these circumstances, the foreign banking entity would not have any prior information regarding its counterparty to the trade. Requiring that the trade be executed anonymously preserves the benefits of allowing U.S. entities to participate in such trades, while reducing the potential for evasion of section 13 that could occur if foreign banking entities directly arranged purchases and sales with U.S. entities.[1540] The final rule specifies that a trade is anonymous if each party to the purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. That is, it is lack of knowledge of the identity of the counterparty(ies) to the trade that is relevant. The final rule does not prohibit foreign banking entities from accessing a trading facility through an unaffiliated U.S. market intermediary (which the foreign banking entity would necessarily know), so long as the foreign banking entity is not aware of the identity of the counterparty to the transaction.

Similarly, also pursuant to section 13(d)(1)(J), the final rule allows a foreign banking entity to trade with an unaffiliated market intermediary acting in a principal capacity and effecting a market intermediation function, in a transaction that is not conducted on an exchange or similar anonymous trading facility, as long as the trade is promptly cleared and settled through a clearing agency or derivatives clearing organization. This provision recognizes that not all financial instruments are traded on an exchange or similar anonymous trading facility and, thus, allows foreign banking entities to trade and contribute to market liquidity in all types of U.S. financial instruments without requiring separate market infrastructure to be developed outside the U.S. for such trading activity, which could result in inefficiencies and reduce U.S. market liquidity. Market intermediaries can serve the same general purpose as exchanges or similar trading facilities in intermediating between buyers and sellers, particularly in asset classes that do not generally trade on these exchanges or facilities, although this intermediation function

[1535] *See* final rule § 75.6(e)(3)(v)(A).

[1536] The Agencies believe that this provision should address commenters' concerns that the proposed rule could cause foreign banking entities to avoid conducting business with U.S. firms outside the United States or could incentivize foreign market places to restrict access to U.S. firms. *See, e.g.,* RBC.

[1537] Under the final rule, ''anonymous'' means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale. *See* final rule § 75.3(e)(1).

[1538] *See, e.g.,* 15 U.S.C. 78f(c)(1) (providing that a national securities exchange shall deny membership to (A) any person, other than a natural person, which is not a registered broker or dealer or (B) any natural person who is not, or is not associated with, a registered broker or dealer).

[1539] *See* final rule § 75.3(e)(6) (defining the term ''exchange''). The rule refers to an ''exchange or similar trading facility.'' A similar trading facility for these purposes may include, for example, an alternative trading system.

[1540] In addition, allowing a foreign banking entity to trade directly with a U.S. end user customer under the foreign trading exemption could give the foreign banking entity a competitive advantage over U.S. banking entities with respect to trading in the United States.

may not be as immediate in the case of market intermediaries.

In either case (*i.e.,* for either an anonymous trade or a trade with an unaffiliated market intermediary), if the U.S. counterparty to the transaction is a banking entity subject to section 13 and these rules, it must comply with an exemption to the prohibition on proprietary trading, such as the market-making exemption or the exemption for riskless principal transactions. Allowing foreign banking entities to trade with unaffiliated U.S. market intermediaries, including banking entities engaged in permitted market making-related activities, expands the range of potential buyers and sellers for which the U.S. entities can trade and may result in more efficient and timely matching of trades, reducing inventory risks to the U.S. market intermediary. At the same time, this exemption does not permit a U.S. market intermediary that is subject to section 13 of the BHC Act to conduct trading activities other than in compliance with the provisions of section 13. Thus, the Agencies believe it is appropriate to allow foreign banking entities to conduct such trading under the exemption in section 13(d)(1)(J).

To reduce risks to U.S. entities and the potential for evasion, the provisions allowing trading with U.S. entities include two additional protections. First, the final rule does not allow a foreign banking entity to trade through an affiliated U.S. entity under the exemption out of concern that it could increase the risk of evasion.[1541] Second, a foreign banking entity's trades conducted through an unaffiliated market intermediary on an exchange or conducted directly with an unaffiliated market intermediary must be promptly cleared and settled through a clearing agency or derivatives clearing organization acting as central counterparty. Consistent with the goals of section 13 to reduce risk to banking entities and the U.S. financial system, this requirement is designed to reduce risk to U.S. entities arising from foreign banking entities' proprietary trading activity, particularly counterparty risk, and preclude foreign banking entities from relying on the exemption for trading that creates exposure of U.S. counterparties pursuant to bilateral, uncleared transactions, which poses heightened counterparty credit risks.[1542] This condition is also consistent with the systemic risk benefits of central clearing and may incentivize the use of central clearing for trading by foreign banking entities and foreign affiliates of U.S. banking entities. The Agencies believe this approach is consistent with and reinforces the goals of the central clearing framework of Title VIII of the Dodd-Frank Act.

The final rule does not allow a foreign banking entity to trade with a broader range of U.S. entities under the exemption because the Agencies are concerned such an approach may result in adverse competitive impacts between U.S. banking entities and foreign banking entities with respect to their trading in the United States, which could harm the safety and soundness of banking entities and U.S. financial stability. For example, such an approach could allow foreign banking entities to act as market makers for U.S. customers under the exemption in § 75.6(e) of the final rule so long as the foreign banking entity held the risk of its market-making trades outside the United States. In turn, this could give foreign banking entities a competitive advantage over U.S. banking entities with respect to U.S. market-making activities because foreign banking entities could trade directly with U.S. non-banking entities without incurring the additional costs, or being subject to the limitations, associated with the market-making or other exemptions under the rule. This competitive disparity in turn could create a significant potential for regulatory arbitrage. The Agencies do not believe this result was intended by the statute. Instead, the final rule seeks to alleviate the concern that an overly broad approach to the exemption (*e.g.,* permitting trading with all U.S. counterparties) may result in competitive impacts and increased risks to the U.S. financial system, while mitigating the concern that an overly narrow approach to the exemption (*e.g.,* prohibiting trading with any U.S. counterparty) may cause market bifurcations, reduce the efficiency and liquidity of markets, and harm U.S. market participants.

9. Section 75.7: Limitations on Permitted Trading Activities

Section 75.8 of the proposed rule implemented section 13(d)(2) of the BHC Act,[1543] which provides that a banking entity may not engage in certain exempt activities (*e.g.,* permitted market making-related activities, risk-mitigating hedging, etc.) if the activity would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or pose a threat to the safety and soundness of the banking entity or U.S. financial stability.[1544] The Agencies sought comment on proposed definitions of the terms ''material conflict of interest,'' ''high-risk asset,'' and ''high-risk trading strategy'' for these purposes.

With respect to general comments regarding the proposed rule, commenters generally agreed on the need to limit banking entities' proprietary trading activities so as to avoid material conflicts of interest and material exposures to high-risk trading strategies and high-risk assets.[1545] One commenter expressed support for the Agencies' proposed approach, stating that the proposed rule was clear and structured in such a manner so that it should remain effective even as financial markets evolve and change.[1546] As discussed in greater detail below, most commenters suggested amendments, clarification, or alternative approaches. For example, some commenters expressed concern regarding the application of the prudential backstops to the activities of foreign banking entities.[1547] The Agencies did not receive any comments on the prohibition against transactions or activities that pose a threat to the safety or soundness of the banking entity or the financial stability of the United States.

As explained in detail below, the Agencies have carefully reviewed

[1541] In addition, allowing a foreign banking entity to trade through or with a U.S. affiliate under the exemption for trading activity of a foreign banking entity could give the foreign banking entity a competitive advantage over U.S. banking entities that are subject to limitations on their trading activities. Thus, the Agencies are not permitting a foreign banking entity to trade through a U.S. affiliate as agent, as requested by some commenters. *See, e.g.,* IIB/EBF. However, the Agencies recognize that, with respect to trading anonymously, there is no way to know the identity of the counterparty to the trade. Thus, a foreign banking entity would not be in violation of this rule if it traded through an unaffiliated market intermediary on an exchange, in accordance with the exemption for trading activity of a foreign banking entity, and the counterparty to its trade happened to be an affiliated entity.

[1542] As discussed above, centralized clearing redistributes counterparty risk among members of a clearing agency or derivatives clearing organization through mutualization of losses, reducing the likelihood of sequential counterparty failure and contagion. *See supra* note 271 and accompanying text.

[1543] Section 75.8 of the proposed rule regarding limitations on permitted trading activities is consistent with § 75.17 of the proposed rule regarding other limitations on permitted covered funds activities. Accordingly, the discussion regarding proposed rule § 75.8 and final rule § 75.7 in this part also pertain to § 75.17 of the proposed rule and § 75.16 of the final rule. *See also* Part VI.B.6., *infra.*

[1544] *See* 12 U.S.C. 1851(d)(2).

[1545] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); Public Citizen; Paul Volcker.

[1546] *See* Alfred Brock.

[1547] *See* IIB/EBF; Ass'n. of German Banks.

comments on the proposed rule's implementation of the prudential backstops under section 13(d)(2) of the BHC Act, including commenters' suggestions for expanding, contracting, or revising the proposed rule. After carefully considering these comments, the Agencies continue to believe the expansive scope of section 13 of the BHC Act supports a similarly inclusive approach focusing on the facts and circumstances of each potential conflict or high-risk activity. Therefore, and in consideration of all issues discussed below, the Agencies are adopting the final rule substantially as proposed.[1548] The Agencies intend to develop additional guidance regarding best practices for addressing potential material conflicts of interest, high-risk assets and trading strategies and practices that pose significant risks to safety and soundness and to the U.S. financial system as the Agencies and banking entities gain experience with implementation of the requirements and limitations in section 13 of the BHC Act and this rule, which are all generally designed to limit risky behavior in trading and investment activities.

a. Scope of ''Material Conflict of Interest''

1. Proposed Rule

Section 75.8(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with a permitted trading activity, were prohibited under the proposal.[1549] As noted in the proposal, conflicts of interest may arise in a variety of circumstances related to permitted trading activities. For example, a banking entity may acquire substantial amounts of nonpublic information about the financial condition of a particular company or issuer through its lending, underwriting, investment advisory or other activities which, if improperly transmitted to and used in trading operations, would permit the banking entity to use such information to its customers', clients' or counterparties' disadvantage. Similarly, a banking entity may conduct a transaction that places the banking entity's own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer involved in that transaction. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1550] In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances.[1551]

To address these types of material conflicts of interest, § 75.8(b) of the proposed rule specified that a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest, and subject to specific requirements provided in the proposal, through either (i) timely and effective disclosure, or (ii) information barriers.[1552] Unless the conflict of interest is addressed and mitigated in one of the two ways specified in the proposal, the related transaction, class of transactions or activity would be prohibited under the proposed rule, notwithstanding the fact that it may be otherwise permitted under §§ 75.4 through 75.6 of the proposed rule.[1553]

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

Section 75.8(b)(1) of the proposed rule described the two requirements that must be met in cases where a banking entity addresses and mitigates a material conflict of interest through timely and effective disclosure. First, § 75.8(b)(1)(A)(i) of the proposed rule required that the banking entity, prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, make clear, timely and effective disclosure of the conflict or potential conflict of interest, together with any other necessary information. This would also require such disclosure to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1554] Disclosure that is only general or generic, rather than specific to the individual, class, or type of transaction or activity, or that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, would not meet this standard. Second, § 75.8(b)(1)(ii) of the proposed rule required that the disclosure be made explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty that was created or would be created by the conflict or potential conflict.[1555]

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

[1548] The Agencies note that proposed Appendix C, which required banking entities to describe how they comply with these provisions, will be adopted as Appendix B with similar requirements regarding compliance with the limitations on permitted activities.

[1549] Section 75.17(b) of the proposed rule defined the scope of material conflicts of interest which, if arising in connection with permitted covered fund activities, are prohibited.

[1550] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), available at *http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.*

[1551] *See* Joint Proposal, 76 FR at 68893.

[1552] *See* proposed rule § 75.8(b)(1).

[1553] *See* Joint Proposal, 76 FR at 68893.

[1554] *See id.*

[1555] *See* proposed rule § 75.8(b)(1)(B).

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

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

Section 75.8(b)(2) of the proposed rule described the requirements that must be met in cases where a banking entity uses information barriers that are reasonably designed to prevent a material conflict of interest from having a materially adverse effect on a client, customer or counterparty. Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among units of the entity. Examples of information barriers include, but are not limited to, restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees. Such information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.[1556]

In order to address and mitigate a conflict of interest through the use of the information barriers pursuant to § 75.8(b)(2) of the proposed rule, a banking entity would be required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. Importantly, the proposed rule also provided that, notwithstanding a banking entity's establishment of such information barriers if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of proposed § 75.8(b)(1).[1557] This aspect of the proposal was intended to make clear that, in specific cases in which a banking entity has established an information barrier but knows or should reasonably know that it has failed or will fail to prevent a conflict of interest arising from a specific transactions or activity that disadvantages a client, customer, or counterparty, the information barrier is insufficient to address that conflict and the transaction would be prohibited, unless the banking entity is otherwise able to address and mitigate the conflict through timely and effective disclosure under the proposal.[1558]

The proposed definition of material conflict of interest did not address instances in which a banking entity has made a material misrepresentation to its client, customer, or counterparty in connection with a transaction, class of transactions, or activity, as such transactions or activity appears to involve fraud rather than a conflict of interest. This is because such misrepresentations are generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws).[1559] In addition, the Agencies noted that any activity involving a material misrepresentation to, or other fraudulent conduct with respect to, a client, customer, or counterparty would not be permitted under the proposed rule in the first instance.

2. Comments on the Proposed Limitation on Material Conflicts of Interest

Commenters expressed a variety of views regarding the treatment of material conflicts of interest under the proposal, including the manner in which conflicts may be mitigated or eliminated. One commenter believed that the proposed material conflict of interest provisions would be effective.[1560] Another commenter stated that conflicts of interest were unavoidable but that the final rule should ensure that institutional investors have confidence that the banking entities they are dealing with

[1556] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)–(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks). 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1557] *See* proposed rule § 75.8(b)(2).

[1558] *See* Joint Proposal, 76 FR at 68894.

[1559] *See* 12 U.S.C. 1851(g)(3).

[1560] *See* Alfred Brock.

are not operating at a conflict with investors' goals.[1561]

Other commenters expressed differing views on whether the proposed rule's provisions for addressing conflicts of interest through disclosure or information barriers were appropriate. A few commenters stated there is no statutory basis for allowing conflicts of interest in connection with exempted activities even if banking entities provide disclosure or establish information barriers, and the rule should prohibit banking entities from engaging in permitted activities if material conflicts of interest exist.[1562] One commenter believed the definition did not appear to address issues of customer favoritism, in which a bank is financially incentivized to treat one customer more favorably than another (typically less sophisticated) customer.[1563] Some commenters believed that the proposed definition of material conflict of interest was too vague or narrow and suggested it should be strengthened by either expanding the types of transactions that may result in a material conflict of interest or by imposing additional limitations or restrictions on transactions.[1564] For instance, one commenter suggested the final rule consider depositors of a banking entity to be ''customers'' for the purpose of this provision, impose a fiduciary duty on any banking entity conducting an exempt activity pursuant to section 13(d)(1) of the BHC Act, and impose size restrictions on any banking entity engaging in proprietary trading under an exemption. This commenter also stated that a banking entity inherently has a material conflict of interest with its customer when it takes the opposite side of a transaction and, therefore, that the final rule should require a banking entity to disgorge all principal gains from transactions conducted pursuant to any exemption under section 13(d)(1) of the BHC Act, including market-making, trading in U.S. government obligations, insurance company activities and other exempt activities.[1565] In addition, a few commenters stated that, if disclosure or information barriers were permitted to mitigates conflicts under the final rule, clients of the banking entity must be required to acknowledge in writing that they understand the potential conflicts of interest present in order for any disclosure to be effective in mitigating a conflict of interest.[1566]

Some commenters believed that the Agencies should consider issuing additional guidance regarding the definition of material conflicts of interest, high-risk assets, and high-risk trading strategies.[1567] One commenter stated that the final rule should limit the extraterritorial impact of section 13 by only applying the restrictions of section 13(d)(2) of the BHC Act to the U.S. operations or activities of foreign banking entities and that the regulation of safety and soundness of the foreign operations and activities of foreign banking entities should be left to the home country regulator or supervisor of a foreign banking entity.[1568]

Some commenters provided general suggestions on enhancing compliance with the prohibition on material conflicts of interest. A common suggestion among industry participants was to implement the prohibition on material conflicts of interest under these rules in a manner consistent with the implementation of section 621 of Dodd-Frank.[1569] One commenter suggested that trading in government obligations should not be subject to the material conflict of interest provision because government obligations are broadly traded and do not present the types of conflicts addressed by the proposed rule.[1570] In contrast, one commenter stated banking entities should be required to receive pre-trade clearance from the Federal Reserve for trading in certain government obligations like municipal bonds and mortgage-backed securities, due to their role in the 2008 financial crisis.[1571]

a. Disclosure

Some commenters expressed concern about potential difficulties associated with the proposed disclosure provision and provided suggestions to address these difficulties. For example, a few commenters noted the difficulty in determining what constitutes effective disclosure,[1572] especially in relation to the volume of disclosure or the impact of information asymmetry in illiquid markets.[1573] One commenter stated that unless the rule requires full disclosure of a banking entity's trading strategy and the rationale behind it, allowing disclosure will permit the banking entity to protect itself without adequately mitigating the harm of the conflict. This commenter also noted the practical difficulties associated with disclosing anticipated future conflicts and conflicts in the context of block trading.[1574] Another commenter stated market participants understand inherent conflicts of interest and believed disclosure in such situations would be burdensome and unnecessary.[1575] One commenter stated that the rule should require a banking entity to negate, not just permit the client, customer, or counterparty to substantially mitigate, the materially adverse effect of the conflict.[1576]

A few commenters disagreed with the disclosure provision, noting that Congress specifically considered and rejected disclosure as a mitigation method for purposes of section 621 of the Dodd-Frank Act and that this indicates the Agencies should not permit a material conflict of interest to be mitigated through disclosure for purposes of section 13 of the BHC Act.[1577]

Commenters were in disagreement as to the extent and timing of disclosure that should be required under the rule. Some commenters stated the disclosure provisions would slow trading, and suggested the rule require only one-time disclosure at the inception of the business relationship [1578] or periodic disclosures to address ongoing conflicts.[1579] One of these commenters noted that extensive trade-by-trade disclosure requirements create the risk of unintended breaches of confidentiality.[1580] Other commenters requested the Agencies provide additional guidance, such as when transaction-specific disclosure is necessary,[1581] whether disclosure should be written,[1582] and what constitutes ''reasonable detail.'' [1583]

[1561] *See* Paul Volcker.

[1562] *See* Public Citizen; Sens. Merkley & Levin; Occupy; AFR *et al.* (Feb. 2012).

[1563] *See* Public Citizen.

[1564] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1565] *See* Occupy.

[1566] *See, e.g.,* Lynda Aiman-Smith; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1567] *See* Rep. Blumenauer *et al.;* Sens. Merkley & Levin (Feb. 2012).

[1568] *See* IIB/EBF; EBF.

[1569] *See* ASF (Conflicts) (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); LSTA (Feb. 2012); Sens. Merkley & Levin (Feb. 2012).

[1570] *See* BDA (Feb. 2012).

[1571] *See* Occupy.

[1572] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR.

[1573] *See* Occupy.

[1574] *See* Public Citizen; *see also* AFR *et al.* (Feb. 2012).

[1575] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012)

[1576] *See* Occupy.

[1577] *See, e.g.,* Occupy.

[1578] *See* ISDA (Apr. 2012); Arnold & Porter.

[1579] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ISDA (Apr. 2012).

[1580] *See* ISDA (Apr. 2012).

[1581] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012);

[1582] *See* Sens. Merkley & Levin (Feb. 2012); ICFR (questioning the effectiveness of enforcement mechanisms if oral disclosure permitted under the rule); Occupy.

[1583] *See* ICFR.

In addition, some commenters provided suggestions on whether parties should be required to acknowledge receipt of disclosures [1584] or affirmatively consent to the conflict.[1585] One commenter proposed allowing a majority of a committee of independent board members to approve consent to waivers of conflicts of interest.[1586] One commenter believed disclosure and consent by a sophisticated investor ought to be sufficient to serve as a waiver to most types of conflict of interest.[1587] In contrast, another commenter asserted general disclosure or waivers of conflicts should never be allowed, and the Agencies should not provide *any* additional guidance as to the extent, timing, frequency, or scope of disclosure appropriate in any given situation.[1588] Similarly, one commenter asserted the Agencies should not provide guidance on what issues can be addressed by disclosure, as such guidance would be ''dangerously prescriptive and would introduce moral hazards.'' [1589]

b. Information Barriers

A few commenters addressed the information barriers provision of the proposed rule. One commenter expressed support for the proposed approach,[1590] while three commenters stated this provision was ineffective.[1591] A few commenters opposed the information barriers provision because they believed information barriers would make conflict mitigation more difficult [1592] or would effectively mandate that no single officer be aware of a banking entity's collective operations.[1593]

A few commenters also requested the Agencies provide guidance regarding the use of information barriers. One commenter requested the Agencies specify the type and nature of information barriers and where they are practical to implement.[1594] Another commenter believed that the Agencies should view information barriers favorably. This commenter stated that information barriers should be permitted for addressing conflicts of interest unless the banking entity knows, or should reasonably know, that the information barrier would not be effective in restricting the spread of information that could lead to the conflict.[1595] To provide greater clarity, another commenter recommended the Agencies provide guidance on certain elements that may be used to determine the reasonableness of information barriers, such as memorialization of procedures and documentation of actions taken pursuant to such procedures.[1596]

3. Final Rule

After considering carefully comments received on the proposal as well as the purpose and language of section 13 of the BHC Act, the Agencies have adopted the final rule largely as proposed. Under the final rule, a banking entity that engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to the transaction, class of transactions, or activity, must address and mitigate the conflict of interest, where possible, through either timely and effective disclosure or informational barriers.[1597] This requirement is in addition to, and does not supplant, any limitations or prohibitions contained in other laws. For example, a material misrepresentation by a banking entity to its client, customer, or counterparty in connection with market-making activities may involve fraud and is generally illegal under a variety of Federal and State regulatory schemes (*e.g.,* the Federal securities laws) [1598] as well as being prohibited under section 13 of the BHC Act.

The Agencies believe that certain of commenters' suggested modifications to the proposed rule are outside the scope of the Agencies' statutory authority. For example, the Agencies do not believe section 13 of the BHC Act provides statutory authority to directly impose limits on the size of banking entities [1599] or to implement specific fiduciary standards on banking entities.[1600] In addition, the Agencies do not believe it is appropriate to expand the definition of ''customer'' to include individuals and entities that solely make use of the bank's traditional banking services because section 13 is focused on the trading activities and investment in which banking entities may be involved.[1601]

The final rule recognizes that a banking entity may address or substantially mitigate a potential conflict of interest by making adequate disclosures or creating and enforcing informational barriers. Some commenters argued that the legislative history of the Dodd-Frank Act suggests that disclosure or informational barriers are not adequate to address a material conflict of interest.[1602] However, section 13 of the BHC Act directs the Agencies to define ''material conflict of interest'' and gives the Agencies discretion to determine how to define this term for purposes of the rule. Under the final rule, a material conflict of interest exists when the banking entity engages in transactions or activities that cause its interests to be materially adverse to the interests of its client, customer, or counterparty. At the same time, the final rule provides banking entities the opportunity to take certain actions to address the conflict, such that the conflict does not have a materially adverse effect on that client, customer, or counterparty. Under the final rule, a banking entity may address a conflict by establishing, maintaining, and enforcing information barriers reasonably designed to avoid a conflict's materially adverse effect, or by disclosing the conflict in a manner that allows the client, customer, or counterparty to substantially mitigate or negate any materially adverse effect created by the conflict of interest. The Agencies believe that, to the extent the materially adverse effect of a conflict has been substantially mitigated, negated, or avoided, it is appropriate to allow the

[1584] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

[1585] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012).

[1586] *See* Arnold & Porter.

[1587] *See* Arnold & Porter.

[1588] *See* Alfred Brock (stating there is no such thing as a ''sophisticated party'').

[1589] *See* ICFR.

[1590] *See* Alfred Brock.

[1591] *See* Better Markets (Feb. 2012); Occupy; Public Citizen.

[1592] *See* Occupy.

[1593] *See* Public Citizen (contending that this would undermine the Dodd-Frank Act's requirement to promote sound management, ensure financial stability, and reduce systemic risk).

[1594] *See* AFR *et al.* (Feb. 2012).

[1595] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1596] *See* ISDA (Apr. 2012) (arguing that its suggested guidance was derived from prior SEC and self-regulatory organization guidance on information barriers).

[1597] The Agencies note that the definition of material conflict of interest and the disclosure provisions related to that definition apply solely for purposes of the rule's definition of material conflict of interest, and does not affect the scope of that term in other contexts or a banking entity's obligation to comply with additional or different requirements with respect to a conflict under applicable securities, banking, or other laws (*e.g.,* section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities).

[1598] *See* 12 U.S.C. 1851(g)(3).

[1599] *See* Occupy.

[1600] *See* Occupy.

[1601] *See* Occupy.

[1602] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

transaction, class of transaction, or activity under the final rule. Continuing to view the conflict as a material conflict of interest under these circumstances would not appear to benefit the banking entity's client, customer, or counterparty. The disclosure standard under the final rule requires clear and meaningful information be provided to the client, customer, or counterparty in a manner that provides such party the opportunity to negate or substantially mitigate, any materially adverse effects on such party created by the conflict.

Some commenters suggested that obtaining consent to or waiver of disclosed conflicts should be sufficient to comply with the rule.[1603] The Agencies do not believe that consent or waivers alone are sufficient to address material conflicts of interest, and continue to believe that any banking entity using disclosure to address a conflict of interest should be required to provide any client, customer, or counterparty with whom the banking entity has a conflict with the opportunity to negate or substantially mitigate the materially adverse effect of the conflict on the client, customer, or counterparty. The Agencies believe this approach, which applies equally to all types of clients, customers, or counterparties, will reduce the potential for unintended or differing impacts on certain types of clients, customers, or counterparties. In response to one commenter's suggestion that the final rules require full negation of the materially adverse effect on the client, customer, or counterparty, the Agencies continue to believe it is appropriate to allow a transaction or activity to continue if the client, customer, or counterparty is provided an opportunity to substantially mitigate the materially adverse effect.[1604] The Agencies are concerned that requiring the conflict's impact to be fully negated under all circumstances could prevent a banking entity from providing a service to a particular customer despite that customer's knowledge of the conflict and ability to substantially reduce the effect of the conflict on that customer.

With regards to commenters' statements that information barriers and disclosure will not work to address the harm caused by conflicts, the Agencies emphasize that under the final rule, like the proposed rule, a banking entity may use disclosure or information barriers to address a conflict only in those instances where the disclosure provides the client, customer, or counterparty with the opportunity to negate or substantially mitigate any materially adverse effect of the conflict on that entity or the information barriers are reasonably designed to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. If the banking entity is unable to effectively use disclosure or information barriers in a way that meets the rule's requirements, then the banking entity is prohibited from engaging in the conflicted transaction, class of transaction, or activity. Additionally, the Agencies note that the material conflict of interest provisions in the final rule do not preempt any duties owed to parties outside the transaction, including any duty of confidentiality.[1605]

In response to commenters' statements that the volume of information included in a disclosure or the manner in which the disclosure is presented may make it difficult for a customer to identify and understand the relevant information regarding the conflict,[1606] the Agencies note that the final rule requires disclosure of the conflict or potential conflict be clear, timely, and effective and that the disclosure includes any other necessary information. Disclosure is also required to be provided in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest.[1607] Thus, disclosure that is only general or generic, that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, or that is hidden in a large volume of needless information would not meet this standard. The Agencies believe these provisions of the final rule are designed to ensure that customers receive sufficient information about the conflict of interest so that they are well informed and, as required by the rule, able to negate or substantially mitigate any materially adverse effect of the conflict.

In addition to requiring that customers are provided with detailed information about the conflict, the final rule, like the proposal, requires that disclosure is made prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise and is otherwise timely. As a result, under § 75.7(b)(2)(i), disclosure must be provided sufficiently close in time to the client's, customer's, or counterparty's decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and take steps that would negate or substantially mitigate the conflict. This approach is similar to the approach permitted by a variety of consumer protection statutes and regulations for addressing potential conflicts of interest in consumer transactions.[1608]

Some commenters requested that the final rule permit a conflict to be negated or substantially mitigated through generic or periodic disclosures, such as at the beginning of a trading relationship or on an annual basis. Other commenters stated that some conflicts, such as anticipated future conflicts or those that arise in the context of block trading, may require the banking entity to provide disclosure in advance of the actual conflict in order to allow the client, customer, or counterparty the opportunity to mitigate the materially adverse effect.[1609] The

[1603] *See, e.g.,* Arnold & Porter.

[1604] *See* Occupy.

[1605] *See* ISDA (Apr. 2012).

[1606] *See* Better Markets (Feb. 2012) (suggesting that a disclosure regime can facilitate abuse by enabling market participants to point to obscure and meaningless disclosure as a shield against liability); Occupy (arguing that a large volume of disclosed information can be difficult to understand or can serve to hide relevant information).

[1607] *See* final rule § 75.7(b)(1)(i) and final rule § 75.16(b)(1)(i).

[1608] *See, e.g.,* 15 U.S.C. 78c(a)(4)(B)(i)(I)—(IV) (finding that disclosure and physical separation of personnel and activities addresses the potential that consumers might be misled by the broker-dealer activities of banks); 15 U.S.C. 80b–6(3) (''It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly . . . acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction.''). *See also* Form ADV, the form used by investment advisers to register with the Securities and Exchange Commission and state securities authorities, and, in particular, Form ADV Part 2: Uniform Requirements for the Investment Adviser Brochure and Brochure Supplements. A registered investment adviser generally must deliver the Form ADV brochure, which contains disclosure about conflicts of interest, to its prospective and existing clients. *See* 17 CFR 275.204–3; Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) 75 FR 49234 (Aug. 12, 2010) (''We are adopting a requirement that investment advisers registered with us provide prospective and existing clients with a narrative brochure written in plain English . . . We believe these amendments will greatly improve the ability of clients and prospective clients to evaluate firms offering advisory services and the firms' personnel, and to understand relevant conflicts of interest that the firms and their personnel face and their potential effect on the firms' services.'').

[1609] *See* Public Citizen; *see also* AFR *et al.* (Feb. 2012).

Agencies emphasize, however, that disclosure provided far in advance of a particular transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating the transaction, would not suffice. At the same time, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the fact, would also not be permissible disclosure under the final rules. The Agencies believe that, in considering the effectiveness of disclosures, the type, timing and frequency of disclosures depends significantly on the customer relationship, the type of transaction, and the matter that creates the potential conflict. Therefore, while written disclosures may be appropriate in certain circumstances, the Agencies are not requiring banking entities to provide written disclosure,[1610] or obtain documentation showing that disclosure was received,[1611] because the Agencies believe it is more important that disclosure is timely than documented. For example, if disclosure were required to be in writing, this might slow a banking entity's ability to provide the disclosure to the relevant customer, which could impede the customer's ability to consider the disclosed information and take steps to negate or substantially mitigate the conflict's effect on the customer. The Agencies further note that the final rule does not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties.

As noted above, one commenter expressed concern about the burdens of disclosing inherent conflicts and stated such disclosure is unnecessary because market participants understand inherent conflicts of interest.[1612] As noted in the proposal, certain inherent conflicts, such as the mere fact that the buyer and seller are on opposite sides of a transaction and have differing economic interests, would not be deemed a ''material'' conflict of interest with respect to permitted activities.[1613]

The Agencies continue to believe that information barriers can be an effective means of addressing conflicts of interest that may arise through, for example, the spread of information among trading desks engaged in different trading activities that may result in potentially inappropriate informational advantage. The Agencies are not adopting one commenter's suggestion that the final rule specify the particular types of scenarios where information barriers may be effective [1614] because, as discussed below, the Agencies believe banking entities are better positioned to determine when information barriers may be effective given their trading activities and business structure.[1615] In response to one commenter's concern that information barriers may result in the banking entity's management not being aware of the firm's collective operations,[1616] the Agencies note that information barriers do not require this result. Rather, information barriers would be established between relevant personnel or functions while other personnel, including senior managers, internal auditors, and compliance personnel, would have access to each group separated by the barrier.

The final rule continues to recognize that a banking entity may address or substantially mitigate a conflict of interest through use of information barriers. In order to address and mitigate a conflict of interest through the use of the information barriers, a banking entity is required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[1617]

Importantly, the final rule also provides that, notwithstanding a banking entity's establishment of such information barriers, if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complied with the requirements of § 75.7(b)(2)(i).[1618]

While some commenters requested that the final rule include additional limitations as part of implementing the material conflict of interest provisions in section 13(d)(2), the Agencies do not believe additional restrictions are appropriate at this time. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.[1619] In all cases, the question of whether a material conflict of interest exists will depend on an evaluation of the specific facts and circumstances. For example, certain

[1610] *See* Sens. Merkley & Levin (Feb. 2012); ICFR; Occupy; Alfred Brock.

[1611] *See, e.g.,* Arnold & Porter; Sens. Merkley & Levin (Feb. 2012); Better Markets (Feb. 2012); Public Citizen; AFR *et al.* (Feb. 2012); Lynda Aiman-Smith.

[1612] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); *but see* Occupy.

[1613] *See* Joint Proposal, 76 FR at 68893. Thus, the Agencies are not adopting one commenter's suggestion that the final rule consider all transactions by a banking entity to involve a material conflict of interest because the banking entity is necessarily on the opposite side of a transaction with its client, customer, or counterparty. *See* Occupy.

[1614] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1615] The Agencies note examples of information barriers that may address or substantially mitigate a material conflict of interest include restrictions on information sharing, limits on types of trading, prohibitions on common officers or employees between functions. Such information barriers have been recognized in Federal securities laws as a means to address or mitigate potential conflicts of interest or other inappropriate activities. *See, e.g.,* 17 U.S.C. 78o(g).

[1616] *See* Public Citizen.

[1617] The Agencies note that a banking entity subject to Appendix B of the final rule must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits conflicts of interest with clients, customers, and counterparties. As part of maintaining and enforcing information barriers, a banking entity should have processes to review, test, and modify information barriers on a continuing basis. In addition, banking entities should have ongoing monitoring to maintain and to enforce information barriers, for example by identifying whether such barriers have not prevented unauthorized information sharing and addressing instances in which the barriers were not effective. This may require both remediating any identified breach as well as updating the information barriers to prevent further breaches, as necessary. Periodic assessment of the effectiveness of information barriers and periodic review of the written policies and procedures are also important to the maintenance and enforcement of effective information barriers and reasonably designed policies and procedures. Such assessments can be done either (i) internally by a qualified employee or (ii) externally by a qualified independent party. *See* Part VI.C.2.e., *infra.*

[1618] If a conflict occurs to the detriment of a client, customer, or counterparty despite an information barrier, the Agencies would also expect the banking entity to review the effectiveness of its information barrier and make adjustments, as necessary, to avoid future occurrences, or review whether such information barrier is appropriate for that type of conflict.

[1619] *See, e.g.,* U.S. Senate Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse (Apr. 13, 2011), available at *http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf.*

simple transactions may implicate conflicts of interest that cannot be mitigated by disclosure or restricted by information barriers. On the other hand, certain highly structured and complex transactions may involve conflicts of interest that can be mitigated by disclosure or restricted by information barriers.

The Agencies believe that conflicts of interest must be determined and addressed in accordance with the specific facts and circumstances presented. One commenter suggested that the proposed rule be modified so that a banking entity could conclusively rely on information barriers unless it knows or has reason to know that policies, procedures, and controls establishing barriers would not be effective in restricting the spread of information.[1620] By focusing on whether a banking entity knows or has reason to know that its policies and procedures would not be effective, rather than on what the banking entity knows or should reasonably know about a conflict of interest that may involve or result in a material adverse effect on a client, customer, or counterparty, the commenter's suggestion has the potential to allow a banking entity to engage in transactions that involve a material conflict of interest. Therefore, the Agencies have determined not to adopt the commenter's suggested approach. Similarly, the Agencies are rejecting some commenters' suggestions that the final rule prescribe the method, scope, or specific content of disclosures.[1621] The Agencies believe that specific guidance on disclosure may provide an incentive for banking entities to consider the form of disclosure provided, rather than whether disclosure can address the substance of the conflict as determined by the specific facts and circumstances at hand. Moreover, the Agencies believe banking entities are in the best position to identify and evaluate the conflicts present in their business as well as the most effective method of disclosing such conflicts. Banking entities must tailor their compliance programs to identify, monitor, and evaluate potential conflicts based on their business structure and specific activities and customer relationships.[1622]

Finally, some commenters requested that the final rule specifically address the conflict of interest provisions related to asset-backed securitizations contained in section 621 of the Dodd-Frank Act. As explained below in Part VI.B.1., some securitizations are subject to the final rule, and others such as securitizations of loans are not subject to section 13 of the BHC Act. For any securitization that meets the definition of covered fund under the final rule, relationships with and transactions by a banking entity involving those securitizations remain subject to the requirements of section 13, including the requirements of section 13(d)(2). In addition, the banking entity would be subject to the limitations contained in section 621 of the Dodd-Frank Act and any rules regarding conflicts of interest relating to securitizations implemented under that section. The final rule in no way limits the application of section 621 of that Act with respect to an asset-backed security that is subject to that section.

b. Definition of ''High-Risk Asset'' and ''High-Risk Trading Strategy''

1. Proposed Rule

Section 75.8(c) of the proposed rule defined ''high-risk asset'' and ''high-risk trading strategy'' for purposes of the proposed limitations on permitted trading activities. Proposed § 75.8(c)(1) defined a ''high-risk asset'' as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. Proposed § 75.8(c)(2) defined a ''high-risk trading strategy'' as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.[1623]

2. Comments on Proposed Limitations on High-Risk Assets and Trading Strategies

With respect to the prohibition on transactions or activities that expose banking entities to high-risk assets or high-risk trading strategies, one commenter stated the provisions were effective,[1624] while other commenters stated the proposed rule was too vague[1625] and implied that banking entities may be required to exit positions in periods of market stress, further reducing liquidity.[1626] A few commenters suggested the Agencies identify and prohibit certain types of high-risk assets or high-risk trading strategies under the rule.[1627] In contrast, one commenter asserted the Agencies should not specify certain classes of assets or trading strategies as ''high risk.''[1628] A few commenters requested greater clarity on the proposed definitions and suggested the Agencies provide additional guidance.[1629] One of these commenters suggested the Agencies simplify compliance by establishing safe harbors, setting pre-determined risk limits within risk-based approaches, or allowing individual banking entities to set practical risk-based standards that the Agencies can review.[1630]

One commenter suggested integrating the ban on high-risk activities throughout the rule and stated that, given the evolving nature of financial markets, regulators should have the flexibility to update criteria for identifying high-risk assets or high-risk trading strategies.[1631] This commenter stated the definition of high-risk trading strategies was appropriately broad and flexible, but suggested improving the rule by encompassing trading strategies that are so complex the risk or value thereof cannot be reliably and objectively determined.[1632] The commenter also suggested that the quantitative measurements collected under proposed Appendix A could be utilized to help inform whether a high-risk asset or trading strategy exists.[1633]

One commenter stated that in large concentrations, all assets can be high risk. This commenter suggested evaluating transactions on a case-by-case basis and believed all activity exempted under section 13(d)(1) of the BHC Act should be viewed as ''high-risk'' absent prior regulatory approval. This commenter further suggested that high-risk assets or trading strategies be defined to include any asset or trading strategy that would have forced a

[1620] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[1621] *See* Occupy; ISDA (Apr. 2012); Better Markets (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ICFR; Alfred Brock; Public Citizen; AFR *et al.* (Feb. 2012); Arnold & Porter; Sens. Merkley & Levin (Feb. 2012).

[1622] For a full discussion of the final rule's compliance requirements, including a discussion of the specific compliance requirements applicable to different banking entities, see Part VI.C. of this **SUPPLEMENTARY INFORMATION**, *infra.*

[1623] *See* Joint Proposal, 76 FR at 68894. The Agencies noted that a banking entity subject to proposed Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits exposure to high-risk assets and high-risk trading strategies, and identifies a variety of assets and strategies (*e.g.,* assets or strategies with significant embedded leverage). *See* Joint Proposal, 76 FR at 68894 n.215.

[1624] *See* Alfred Brock.

[1625] *See* AFR *et al.* (Feb. 2012); Japanese Bankers Ass'n.; Investure; AllianceBernstein; Comm. on Capital Markets Regulation.

[1626] *See* Obaid Syed.

[1627] *See* Sens. Merkley & Levin (Feb. 2012); Johnson & Prof. Stiglitz; Occupy.

[1628] *See* Alfred Brock.

[1629] *See* Japanese Bankers Ass'n.; Sens. Merkley & Levin (Feb. 2012); Occupy; Public Citizen.

[1630] *See* Japanese Bankers Ass'n.

[1631] *See* Sens. Merkley & Levin (Feb. 2012).

[1632] *See* Sens. Merkley & Levin (Feb. 2012).

[1633] *See* Sens. Merkley & Levin (Feb. 2012).

banking entity to exit the market during the 2008 financial crisis, and that leverage, rehypothecation, concentration limits, and high frequency trading should be viewed as indicia of high-risk trading strategies. Finally, this commenter suggested the Agencies require banking entity CEOs to certify that their institution's activities do not result in a material exposure to high-risk assets or high-risk trading strategies.[1634]

3. Final rule

After considering carefully the comments received, the Agencies have modified the final rule to provide that a high-risk asset means an asset or group of assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States. Similarly, the final rule defines high-risk trading strategy to include any strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

Importantly, under the final rule, banking entities that engage in activities pursuant to an exemption must have a reasonably designed compliance program in place to monitor and understand whether it is exposed to high-risk assets or trading strategies. For instance, any banking entity engaged in activity pursuant to the market-making exemption in § 75.4(b) must, as part of its compliance program, have reasonably designed written policies and procedures, internal controls, analysis and independent testing regarding the limits for each trading desk, including limits on the level of exposures to relevant risk factors that the trading desk may incur. These policies and procedure and any activity conducted pursuant to the final rule will be evaluated by the Agencies, as appropriate, as part of ensuring the safety and soundness of banking entities and monitoring for exposures to high-risk activities or assets.

While some commenters stated that the definition of high risk asset or trading strategy should be more clearly defined, the Agencies believe that it is appropriate to include a broad definition of these terms that accounts for different facts and circumstances that may impact whether a particular asset or trading strategy is high-risk with respect to a banking entity. As stated by commenters, this framework is effective and flexible enough to be utilized by the Agencies in a variety of contexts. For instance, a trading strategy or asset may be high-risk to one banking entity but not another, or may be high-risk to a banking entity under some market conditions but not others. As part of evaluating whether a banking entity is exposed to a high-risk asset or trading strategy, the Agencies expect that a variety of factors will be considered, such as the presence of excess leverage, rehypothecation or excessively high concentration of assets, or unsafe and unsound trading strategies.

We believe an approach limiting this provision's applicability to certain permitted activities or creating a safe harbor for certain assets or trading strategies would be inconsistent with the statutory language, which prohibits any permitted activity that involves or results in a material exposure to a high-risk asset or high-risk trading strategy.[1635] In addition, the Agencies decline to identify any particular assets or trading strategies as per se high-risk because a determination of the specific risk posed to a banking entity depends on the facts and circumstances.[1636] Certain facts and circumstances may include, but are not limited to, the amount of capital at risk in a transaction, whether or not the transaction can be hedged, the amount of leverage present in the transaction, and the general financial condition of the banking entity engaging in the transaction. In response to one commenter's recommendation that the Agencies adopt a CEO certification requirement specific to the high-risk provisions,[1637] the Agencies believe such a requirement is unnecessary in light of the required management framework in the compliance program provision of § 75.20 of the final rule, as well as the CEO certification requirement included in the final rule.[1638]

c. Limitations on Permitted Activities That Pose a Threat to Safety and Soundness of the Banking Entity or the Financial Stability of the United States

Finally, as the Agencies did not receive any comments on the proposed rule's limitations on permitted activities that pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States and the proposed approach mirrored the statutory language, the Agencies have determined no changes to final rule are necessary.

B. Subpart C—Covered Fund Activities and Investments

As noted above and except as otherwise permitted, section 13(a)(1)(B) of the BHC Act generally prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a covered fund.[1639] Section 13(d) of the BHC Act contains certain exemptions to this prohibition. Subpart C of the final rule implements these and other provisions of section 13 related to covered funds. Additionally, subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in subpart D of the final rule, as well as Appendix B, to the extent applicable.

1. Section 75.10: Prohibition on Acquisition or Retention of Ownership Interests in, and Certain Relationships With, a Covered Fund

Section 75.10 of the final rule defines the scope of the prohibition on the acquisition and retention of ownership interests in, and certain relationships with, a covered fund. It also defines a number of key terms, including the definition of covered fund.

The term ''covered fund'' specifies the types of entities to which the prohibition contained in § 75.10(a) applies, unless the activity is specifically permitted under an available exemption contained in subpart C of the final rule.[1640] The final rule modifies the proposed definition of covered fund in a number of key aspects. The Agencies have defined the term ''covered fund'' with reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 (''Investment Company Act'') with some additions and subject to a number of exclusions, several of which have been modified from permitted activity exemptions included in the proposal.

The Agencies have tailored the final definition to include entities of the type that the Agencies believe Congress intended to capture in its definition of private equity fund and hedge fund in section 13(h)(2) of the BHC Act by reference to section 3(c)(1) and 3(c)(7) of

[1634] *See* Occupy.

[1635] *See* BDA (Feb. 2012); Japanese Bankers Ass'n.

[1636] *See* Occupy.

[1637] *See* Occupy.

[1638] *See* § 75.20 and Appendix B of the final rule, also discussed in Part VI.C., *infra*.

[1639] *See* 12 U.S.C. 1851(a)(1)(B).

[1640] *See* final rule §§ 75.10(b)–(c). The term banking entity is defined in final rule § 75.2(c).

the Investment Company Act. Thus, the final definition focuses on the types of entities formed for the purpose of investing in securities or derivatives for resale or otherwise trading in securities or derivatives, and that are offered and sold in offerings that do not involve a public offering, but typically involve offerings to institutional investors and high-net worth individuals (rather than to retail investors). These types of funds are not subject to all of the securities law protections applicable with respect to funds that are registered with the SEC as investment companies, and the Agencies therefore believe that these types of entities may be more likely to engage in risky investment strategies. At the same time, the Agencies have tailored the definition to exclude entities that have more general corporate purposes and do not present the same risks for banking entities as those associated with the funds described above, as well as certain other entities as further discussed below.

The final rule also contains a revised version of the proposal's treatment of certain foreign funds as covered funds, which has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute, such as certain foreign funds that are established by U.S. banking entities and not otherwise subject to the Investment Company Act.

The Agencies have not included all commodity pools within the definition of covered fund as proposed. Instead, and as discussed in more detail below, the Agencies have included only commodity pools for which the commodity pool operator has claimed exempt pool status under section 4.7 of the CFTC's regulations or that could qualify as exempt pools and which have not been publicly offered [1641] to persons who are not qualified eligible persons under section 4.7 of the CFTC's regulations.[1642] Qualified eligible persons are typically institutional investors, banking entities and high net worth individuals (rather than retail investors). This more tailored approach, together with the various exclusions from the covered fund definition in the final rule, is designed to include as covered funds those commodity pools that are similar to funds that rely on section 3(c)(1) or 3(c)(7) while not also including as covered funds entities, like commercial end-users or registered investment companies, whose activities do not implicate the concerns that section 13 was designed to address.

Finally, other related terms, including ''ownership interest,'' ''resident of the United States,'' ''sponsor,'' and ''trustee,'' are also defined in § 75.10(d) of the final rule.[1643] As explained below, these terms are largely defined in the same manner as in the proposal although with certain changes, including changes to help clarify the scope of these definitions as requested by commenters. Some of these terms and related provisions also have been reorganized to improve clarity. As explained in more detail below, the Agencies received a number of comments relating to some of the terms defined in § 75.10. Some comments directly relate to the scope of the proposed rule and the economic effects associated with the prohibitions on covered funds activities and investments, some of which commenters argued did not further the purposes of section 13.[1644] The Agencies have carefully considered these and other comments when defining the key terms used in the statute and in providing certain exclusions to the definition of the term covered fund. The Agencies also have sought to provide guidance below, where appropriate, on how these key terms would operate in order to better enable banking entities to understand their obligations under section 13 and the final rule.

a. Prohibition Regarding Covered Fund Activities and Investments

Section 75.10(a) of the final rule implements section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, directly or indirectly, acquiring or retaining as principal an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless otherwise permitted under subpart C of the final rule.[1645] This provision of the rule reflects the statutory prohibition.

The general prohibition in § 75.10(a) of the proposed rule applied solely to the acquisition or retention of an ownership interest in, or acting as sponsor to, a covered fund, ''as principal.'' [1646] Commenters generally supported this approach, arguing that applying the prohibition related to covered fund activities and investments by a banking entity only to instances where the banking entity acts as principal is consistent with the statutory focus on principal activity.[1647] The final rule takes this approach as discussed below.

The proposed rule and preamble accompanying it described potential exemptions from the definition of ownership interest for a variety of interests, including interests related to employee benefit plans, interests held in the ordinary course of collecting a debt previously contracted, positions as trustee, or interests acquired as agent, broker or custodian. Commenters provided information on each of these types of ownership interests, and generally supported excluding each of these from the section's prohibition on acquiring or retaining an ownership interest in a covered fund.

A significant number of commenters focused on employee benefit plans. Commenters generally argued that the prohibition in section 13(a) of the BHC Act did not encompass interests held on behalf of employees through an employee benefit plan. While the proposed rule did not explicitly cover certain ''qualified plans'' under the Internal Revenue Code, a number of commenters argued that the prohibition should not cover activity or investments related to other types of employee benefit plans that are not a ''qualified plan'' under the Internal Revenue Code.[1648] A significant number of commenters urged exclusion of interests in and relationships with foreign employee benefit plans.[1649] Commenters argued that the risks of investments made through employee benefit plans are borne by the employee beneficiaries of these plans, and any decision to cover employee benefit plans or investments made by these plans under the prohibitions in section 13 of the BHC Act would eliminate or severely restrict the availability of employee programs that are widely offered, regulated and endorsed under a system of Federal, state and foreign laws.[1650]

Commenters also supported the exemption under the proposed rule for holdings in satisfaction of a debt previously contracted in good faith.[1651]

[1641] *See infra* note 1726 and accompanying text regarding the meaning of the term ''offer'' as used in the final rule's inclusion of certain commodity pools as covered funds.

[1642] *See* final rule § 75.10(b)(1)(ii).

[1643] *See* final rule § 75.10(d)(6), (8), (9), and (10).

[1644] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Goldman (Covered Funds); Rep. Himes; SVB; Scale.

[1645] *See* final rule § 75.10(a).

[1646] *See* proposed rule § 75.10(a); *see also* Joint Proposal, 76 FR at 68896.

[1647] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012).

[1648] *See* Credit Suisse (Williams); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1649] *See, e.g.,* Credit Suisse (Williams); Arnold & Porter; UBS; NAB; Hong Kong Inv. Funds Ass'n; Australian Bankers Ass'n. (Feb. 2012).

[1650] *See, e.g.,* Arnold & Porter.

[1651] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); LSTA (Feb. 2012).

This provision of the proposal recognized that banking entities may acquire an ownership interest in or relationship with a covered fund as a result of a counterparty's failure to repay a *bona fide* debt and without an intent to engage in those activities as principal.[1652]

Several commenters urged revision to the proposal to add a specific exclusion for investments held by a banking entity in the capacity of trustee (including as trustee for a charitable trust).[1653] These commenters argued that failing to recognize and exempt these types of activities in the final rule would prevent banking entities that act as trustees from effectively meeting their trust and fiduciary obligations and from providing these services to customers. Commenters also argued that the exemption for trust activities should not be dependent on the duration of the trust because the law governing the duration of trusts is changing and varies across jurisdictions.[1654]

As with the proposed rule, the prohibition in § 75.10(a) of the final rule applies only to the acquisition or retention of an ownership interest in, or sponsorship of, a covered fund as principal. The Agencies continue to believe section 13 of the BHC Act was designed to address the risks attendant to principal activity and not those that are borne by customers of the banking entity or for which the banking entity lacks design or intent to take a proprietary interest as principal.

In order to address commenter concerns regarding the types of activity that are subject to the prohibition, the Agencies have modified and reorganized the final rule to make the scope of acting ''as principal'' clear and more consistent with the proprietary trading restrictions under the final rule.[1655] The final rule provides that the prohibition does not include acquiring or retaining an ownership interest in a covered fund by a banking entity: (1) Acting solely as agent, broker, or custodian, so long as the activity is conducted for the account of, or on behalf of, a customer, and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest;[1656] (2) through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of people who are or were employees of the banking entity (or an affiliate thereof);[1657] (3) in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the appropriate agency; or (4) on behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of, or on behalf of, the customer, and the banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.[1658]

Because these activities do not involve the banking entity engaging in an activity intended or designed to take ownership interests in a covered fund as principal, they do not appear to be the types of activities that section 13 of the BHC Act was designed to address. However, the Agencies note that in order to prevent a banking entity from evading the requirements of section 13 and the final rule, the exclusions for these activities do not permit a banking entity to engage in establishing, organizing and offering, or acting as sponsor to a covered fund in a manner other than as permitted elsewhere in the final rule. The Agencies intend to monitor these activities and investments for efforts to evade the restrictions in section 13 of the BHC Act and the final rule on banking entities' investments in and relationships with covered funds.

b. ''Covered Fund'' Definition

Section 13(h)(2) of the BHC Act defines hedge fund and private equity fund to mean an issuer that would be an investment company, but for section 3(c)(1) or 3(c)(7) of the Investment Company Act, or ''such similar funds'' as the Agencies determine by rule.[1659] Given that the statute defines ''hedge fund'' and ''private equity fund'' without differentiation, the proposed rule and the final rule combine the terms into the definition of a ''covered fund.'' Sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act.[1660] The proposal included as a covered fund any entity that would be an investment company but for the exclusion from that definition contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, any foreign entity that would also be an investment company but for those same exclusions were the foreign entity to be organized or offered in the United States, and a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1661] The preamble to the proposal recognized that this definition was broad and specifically requested comment on whether and how the definition of covered fund should be modified for purposes of the final rule.

Commenters contended that the definition of covered fund should not focus exclusively on whether an entity relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Commenters argued that sections 3(c)(1) and 3(c)(7) of the Investment Company Act are exclusions commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of ''investment company'' contained in that Act. Under the Investment Company Act, any entity that holds investment securities (*i.e.,*

[1652] *See* proposed rule § 75.14(b).

[1653] *See, e.g.,* ABA (Keating).

[1654] *See, e.g.,* ABA (Keating); Arnold & Porter; NAB.

[1655] *See* final rule § 75.3(d)(7)–(9).

[1656] A banking entity acting as agent, broker, or custodian is not acting ''as principal'' under the final rule so long as the activity is conducted for the account of, or on behalf of, a customer and the banking entity does not have or retain beneficial ownership of such ownership interest, as noted above. This provision is consistent with the final rule's treatment of banking entities acting on behalf of customers as trustee or in a fiduciary capacity.

[1657] The Agencies note that this provision does not permit joint investments between the banking entity and its employees. Rather, this provision is intended to enable banking entities to maintain deferred compensation and other similar plans formed for the benefit of employees. The Agencies recognize that, since it is possible an employee may forfeit its interest in such a plan, the banking entity may have a residual or reversionary interest in the assets referenced under the plan. However, other than such residual or reversionary interests, a banking entity may not rely on this provision to invest in a covered fund.

[1658] *See* final rule § 75.10(a)(2). For instance, as part of engaging in its traditional trust company functions, a bank or savings association typically may act through an entity that is excluded from the definition of investment company under section 3(c)(3) or 3(c)(11). This would be included within the scope of acting on behalf of customers as trustee or in a similar fiduciary capacity, provided that it meets the applicable requirements of the exclusion under the final rule.

[1659] *See* 12 U.S.C. 1851(h)(2).

[1660] 12 U.S.C. 1851(h)(2). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of ''investment company'' for: (1) Any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper); or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. *See* 15 U.S.C. 80a-3(c)(1) and (c)(7).

[1661] *See* proposed rule § 75.10(b)(1).

generally all securities other than U.S. government securities) representing at least 40 percent of the entity's total assets would be an investment company.[1662] According to commenters, this definition and the accompanying exclusions are part of a securities law and regulatory framework designed for purposes different than the prudential purpose that underlies section 13 of the BHC Act.[1663]

A number of comments received on the proposal argued that the proposed definition of covered fund was overly broad and would lead to anomalous results inconsistent with the words, structure, and purpose of section 13.[1664] For instance, many commenters asserted that the proposed rule's definition of covered fund would cause a number of commonly used corporate entities that are not traditionally thought of as hedge funds or private equity funds, such as wholly-owned subsidiaries, joint ventures, and acquisition vehicles, to be subject to the covered fund restrictions of section 13. These commenters argued that this interpretation of section 13 would cause a disruption to the operations of banking entities and their closely related affiliates that does not relate to the intent of section 13 and therefore cause an unnecessary burden on banking entities. Commenters argued that the words, structure and purpose of section 13 allow the Agencies to adopt a more tailored definition of covered fund that focuses on vehicles used for investment purposes that were the target of section 13's restrictions.

In particular, commenters requested that the final rule exclude at least the following from the definition of covered fund: U.S. registered investment companies (including mutual funds); the foreign equivalent of U.S. registered investment companies; business development companies; wholly-owned subsidiaries; joint ventures; acquisition vehicles; financial market utilities; foreign pension or retirement funds; insurance company separate accounts; loan securitizations, including asset-backed commercial paper conduits; cash management vehicles or cash collateral pools; credit funds; real estate investment trusts; various securitization vehicles; tender option bond programs; and venture capital funds.[1665] Commenters requested some of these exclusions in order to mitigate the impact of the proposal's inclusion of commodity pools as part of the definition of covered fund.[1666]

Some commenters argued that the proposal failed to distinguish between different types of investment funds.[1667] These commenters expressed the view that the statute provides the Agencies with the discretion to distinguish between investment funds generally and a subset of funds—hedge funds and private equity funds—that may engage in particularly risky trading and investment activities. For example, several commenters argued that the proposed rule's restrictions on covered fund investments should not cover venture capital funds that provide investment capital to new businesses.[1668] Others argued an exclusion for securitization vehicles such as securitizations that are backed, in whole or in part, by assets that are not loans, including corporate debt repackagings,[1669] CLOs,[1670] ABCP conduits,[1671] insurance-linked securities,[1672] and synthetic securitizations backed by derivatives.[1673]

As a potential solution to some of these concerns, a number of commenters argued that the Agencies should define covered fund by reference to characteristics that are designed to distinguish hedge funds and private equity funds from other types of entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1674] Commenters believed this approach would help exclude some of the corporate vehicles and funds mentioned above that they did not believe were intended by Congress to be included as hedge funds and private equity funds and therefore reduce costs that, in the commenters' view, did not further the purposes of section 13.[1675]

These commenters proposed a number of different potential types of characteristics for defining hedge fund and private equity fund. Some commenters focused on certain structural or investment characteristics found in traditional private equity funds and hedge funds, such as investor redemption rights, performance compensation fees, leverage and the use of short-selling.[1676] Another commenter argued that the characteristics used to define a covered fund should focus on the types of speculative behavior that the statute was intended to address, citing characteristics such as volatility of asset performance and high leverage.[1677]

In contrast to the majority of the commenters, one commenter urged that characteristics be used to expand the proposed definition to include any

[1662] 15 U.S.C. 80a-3(a)(1)(A) and (C). The definition of securities is very broad under the Investment Company Act and has been interpreted to include instruments such as loans, that would not be regarded as securities under the Securities Act of 1933 and the Securities Exchange Act of 1934. In addition, the determination of what constitutes an ''investment security'' under the Investment Company Act requires complex analysis and consideration of a broad set of facts and circumstances.

[1663] *See, e.g.,* NVCA.

[1664] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.;* Rep. Garrett *et al.*

[1665] *See* ABA (Keating); ABA (Abernathy); SIFMA *et al.* (Covered Funds) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); Allen & Overy (on behalf of Canadian Banks); Deutsche Bank (Repackaging Transactions); ICI (Feb. 2012); Putnam; JPMC; GE (Feb. 2012); Chamber (Feb. 2012); Rep. Himes; BOK; Ass'n. of Institutional Investors (Feb. 2012); Wells Fargo (Covered Funds); BoA; NAIB *et al.;* PNC; SunTrust; Nationwide; STANY; BNY Mellon *et al.;* RMA; Goldman (Covered Funds); Japanese Bankers Ass'n; IRSG; ISDA (Feb. 2012); IIB/EBF; Citigroup (Jan. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Eaton Vance; Fidelity; SBIA; River Cities; Ashurst; Sen. Hagan; Sen. Bennet.

[1666] As discussed below, the Agencies have modified the final rule to include only certain commodity pools within the definition of covered fund.

[1667] *See* NVCA; *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating).

[1668] *See, e.g.,* ABA (Keating); ABA (Abernathy); Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Growth Managers; River Cities; SVB; EVCA.

[1669] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Deutsche Bank (Repackaging Transactions); SIFMA (Securitization) (Feb. 2012).

[1670] *See* SIFMA (Securitization) (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); JPMC; LSTA (Feb. 2012).

[1671] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); Eaton Vance; Fidelity; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012); AFME *et al.*

[1672] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1673] *See* AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); ABA (Keating).

[1674] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Credit Suisse (Williams); SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); Allen & Overy (on behalf of Foreign Bank Group).

[1675] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Ashurst; Barclays; BDA (Feb. 2012); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Fidelity; ICI (Feb. 2012); ISDA (Feb. 2012); JPMC; Nuveen Asset Mgmt.; PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Municipal Securities) (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds).

[1676] *See* Ass'n. of Institutional Investors (Feb. 2012); Barclays; JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* FSOC study at 62–63 (suggesting a characteristics-based approach considering compensation structure; trading/investment strategy; use of leverage; investor composition); ABA (Keating); BNY Mellon *et al.;* Northern Trust, SSgA (Feb. 2012); State Street (Feb. 2012); Deutsche Bank (Repackaging Transactions); T. Rowe Price; RMA (suggesting use of characteristics derived from the SEC's Form PF for registration of investment advisers of private funds).

[1677] *See* RBC (citing FSOC study).

issuer that exhibits characteristics of proprietary trading that the statute prohibits to be done by a banking entity.[1678] According to this commenter, any fund engaging in more than minimal proprietary trading should be a covered fund and subject to the requirements of section 13.

However, not all commenters supported a characteristics-based definition. One commenter opposed a characteristics-based definition, suggesting that the final rule rely only on the statutory reference to the Investment Company Act, and arguing that using characteristics to define a covered fund (*e.g.,* leverage) could create opportunities for circumvention of the rule.[1679] Commenters that generally supported the proposed definition argued that its broad scope prevented circumvention.[1680]

One commenter argued in favor of broadening the definition of covered fund to include entities that rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) and 3(c)(7), such as section 3(c)(2) (which provides an exclusion for underwriters and brokers) or 3(c)(6) (which provides an exclusion for entities engaged in a business other than investing in securities).[1681] By contrast, other commenters argued that an entity should not be considered a covered fund if the entity relies on an exclusion or exemption contained in the Investment Company Act other than an exclusion contained in section 3(c)(1) or 3(c)(7) under that Act, such as the exclusion contained in section 3(c)(3) for bank collective investment funds.[1682]

The Agencies have carefully considered all of the comments related to the definition of covered fund. While the Agencies believe that the proposal reflected a reasonable interpretation of the statutory provision, on further review and in light of the comments the Agencies have determined to adopt a different approach. The Agencies have revised the final rule to address many of the concerns raised by commenters regarding the scope of the original proposal in a manner the Agencies believe is a better reading of the statutory provision because it is both consistent with the language, purpose and structure of section 13 and avoids unintended consequences of the less precise definitional approach of the proposal.

In the final rule, the Agencies have joined the definitions of ''hedge fund'' and ''private equity fund'' into a single definition ''covered fund'' (as in the statute) and have defined this term as any issuer that would be an investment company as defined in the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act with a number of express exclusions and additions (explained below) as determined by the Agencies. Thus, for example, an entity that invests in securities and relies on any exclusion or exemption from the definition of ''investment company'' under the Investment Company Act other than the exclusion contained in section 3(c)(1) or 3(c)(7) of that Act would not be considered a covered fund so long as it satisfies the conditions of another Investment Company Act exclusion or exemption.[1683] Such an entity would not be an investment company but for section 3(c)(1) or 3(c)(7), and the Agencies have modified the final rule to explicitly exclude such an entity.[1684]

The Agencies believe this definition is consistent with the words, structure, purpose and legislative history of section 13 of the BHC Act. As noted above, section 13(h)(2) provides that the terms ''hedge fund'' and ''private equity fund'' mean an issuer that would be an investment company as defined in the Investment Company Act (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, *or* such similar funds as the Agencies may, by rule, as provided in subsection (b)(2), determine.[1685] The statutory provision contains two parts: A first part that refers to any issuer that is ''an investment company, as defined in the Investment Company Act, but for section 3(c)(1) and 3(c)(7) of the Act''; and a second part that covers ''such similar funds as the [Agencies] may, by rule . . . determine.'' The proposed rule offered a reading of this provision as a simple concurrent definition with two self-contained, supplementary parts. Under this approach, all entities covered by part one of the definition would be included in the definitions of ''hedge fund'' and ''private equity fund,'' and the role of the Agencies under the second part was limited to considering whether and how to augment the scope of the primary statutory definition.

As noted above, commenters argued that this interpretation led to unintended consequences that were not consistent with other provisions of section 13 or the purposes of section 13, and that other interpretations of the definition of covered fund were consistent with both the words and the purpose of the statute. Also as explained above, commenters offered multiple alternative interpretations of the definition of, the scope of the prohibition on ownership interests in, and relationships with, a covered fund.[1686]

The Agencies believe that the language of section 13(h)(2) can best be interpreted to provide two alternative definitions of the entities to be covered by the statutory terms ''hedge fund'' and ''private equity fund.'' Under this reading, the first part of section 13(h)(2) contains a base definition that references the noted exclusions under the Investment Company Act (the ''default definition''), while the second part grants the Agencies the authority to adopt an alternate definition that is triggered by agency action (the ''tailored definition''). Thus, if the Agencies do not act by rule, the definition is set by reference to the Investment Company Act and the relevant exclusions alone; if the Agencies act by rule, the definitions are set by the Agencies under that rule. As noted above, the Agencies have determined to exercise the authority under the second part of the statute to define ''hedge fund'' and ''private equity fund'' in the final rule.

Relying on the Agencies' authority to adopt an alternative, tailored definition of ''hedge fund'' and ''private equity fund,'' the final rule references funds that are similar to the funds in the base

[1678] *See* Occupy.

[1679] *See* AFR *et al.* (Feb. 2012).

[1680] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Alfred Brock.

[1681] *See* Occupy (also arguing in favor of including entities that rely on rule 3a-1 (which provides an exemption for issuers that hold less than 45% of their assets in securities excluding government securities) or 3a-6 (which provides an exemption for foreign banks and insurance companies) to avoid being regulated as investment companies under the Investment Company Act).

[1682] *See, e.g.,* ABA (Keating).

[1683] For instance, bank common trust and collective funds that qualify for the exclusion from the definition of investment company pursuant to section 3(c)(3) or 3(c)(11) of the Investment Company Act are not covered funds. *See* 15 U.S.C. 78a-3(c)(3) and (c)(11). These funds are subject to supervision and regulation by a Federal banking agency, thus helping to distinguish them from traditional hedge funds and private equity funds which are generally not themselves subject to such supervision or regulation.

[1684] *See* final rule § 75.10(c)(12).

[1685] *See* 12 U.S.C. 1851(h)(2) (emphasis added).

[1686] In addition to the readings described above, one commenter argued that the section could be read to provide that both the reference to issuers covered by section 3(c)(1) or 3(c)(7) of the Investment Company Act in the first part of section 13(h)(2) and the reference to similar funds in the second part of the section should be read as qualified by the clause ''as the Agencies may by rule. . . determine.'' Under this reading, Congress granted the Agencies authority to determine by rule whether an entity described by the first part would be covered and whether an issuer would be deemed to be a similar fund under the second part. *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

alternative provided in the first alternative definition—that is, an issuer that would be an investment company under the Investment Company Act but for section 3(c)(1) or 3(c)(7) of that Act. The additions and exclusions from that definition represent further determinations by the Agencies regarding the scope of that definition that were made in the course of a rulemaking conducted in accordance with section 13(b)(2) of the BHC Act.

The Agencies believe that this reading of the statutory provision is consistent with the purpose of section 13. That purpose appears to be to limit the involvement of banking entities in high-risk proprietary trading, as well as their investment in, sponsorship of, and other connections with, entities that engage in investment activities for the benefit of banking entities, institutional investors and high-net worth individuals.[1687] Further, the Agencies believe that the provision permits them to tailor the scope of the definition to funds that engage in the investment activities contemplated by section 13 (as opposed, for example, to vehicles that merely serve to facilitate corporate structures); doing so allows the Agencies to avoid the unintended results, some of which commenters identified, that might follow from a definition that is inappropriately imprecise.[1688]

The Agencies also note that nothing in the structure or history of the Dodd-Frank Act suggests that the definition of hedge fund and private equity fund was intended to necessitate a fundamental restructuring of banking entities by disallowing investments in common corporate vehicles such as intermediate holding companies, joint operating companies, acquisition vehicles and similar entities that do not engage in the types of investment activities contemplated by section 13. Moreover, other provisions of the Dodd-Frank Act and existing banking laws and regulations would be undermined or vitiated by a reading that restricts investments in these types of corporate vehicles and structures.[1689]

Based on the interpretive and policy considerations raised by commenters, the language of section 13(h)(2), and the language, structure, and purpose of the Dodd-Frank Act, the Agencies have adopted a tailored definition of covered fund in the final rule that covers issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act with exclusions for certain specific types of issuers in order to focus the covered fund definition on vehicles used for the investment purposes that were the target of section 13. The definition of covered fund under the final rule also includes certain funds organized and offered outside of the United States in order to address foreign fund structures and certain commodity pools that might otherwise allow circumvention of the restrictions of section 13. The Agencies also expect to exercise the statutory anti-evasion authority provided in section 13(e) of the BHC Act and other prudential authorities in order to address instances of evasion.[1690]

As discussed above, an alternative approach to defining a covered fund would be to reference fund characteristics. Commenters arguing for a characteristics-based approach stated that it would more precisely tailor the final rule to the intent of section 13 and limit the potential for undue burden on banking entities. A characteristics-based definition, however, could be less effective than the approach taken in the final rule as a means to prohibit banking entities, either directly or indirectly, from engaging in the covered fund activities limited or proscribed by section 13. A characteristics-based approach also could require more analysis by banking entities to apply those characteristics to every potential covered fund on a case-by-case basis, and create greater opportunity for evasion. As discussed below, the Agencies have sought to address some of the concerns raised by commenters suggesting a characteristics-based approach by tailoring the definition of covered fund to provide exclusions for certain entities that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and otherwise would be treated as covered funds.

Some commenters discussed the potential cost to banking entities to analyze the covered fund status of certain entities if the Agencies were to define the term covered fund by reference to sections 3(c)(1) and 3(c)(7), arguing that this analysis would be costly.[1691] A characteristics-based approach could mitigate the costs associated with an investment company analysis but, depending on the characteristics, could result in additional compliance costs in some cases to the extent banking entities would be required to implement policies and procedures to prevent potential covered funds from having characteristics that would bring them within the covered fund definition. Furthermore, banking entities may currently rely on section 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid registering various entities under the Investment Company Act, and the costs to analyze the status of these entities under a statutory-based definition of covered fund are generally already included as part of the fund formation process and the costs of determining covered fund status may thus be mitigated, especially given the exclusions provided in the final rule.

The entities excluded from the definition of covered fund are described in detail in section (c) below.

[1687] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[1688] The Agencies believe that the choice of the tailored definition is supported by the legislative history that suggests that Congress may have foreseen that its base definition could lead to unintended results and might be overly broad, too narrow, or otherwise off the mark. Part two of the statutory definition was not originally included in the bill reported by the Senate Committee on April 30, 2010. While the addition of part two did not receive specific comment, Rep. Frank, a co-sponsor and principal architect of the Dodd-Frank Act, noted that the default definition ''could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds'' and confirmed that ''[w]e do not want these overdone.'' *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored).

[1689] For example, the Dodd-Frank Act requires banking entities to serve as a source of financial strength to their insured depository institutions and requires certain banking entities to form intermediate holding companies to separate their financial and non-financial activities. *See* Sections 167, 616(d) & 626 of the Dodd-Frank Act. These provisions would be severely undermined if the prohibitions on investments and activities contained in section 13 were applied to ownership of intermediate holding companies. For instance, a bank holding company would not be able to serve as a source of strength to an intermediate holding company (or any subsidiary thereof) that is a covered fund due to the transaction restrictions contained in section 13(f). *See* 12 U.S.C. 1851(f). As another example, the Agencies have made certain modifications to the final rule to make clear that it will not affect the resolution authority of the Federal Deposit Insurance Corporation, including by excluding from the covered fund definition issuers formed by or on behalf of the Corporation for the purpose of facilitating the disposal of assets acquired in the Corporation's capacity as conservator or receiver. *See* § 75.10(c)(13).

[1690] As discussed in Part VI.C.1 of this **SUPPLEMENTARY INFORMATION** regarding the compliance program requirements of the final rule, the Agencies will consider information maintained and provided by banking entities under the compliance program mandate to help monitor potential evasions of the prohibitions and restrictions of section 13. Additionally and consistent with the statute, the final rule permits the Agencies to jointly determine to include within the definition of covered fund any fund excluded from that definition. The Agencies expect that this authority may be used to help address situations of evasion.

[1691] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

1. Foreign Covered Funds

In order to prevent evasion of the prohibition and purposes of section 13, the proposal included within the definition of covered fund any issuer organized or offered outside of the United States (''foreign covered fund'') that would be a covered fund were it organized or offered in the United States.[1692]

Commenters expressed concern that the proposed treatment of foreign covered funds was overly broad, exceeded the Agencies' statutory authority, was not consistent with principles of national treatment, and violated international treaties.[1693] Commenters expressed concern about the difficulties of applying Investment Company Act concepts to foreign funds that are structured to comply with regulatory schemes under local laws outside the United States. They also argued that it would be burdensome and costly to require foreign banking entities to interpret and apply U.S. securities laws to foreign structures that are designed primarily to be offered and sold outside the United States.[1694] Commenters also contended that foreign mutual fund equivalents, such as retail Undertakings for Collective Investments in Transferable Securities (''UCITS''),[1695] would be treated as covered funds under the proposal even though they generally are similar to U.S. registered investment companies, which are not covered funds, meaning that under the proposal the scope of foreign funds captured was broader than the scope of domestic funds.[1696] These commenters argued that a foreign fund organized and offered outside of the United States should not be treated as a covered fund simply because the foreign fund may (or could) rely on the exclusion under section 3(c)(1) or 3(c)(7) of the Investment Company Act were it to be offered in the United States.[1697]

Some commenters argued that the proposal did not clearly identify which foreign funds would be covered, thereby creating uncertainty about the scope of funds to which section 13 would apply.[1698] Several commenters argued that the proposal's foreign covered fund definition could be read to include a foreign fund, even if its securities were never offered and sold to U.S. persons, because the fund could theoretically be offered in the United States in reliance on section 3(c)(1) or 3(c)(7).[1699] Commenters argued that the definition of foreign covered fund should be tailored.[1700] Some commenters argued that foreign funds that are not made available for sale in the U.S. or actively marketed to U.S. investors should be specifically excluded from the definition of covered fund.[1701] Several other commenters supported narrowing the definition of foreign covered fund to those foreign funds with characteristics similar to domestic hedge funds or private equity funds.[1702]

After considering the comments in light of the statutory provisions and purpose of section 13, the Agencies have modified the final rule to more effectively tailor the scope of foreign funds that would be covered funds under the rule and better implement the language and purpose of section 13. As noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities, and one of the purposes of section 13 is to reduce the risk to the U.S. financial system of activities with and investments in covered funds. The Agencies proposed to include foreign funds within the definition of covered fund in order to more effectively accomplish the purpose of section 13. In particular, the Agencies were concerned that a definition of covered fund that did not include foreign funds would allow U.S. banking entities to be exposed to risks and engage in covered fund activities outside the United States that are specifically prohibited in the United States. This result would undermine section 13 and pose risks to U.S. banking entities and the stability of the U.S. financial system that section 13 was designed to prevent.

At the same time, section 13 includes other provisions that explicitly limit its extra-territorial application to the activities of foreign banks outside the United States. As explained below, section 13 specifically exempts certain activities in covered funds conducted by foreign banking entities solely outside of the United States.

Based on these considerations and the information provided by commenters, the Agencies have revised the definition of covered fund in the final rule to include certain foreign funds under certain circumstances. The final rule provides that a foreign fund is included within the definition of covered fund only for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State. Under this definition a foreign fund becomes a covered fund only with respect to the U.S. banking entity (or foreign affiliate of a U.S. banking entity) that acts as a sponsor to the foreign fund or has an ownership interest in the foreign fund. Under the rule, a foreign fund is any entity that: (i) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States; (ii) is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or

[1692] *See* proposed rule § 75.10(b)(1)(iii).

[1693] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BNY Mellon *et al.;* BlackRock; ABA (Keating); AFTI; AFG; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal et al. (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; TCW; Govt. of Japan/Bank of Japan.

[1694] *See* JPMC; *see also* Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Ass'n. of Banks in Malaysia; Govt. of Japan/Bank of Japan.

[1695] UCITS are public limited companies that, under a series of directives issued by the EU Commission, coordinate distribution and management of unit trusts or collective investment schemes in financial instruments on a cross-border basis throughout the European Union on the basis of the authorization of a single member state.

[1696] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); AFG; AFTI; BoA; French Banking Fed'n.; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* BNY Mellon *et al.;* BlackRock; ICI Global; Ass'n. of Institutional Investors (Feb. 2012); ICI (Feb. 2012); SSgA (Feb. 2012); State Street (Feb. 2012); JPMC; BoA; Goldman (Covered Funds); Bank of Montreal *et al.* (Jan. 2012); AGC; Cadwalader (on behalf of Thai Banks); ALFI; BVI; EBF; British Bankers Ass'n.; French ACP; AFME *et al.;* F&C; IIF; ICSA; IMA; EFAMA; UKRCBC; AIMA; AFMA; Australian Bankers Ass'n. (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); IFIC; Allen & Overy (on behalf of Canadian Banks); RBC; French Treasury *et al.;* Hong Kong Inv. Funds Ass'n.; HSBC Life; ICSA Ass'n. of Banks in Malaysia (arguing that foreign banking organization would have to determine how a fund would be regulated under U.S. law before making investments in funds in their home markets).

[1697] *See* Allen & Overy (on behalf of Foreign Bank Group); ABA (Keating); SSgA (Feb. 2012); BoA; Goldman (Covered Funds).

[1698] *See* Australian Bankers Ass'n. (Feb. 2012); BlackRock.

[1699] *See* BlackRock; SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; ABA (Keating); IIB/EBF. These commenters argued that the proposed definition of a covered fund could result in virtually every foreign fund being considered a covered fund, regardless of whether the fund is similar to a hedge fund or private equity fund.

[1700] *See, e.g.,* AGC; Ass'n. of Institutional Investors (Feb. 2012); ABA (Keating); Goldman (Covered Funds); BoA; GE (Feb. 2012); Japanese Bankers Ass'n.; EBF.

[1701] *See* Australian Bankers Ass'n. (Feb. 2012); AFG; BNY Mellon *et al.;* BlackRock; Goldman (Covered Funds); IIB/EBF.

[1702] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; Goldman (Covered Funds); Credit Suisse (Williams); ABA (Keating); IIB/EBF; Barclays; BoA; GE (Feb. 2012) (discussing the uncertainty with respect to foreign-based loan and securitization programs and whether they would be deemed covered funds).

otherwise trading in securities; and (iii) has as its sponsor the U.S. banking entity (or an affiliate thereof) or has issued an ownership interest that is owned directly or indirectly by the U.S. banking entity (or an affiliate thereof).[1703] A foreign fund therefore may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States.

This approach is designed to include within the definition of covered fund only foreign entities that would pose risks to U.S. banking entities of the type section 13 was designed to address. The Agencies note that any foreign fund, including a foreign fund sponsored or owned by a foreign banking entity, that is offered or sold in the United States in reliance on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act would be included in the definition of covered fund under § 75.10(b)(1)(i) of the final rule unless it meets the requirements of an exclusion from that definition as discussed below.[1704] Thus, the rule is designed to provide parity—and no competitive advantages or disadvantages—between U.S. and non-U.S. funds sold within the United States.

To further ensure that this approach to foreign funds is consistent with the scope of coverage applied within the United States, the final rule excludes from the definition of covered fund any foreign issuer that, were it subject to U.S. securities laws, would be able to rely on an exclusion or exemption from the definition of investment company other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1705]

As explained below, the final rule also contains an exclusion for foreign public funds.[1706] This is designed to prevent the extension of the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies, which are by statute not covered by section 13.

2. Commodity Pools

Under the proposal, the Agencies proposed to use their authority to expand the definition of covered fund to include a commodity pool as defined in section 1a(10) of the Commodity Exchange Act.[1707] A commodity pool is defined in the Commodity Exchange Act to mean any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests.[1708] The Agencies proposed to include commodity pools in the definition of covered fund because some commodity pools are managed and structured in a manner similar to a covered fund.

Some commenters objected to this expansion of the definition of covered fund as beyond the scope of section 13. Commenters argued that covering commodity pools would extend section 13 of the BHC Act to any entity that engages in a single commodity, futures or swap transaction, including entities that share few, if any, of the characteristics or risk associated with private equity funds or hedge funds.[1709] For example, some commenters argued that many non-bank businesses that are not investment companies but that hedge risks using commodity interests would be treated as covered funds if all commodity pools were covered.[1710] In addition, registered mutual funds, pension funds, and many investment companies that rely on exclusions or exceptions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act would be covered as commodity pools. Commenters argued that the CFTC has ample authority to regulate the activities of commodity pools and commodity pool operators, and nothing in section 13 indicates that Congress intended section 13 to govern commodity pool activities or investments in commodity pools.[1711] Commenters also argued that expanding the definition of covered fund to include commodity pools would have the unintended consequence of limiting all covered transactions between a banking entity sponsor or investor in a commodity pool and the commodity pool itself.[1712] If a commercial end user is a commodity pool for example, this restriction could limit access to credit for that entity.

Commenters that opposed the proposal's inclusion of commodity pools generally asserted that, if commodity pools were nonetheless included as covered funds under the final rule, the definition of commodity pool should be modified so that it would include only those pools that engage ''primarily'' or ''principally'' in commodities trading and exhibit characteristics similar to those of conventional hedge funds and private equity funds.[1713] Other commenters urged the Agencies to incorporate the exemptions from the commodity pool operator registration requirements under the Commodity Exchange Act (such as rule 4.13(a)(4)).[1714]

Some commenters supported including commodity pools within the definition of covered fund,[1715] with some suggesting that this approach would be consistent with the goals of the statute.[1716] One commenter asserted that including commodity pools would be necessary to prevent banking entities from indirectly engaging in prohibited proprietary trading through commodity pools.[1717] Another commenter asserted that the inclusion of commodity pools was advisable because the CFTC has in the past viewed many commodity pools as similar to hedge funds.[1718]

After carefully considering these comments, the Agencies have determined not to include all commodity pools as covered funds as proposed. Instead, and taking into account commenters' concerns, the Agencies have taken a more tailored approach that is designed to more accurately identify those commodity pools that are similar to issuers that would be investment companies as defined the Investment Company Act of 1940 but for section 3(c)(1) or 3(c)(7) of

[1703] *See* final rule § 75.10(b)(1)(iii).

[1704] *See also* Goodwin, Procter & Hoar LLP, SEC Staff No-Action Letter (Feb. 28, 1997); Touche Remnant & Co., SEC Staff No-Action Letter (Aug. 27, 1984).

[1705] *See* final rule § 75.10(b)(2). Because any issuer that offers its securities under the U.S. securities laws that may rely on an exclusion or exemption from the definition of investment company other than the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be a covered fund, this exclusion is designed to provide equivalent treatment for foreign covered funds.

[1706] *See* § 75.10(c)(1).

[1707] *See* proposal rule § 75.10(b)(1)(ii).

[1708] Commodity interests include: (i) Commodity for future delivery, security futures product, or swap; (ii) agreement, contract, or transaction described in section 2(c)(2)(C)(i) or 2(c)(2)(D)(i) of the Commodity Exchange Act; (iii) commodity option authorized under section 4c of the Commodity Exchange Act; or (iv) leveraged transaction authorized under section 23 of the Commodity Exchange Act. *See* Joint Proposal, 76 FR at 68897 n.224 and accompanying text.

[1709] *See, e.g.,* ABA (Keating) (citing *see, e.g.,* CFTC Interpretative Letter No. 86–22, Comm. Fut. L. Rep. (CCH) ¶ 23,280 (Sept. 19, 1986)); SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock; Goldman (Covered Funds); Wells Fargo (Covered Funds); BoA; EFAMA; TCW; ISDA (Feb. 2012); Arnold & Porter; BNY Mellon *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); RMA; IIB/EBF.

[1710] *See* Goldman (Covered Funds); TCW; IIB/EBF.

[1711] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); ICI (Feb. 2012); BlackRock.

[1712] *See, e.g.,* BoA.

[1713] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); BlackRock; Wells Fargo (Covered Funds); BNY Mellon, *et al.;* SSgA (Feb. 2012); State Street (Feb. 2012); Credit Suisse (Williams); ABA (Keating); FIA; IIB/EBF; BoA.

[1714] *See* Credit Suisse (Williams).

[1715] *See* AFR *et al.* (Feb. 2012); Alfred Brock; Occupy; Sens. Merkley & Levin (Feb. 2012).

[1716] *See* Sens. Merkley & Levin (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Alfred Brock.

[1717] *See* Sens. Merkley & Levin (Feb. 2012).

[1718] *See* Occupy.

that Act, consistent with section 13(h)(2) of the BHC Act.

Under the final rule, as a threshold matter, a collective investment vehicle must determine whether it is a ''commodity pool'' as that term is defined in section 1a(10) of the Commodity Exchange Act.[1719] The Agencies note that collective investment vehicles need to make this determination for purposes of complying with the Commodity Exchange Act regardless of whether commodity pools are covered funds. Under section 1a(10), a commodity pool is ''any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading commodity interests.'' [1720] If a collective investment vehicle meets that definition, the commodity pool would be considered a covered fund provided it meets one of two alternative tests and does not also qualify for an exclusion from the covered fund definition (*e.g.,* the exclusion for registered investment companies).

First, a commodity pool will be a covered fund if it is an ''exempt pool'' under section 4.7(a)(1)(iii) of the CFTC's regulations,[1721] meaning that it is a commodity pool for which a registered commodity pool operator has elected to claim the exemption provided by section 4.7 of the CFTC's regulations. The Agencies believe that such commodity pools are appropriately considered covered funds because, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools sell their participation units in restricted offerings that are not registered under the Securities Act of 1933 and are offered only to investors who meet certain heightened qualification standards, as discussed above.[1722] The Agencies therefore have determined that they properly are considered ''such similar funds'' as specified in section 13(h)(2) of the BHC Act.

Alternatively, a commodity pool for which exempt pool status under section 4.7 of the CFTC's regulations has not been elected may also be a covered fund if the pool features certain elements that make the pool substantively similar to exempt pools under section 4.7. The Agencies are including the alternative definition of commodity pools that are covered funds because, if the Agencies had included only pools for which exempt pool status had been elected, covered fund status for pools in which banking entities are invested could easily be avoided merely by not electing exempt pool status under section 4.7. The following is a description of the elements of a pool that would cause a pool that is not an exempt pool under section 4.7 to be a covered fund.

The first element is that a commodity pool operator for the pool is registered pursuant to the Commodity Exchange Act in connection with the operation of that commodity pool. This element is present for all pools that are exempt pools under section 4.7 because exempt pool status can only be elected by registered commodity pool operators. This element excludes from the definition of covered fund an entity that is a commodity pool, but for which the pool operator has been either exempted from registration as a commodity pool operator or excluded from the definition of commodity pool operator under the CFTC's regulations or pursuant to a no-action letter issued by CFTC staff.[1723]

The second element under the alternative definition is that substantially all of the commodity pool's participation units are owned only by qualified eligible persons under section 4.7(a)(2) and (a)(3).[1724] This element is consistent with the requirement under section 4.7 that exempt pool status can only be claimed if the participation units in the pool are only offered or sold to qualified eligible persons.[1725] Moreover, the inclusion of this element aligns the elements of the alternative test with features that define funds that rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940.

The assessment as to whether the commodity pool in question satisfies this condition must be made at the time that the banking entity is required to make the following determinations: whether it can obtain new participation units in the commodity pool, whether it can retain previously purchased participation units in the commodity pool, and whether it can act as the commodity pool's sponsor. The Agencies believe this to be appropriate because it would require the banking entity to consider current information regarding the commodity pool and its participants rather than assess the composition of the pool's participants over time even though its investments in or relationships with the pool do not change, which could be difficult depending upon the length of time that the pool has been in operation and the records available at the time of determination.

Finally, the third element under the alternative definition is that the commodity pool participation units have not been publicly offered to persons other than qualified eligible persons. Consistent with CFTC regulations addressing the meaning of ''offer'' in the context of the CFTC's regulations, the term ''offer'' as used in § 75.10(b)(1)(ii)(B) ''has the same meaning as in contract law, such that, if accepted the terms of the offer would form a binding contract.'' [1726] This aspect of the alternative definition is intended to limit the ability for commodity pools to avoid classification as covered funds through an offer, either in the past or currently ongoing, to non-qualified eligible persons ''in name only'' where there is no actual offer to non-qualified eligible persons.

Accordingly, unless the pool operator can show that the pool's participation units have been actively and publicly offered to non-affiliated parties that are not qualified eligible persons whereby such non-qualified eligible persons could in fact purchase a participation unit in the commodity pool, a pool that features the other elements listed in the

[1719] *See* 7 U.S.C. 1a(10).

[1720] *Id.* The CFTC and its divisions have provided interpretative guidance with respect to the meaning of the definition of commodity pool. *See, e.g.,* 46 FR 26004, 26005 (May 8, 1981) (adopting the CFTC's regulatory definition of commodity pool in 17 CFR 4.10(d), which is substantively identical to the definition in section 1a(10) of the Commodity Exchange Act); 77 FR 11252, 11258 (Feb. 24, 2012) (explaining the need for swaps to be included in the de minimis exclusion and exemption in 17 CFR 4.5 and 4.13); CFTC Staff Letter 12–13 (Oct. 11, 2012) (providing interpretative guidance to equity real estate investment trusts); and CFTC Staff Letters Nos. 12–14 (Oct. 11, 2012) and 12–45 (Dec. 7, 2012) (providing interpretative relief that certain securitization vehicles are not commodity pools).

[1721] 17 CFR 4.7(a)(1)(iii).

[1722] Although section 3(c)(1) itself does not limit the types of investors who may invest in a fund relying on that exclusion, section 3(c)(1) provides that the fund may not conduct a public offering. A fund relying on section 3(c)(1) therefore must offer and sell its interests in offerings that are not registered under the Securities Act of 1933, which offerings generally are limited to persons who meet certain qualification standards.

[1723] *See, e.g.,* CFTC regulations 3.10(c) and 4.13 and CFTC Staff Letters Nos. 12–37 (Nov. 29, 2012) (relief from registration for operators of certain types of family office pools), 12–40 (Dec. 4, 2012) (relief from registration for operators of business development companies that meet certain conditions) and 12–44 (Dec. 7, 2012) (relief from registration for operators of mortgage real estate investment trusts that meet certain conditions). *See also supra* note 1720.

[1724] 17 CFR 4.7(a)(2) and (a)(3).

[1725] Although section 4.7 requires that all participation units be owned by qualified eligible persons, this element of the final rule has been modified to include pools for which ''substantially all'' participation units are owned by qualified eligible persons to prevent avoidance of covered fund status by distributing a small number of participation units to persons who are not qualified eligible persons.

[1726] *See* 77 FR 9734, 9741 (Feb. 17, 2012) (describing the meaning of the term ''offer'' in the context of the business conduct standards for swap dealers and major swap participants with counterparties adopted by the CFTC). The term ''offered'' as used in this section of the final rule is not intended to denote an ''offer'' for purposes of the Securities Act of 1933.

alternative definition would be a covered fund. Such a showing will not turn solely on whether the commodity pool has filed a registration statement to offer its participation units under the Securities Act of 1933 or whether the commodity pool operator has prepared a disclosure document consistent with the provisions of section 4.24 of the CFTC's regulations.[1727] Rather, the pool operator would need to show that a reasonably active effort, based on the facts and circumstances, has been undertaken by brokers and other sales personnel to publicly offer the pool's participation units to non-affiliated parties that are not qualified eligible persons.

In taking this more tailored approach to commodity pools that will be covered funds, the Agencies are more closely aligning the types of commodity pools that will be covered funds under the final rule with section 13's definition of a hedge fund and private equity fund by reference to section 3(c)(1) or section 3(c)(7), and addressing concerns of commenters that the proposal was overly broad and would lead to outcomes inconsistent with the words, structure, and purpose of section 13.[1728] The Agencies believe that the types of commodity pools described above generally are similar to funds that rely on section 3(c)(1) and 3(c)(7) in that, like funds that rely on section 3(c)(1) or 3(c)(7), these commodity pools may be owned only by investors who meet certain heightened qualification standards, as discussed above.[1729] Further, the Agencies believe that the final rule's identification of the elements of a commodity pool that is a covered fund are clearly established and readily ascertainable such that once it is determined whether an entity is a commodity pool, an assessment that is already necessary to comply with the Commodity Exchange Act, then the further determination of whether an entity that is a commodity pool is also a covered fund can be made based on readily ascertainable information.

In adopting this approach, the Agencies also are utilizing the current regulatory structure promulgated by the CFTC under the CEA. As the CFTC regulates commodity pools, commodity pool operators, and commodity trading advisors that advise commodity pools, the Agencies believe that it is beneficial to utilize an already established set of rules, regulations, and guidance. The Agencies considered alternative approaches provided by the commenters, but have adopted the approach taken in the final rule for the reasons discussed above and because the Agencies believe that the final rule, by incorporating concepts with which commodity pools and their operators are familiar, more clearly delineates the commodity pools that are covered funds.[1730]

The Agencies believe that the final rule's tailored approach to commodity pools includes in the definition of covered fund commodity pools that are similar to funds that rely on section 3(c)(1) and 3(c)(7). The Agencies also note in this regard that a commodity pool that would be a covered fund even under this tailored approach will not be a covered fund if the pool also qualifies for an exclusion from the covered fund definition, including the exclusion for registered investments companies. Accordingly, this approach excludes from covered funds entities like commercial end users and registered investment companies, whose activities do not implicate the concerns section 13 was designed to address. Rather, the final rule limits the commodity pools that will be included as covered funds to those that are similar to other covered funds except that they are not generally subject to the Investment Company Act of 1940 due to the instruments in which they invest. For all of these reasons, the Agencies believe that the final rule's approach to commodity pools addresses both the Agencies' concerns about the potential for evasion and commenters' concerns about the breadth of the proposed rule, and provides that the commodity pools captured as covered funds are ''such similar funds,'' consistent with section 13(h)(2) of the BHC Act.

The Agencies acknowledge that as a result of including certain commodity pools in the definition of covered fund, the prohibitions under section 13(f) and § 75.14 may result in certain structural changes in the industry. The Agencies note that these changes (*e.g.,* bank-affiliated FCMs may not be able to lend money in certain clearing transactions to affiliated commodity pools that are covered funds) may result in certain changes in the way related entities do business with each other. However, the Agencies believe that because the industry is competitive with a significant number of alternative non-affiliate competitors, the changes would not result in a less competitive landscape for investors in commodity pools.

3. Entities Regulated Under the Investment Company Act

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[1731] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[1732] A few commenters argued that the final rule should specifically provide that all SEC-registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[1733]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to

[1727] 17 CFR 4.24 (2013).

[1728] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; AHIC; Sen. Carper *et al.;* Rep. Garrett *et al.*

[1729] Funds relying on section 3(c)(7) must be owned exclusively by qualified purchasers, as defined in the Investment Company Act. The Agencies note in this regard that section 4.7 of the CFTC's regulations use substantially the same definition of a qualified purchaser in defining the term qualified eligible person.

[1730] Operators of commodity pools currently must consider whether they are required to register with the CFTC as commodity pool operators, and whether the pools have the characteristics that would make it possible for the operator to claim an exemption under section 4.7. These concepts thus should be familiar to commodity pools and their operators, and including these concepts in the final rule should allow banking entities more easily to determine if a particular commodity pools is a covered fund than if the Agencies were to develop new concepts solely for purposes of the final rule.

[1731] *See* proposed rule § 75.10(b)(1).

[1732] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

[1733] *See* Arnold & Porter; Goldman (Covered Funds); *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC; (requesting clarification that registered investment companies are not banking entities); TCW.

facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[1734]

The Agencies did not intend to include registered investment companies and business development companies as covered funds under the proposal. Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are excluded from SEC regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which *are* regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[1735]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed in more detail below in Part VI.B.1.c.12 of this **SUPPLEMENTARY INFORMATION.**

The Agencies also understand that registered investment companies may establish and hold subsidiary entities that rely on section 3(c)(1) or 3(c)(7) in order to trade in various financial instruments for the registered investment company parent. If a registered investment company were itself a banking entity, section 13 and the final rule would prohibit the registered investment company from sponsoring or investing in such an investment subsidiary. But a registered investment company would only itself be a banking entity if it is an affiliate of an insured depository institution. As explained in the proposal, a registered investment company, such as a mutual fund or exchange traded fund, or an entity that has made an effective election to be regulated as a business development company, would not be an affiliate of a banking entity for purposes of section 13 of that Act solely by virtue of being advised, or organized, sponsored and managed by a banking entity in accordance with the BHC Act (including section 13) and the Board's Regulation Y.[1736]

Under the BHC Act, an entity (including a registered investment company) would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution.[1737] Pursuant to the BHC Act, a company controls another company if: (i) The company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company; (ii) the company controls in any manner the election of a majority of the directors of trustees of the other company; or (iii) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the company.[1738]

The Board's regulations and orders have long recognized that a bank holding company may organize, sponsor, and manage a mutual fund such as a registered investment company, including by serving as investment adviser to registered investment company, without controlling the registered investment company for purposes of the BHC Act.[1739] For example, the Board has permitted a bank holding company to own up to 5 percent of the voting shares of a registered investment company for which the bank holding company provides investment advisory, administrative, and other services, and has a number of director and officer interlocks, without finding that the bank holding company controls the fund.[1740] The Board has also permitted a bank holding company to own less than 25 percent of the voting shares of a registered investment company and provide similar services without finding that the bank holding company controls the fund, so long as the fund limits its investments to those permissible for the holding company to make itself.[1741]

The BHC Act, as amended by the Gramm-Leach-Bliley Act, and the Board's Regulation Y authorize a bank holding company that qualifies as a financial holding company to engage in a broader set of activities, and to have a broader range of relationships or investments with entities, than bank holding companies.[1742] For instance, a financial holding company may engage in, or acquire shares of any company engaged in, any activity that is financial in nature or incidental to such financial activity, including any activity that a bank holding company is permitted to engage in or acquire by regulation or order.[1743] In light of the foregoing, for purposes of section 13 of the BHC Act a financial holding company may own more than 5 percent (and less than 25 percent) of the voting shares of a registered investment company for which the holding company provides investment advisory, administrative, and other services and has a number of director and officer interlocks, without

[1734] *See* ICI (Feb. 2012); TCW.

[1735] *See* final rule § 75.10(c)(12).

[1736] *See* Joint Proposal, 76 FR at 68856.

[1737] *See* final rule § 75.2(a) (defining ''affiliate'' for purposes of the final rule).

[1738] *See* 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

[1739] *See, e.g.,* 12 CFR 211.10(a)(11); 225.28(b)(6)(i); 225.86(b)(3); Unicredito, 86 Fed. Res. Bull. 825 (2000); Societe Generale, 84 Fed. Res. Bull. 680 (1998); Commerzbank AG, 83 Fed. Res. Bull. 678 (1997); The Governor and Company of the Bank of Ireland, 82 Fed. Res. Bull. 1129 (1996); Mellon Bank Corp., 79 Fed. Res. Bull. 626 (1993); Bayerische Vereinsbank AG, 73 Fed. Res. Bull. 155 (1987).

[1740] *See, e.g.,* Societe Generale, 84 Fed. Res. Bull. 680 (1998) (finding that a bank holding company does not control a mutual fund for which it holds up to 5 percent of the voting shares and also provides investment advisory, administrative and other services, has directors or employees who comprise less than 25 percent of the board of directors of the fund (including the chairman of the board), and has three senior officer interlocks and a number of junior officer interlocks).

[1741] *See* letter dated June 24, 1999, to H. Rodgin Cohen, Esq., Sullivan & Cromwell (First Union Corp.), from Jennifer J. Johnson, Secretary of the Board of Governors of the Federal Reserve System (finding that a bank holding company does not control a mutual fund for which it provides investment advisory and other services and that complies with the limitations of section 4(c)(7) of the BHC Act (12 U.S.C. 1843(c)(7)), so long as (i) the bank holding company reduces its interest in the fund to less than 25 percent of the fund's voting shares after a six-month period, and (ii) a majority of the fund's directors are independent of the bank holding company and the bank holding company cannot select a majority of the board) (''First Union Letter''); H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies); *see also* 12 U.S.C. 1843(k)(1), (6).

[1742] *See, e.g.,* H.R. Rep. No. 106–434 at 153 (1999) (Conf. Rep.) (noting that the Act permits a financial holding company to sponsor and distribute all types of mutual funds and investment companies).

[1743] *See* 12 U.S.C. 1843(k)(1); 12 CFR 225.86.

controlling the fund for purposes of the BHC Act.[1744]

So long as a bank holding company or financial holding company complies with these limitations, it would not, absent other facts and circumstances, control a registered investment company and the registered investment company for purposes of section 13 (and any subsidiary thereof) would not itself be a banking entity subject to the restrictions of section 13 of the BHC Act and any final implementing rules (unless the registered investment company itself otherwise controls an insured depository institution). Also consistent with the Board's precedent regarding bank holding company control of and relationships with funds, a seeding vehicle that will become a registered investment company or SEC-regulated business development company would not itself be viewed as violating the requirements of section 13 during the seeding period so long as the banking entity that establishes the seeding vehicle operates the vehicle pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or SEC-regulated business development company within the time period provided by section 13(d)(4) and § 75.12 for seeding a covered fund.[1745]

c. Entities Excluded From Definition of Covered Fund

As noted above, the final rule excludes a number of entities from the definition of covered fund.[1746] As discussed in more detail below, these exclusions more effectively tailor the definition of covered fund to those types of entities that section 13 was designed to focus on. The exclusions thus are designed to provide certainty, mitigate compliance costs and other burdens, and address the potential over-breadth of the covered fund definition and related requirements without such exclusions by permitting banking entities to invest in and have other relationships with entities that do not relate to the statutory purpose of section 13. These exclusions, described in more detail below, take account of information provided by many commenters regarding entities that would likely be included within the proposed definition of a covered fund, but that are not traditionally thought of as hedge funds or private equity funds.[1747] Finally, the Agencies note that providing exclusions from the covered fund definition, rather than providing permitted activity exemptions as proposed in some cases, aligns the final rule with the statute in applying the restrictions imposed by section 13(f) on transactions with covered funds only to transactions with issuers that are defined as covered funds and thus raise the concerns section 13 was designed to address.

The Agencies recognize, however, that the final rule's definition of covered fund does not include certain pooled investment vehicles. For example, the definition of covered fund excludes business development companies, entities that rely on section 3(c)(5)(C), 3(c)(3), or 3(c)(11) of the Investment Company Act, and certain foreign public funds that are subject to home-country regulation. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule.

1. Foreign Public Funds

As discussed above, under the proposal a covered fund was defined to include the foreign equivalent of any covered fund in order to address the potential for circumvention. Many commenters argued that the proposed definition could capture non-U.S. public retail funds, such as UCITS.[1748] These commenters contended that non-U.S. public retail funds should be excluded from the definition of covered fund because they are regulated in their home jurisdiction; commenters noted that similar funds registered in the United States, such as mutual funds, are not covered funds.[1749]

Some commenters were concerned that the proposed definition could inadvertently capture exchange-traded funds trading in foreign jurisdictions,[1750] separate accounts set up to fund foreign pension plans,[1751] non-U.S. issuers of asset-backed securities,[1752] and non-U.S. regulated funds specifically designed for institutional investors.[1753] Commenters also provided several potential effects of capturing foreign public funds under the covered fund definition: U.S. banking entities would incur unnecessary and substantial costs to rebrand and restructure their non-U.S. regulated funds,[1754] banking entities could be eliminated from the potential pool of counterparties, thereby affecting pricing and efficiency,[1755] U.S. banking entities may exit the UCITS market and lose competitiveness,[1756] the growth of mutual fund formation in foreign countries could be limited,[1757] and market liquidity in foreign jurisdictions could be impaired.[1758]

Some commenters supported excluding any foreign public fund that is organized or formed under non-U.S. law, authorized for public sale in the jurisdiction in which it is organized or formed, and regulated as a public investment company in that

[1744] *See* First Union Letter (June 24, 1999); *see also* 12 CFR 225.86(b)(3) (authorizing a financial holding company to organize, sponsor, and manage a mutual fund so long as (i) the fund does not exercise managerial control over the entities in which the fund invests, and (ii) the financial holding company reduces its ownership in the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund or such additional period as the Board permits).

[1745] *See* final rule §§ 75.10(c)(12) and 75.20(e). Under the final rule, these seeding vehicles also must comply with the limitations on leverage under the Investment Company Act that apply to registered investment companies and SEC-regulated business development companies. *See* final rule § 75.10(c)(12).

[1746] *See* final rule § 75.10(c).

[1747] *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank) (noting intent that subsidiaries or joint ventures not be included within the definition of covered fund); 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statement of Sens. Boxer and Dodd) (noting broad definition of hedge fund and private equity fund and recommending that the Agencies take steps to ensure definition is reasonably tailored); *see also* FSOC study at 61–63.

[1748] As discussed above, the proposed rule generally included in the covered fund definition a foreign fund that, were it organized or offered under the laws of the United States or offered to U.S. residents, would meet the definition of a domestic covered fund (*i.e.,* would need to rely section 3(c)(1) or 3(c)(7) of the Investment Company Act). Many commenters argued that this definition is too broad and could include as covered funds various types of foreign funds, like UCITS, that commenters argued should not be included. *See, e.g.,* JPMC; BlackRock.

[1749] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Hong Kong Inv. Funds Ass'n.; UBS; ICI Global; BlackRock; TCW; State Street (Feb. 2012); SSgA (Feb. 2012); IAA; JPMC; Goldman (Covered Funds); BoA; Credit Suisse (Williams); BNY Mellon, *et al.;* Union Asset; EFAMA; BVI; IRSG, SEB; IIB/EBF; GE (Feb. 2012) (commenting on the overbreadth of the definition because of the effect on foreign issuers of asset-backed securities); Allen & Overy (on behalf of Foreign Bank Group).

[1750] *See* BlackRock; Vanguard.

[1751] *See* BlackRock.

[1752] *See* ASF (Feb. 2012).

[1753] *See* Union Asset; EFAMA; BVI.

[1754] *See* Goldman (Covered Funds).

[1755] *See* AFMA.

[1756] *See* BoA.

[1757] *See* BVI.

[1758] *See* Goldman (Covered Funds).

See AFMA.

See BoA.

jurisdiction.[1759] In light of the proposal's broad definition of covered fund, some commenters recommended explicitly excluding non-U.S. regulated funds based on characteristics to distinguish the foreign funds that should be treated as covered funds.[1760] Several commenters recommended excluding non-U.S. funds based upon whether the funds are subject to a regulatory framework comparable to that which is imposed on SEC-registered funds;[1761] one commenter specifically identified European UCITS, Canadian mutual funds, Australian unit trusts, and Japanese investment trusts as examples of regulated funds to be excluded.[1762]

To address these concerns, the final rule generally excludes from the definition of covered fund any issuer that is organized or established outside of the United States and the ownership interests of which are authorized to be offered and sold to retail investors in the issuer's home jurisdiction and are sold predominantly through one or more public offerings outside of the United States.[1763] Foreign funds that meet these requirements will not be covered funds, except that an additional condition applies to U.S. banking entities[1764] with respect to the foreign public funds they sponsor. The foreign public fund exclusion is only available to a U.S. banking entity with respect to a foreign fund sponsored by the U.S. banking entity if, in addition to the requirements discussed above, the fund's ownership interests are sold predominantly to persons other than the sponsoring banking entity, affiliates of the issuer and the sponsoring banking entity, and employees and directors of such entities.

For purposes of this exclusion, the Agencies note that the reference to retail investors, while not defined, should be construed to refer to members of the general public who do not possess the level of sophistication and investment experience typically found among institutional investors, professional investors or high net worth investors who may be permitted to invest in complex investments or private placements in various jurisdictions. Retail investors would therefore be expected to be entitled to the full protection of securities laws in the home jurisdiction of the fund, and the Agencies would expect a fund authorized to sell ownership interests to such retail investors to be of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund.

In order to help maintain this distinction and to avoid circumstances that could result in an evasion of section 13 and the final rule, the ownership interests of the fund must be sold predominantly in one or more public offerings outside of the United States to qualify for the exclusion. Given this restriction, a U.S. banking entity therefore could not rely on this exclusion to set up a foreign public fund for the purpose of selling a significant amount of ownership interests in the fund through one or more offerings conducted on an unregistered basis (whether in a foreign jurisdiction or in the United States). The Agencies generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States.

The requirements that a foreign public fund both be authorized for sale to retail investors and sold predominantly in public offerings outside of the United States are based in part on the Agencies' view that foreign funds that meet these requirements generally will be sufficiently similar to U.S. registered investment companies such that it is appropriate to exclude these foreign funds from the covered fund definition. A foreign fund authorized for sale to retail investors that is also publicly offered may, for example, provide greater information than funds that are sold through private offerings like funds that rely on section 3(c)(1) or 3(c)(7). Such foreign funds also may be subject to various restrictions, as deemed appropriate by foreign regulators in light of local conditions and practices, that exceed those applicable to privately offered funds. Foreign regulators may apply these or other enhanced restrictions or other requirements to funds that are offered on a broad basis to the general public for the protection of investors in those jurisdictions.

A foreign fund that purports to publicly offer its shares but in fact offers them on a more limited basis, however, may be less likely to resemble a registered investment company in these and other respects. In order to limit the foreign public fund exclusion to funds that publicly offer their shares on a sufficiently broad basis, the final rule defines the term ''public offering'' for purposes of this exclusion to mean a ''distribution'' (as defined in § 75.4(a)(3) of subpart B) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that (i) the distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; (ii) the distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and (iii) the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.[1765]

Under the final rule, therefore, a foreign fund's distribution would not be a public offering for purposes of the foreign public fund exclusion if the distribution imposes investor restrictions based on a required minimum level of net worth or net investment assets. This would not be affected by any suitability requirements that may be imposed under applicable local law. In addition, the final rule requires that, in connection with a public offering by a foreign public fund, the offering disclosure documents must be ''publicly available.'' This requirement will provide assurance regarding the transparency for such an offering and will generally be satisfied where the documents are made accessible to all persons in such jurisdiction. Disclosure documents may be made publicly available in a variety of means, such as through a public filing with a regulatory agency or through a Web site that provides broad accessibility to persons in such jurisdiction.

In addition and as discussed above, the final rule also places an additional condition on a U.S. banking entity's ability to rely on the foreign public fund exclusion with respect to the foreign public funds it sponsors. For a U.S. banking entity to rely on the foreign public fund exclusion with respect to a foreign public fund it sponsors, the ownership interests in the fund must be sold predominantly to persons other than the sponsoring U.S. banking entity

[1759] *See* ICI Global; ICI (Feb. 2012); SSgA (Feb. 2012); BNY Mellon *et al.*

[1760] *See* UBS; ICI Global; ICI (Feb. 2012); Allen & Overy (on behalf of Foreign Bank Group); T. Rowe Price; HSBC Life; Union Asset; EFAMA; BVI; EBF; Hong Kong Inv. Funds Ass'n.; IMA; Ass'n. of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); Credit Suisse (Williams).

[1761] *See* T. Rowe Price; Credit Suisse (Williams); SSgA (Feb. 2012); BNY Mellon *et al.*

[1762] *See* T. Rowe Price.

[1763] *See* final rule § 75.10(c)(1).

[1764] Although the discussion of this condition generally refers to U.S. banking entities for ease of reading, the condition also applies to foreign affiliates of a U.S. banking entity. *See* final rule § 75.10(c)(1)(ii) (applying this limitation ''[w]ith respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor'').

[1765] *See* final rule § 75.10(c)(1)(iii).

and certain persons connected to that banking entity. Consistent with the Agencies' view concerning whether a foreign public fund has been sold predominantly outside of the United States, the Agencies generally expect that a foreign public fund will satisfy this additional condition if 85 percent or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity.

This additional condition reflects the Agencies' view that the foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of section 13 of the BHC Act, including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States. The exclusion is not intended to permit a U.S. banking entity to establish a foreign fund for the purpose of investing in the fund as a means of avoiding the restrictions imposed by section 13. Permitting a U.S. banking entity to invest in a foreign public fund under this exclusion only when that fund is sold predominantly to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity permits U.S. banking entities to continue their asset management businesses outside of the United States while also limiting the opportunity for evasion of section 13 as discussed below.

This additional condition only applies to U.S. banking entities with respect to the foreign public funds they sponsor because the Agencies believe that a foreign public fund sponsored by a U.S. banking entity may present heightened risks of evasion. Absent the additional condition, a U.S. banking entity could establish a foreign public fund for the purpose of itself investing substantially in that fund and, through the fund, making investments that the banking entity could not make directly under section 13. The Agencies believe it is less likely that a U.S. banking entity effectively could evade section 13 by investing in third-party foreign public funds that the banking entity does not sponsor. In those cases it is less likely that the U.S. banking entity would be able to control the investments of the fund, and the fund thus likely would be a less effective means for the banking entity to engage in proprietary trading through the fund. The Agencies therefore have declined to apply this additional condition with respect to *any* foreign public fund in which a U.S. banking entity invests but does not act as sponsor.

The Agencies note that the foreign public fund exclusion is not intended to permit a banking entity to sponsor a foreign fund for the purpose of selling ownership interests to any banking entity (affiliated or unaffiliated) that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State (or to a limited group of such banking entities). The Agencies intend to monitor banking entities' investments in foreign public funds to ensure that banking entities do not use the exclusion for foreign public funds in a manner that functions as an evasion of section 13 in this or any other way. The Agencies expect that one area of focus for such monitoring would be significant investments in a foreign public fund, including a fund that is unaffiliated with any banking entity located in or organized under the laws of the United States or of any State, where such investments represent a substantial percentage of the ownership interests in such fund.

In order to conduct this monitoring more effectively, the Agencies also are adopting certain documentation requirements concerning U.S. banking entities' investments in foreign public funds, as discussed in more detail below in Part VI.C.1 of this **SUPPLEMENTARY INFORMATION**. Under the final rule, a U.S. banking entity with more than $10 billion in total consolidated assets will be required to document its investments in foreign public funds, broken out by each foreign public fund and each foreign jurisdiction in which any foreign public fund is organized, if the U.S. banking entity and its affiliates' ownership interests in foreign public funds exceed $50 million at the end of two or more consecutive calendar quarters. This requirement thus is tailored to apply only to U.S. banking entities above a certain size that also have substantial investments in foreign public funds.[1766] The Agencies believe this approach appropriately balances the Agencies' evasion concerns and the burdens that documentation requirements impose.

For all of the reasons discussed above, the Agencies believe that the final rule's approach to foreign public funds is consistent with the final rule's exclusion of registered or otherwise exempt (without reliance on the exemptions in section 3(c)(1) or 3(c)(7)) funds in the United States. It also limits the extraterritorial application of section 13 of the BHC Act and reduces the potential economic and other burdens commenters argued would result for banking entities. The Agencies believe that this exclusion represents an appropriate balancing of considerations that should not significantly increase the risks to the U.S. financial system that section 13 was designed to limit.

2. Wholly-Owned Subsidiaries

Under the proposed rule, a banking entity would have been permitted to invest in or sponsor a wholly-owned subsidiary that relies on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company under that Act if the subsidiary was carried on the balance sheet of its parent and was engaged principally in performing *bona fide* liquidity management activities.[1767]

Commenters argued that, instead of providing a permitted activity exemption for banking entities to invest in or sponsor certain wholly-owned subsidiaries as proposed, all wholly-owned subsidiaries should be excluded from the definition of covered fund under the final rule because wholly-owned subsidiaries are typically used for organizational convenience and generally do not have the characteristics, risks, or purpose of a hedge fund or private equity fund, which involves unaffiliated investors owning interests in the structure for the purpose of sharing in the profits and losses from investment activities.[1768] Commenters explained that publicly traded companies often establish wholly-owned intermediate companies for the purpose of holding securities of operating entities or other corporate vehicles necessary to the business of the entity. Because these intermediate companies invest entirely (or substantially) in the securities of other entities, these intermediate companies may be investment companies for purposes of the Investment Company Act but for the exclusion provided by section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1769]

Commenters contended that requiring banking entities to divest their interests in wholly-owned subsidiaries and cease certain intercompany transactions would have a material adverse effect on the safety, soundness, efficiency and stability of the U.S. and global financial systems, which could in turn have a material adverse effect on the wider

[1766] *See* final rule § 75.20(e).

[1767] *See* proposed rule § 75.14(a)(2)(iv); Joint Proposal, 76 FR at 68913.

[1768] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012), JPMC; Goldman (Covered Funds), NAIB *et al.*; GE (Feb. 2012); BoA; Chamber (Feb. 2012); Wells Fargo (Covered Funds); ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); Credit Suisse (Williams); Rep. Himes; BOK.

[1769] *See* 15 U.S.C. 80a-3(a)(1)(A) & (C).

economy in terms of reduced credit, increased unemployment and reduced output.[1770] Commenters also argued that an exclusion for wholly-owned subsidiaries is necessary in order to avoid a conflict with other important requirements in the Dodd-Frank Act. For example, commenters alleged that including wholly-owned subsidiaries within the definition of covered fund for purposes of section 13 would create a conflict with the requirement that a banking entity that is a bank holding company serve as a source of strength to its subsidiaries because the prohibition in section 13(f) on transactions between a banking entity and covered funds owned or sponsored by the banking entity would effectively prohibit the banking entity from providing financial resources to wholly-owned intermediate holding companies and their subsidiaries.[1771] Other commenters argued that banking entities would bear extensive compliance costs and operational burdens and likely would be restricted from structuring themselves effectively.[1772]

Commenters proposed several alternatives to address these concerns. For instance, commenters recommended that the final rule exclude all wholly-owned subsidiaries from the definition of covered fund.[1773] Commenters also urged that the final rule include ownership interests held by employees of a banking entity with any ownership interests held directly by the banking entity for purposes of qualifying for any exclusion granted by the rule for wholly-owned subsidiaries.[1774] Another commenter recommended the exclusion of subsidiaries, wholly owned or not, that engage in *bona fide* liquidity management.[1775]

In light of these comments and consistent with the purposes of section 13 and the terms of the Dodd-Frank Act as discussed in more detail above, the Agencies have revised the final rule to exclude wholly-owned subsidiaries from the definition of covered fund, including those not engaged in liquidity management.[1776] A wholly-owned subsidiary, as defined in the final rule, is an entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that (i) up to five percent of the entity's ownership interests may be owned by directors, employees, and certain former directors and employees of the banking entity (or an affiliate thereof); and (ii) within the five percent ownership interests described in clause (i), up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.[1777]

Although the final rule includes ownership interests held by certain former directors and employees for purposes of qualifying for the exclusion, the exclusion requires that an interest held by a former (or current) director or employee must actually be held by that person (or by the banking entity) and must have been acquired while employed by or in the service of the banking entity. For example, if a former employee subsequently transfers his/her interest to a third party (other than to immediate family members of the employee or through intestacy of the employee), then the ownership interest would no longer be held by the banking entity or persons whose ownership interests may be aggregated with interests held by the banking entity for purposes of the exclusion for wholly-owned subsidiaries under the final rule.

The final rule also permits up to 0.5 percent of the ownership interest of a wholly-owned subsidiary to be held by a third party if the interest is held by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns, and the ownership interest is included when calculating the five percent cap on employee and director ownership. The Agencies understand that it is often important, or in certain circumstances required, under the laws of various jurisdictions for a parent company to establish corporate separation of a subsidiary through the issuance of a small amount of ownership interest to a third party.

The Agencies believe that permitting limited employee and director ownership of a vehicle and accommodating the foreign law requirements discussed above is consistent with a vehicle's treatment as a wholly-owned subsidiary. Under the final rule, the banking entity (or an affiliate thereof) will control the vehicle because it must, as principal, own at least 95% of the vehicle.[1778] These conditions are designed to exclude from the covered fund definition vehicles that are formed for corporate and organizational convenience, as discussed above, and that thus do not engage in the investment activities prohibited by section 13. The exclusion also should reduce the disruption to the operations of banking entities that commenters asserted would result from the proposed rule.[1779]

Importantly, the Agencies note that a wholly-owned subsidiary of a banking entity—although excluded from the definition of covered fund—still would itself be a banking entity, and therefore remain subject to the prohibitions and other provisions of section 13 of the BHC Act and the final rule.[1780] Accordingly, a wholly-owned subsidiary of a banking entity would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading) and may not engage in activity in violation of the prohibitions of section 13 and the final rule.

3. Joint Ventures

The proposed rule would have permitted a banking entity to invest in or manage a joint venture between the banking entity and any other person,

[1770] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1771] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Rep. Himes.

[1772] *See, e.g.,* Goldman (Covered Funds); BoA.

[1773] *See* Rep. Himes; Fin. Services Roundtable (June 14, 2011); SIFMA *et al.* (Covered Funds) (Feb. 2012); BOK; Chamber (Feb. 2012); ABA (Keating); GE (Feb. 2012); Wells Fargo (Covered Funds); Goldman (Covered Funds); Ass'n. of Institutional Investors (Feb. 2012); BoA; NAIB *et al.*

[1774] *See* Wells Fargo (Covered Funds); Credit Suisse (Williams).

[1775] *See* Credit Suisse (Williams).

[1776] Although not a condition of the exclusion, banking entities may use wholly-owned subsidiaries to engage in *bona fide* liquidity management. As discussed below, however, a wholly-owned subsidiary is itself a banking entity, and thus is subject to all of the requirements that apply to banking entities, including the requirements applicable to a banking entity's liquidity management activities under § 75.3(d)(3).

[1777] *See* final rule § 75.10(c)(2).

[1778] *Cf.* Section 2(a)(43) of the Investment Company Act (defining a ''wholly-owned subsidiary'' of a person to mean ''a company 95 per centum or more of the outstanding voting securities of which are owned by such person, or by a company which, within the meaning of this paragraph, is a wholly-owned subsidiary of such person'').

[1779] The Agencies also note that depositors for asset-backed securities offerings are important to the process of securitization. *See, e.g.,* ASF (July 2012) (noting that a depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities). *See also,* Rule 191 under the Securities Act of 1933 (17 CFR 230.191) (depositor as issuer for registered asset-backed securities offerings). Commenters raised a question about the treatment of depositors under the Investment Company Act, and therefore, whether they would technically fall within the definition of covered fund. *See* ASF (July 2012); GE (Aug. 2012). For purposes of the covered fund prohibitions, the Agencies note that depositors may fall within the wholly-owned subsidiary exclusion from the covered fund definition.

[1780] *See* 12 U.S.C. 1851(h)(1) (defining banking entity to include any affiliate or subsidiary of a banking entity).

provided that the joint venture was an operating company and did not engage in any activity or any investment not permitted under the proposed rule. As noted in the proposal, many joint ventures rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1781] Joint ventures are a common form of business, especially for firms seeking to enter new lines of business or new markets, or seeking to share complementary business expertise.

Commenters supported this aspect of the proposal and argued that joint ventures do not share the same characteristics as a hedge fund or private equity fund. However, they expressed concern that joint ventures were defined too narrowly under the proposal because the exclusion was limited to joint ventures that were operating companies.[1782] Some commenters criticized the lack of guidance regarding the meaning of operating company.[1783] One commenter proposed defining operating company as any company engaged in activities that are permissible for a financial holding company under sections 3 or 4 of the BHC Act, other than a company engaged exclusively in investing in securities of other companies for resale or other disposition.[1784]

Another commenter argued that joint ventures are often used to share risk from non-performing loans, credit card receivables, consumer loans, commercial real estate loans or automobile loans.[1785] According to this commenter, these joint ventures, while not generally viewed as operating companies, promote safety and soundness by allowing a banking entity to limit the size of its exposure to permissible investments or to more efficiently transfer the risk of existing assets to a small number of partners. Commenters stated that banking entities often employ similar types of non-operating company joint ventures to engage in merchant banking activities or other permissible banking activities, and that the final rule should not prevent a banking entity from sharing the risk of a portfolio company investment with third parties.[1786] A number of commenters argued that treating joint ventures as covered funds would create the same inconsistencies with other provisions and principles embodied in the Dodd-Frank Act noted for wholly-owned subsidiaries, were they to be treated as covered funds.[1787] Several commenters argued that the proposed exemption, as drafted, was unworkable because it did not appear to provide an exception to the intercompany limitations on transactions under section 13(f), which prohibits transactions between a banking entity and a related covered fund.[1788]

Commenters proposed several alternatives to address these issues. Several commenters recommended that the final rule eliminate the operating company condition under the proposed exemption.[1789] Other commenters recommended excluding joint ventures that have an unspecified but limited number of partners (such as five or fewer joint venture partners).[1790] One commenter recommended excluding all ''controlled joint ventures'' but did not provide an explanation of how to define that term.[1791] Another commenter suggested defining a joint venture in one of the following ways: (1) Any company with a limited number of co-venturers that is managed pursuant to a shareholders' agreement, as opposed to managed by a general partner;[1792] or (2) a joint venture in which: (a) There are a limited number of unaffiliated partners; (b) the parties operate the venture on a joint basis or in proportion to their relative ownership, including pursuant to a shareholders' agreement; (c) material decisions are made by one party (for example, a general partner); and (d) the joint venture does not engage in any activity or investment not permitted under section 13, other than activities or investments incidental to its permissible business.[1793]

In response to commenter concerns, the final rule excludes joint ventures from the definition of covered fund with some modifications from the proposal to more clearly identify entities that are excluded. Under the final rule, a joint venture is excluded from the definition of covered fund if the joint venture is between the banking entity or any of its affiliates and no more than 10 unaffiliated co-venturers, is in the business of engaging in activities that are permissible for the banking entity other than investing in securities for resale or other disposition, and is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.[1794] Banking entities, therefore, will continue to be able to share the risk and cost of financing their banking activities through these types of entities which, as noted by commenters as discussed above, may allow banking entities to more efficiently manage the risk of their operations.

The Agencies have specified a limit on the number of joint venture partners at the request of many commenters that suggested such a limit be added (though typically without suggesting the specific number of partners). The Agencies believe that a limit of 10 partners allows flexibility in structuring larger business ventures without involving such a large number of partners as to suggest the venture is in reality a hedge fund or private equity fund established for investment purposes. The Agencies will monitor joint ventures—and other excluded entities—to ensure that they are not used by banking entities to evade the provisions of section 13.

The final rule's requirement that a joint venture not be an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities prevents a banking entity from relying on this exclusion to evade section 13 of the BHC Act by owning or sponsoring what is or will become a covered fund. Consistent with this restriction and to prevent evasion of section 13, a banking entity may not use a joint venture to engage in merchant banking activities because that involves acquiring or retaining shares, assets, or ownership interests for the purpose of ultimate resale or disposition of the investment.[1795]

As with wholly-owned subsidiaries, if a banking entity owns 25 percent or more of the voting securities of the joint venture or otherwise controls an entity

[1781] *See* Joint Proposal, 76 FR at 68913.

[1782] *See,, e.g.,* ABA (Keating); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Aug. 2012); Goldman (Covered Funds); NAIB *et al.;* Rep Himes; Sen. Bennet; *see also* 156 Cong Rec. H5226 (daily ed. June 30, 2010) (statement of Rep. Himes).

[1783] *See, e.g.,* ABA (Keating); NAIB *et al.;* GE (Aug. 2012); Chamber (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); Wells Fargo (Covered Funds); Credit Suisse (Williams); Goldman (Covered Funds).

[1784] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1785] *See* Goldman (Covered Funds).

[1786] *See* ABA (Keating); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1787] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); Chamber (Feb. 2012).

[1788] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); Goldman (Covered Funds); ABA (Keating); GE (Feb. 2012); Chamber (Feb. 2012).

[1789] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); Credit Suisse (Williams).

[1790] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[1791] *See* Goldman (Covered Funds).

[1792] *See* ABA (Keating); Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); *see also* GE (Feb. 2012); NAIB *et al.*

[1793] *See* Goldman (Covered Funds).

[1794] *See* final rule § 75.10(c)(3).

[1795] *See* 12 U.S.C. 1843(k)(4)(H).

that qualifies for the joint venture exclusion, the joint venture would then itself be a banking entity and would remain subject to the restrictions of section 13 and the final rule (including the ban on proprietary trading).

The Agencies note that the statute defines banking entity to include not only insured depository institutions and bank holding companies, but also their affiliates. In the context of a company that owns an insured depository institution but is not a bank holding company or savings and loan holding company, the insured depository institution's affiliates may engage in commercial activities impermissible for banks and bank holding companies. However, section 13 of the BHC Act and the final rule do not authorize a banking entity to engage in otherwise impermissible activities. Because of this, the scope of activities in which a joint venture may engage under the final rule will depend on the status and identity of its co-venturers. For instance, a joint venture between a bank holding company and unaffiliated companies may not engage in commercial activities impermissible for a bank holding company.

4. Acquisition Vehicles

Similar to wholly-owned subsidiaries and joint ventures, the proposed rule would have permitted a banking entity to invest in or sponsor an acquisition vehicle provided that the sole purpose and effect of the acquisition vehicle was to effectuate a transaction involving the acquisition or merger of an entity with or into the banking entity or one of its affiliates. As noted in the proposal, banking entities often form corporate vehicles for the purpose of accomplishing a corporate merger or asset acquisition.[1796] Because of the way they are structured, acquisition vehicles may rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1797]

Commenters supported the exclusion of acquisition vehicles from the restrictions governing covered funds, and argued that acquisition vehicles do not share the same characteristics as a hedge fund or private equity fund.[1798] However, similar to concerns articulated above with respect to wholly-owned subsidiaries and joint ventures, commenters argued that the proposed rule, as drafted, left uncertain how other provisions of section 13 would apply to these vehicles.[1799]

In light of the comments, the final rule has been modified to exclude acquisition vehicles from the definition of covered fund, rather than provide a permitted activity exemption for banking entities to invest in or sponsor the vehicles, so long as the vehicle is formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction and the vehicle exists only for such period as necessary to effectuate the transaction.[1800] The final rule thus reflects modifications from the exemption for acquisition vehicles in the proposal, which was available for acquisition vehicles where the sole purpose and effect of the entity was to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity.[1801] The Agencies modified the conditions in the final rule, as discussed above, to more clearly reflect the limited activities in which an excluded acquisition vehicle may engage and to exclude acquisition vehicles from the definition of covered fund, rather than only permit banking entities to invest in or sponsor them pursuant to an exemption.

The Agencies also note that an acquisition vehicle that survives a transaction would likely be excluded from the definition of covered fund under the separate exclusion for either joint ventures or wholly-owned subsidiaries described above. An acquisition vehicle that is controlled by a banking entity would be a banking entity itself and would be subject to the restrictions of section 13 and the final rule that apply to a banking entity.

5. Foreign Pension or Retirement Funds

Under the proposed rule, a foreign pension plan that relied on section 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid being an investment company (or that was a commodity pool), would have been a covered fund. Commenters argued that including pension funds within the definition of covered fund would produce many unexpected results for pension plans as well as plan participants.[1802]

Commenters generally argued that foreign pension or retirement funds are established by a foreign company or foreign sovereign for the purpose of providing a specific group of foreign persons with income during retirement or when they reach a certain age or meet certain predetermined criteria and are typically eligible for preferential tax treatment, and are not formed for the same purposes as hedge funds or private equity funds.[1803] Commenters argued that the definition of covered fund should not include certain foreign pension or retirement funds, including managed investment arrangements and wrap platforms, such as so-called ''superannuation funds,'' that are managed by foreign banks as part of providing retirement or pension schemes to foreign citizens pursuant to foreign law and are generally not available for sale to U.S. citizens. Commenters asserted that many foreign banking entities act as sponsor to and organize and offer foreign pension funds abroad as part of a foreign sovereign program to provide retirement, pension, or similar benefits to its citizens or workforce.[1804] These commenters contended that a foreign pension plan might itself rely on the exclusion in section 3(c)(1) or 3(c)(7) in order to avoid being an investment company if it is offered to citizens of the foreign sovereign present in the United States.[1805]

Several commenters argued that foreign pension and retirement plans should be excluded from the definition of covered fund on the same basis as U.S. pension and retirement funds that are ERISA-qualified funds that rely on the exclusion from the definition of investment company provided under section 3(c)(11) of the Investment Company Act.[1806] Commenters alleged that without an exclusion for foreign

[1796] *Cf.* Joint Proposal, 76 FR at 68897.

[1797] *See* Joint Proposal, 76 FR at 68913; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[1798] *See, e.g.,* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012); GE (Feb. 2012); Sen. Bennet; Sen. Carper *et al.*

[1799] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC; GE (Feb. 2012).

[1800] *See* final rule § 75.10(c)(4).

[1801] The proposed rule contained an exemption for investments in acquisition vehicles, provided that the ''the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the covered banking entity or one of its affiliates.'' *See* proposed rule § 75.14(a)(2)(ii). The final rule excludes an acquisition vehicle, which is defined as an issuer that is ''[f]ormed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction'' and that ''exists only for such period as necessary to effectuate the transaction.'' *See* final rule § 75.10(c)(4).

[1802] As explained above, commenters also argued that a foreign pension plan should not be considered a banking entity if the plan is sponsored by a banking entity or is established for the benefit of employees of the banking entity. If deemed a banking entity, the pension plan could become subject to the limits on section 13 on investing in covered funds. *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; Credit Suisse (Williams). The final rule addresses these comments with the exclusions described above.

[1803] *See, e.g.,* Allen & Overy (on behalf of Canadian Banks).

[1804] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.

[1805] *See* Allen & Overy (on behalf of Canadian Banks); Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

[1806] *See* Arnold & Porter; UBS; Hong Kong Inv. Funds Ass'n.; Credit Suisse (Williams).

pension or retirement funds, section 13 of the BHC Act would have an extra-territorial effect on pension or retirement benefits abroad that would be severe and beyond what was contemplated by section 13 of the BHC Act.

In light of comments received on the proposal, the final rule excludes from the definition of covered fund a plan, fund, or program providing pension, retirement, or similar benefits that is: (i) Organized and administered outside of the United States; (ii) a broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and (iii) established for the benefit of citizens or residents of one or more foreign sovereign or any political subdivision thereof.[1807] This is similar to the treatment provided to U.S. pension funds by virtue of the exclusion from the definition of investment company under the Investment Company Act for certain broad-based employee benefit plans provided by section 3(c)(11) of that Act. The exclusion from the covered fund definition for foreign plans would be available for *bona fide* plans established for the benefit of employees or citizens outside the U.S. even if some of the beneficiaries of the fund reside in the U.S. or subsequently become U.S. residents.

The Agencies believe this exclusion is appropriate in order to facilitate parallel treatment of domestic and foreign pension and retirement funds to the extent possible and to assist in ensuring that section 13 of the BHC Act does not apply to foreign pension, retirement, or similar benefits programs.[1808]

6. Insurance Company Separate Accounts

Under the proposed rule, insurance company separate accounts would have been covered funds to the extent that the separate accounts relied on section 3(c)(1) or 3(c)(7). Such reliance would generally occur in circumstances where policies funded by the separate account are distributed in an unregistered securities offering solely to qualified purchasers or on a limited basis to accredited investors. While the proposed rule did not generally exclude insurance company separate accounts from the definition of covered fund, the proposed rule did provide a limited exemption for investing in or acting as sponsor to separate accounts that were used for the purpose of allowing a banking entity to purchase bank owned life insurance (''BOLI''), subject to certain restrictions.[1809]

Various state or foreign laws allow regulated insurance companies to create separate accounts that are generally not separate legal entities but represent a segregated pool of assets on the balance sheet of the insurance company that support a specific policy claim on the insurance company. These accounts have assets and obligations that are separate from the general account of the insurance company. Insurance companies often utilize these separate accounts to allow policyholders of variable annuity and variable life insurance to allocate premium amounts for the purpose of engaging in various investment strategies that are tailored to the requirements of the individual policyholder. The policyholder, and not the insurance company, primarily benefits from the results of investments in the separate account. These separate accounts are generally investment companies for purposes of the Investment Company Act, unless an exclusion from that definition is applicable,[1810] and, as noted above, may rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

While most commenters supported the proposal's recognition that interests in BOLI separate accounts should be permitted, commenters generally argued that the final rule should also provide a broader exclusion from the definition of covered fund for all insurance company separate accounts. Commenters argued that covering separate accounts could lead to unintended consequences and was inconsistent with the statutory recognition that the business of insurance should continue to be accommodated.[1811] These commenters argued that covering separate accounts within the definition of covered fund would disrupt a substantial portion of customer-driven insurance or retirement planning activity and pose a burden on insurance companies and holders of insurance policies funded by separate accounts, a result commenters alleged Congress did not intend.[1812]

In response to commenter concerns and in order to more appropriately accommodate the business of insurance in a regulated insurance company, the final rule excludes an insurance company separate account from the definition of covered fund under certain circumstances. To prevent this exclusion from being used to evade the restrictions on investments and sponsorship of covered funds by a banking entity, the final rule provides that no banking entity other than the insurance company that establishes the separate account may participate in the account's profits and losses.[1813] In this manner, the final rule appropriately accommodates the business of insurance by permitting an insurance company that is a banking entity to continue to provide its customers with a variety of insurance products through separate account structures in accordance with applicable insurance laws while protecting against the use of separate accounts as a means by which banking entities might take a proprietary or beneficial interest in an account that engages in prohibited proprietary trading and thereby evade the requirements of section 13 of the BHC Act. The exclusion of insurance company separate accounts from the definition of covered fund therefore is designed to reduce the potential burden of the final rule on insurance companies and holders of insurance policies funded by separate accounts while also continuing to prohibit banking entities from taking ownership interests in, and sponsoring or having certain relationships with, entities that engage in investment and trading activities prohibited by section 13.

7. Bank Owned Life Insurance Separate Accounts

As explained above, bank owned life insurance (''BOLI'') is generally offered through a separate account held by an insurance company. In recognition of the fact that banking entities have for many years invested in life insurance policies that covered key employees, in accordance with supervisory policies established by the Federal banking agencies, the proposal contained a provision that would permit banking

[1807] *See* final rule § 75.10(c)(5).

[1808] Additionally and as discussed above, the prohibitions of section 13 and the final rule do not apply to an ownership interest that is acquired or retained by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by a banking entity as trustee for the benefit of persons who are or were employees of the banking entity.

[1809] *See* proposed rule § 75.14(a)(1).

[1810] *See* In re The Prudential Ins. Co. of Am., 41 S.E.C. 335, 345 (1963), *aff'd,* The Prudential Ins. Co. of Am. v. SEC, 326 F.2d 383 (3d Cir.), *cert. denied,* 377 U.S. 953 (1964).

[1811] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* STANY.

[1812] *See* ACLI (Jan. 2012); Nationwide; Sutherland (on behalf of Comm. of Annuity Insurers); *see also* STANY.

[1813] *See* final rule § 75.10(c)(6).

entities to invest in and sponsor BOLI separate accounts.[1814]

Many commenters supported the exemption in the proposal for BOLI separate accounts, arguing that permitting this kind of activity was appropriate and consistent with safety and soundness as well as financial stability.[1815] Conversely, one commenter objected to the proposed rule's exemption for investments in BOLI separate accounts, contending that such an exemption did not promote and protect the safety and soundness of banking entities or the financial stability of the United States.[1816]

After considering comments received on the proposal, the final rule excludes BOLI separate accounts from the definition of covered fund but maintains the substance of the conditions from the proposal designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that section 13 of the BHC Act was designed to address. In particular, in order for a separate account to qualify for the BOLI exclusion from the definition of covered fund, the final rule requires that the separate account be used solely for the purpose of allowing one or more banking entities (which by definition includes their affiliates) to purchase a life insurance policy for which such banking entity(ies) is a beneficiary.[1817] Additionally, if the banking entity is relying on this exclusion, the banking entity that purchases the insurance policy (i) must not control the investment decisions regarding the underlying assets or holdings of the separate account,[1818] and (ii) must participate in the profits and losses of the separate account in compliance with applicable supervisory guidance regarding BOLI.[1819]

When made in the normal course, investments by banking entities in BOLI separate accounts do not involve the types of speculative risks section 13 of the BHC Act was designed to address. Rather, these accounts permit the banking entity to effectively hedge and cover costs of providing benefits to employees through insurance policies related to key employees. Moreover, applying the prohibitions of section 13 to investments in these accounts would eliminate an investment that helps banking entities to efficiently reduce their costs of providing employee benefits, and therefore potentially introduce a burden to banking entities that would not further the statutory purpose of section 13. The Agencies expect this exclusion to be used by banking entities in a manner consistent with safety and soundness.

8. Exclusion for Loan Securitizations and Definition of Loan

a. Definition of Loan

The proposal defined the term ''loan'' for purposes of the restrictions on proprietary trading and the covered funds provisions and, as discussed in more detail below, provided an exemption for loan securitizations in two separate sections of the proposed rule. As proposed, loan was defined as ''any loan, lease, extension of credit, or secured or unsecured receivable.'' [1820] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security issued in connection with a loan securitization or otherwise backed by loans.

Some commenters requested that the Agencies narrow the proposed definition of ''loan.'' [1821] One of these commenters was concerned that the proposed definition could apply to any banking activity and argued that the definition of loan for purposes of the final rule should not include securities.[1822] Another commenter, citing a statement made by Senator Merkley, asserted that Congress did not intend the rule of construction for the sale and securitization of loans in section 13(g)(2) to include ''loans that become financial instruments traded to capture the change in their market value.'' [1823]

Other commenters requested that the Agencies expand the proposed definition of ''loan'' to capture many traditional extensions of credit that the proposal would otherwise exclude.[1824] Examples of traditional credit extensions that commenters requested be specifically included within the definition of ''loan'' included loan participations,[1825] variable funding notes or certificates,[1826] note purchase facilities,[1827] certain forms of revolving credit lines,[1828] corporate bonds,[1829] municipal securities,[1830] securities lending agreements and reverse repurchase agreements,[1831] auto lease securitizations,[1832] and any other type of credit extension that banking entities traditionally have been permitted to issue under their lending authority.[1833]

The definition of ''loan'' in the final rule applies both in the context of the

[1814] *See* proposed rule § 75.14(a)(1).

[1815] *See* ACLI (Jan. 2012); Mass. Mutual; Jones of Northwestern; AALU; BBVA; BoA; Chris Barnard; Clark Consulting (Feb. 7, 2012); Clark Consulting (Feb. 13, 2012); Gagnon of GW Financial.

[1816] *See* Occupy.

[1817] *See* final rule § 75.10(c)(7).

[1818] This requirement is not intended to preclude a banking entity from purchasing a life insurance policy from an affiliated insurance company.

[1819] *See, e.g.,* Bank Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance (Dec. 7, 2004).

[1820] *See* proposed rule § 75.2(q).

[1821] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1822] *See* Public Citizen. This commenter argued that the loan definition should be limited to the plain meaning of the term ''loan'' and noted that a loan is not a security. *Id.*

[1823] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1824] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); Goldman (Covered Funds); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One individual commenter supported the proposed definition of loan. *See* Alfred Brock. For example, one commenter requested that definition of ''loan'' be revised to include ''(i) any loan, lease (including any lease residual), extension [of] credit, or secured or unsecured receivables, (ii) any note, bond or security collateralized and payable from pools of loans, leases (including Lease residuals), extensions of credit or secured or unsecured receivables, and (iii) any contractual rights arising from, or security interests or liens, assets, property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the foregoing.'' *See* RBC. Another commenter requested that the definition of ''loan'' be revised to include ''any type of credit extension (including bonds, other [banking entity-eligible] debt securities, asset-backed securities [as defined in their letter], variable funding notes and securities lending agreements, repurchase agreements, reverse repurchase agreements and other similar extensions of credit) that a banking entity could hold or deal in.'' *See* SIFMA (Securitization) (Feb. 2012).

[1825] *See* JPMC.

[1826] *See* ASF (Feb. 2012); Credit Suisse (Williams); JPMC (arguing that such notes operate in economic substance as loans); SIFMA (Securitization) (Feb. 2012).

[1827] *See* ASF (Feb. 2012). This commenter asserted that a note purchase facility is negotiated by the asset-backed commercial paper conduit and allows the asset-backed commercial paper conduit to purchase asset-backed securities issued by an intermediate special purpose vehicle and backed by loans or asset-backed securities backed by loans. *Id.*

[1828] *See* ASF (Feb. 2012).

[1829] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); JPMC.

[1830] *See* ASF (Feb. 2012). This commenter argued that certain municipal securities may be ABS, including revenue bonds that involve the issuance of senior and subordinate bonds. *Id.*

[1831] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1832] *See* SIFMA (Securitization) (Feb. 2012). This commenter contended that because securitization transactions have been viewed by the Agencies and courts as 'legally transparent' (*i.e.,* as simply another way for banking entities to buy and sell the loans or other assets underlying such securities), auto lease securitizations supported by a beneficial interest in a titling trust should be treated as securitizations of the underlying auto leases and should fall within the loan securitization exemption. This commenter also argued that if the definition of ''loan'' is not expanded to include securities, then banking entities could not act as sponsors for auto lease securitizations (including resecuritizations) supported by a beneficial interest in a titling trust.

[1833] *See* Credit Suisse (Williams); Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

proprietary trading restrictions as well as in determining the scope of the exclusion of loan securitizations and asset-backed commercial paper conduits from the definition of covered fund. The final rule modifies the proposed definition and defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1834] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1835] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading.

The definition of loan in the final rule excludes loans that are securities or derivatives, including securities or derivatives of or based on such instruments. The definition of ''loan'' does not specify the type, nature or structure of loans included within the definition, other than by excluding securities and derivatives. In addition, the definition of loan does not limit the scope of parties that may be lenders or borrowers for purposes of the definition. The Agencies note that the parties' characterization of an instrument as a loan is not dispositive of its treatment under the Federal securities laws or Federal laws applicable to derivatives. The determination of whether a loan is a security or a derivative for purposes of the loan definition is based on the Federal securities laws and the Commodity Exchange Act. Whether a loan is a ''note'' or ''evidence of indebtedness'' and therefore a security under the Federal securities laws will depend on the particular facts and circumstances, including the economic terms of the loan.[1836] For example, loans that are structured to provide payments or returns based on, or tied to, the performance of an asset, index or commodity or provide synthetic exposure to the credit of an underlying borrower or an underlying security or index may be securities or derivatives depending on their terms and the circumstances of their creation, use, and distribution.[1837] Regardless of whether a party characterizes the instrument as a loan, these kinds of instruments, which may be called ''structured loans,'' must be evaluated based on the standards associated with evaluating derivatives and securities in order to prevent evasion of the restrictions on proprietary trading and ownership interests in covered funds.

b. Loan Securitizations

An exemption for loan securitizations was contained in two separate sections of the proposed rule. The first, in section 75.13(a), was proposed as part of ''other permitted covered fund activities and investments.'' The second, in § 75.14(d), was proposed as part of ''covered fund activities determined to be permissible.'' These proposed provisions would have acted in concert to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a loan securitization regardless of the relationship that the banking entity had with the securitization. The Agencies have evaluated all comments received on securitizations. These sections of the proposed rule were intended to implement the rule of construction contained in section 13(g)(2) of the BHC Act which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise permitted by law.[1838] The language of the proposed exemption for loan securitizations would have permitted a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which were solely comprised of: (i) Loans (as defined); (ii) rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or rights or assets and (B) are used for hedging purposes with respect to the securitization structure.[1839] The proposed rule in § 75.13(d) was further augmented by the proposed rule in § 75.14(a)(2) so that a banking entity would be permitted to purchase loan securitizations and engage in the sale and securitization of loans. This was accomplished through the authorization in proposed section 75.14(a)(2) of a banking entity's acquisition or retention of an ownership interest in such securitization vehicles that the banking entity did not organize and offer, or for which it did not act as sponsor, provided that the assets or holdings of such vehicles were solely comprised of the instruments or obligations identified in the proposed exemption.

The proposed rules would have allowed a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in certain securitization vehicles (which could be a covered fund for purposes of the proposed rules) that the banking entity organized and offered, or acted as sponsor to, without being subject to the ownership and sponsor limitations contained in the proposed rule.[1840] As noted in the proposing release, the Agencies recognized that by defining ''covered fund'' broadly, and, in particular, by reference to sections 3(c)(1) and 3(c)(7) of the Investment Company Act, securitization vehicles may be affected by the restrictions and requirements of the proposed rule. The Agencies attempted to mitigate the potential adverse impact on the securitization market by excluding loan securitizations from the restrictions on sponsoring or acquiring and retaining ownership interests in covered funds, consistent with the rule of construction contained in section 13(g)(2) of the BHC Act.[1841] As a result, under the proposal, loan securitizations would not be limited or restricted because banking entities would be able to find investors or buyers for their loans or loan securitizations. The proposing release included several requests for comment on the proposed loan securitization exemption and the application of the covered fund prohibitions to securitizations.

Some commenters supported a narrow exemption for loan securitizations and in some cases suggested that the proposed exemption could be narrowed even further. For example, one commenter argued that the definition of ''loan'' for purposes of the exemption could include any extension of credit and any banking activity.[1842] Also, in response to the

[1834] *See* final rule § 75.2(s).

[1835] 12 U.S.C. 1851(h)(4).

[1836] *See* 15 U.S.C. 77b(a)(1) and 15 U.S.C. 78c(a)(10); Reves v. Ernst & Young, 494 U.S. 56 (1990) ; Trust Company of Louisiana v. N.N.P. Inc., 104 F.3d 1478 (5th Cir. 1997); Pollack v. Laidlaw Holdings, 27 F.3d 808 (2d Cir. 1994); *but see* Marine Bank v. Weaver, 455 U.S. 551 (1982); Banco Espanol de Credito v. Security Pacific National Bank, 973 F.2d 51 (2d Cir. 1992); Bass v. Janney Montgomery Scott, Inc., 210 F.3d 577 (6th Cir. 2000); Piaubert v. Sefrioui, 2000 WL 194140 (9th Cir. 2000).

[1837] *Id.*

[1838] *See* 12 U.S.C. 1851(g)(2).

[1839] *See* proposed rule § 75.13(d); Joint Proposal, 76 FR at 68912.

[1840] *Id.*

[1841] *See* Joint Proposal, 76 FR at 68931.

[1842] *See, e.g.,* Public Citizen. This commenter argued that any exemption should prevent evasion, should ensure that each exempted securitization reduces risk and should be designed to only serve client needs. A different commenter recommended a safe harbor available only to a particular pre-specified, transparent and standardized securitization structure, where Agencies would need to justify why the specified structure protects

Continued

proposing release,[1843] some commenters suggested that any exemption for securitizations should seek to prevent evasion of the covered fund prohibitions by issuers with ''hedge-fund or private equity fund-like characteristics'' or issuers with ''hidden proprietary trading operations.'' [1844]

On the other hand, many commenters believed that the proposed exemption from the covered fund prohibitions for loan securitizations should be expanded to cover securitizations generally and not just loan securitizations. These commenters provided various arguments for their request to exempt all securitizations from the covered fund prohibitions, including that the regulation of securitizations was addressed in other areas of the Dodd-Frank Act,[1845] that securitization is essentially a lending activity,[1846] and that securitizations have ''long been recognized as permissible activities for banking entities.'' [1847]

Commenters recommending a broader exclusion for securitizations also provided a wide variety of specific suggestions or concerns. Some commenters suggested that permissible assets for a loan securitization include assets other than loans acquired in the course of collecting a debt previously contracted, restructuring a loan, during a loan work out or during the disposition of a loan or other similar situation.[1848] Commenters noted that, for example, rules 2a–7 and 3a–7 under the Investment Company Act define eligible assets for a securitization as not only including financial assets but also ''any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.'' [1849] Commenters requested that various additional rights or assets be added to the list of permissible assets held by a loan securitization such as cash and cash accounts,[1850] cash equivalents,[1851] and various other high quality short term investments, liquidity agreements or credit enhancements, certain beneficial interests in titling trusts used in lease securitizations or lease residuals.[1852] One commenter suggested that a loan securitization be permitted to include ''any contractual rights arising from or supporting obligations underlying or relating to the loans.'' [1853]

Others requested that loan securitizations also be permitted to hold repurchase agreements or unlimited amounts of various forms of securities, including municipal securities, asset-backed securities, credit-linked notes, trust certificates and ''equity like-rights.'' [1854] Some commenters requested that loan securitizations be permitted to hold a limited amount of certain rights such as securities.[1855] Commenters also had suggestions about the types of derivatives that an exempted securitization vehicle be permitted to hold.[1856] For example, one industry association requested that the loan securitization exemption include securitizations where up to 10 percent of the assets are held in the form of synthetic risk exposure that references ''loans that could otherwise be held directly'' under the proposal in order to achieve risk diversification.[1857] This commenter stated its belief that the rule of construction requires that synthetic exposures be permitted because they are used in certain types of loan securitizations.

In addition to requests that specific types of underlying assets be permitted under the loan securitization exemption, the Agencies also received comments about specific types of asset classes or structures. Some commenters suggested certain asset classes or structures should be an excluded securitization from the covered fund prohibitions including insurance-linked securities, collateralized loan obligations, tender option bonds, asset-backed commercial paper conduits (ABCP conduits), resecuritizations of asset-backed securities, and corporate debt re-packagings.[1858] In some cases, commenters believed that the Agencies should use their authority under section 13(d)(1)(J) of the BHC Act to exempt these types of vehicles. Some commenters identified other vehicles such as credit funds and issuers of covered bonds that they believed should be excluded from the covered fund

against the systemic risks associated with securitization. *See* AFR (Nov. 2012).

[1843] *See* Request for Comment No. 231 in the Proposing Release (noting that many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (*e.g.,* CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities) and requesting comment on how to prevent hedge funds or private equity funds from structuring around an exemption for asset-backed securities from the covered fund prohibitions).

[1844] *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen. *But see* Credit Suisse (Williams) (arguing it would be difficult to use the typical structure and operation of securitizations to avoid the prohibition on proprietary trading because the structures are not set up to engage in the kind of proprietary trading about which Congress was concerned).

[1845] *See* AFME *et al.*; Ass'n. of German Banks; Cleary Glottlieb; Credit Suisse (Williams); GE (Feb. 2012); IIB/EBF; RBC; SIFMA (Securitization) (Feb. 2012).

[1846] *See, e.g.,* Credit Suisse (Williams).

[1847] *See* Credit Suisse (Williams); JPMC. These commenters cited the sponsoring of asset-backed commercial paper conduits as an example of permissible bank securitization activity.

[1848] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); JPMC.

[1849] *See* GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012).

[1850] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams) (including cash that did not arise directly from the underlying loans); JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012).

[1851] *See* Cleary Gottlieb; Credit Suisse (Williams).

[1852] *See* JPMC (requesting high quality, highly liquid investments, including Treasury securities and highly rated commercial paper); LSTA (Feb. 2012); LSTA (July 2012) (requesting short-term highly liquid investments such as obligations backed by the full faith and credit of the United States, deposits insured by the Federal Deposit Insurance Corporation, various obligations of U.S. financial institutions and investments in money market funds); ASF (Feb. 2012); Commercial Real Estate Fin. Council; RBC (requesting short-term, high quality investments); Allen & Overy (on behalf of Foreign Bank Group) (requesting short-term eligible investments); Credit Suisse (Williams) (requesting government guaranteed securities, money market funds and other highly credit-worthy and liquid investments); Cleary Gottlieb (requesting money-market interests; SIFMA (Securitization) (Feb. 2012) (requesting associated investments which are customarily employed in securitization transactions). One commenter further noted that such investments are required by securitization documents. *See* Commercial Real Estate Fin. Council.

[1853] RBC. This commenter argued that the loan securitization exemptions as proposed would not permit ''traditional securitizations and securitizations with the characteristics of traditional securitizations'' and ''would effectively eliminate a substantial portion of the very securitization activities carried on by banks that the [loan securitization exemptions] are designed to preserve.''

[1854] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1855] *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; LSTA (Feb. 2012). LSTA (Feb. 2012) specifically requested that entities issuing collateralized loan obligations that are primarily backed by loans or loan participations also be permitted to hold a limited amount of corporate credit obligations. This commenter provided recommendations about such limitations—if the amount of such corporate credit obligations exceeded 10 percent, a CLO would not be able to purchase any assets other than senior, secured syndicated loans and temporary investments (as defined in the letter). If the amount of such assets exceeded 30 percent, the entity should not be able to purchase any assets other than loans.

[1856] *See* AFME *et al.*; Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1857] *See* ASF (Feb. 2012). Permissible synthetic exposure would include ''credit default swaps, total return swaps or other agreements referencing corporate loans or corporate bonds pursuant to which the issuer is the seller of credit protection or otherwise 'long' the credit exposure of the reference corporate loan or bond, and receives a yield derived from the yield on the reference corporate loan or bond.''

[1858] *See* AFME *et al.*; ASF (July 2012); GE (Aug. 2012); Capital Group; Goldman (Covered Funds); LSTA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

prohibitions.[1859] On the other hand, the Agencies also received comment letters that argued that certain securitizations should not be exempted from the covered fund prohibitions, including resecuritizations, CDO-squared, and CDO-cubed securitizations because of concern about their complexity and lack of reliable performance data or ability to value those securities.[1860]

Because a loan securitization could still be a covered fund, several commenters expressed concern that the proposed loan securitization exemption, as drafted, did not exempt loan securitizations from the prohibitions of section 13(f) of the BHC Act. As a result, one commenter noted that the proposed loan securitization exemptions would not have their intended result of excluding loan securitizations from the BHC Act restrictions applicable to covered funds.[1861]

Certain securitization transactions may involve the issuance of an intermediate asset-backed security that supports the asset-backed securities that are issued to investors, such as in auto lease securitizations and ABCP conduits. Commenters suggested that the Agencies should look through intermediate securitizations to the assets that support the intermediate asset-backed security to determine if those assets would satisfy the definition of ''loan'' for purposes of the loan securitization exemption. If those assets are loans, these commenters suggested that the entire securitization transaction should be deemed a loan securitization, even if the assets supporting the asset-backed securities issued to investors are not loans.[1862] However, some commenters argued that each step in a multi-step securitization should be viewed separately to ensure compliance with the specific restrictions in the proposal because otherwise a multi-step securitization could include impermissible assets.[1863] Some commenters also raised question about whether depositors would fall within the definition of ''investment company'' under the Investment Company Act and, therefore, may fall within the proposed definition of covered fund.[1864]

After considering carefully the comments received on sections of the proposed rule, the Agencies have determined to adopt a single section in the final provision relating to loan securitizations that would exclude loan securitizations that meet certain criteria contained in the rule from the definition of covered fund. The rule, as adopted, takes into account comments received on each of the conditions specified in the two loan securitization sections of the proposed provisions and has adopted those conditions with some clarifying changes from the proposed language. In addition, in response to comments, as discussed more fully below, the Agencies are adopting additional exclusions from the definition of covered fund for certain types of vehicles if they are backed by the same types of assets as the assets that are permitted to be held in the loan securitization exclusion. These additional exclusions are tailored to vehicles that are very similar to loan securitizations but have particular structural issues, which are described in more detail below.

In light of the comments received on the proposal, the final rule was revised to exclude from the definition of covered fund an issuing entity of asset-backed securities, as defined in Section 3(a)(79) of the Exchange Act,[1865] if the underlying assets or holdings are comprised solely of: (A) loans, (B) any rights or other assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans, (C) certain interest rate or foreign exchange derivatives, and (D) certain special units of beneficial interests and collateral certificates (together, ''loan securitizations'').[1866] In addition, as discussed below, the Agencies are adopting specific exclusions for certain vehicles that issue short term asset-backed securities and for pools of assets that are part of covered bond transactions which pools also meet the conditions delineated above.[1867]

Although commenters argued that various types of assets should be included within the definition of loan or otherwise permitted to be held under the loan securitization exclusion, the loan securitization exclusion in the final rule has not been expanded to be a broad exclusion for all securitization vehicles. Although one commenter suggested that any securitization is essentially a lending activity,[1868] the Agencies believe such an expansion of the exclusion would not be consistent with the rule of construction in section 13(g)(2) of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' The Agencies believe that a broad definition of loan and therefore a broad exemption for transactions that are structured as securitizations of pooled financial assets could undermine the restrictions Congress intended to impose on banking entities' covered fund activities, which could enable market participants to use securitization structures to engage in activities that otherwise are constrained for covered funds. The Agencies believe the purpose underlying section 13 is not to expand the scope of assets in an excluded loan securitization beyond loans as defined in the final rule and the other assets that the Agencies are specifically permitting in a loan securitization.

[1859] *See* Goldman (Covered Funds) (requesting exclusion for credit funds). AFME *et al.* (requesting exclusion for covered bonds); FSA (Apr. 2012) (requesting exclusion for covered bonds); UKRCBC (requesting exclusion for covered bonds).

[1860] *See* Sens. Merkley & Levin (Feb. 2012). These commenters argued that there should be increased capital charges in line with the complexity of a securitization and using the ''high risk asset limitations on permitted activities to bar any securitization by a bank from using complex structures, re-securitization techniques, synthetic features, or other elements that may increase risk or make a risk analysis less reliable.''

[1861] *See* AFME *et al.*; SIFMA (May 2012) (arguing that because of the narrowness of the proposed exemption and because it would not exempt securitizations from prohibitions on covered transactions imposed by section 13(f), the rule as proposed ''will effectively prevent banking entities from sponsoring and owning a large variety of asset-backed securities, in contravention of the rule of construction.'')

[1862] *See* AFME *et al.*; ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1863] *See* Occupy; Public Citizen. Occupy contended that the structured security issued in a multi-step securitization can hide underlying risks under layers of structured complexity. *See* Occupy. Public Citizen argued that prohibiting such activity would ensure that securitizations do not become proprietary trading vehicles for banking entities that are effectively off-balance sheet. *See* Public Citizen. *See infra* Part VI.B.1.c.8.b.iv. of this **SUPPLEMENTARY INFORMATION**.

[1864] A depositor, as used in a securitization structure, is an entity that generally acts only as a conduit to transfer the loans from the originating bank to the issuing entity for the purpose of facilitating a securitization transaction and engages in no discretionary investment or securities issuance activities. *See* ASF (July 2012); GE (Aug. 2012). For purposes of this rule, the Agencies believe the wholly owned subsidiary exclusion is available for depositors. *See supra* note 1779.

[1865] 15 U.S.C. 78c(a)(79). This definition was added by Section 941 of the Dodd-Frank Act.

[1866] *See* final rule § 75.10(c)(8). Consistent with the proposal, certain securitizations, regardless of asset composition, would not be considered covered funds because the securitization issuer is deemed not to be an investment company under Investment Company Act exclusions other than section 3(c)(1) or 3(c)(7) of the Investment Company Act. For example, this would include issuers that meet the requirements of section 3(c)(5) or rule 3a–7 of the Investment Company Act, and the asset-backed securities of such issuers may be offered in transactions registered under the Securities Act.

[1867] As discussed below, the Agencies are adopting an exclusion from the definition of covered funds for the pools of assets that are involved in the covered bond financings. Although the cover pools must satisfy the same criteria as the excluded loan securitizations, a separate exclusion is needed because the securities involved in the covered bond issuance are not asset-backed securities.

[1868] *See, e.g.,* Credit Suisse (Williams).

While not expanding the permitted assets under the loan securitization exclusion, the Agencies have made modifications in response to commenters to ensure that the provisions of the final rule appropriately accommodate the need, in administering a loan securitization transaction on an ongoing basis, to hold various assets other than the loans that support the asset-backed securities. Moreover, the Agencies do not believe that the assets permitted under the loan securitization need to be narrowed further to prevent evasion and hidden proprietary trading as requested by certain commenters because the Agencies believe that the potential for evasion has been adequately addressed through modifications to the definition of loan and more specific limitations on the types of securities and derivatives permitted in an excluded loan securitization. The Agencies have revised the scope of the loan securitization exclusion to accommodate existing market practice for securitizations as discussed by commenters while limiting the availability of the exclusion for these particular types of securitization transactions to issuers of asset-backed securities supported by loans.

The Agencies are not adopting specific exclusions for other securitization vehicles identified by commenters, including insurance-linked securities, collateralized loan obligations, and corporate debt re-packagings.[1869] The Agencies believe that providing such exclusions would not be consistent with the rule of construction in section 13(g)(2) of the BHC Act, which specifically refers to the ''sale and securitization of loans.'' These other types of securitization vehicles referenced by commenters are used to securitize exposures to instruments which are not included in the definition of loan as adopted by the final rule. Moreover, the Agencies note in response to commenters that resecuritizations of asset-backed securities and CDO-squared and CDO-cubed securitizations could be used as a means of evading the prohibition on the investment in the ownership interests of covered funds.

As with the proposed rules, the Agencies are excluding certain loan securitizations from the definition of covered fund and therefore the prohibitions applicable to banking entities' involvement in covered funds in order to implement Congressional intent expressed in the rule of construction in section 13(g)(2) of the BHC Act.[1870] The Agencies believe that, as reflected in the rule of construction, the continued ability of banking entities to participate in loan securitizations is important to enable banks of all sizes to be able to continue to provide financing to loan borrowers at competitive prices. Loan securitizations provide an important avenue for banking entities to obtain investor financing for existing loans, which allows such banks greater capacity to continuously provide financing and lending to their customers. The Agencies also believe that loan securitizations that meet the conditions of the rule as adopted do not raise the same types of concerns as other types of securitization vehicles that could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act.

Under the rule as adopted, loan securitizations that meet the conditions of the rule as adopted are excluded from the definition of covered fund and, consequently, banking entities are not restricted as to their ownership of such entities or their ongoing relationships with such entities by the final rule. As the Agencies stated in the proposal, permitting banking entities to acquire or retain an ownership interest in these loan securitizations will allow for a deeper and richer pool of potential participants and a more liquid market for the sale of such securitizations, which in turn should result in the continued availability of funding to individuals and small businesses, as well as provide an efficient allocation of capital and sharing of risk. The Agencies believe that excluding these loan securitizations from the definition of covered fund is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction regarding loan securitizations.[1871]

i. Loans

The first condition of the loan securitization exclusion from the definition of covered fund is that the underlying assets or holdings are comprised of loans. In the proposal, ''loan'' was a defined term for purposes of the restrictions on proprietary trading and the covered funds provisions. As proposed, a loan was defined as a loan, lease, extension of credit, or secured or unsecured receivable.[1872] The definition of loan in the proposed rule was expansive, and included a broad array of loans and similar credit transactions, but did not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans.

As discussed above under ''Definition of Loan,'' the Agencies received comments regarding the loan definition in the securitization context. In particular, one commenter, citing a statement made by Senator Merkley, argued that Congress did not intend the loan securitization exemption to include ''loans that become financial instruments traded to capture the change in their market value.'' [1873]

The Agencies, after considering carefully the comments received, have adopted a definition of loan that is revised from the proposed definition. The final rule defines ''loan'' as ''any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.'' [1874] The definition of loan in the final rule specifically excludes loans that are securities or derivatives because trading in these instruments is expressly included in the statute's definition of proprietary trading.[1875] In addition, the Agencies believe these instruments, if not excluded from the definition of loan, could be used to circumvent the restrictions on proprietary trading. Further, for purposes of the loan securitization exclusion, the loan securitization must own the loan directly; a synthetic exposure to a loan, such as through holding a derivative, such as a credit default swap, will not satisfy the conditions for the loan securitization exclusion.[1876] As such, a securitization that owns a tranche of another loan securitization is not itself a loan securitization, even if the ownership of such tranche by a banking entity would otherwise be permissible under the final rule.

As discussed above under ''Definition of Loan,'' the definition of loan in the final rule has not been expanded as requested by some commenters but has

[1869] Commenters' concerns regarding credit funds are discussed below in Part VI.B.1.d.6. of this **SUPPLEMENTARY INFORMATION**.

[1870] As discussed below, the Agencies are excluding those loan securitizations that hold only loans (and certain other assets identified in the final rule), consistent with the rule of construction in section 13(g)(2) of the BHC Act.

[1871] The Agencies note that the loan securitization and other securitization exclusions apply only to the definition of covered fund, and therefore the covered fund-related provisions of the rule, and not to its prohibition on proprietary trading. The Agencies recognize that trading in loans is not subject to the proprietary trading restrictions.

[1872] *See* proposed rule § 75.2(q).

[1873] *See* Occupy (citing 156 Cong. Rec. S5895 (daily ed. July 15, 2010)).

[1874] *See* § 75.2(r).

[1875] 12 U.S.C. 1851(h)(4).

[1876] Under the final provision, the issuing entity for the SUBIs and collateral certificate may rely on the loan securitization exclusion because of the separate provisions allowing such a holding.

been clarified in some respects in response to comments. The final rule explicitly excludes securities or derivatives.[1877] In addition, the definition of loan has not been modified to include repurchase agreements or reverse repurchase agreements regardless of the character of the underlying asset. The Agencies are concerned that parties, under the guise of a ''loan'' might instead create instruments that provide the same exposures to securities and derivatives that otherwise are prohibited by section 13 and might attempt to use the loan securitization exclusion to acquire ownership interests in covered funds holding those types of instruments, counter to the terms and the purpose of section 13 of the BHC Act. As the Agencies have noted previously, the rules relating to covered funds and to proprietary trading are not intended to interfere with traditional lending practices or with securitizations of loans generated as a result of such activities. Although the Agencies have revised the definition of loan in response to commenters' concerns as discussed above, the Agencies are not adopting a separate definition of loan for securitization transactions as requested by commenters. The Agencies believe that the definition of loan adopted in the final rule appropriately encompasses the financial instruments that result from lending money to customers.

ii. Contractual Rights or Assets

Under the proposed loan securitization definition, a covered fund that is an issuer of asset-backed securities would have been permitted to hold contractual rights or assets directly arising from those loans supporting the asset-backed securities.[1878] The proposal did not identify or describe such contractual rights or assets.

Commenters requested that the Agencies expand the list of contractual rights and assets that an issuer of asset-backed securities would be permitted to hold under the proposed loan securitization exemption.[1879] Examples of the additional rights and assets requested by commenters include cash and cash accounts;[1880] cash equivalents;[1881] liquidity agreements, including asset purchase agreements, program support facilities and support commitments;[1882] credit enhancements:[1883] asset-backed securities;[1884] municipal securities;[1885] repurchase agreements;[1886] credit-linked notes;[1887] trust certificates;[1888] lease residuals;[1889] debt securities;[1890] and derivatives.[1891] As an alternative, commenters requested that an issuer of asset-backed securities be permitted to hold under the proposed loan securitization exemption certain of such additional rights and/or assets up to a threshold, such as a specified

[1877] The determination of whether an instrument falls outside the definition of loan because it is a security or a derivative is based on the Federal securities laws and the Commodity Exchange Act. Whether a loan, lease, extension of credit, or secured or unsecured receivable is a note or evidence of indebtedness that is defined as a security under the Federal securities laws will depend on the particular facts and circumstances, including the economic terms of the transaction. *See supra* note 1836 and accompanying text.

[1878] *See* proposed rule § 75.13(d).

[1879] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); Japanese Bankers Ass'n.; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Vanguard.

[1880] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams).

[1881] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); Commercial Real Estate Fin. Council; JPMC; LSTA (Feb. 2012); LSTA (July 2012); RBC; SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of cash equivalents: government guaranteed securities, money market funds, and ''other highly credit-worthy and liquid investments'' (Credit Suisse (Williams)); and high quality, highly liquid investments, including Treasury securities and highly rated commercial paper (JPMC). In addition, LSTA (Feb. 2012) requested inclusion of the following: (i) short-term highly liquid investments; (ii) direct obligations of, and obligations fully guaranteed as to full and timely payment by, the United States (or by any agency thereof to the extent such obligations are backed by the full faith and credit of the United States); (iii) demand deposits, time deposits or certificates of deposit that are fully insured by the Federal Deposit Insurance Corporation; (iv) corporate, non-extendable commercial paper; (v) notes that are payable on demand or bankers' acceptances issued by regulated U.S. financial institutions; (vi) investments in money market funds or other regulated investment companies; time deposits having maturities of not more than 90 days; (vii) repurchase obligations with respect to direct obligations and guaranteed obligations of the U.S. entered into with a regulated U.S. financial institution; and (viii) other investments with a maturity one year or less, with the requirement that each of the investments listed have, at the time of the securitization's investment or contractual commitment to invest therein, a rating of the highest required investment category.

[1882] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012).

[1883] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); GE (Feb. 2012); JPMC; RBC; SIFMA (Securitization) (Feb. 2012). For example, SIFMA (Securitization) (Feb. 2012) requested inclusion of third party credit enhancements such as guarantees and letters of credit. Commenters requested inclusion of the following examples of credit enhancements: (i) external credit support of borrower obligations under such loans, including a credit support facilities, third party or parent guarantee, insurance policy, letter of credit or other contractual commitment to make payments or perform other obligations of the borrower under the loans (ASF (Feb. 2012)); and (ii) property guarantees, insurance policies, letters of credit, or supporting obligations underlying or relating to any of the loans (RBC).

[1884] *See* Allen & Overy (on behalf of Foreign Bank Group); AFME *et al.;* ASF (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); ICI (Feb. 2012); JPMC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of asset-backed securities: (i) SUBI certificates (beneficial interests in titling trusts typically used in lease securitizations) (AFME *et al.;* ASF (Feb. 2012); GE (Aug. 2012); SIFMA (Securitization) (Feb. 2012)); (ii) ownership interests and bonds issued by CLOs (JPMC); a broad array of receivables that support asset-backed commercial paper (ICI (Feb. 2012)); certain notes, certificates or other instruments backed by loans or financial assets that are negotiated by the purchasing asset-backed commercial paper conduit (ASF (Feb. 2012); GE (Feb. 2012)); municipal securities that are technically ABS, including revenue bonds that involve the issuance of senior and subordinate bonds (ASF (Feb. 2012)); ownership interests in credit funds (as defined in their letter) (SIFMA *et al.* (Covered Funds) (Feb. 2012)); any note, bond or security collateralized and payable from pools of loans, leases (including lease residuals), extensions of credit or secured or unsecured receivables (RBC); asset-backed securities issued by intermediate vehicles in a securitization collateralized predominantly by loans and financial assets, and other similar instruments (Credit Suisse (Williams)); and asset-backed securities backed by loans or receivables that are originated by or owned by the sponsor of such securitization or which are issued by an entity that is organized under the direction of the same sponsor as the issuer of the covered fund (ASF (Feb. 2012)).

[1885] *See* ICI (Feb. 2012); Vanguard.

[1886] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012).

[1887] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1888] *See* Credit Suisse (Williams).

[1889] *See* ASF (Feb. 2012); GE (Feb. 2012); GE (Aug. 2012); RBC.

[1890] *See* GE (Aug. 2012).

[1891] *See* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012); SIFMA (Securitization) (Feb. 2012). Commenters requested inclusion of the following examples of derivatives: (i) credit derivatives (without explanation) as a means of diversifying the portfolio (Japanese Bankers Association); (ii) synthetic securities that reference corporate credits or other debt (Credit Suisse (Covered Fund)); (iii) credit instruments or other obligations that the banking entity could originate or invest or deal in directly, including tranched or untranched credit linked notes exposed to the credit risk of such reference assets through a credit default swap or other credit derivative entered into by the related ABS Issuer (SIFMA (Securitization) (Feb. 2012)); (iv) any derivatives structured as part of the securitization of loans (without explanation) (Allen & Overy (on behalf of Foreign Bank Group)); (v) hedge agreements (Credit Suisse (Williams)); and (vi) any derivative, including a credit default swap, as and to the extent a banking entity could use such derivative in managing its own investment portfolio (SIFMA (Securitization) (Feb. 2012)).

percentage of the assets of such covered fund.[1892]

In response to comments, the final rule modifies the loan securitization exclusion from the proposal to identify the types of contractual rights or assets directly arising from those loans supporting the asset-backed securities that a loan securitization relying on such exclusion may hold. Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold contractual rights or assets (i) designed to assure the servicing or timely distribution of proceeds to security holders or (ii) related or incidental to purchasing or otherwise acquiring, and holding the loans (''servicing assets'').[1893] The servicing assets are permissible in an excluded loan securitization transaction only to the extent that they arise from the structure of the loan securitization or from the loans supporting a loan securitization. If such servicing assets are sold and securitized in a separate transaction, they will not qualify as permissible holdings for the loan securitization exclusion.[1894]

In adopting this approach, the Agencies considered commenters' concerns and determined to revise the condition to be more consistent with the definition and treatment of servicing assets in other asset-backed securitization regulations, such as the exemption from the definition of ''investment company'' under rule 3a–7 promulgated under the Investment Company Act.[1895]

Although the Agencies have revised the proposal in response to commenters' concerns, the final rule does not permit a loan securitization to hold as servicing assets a number of instruments specifically requested by commenters whether in their entirety or as a percentage of the pool. Under the final rule, servicing assets do not include securities or derivatives other than as specified in the rule.

Under the final rule, a loan securitization which is eligible for the loan securitization exclusion may hold securities if those securities fall into one of three categories.[1896] First, such loan securitizations may hold securities that are cash equivalents. For purposes of the exclusion for loan securitizations, the Agencies interpret ''cash equivalents'' to mean high quality, highly liquid short term investments whose maturity corresponds to the securitization's expected or potential need for funds and whose currency corresponds to either the underlying loans or the asset-backed securities.[1897] Depending on the specific funding needs of a particular securitization, ''cash equivalents'' might include deposits insured by the Federal Deposit Insurance Corporation, certificates of deposit issued by a regulated U.S. financial institution, obligations backed by the full faith and credit of the United States, investments in registered money market funds, and commercial paper.[1898] Second, such loan securitizations may hold securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities. Finally, such loan securitizations may hold securities that qualify as SUBIs or collateral certificates subject to the provisions set forth in the rule for such intermediate asset-backed securities.

The Agencies have specifically limited the types of securities held as eligible assets in a loan securitization that may be excluded from the definition of covered fund under the final rule, even in limited amounts, in order to assure that the types of securities are cash equivalents or otherwise related to the loan securitization and to prevent the possible misuse of the loan securitization exclusion to circumvent the restrictions on proprietary trading, investments in covered funds and prohibitions in section 13(f) of the BHC Act.[1899] The Agencies believe that types of securities other than those specifically included in the final rule could be misused in such manner, because without limitations on the types of securities in which an excluded loan securitization may invest, a banking entity could structure an excluded loan securitization with provisions to engage in activities that are outside the scope of the definition of loan as adopted and also to engage in impermissible proprietary trading. Further, the Agencies do not believe that the use of thresholds with respect to such other types of securities as an alternative is appropriate because similarly, such a securitization would then involve a securitization of non-loan assets, outside the scope of what the Agencies believe the rule of construction was intended to cover. By placing restrictions on the securities permitted to be held by an excluded loan securitization, the potential for evasion is reduced. Loan securitizations are intended, as contemplated by the rule of construction, to permit banks to continue to engage in securitizations of loans. Including all types of securities within the scope of permitted assets in an excluded loan securitization would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

iii. Derivatives

Under the proposed loan securitization definition, an exempted loan securitization would be permitted to hold interest rate or foreign exchange derivatives that materially relate to the terms of any loans supporting the asset-backed securities and any contractual rights or assets directly arising from such loans so long as such derivatives are used for hedging purposes with respect to the securitization structure.[1900] The Agencies indicated in the proposing release that the proposed loan securitization definition would not allow an exempted loan securitization to use credit default swaps.[1901]

Commenters criticized the proposed limitations on the use of derivatives included in the proposed loan securitization definition.[1902] In particular, one commenter indicated that the use of credit derivatives such as credit default swaps is important in loan securitizations to provide diversification

[1892] *See* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); GE (Feb. 2012); GE (Aug. 2012); LSTA (Feb. 2012); LSTA (July 2012).

[1893] *See* final rule § 75.10(c)(8)(i)(B). The use of the term ''servicing assets'' is not meant to imply that servicing assets are limited to those contractual rights or assets related to the servicer and the performance of the servicer's obligations.

[1894] For example, under the final rule, mortgage insurance policies supporting the mortgages in a loan securitization are servicing assets permissible for purposes of § 75.10(c)(8)(i)(B). However, a separate securitization of the payments on those mortgage insurance policies would not qualify for the loan securitization exclusion.

[1895] The Agencies believe that for purposes of the final rule, in the context of securitization, such related or incidental assets in a loan securitization should support or further, and therefore, be secondary to the loans held by the securitization vehicle.

[1896] *See* final rule § 75.10(c)(8)(iii).

[1897] If either the loans supporting the loan securitization or the asset-backed securities issued by the loan securitization are denominated in a foreign currency, for purposes of the exclusion a loan securitization would be permitted to hold foreign currency, cash equivalents denominated in foreign currency and foreign exchange derivatives that comply with § 75.10(c)(8)(iv).

[1898] Servicing assets should not introduce significant additional risks to the transaction, including foreign currency risk or maturity risk. For instance, funds on deposit in an account that is swept on a monthly basis should not be invested in securities that mature in 90 days.

[1899] Commenters expressed concerns about the use of securitization vehicles for evasion. *See, e.g.,* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1900] *See* Joint Proposal, 76 FR at 68912.

[1901] *Id.*

[1902] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012) (requesting that an excluded loan securitization be permitted to hold up to 10% of its assets in the form of synthetic risk exposure to loans); Credit Suisse (Williams); Japanese Bankers Ass'n.; LSTA (Feb. 2012) (for CLOs); SIFMA (Securitization) (Feb. 2012).

of assets.[1903] Another commenter noted the use of such instruments to manage risks with respect to corporate loan and debt books by accessing capital from a broad group of capital markets investors and facilitates making markets.[1904] In contrast, two commenters generally supported the limitations on the use of derivatives under the proposed loan securitization definition and indicated that excluding credit default swaps from the loan securitization definition was appropriate.[1905]

With respect to the use of derivatives, the Agencies are adopting the loan securitization exclusion substantially as proposed with certain modifications to reflect a restructuring of this provision in order to more closely align the permissible uses of derivatives under the loan securitization exclusion with the loans, the asset-backed securities, or the contractual rights and other assets that a loan securitization relying on the loan securitization exclusion may hold. As adopted, for a loan securitization to be eligible for the loan securitization exclusion, the loan securitization may hold only interest rate or foreign exchange derivatives that meet the following requirements: (i) the written terms of the derivatives directly relate to either the loans or the asset-backed securities that such loan securitization may hold under the other provisions of the loan securitization exclusion; and (ii) the derivatives reduce interest rate and/or foreign exchange risk with respect to risks related to either such loans, the asset-backed securities or the contractual rights or other assets that a loan securitization may hold.[1906]

The first requirement that the written terms of the derivatives ''directly relate'' to either the loans or the asset-based securities themselves is intended to quantitatively and qualitatively limit the use of derivatives permitted under the loan securitization exclusion.[1907] The Agencies would expect that neither the total notional amount of directly related interest rate derivatives nor the total notional amount of directly related foreign exchange derivatives would exceed the greater of either the outstanding principal balance of the loans supporting the asset-backed securities or the outstanding principal balance of the asset-backed securities.[1908] Moreover, under the loan securitization exclusion, the type of derivatives must be related to the types of risks associated with the underlying assets and may not be derivatives designed to supplement income based on general economic scenarios, income management or unrelated risks.

The second requirement that derivatives reduce the interest rate and/or foreign exchange risks related to either such loans, contractual rights or other assets, or such asset-backed securities is intended to permit the use of derivatives to hedge interest rate and/or foreign exchange risks that result from a mismatch between the loans and the asset-backed securities.[1909]

The Agencies believe that the statutory rule of construction should be implemented in a manner that does not limit or restrict the sale and securitization of loans. The Agencies further believe that the sale and securitization of credit exposures other than ''loans'' as defined in the rule, such as through securities or derivatives, could be abused. The derivatives that may be held in a loan securitization for purposes of the exclusion may not be used for speculative purposes. Consistent with the proposal, the loan securitization exclusion does not permit a loan securitization relying on such exclusion to hold credit default swaps or other types of derivatives whether or not they are related either to the underlying loans or the asset-backed securities.[1910] Under the final rule, a synthetic securitization in which the asset-backed securities are supported by cash flow from derivatives, such as credit default swaps and total return swaps, would not be permitted to rely on the loan securitization exclusion because such derivatives are excluded from the final rule's definition of loan specifically, as a derivative. Similarly, a loan securitization that relies on the loan securitization exclusion would not be permitted to hold a credit default swap or total return swap that references a loan that is held by the loan securitization. Under the final rule as adopted, an excluded loan securitization would not be able to hold derivatives that would relate to risks to counterparties or issuers of the underlying assets referenced by these derivatives because the operation of derivatives, such as these, that expand potential exposures beyond the loans and other assets, would not in the Agencies' view be consistent with the limited exclusion contained in the rule of construction under section 13(g)(2) of the BHC Act, and could be used to circumvent the restrictions on proprietary trading and prohibitions in section 13(f) of the BHC Act. The Agencies believe that the use of derivatives by an issuing entity for asset-backed securities that is excluded from the definition of covered fund under the loan securitization exclusion should be narrowly tailored to hedging activities that reduce the interest rate and/or foreign exchange risks directly related to the asset-backed securities or the loans supporting the asset-backed securities because the use of derivatives for purposes other than reducing interest rate risk and foreign exchange risks would introduce credit risk without necessarily relating to or involving a reduction of interest rate risk or foreign exchange risk.

On the other hand, while the Agencies are not expanding the types of permitted derivatives to be held in a loan securitization, the Agencies in the final rule are not restricting the use of all derivatives under the loan securitization exclusion as requested by certain commenters. The Agencies believe that a loan securitization that is excluded from the definition of covered fund should be allowed to engage in activities that reduce interest rate and

[1903] *See* Japanese Bankers Ass'n. This commenter indicated that credit derivatives are important in securitizations to provide diversification when the desired mix of assets cannot be achieved.

[1904] *See* ASF (Feb. 2012). This commenter argued that for some loan securitizations, investors may seek a broader pool of credit exposures than the bank has available or can obtain to securitize in order to achieve risk diversification.

[1905] *See* AFR *et al.* (Feb. 2012); Public Citizen. One of these commenters stated that the credit default exclusion was appropriate because ''synthetic securitizations and resecuritizations were a key contributor to financial contagion during the crisis.'' *See* AFR *et al.* (Feb. 2012). Another commenter argued that the loan securitization definition should not permit the use of derivatives. *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity. This commenter also argued that the inclusion of derivatives in the loan securitization definition exceeded the Agencies' statutory authority. *Id.* Two senators indicated that ''complex securitizations'' including those with ''synthetic features'' and ''embedded derivatives'' should not be allowed to rely on the exclusion for loan securitizations. *See* Sens. Merkley & Levin (Feb. 2012).

[1906] *See* final rule § 75.10(c)(8)(iv).

[1907] Under the final rule, the Agencies expect that a loan securitization relying on the loan securitization exclusion would not have a significant amount of interest rate and foreign exchange derivatives with respect to risks arising from contractual rights or other assets.

[1908] For example, a $100 million securitization cannot be hedged using an interest rate hedge with a notional amount of $200 million.

[1909] The derivatives permitted in a securitization that may rely on the loan securitization exclusion would permit a securitization to hedge the risk resulting from differences between the income received by the issuing entity and the amounts due under the terms of the asset-backed securities. For example, fixed rate loans could support floating rate asset-backed securities; loans with an interest rate determined by reference to the Prime Rate could support asset-backed securities with an interest rate determined by reference to LIBOR; or Euro-denominated loans could support U.S. Dollar-denominated asset-backed securities.

[1910] Loan securitizations excluded from the covered fund definition may only hold certain directly related derivatives as specified in § 75.11(c)(8)(iv) and as discussed in this Part.

foreign exchange risk because the hedging of such risks is consistent with the prudent risk management of interest rate and currency risk in a loan portfolio while at the same time avoiding the potential for additional risk arising from other types of derivatives.[1911] The Agencies do not believe that the exemption for hedging activity applicable to market making and underwriting under the final rule is the appropriate measure for permitted derivatives in a loan securitization that would be excluded from definition of covered fund [1912] because the hedging exemptions for market making and underwriting are not tailored to the hedging requirements of a securitization transaction.[1913] The Agencies also do not believe that they lack the statutory authority to permit a loan securitization relying on the loan securitization exclusion to use derivatives, as suggested by one commenter,[1914] because the Agencies believe that the permitted derivatives relate directly to loans that are permitted and have limited the quality and quantity of derivatives that an excluded loan securitization is permitted to hold directly to the reduction of risks that result from the loans and the loan securitization.

While loan securitizations that include non-loan assets are not excluded from the definition of covered fund, banking entities are not prohibited from owning interests or sponsoring these covered funds under the final rule. Under the final rule, these securitizations would be covered funds, and banking entities engaged with these covered funds would be subject to the limitations on ownership interests and relationships with these covered funds imposed by section 13 of the BHC Act.

iv. SUBIs and Collateral Certificates

Commenters also argued that, under the proposed exemption for loan securitizations, securitizations that are backed by certain intermediate asset-backed securities would not satisfy the conditions for the exemption and therefore would be subject to the covered fund prohibitions.[1915] For example, commenters noted that, in a securitization of leases with respect to equipment where a titling trust is used to hold ownership of the equipment, a titling trust will typically own the equipment and the right to payment on the leases, and then will issue a security or other instrument, often referred to as a special unit of beneficial interest (SUBI), that represents an ownership interest in the titling trust to the securitization issuer.[1916] As another example, certain securitizations frequently use a master trust structure allowing the trust to issue more than one series of asset-backed security collectively backed by a common revolving pool of assets. In such a structure, a master trust may hold assets (such as loans) and issue a collateral certificate supported by those assets to an issuing trust that issues asset-backed securities to investors. The assets held by the master trust are typically a pool of revolving accounts that may be paid in full each month (*e.g.,* credit card receivables) or a revolving pool of short-term loans that are replaced with new loans as they mature (*e.g.,* floor plan loans).[1917] One commenter opposed the inclusion of securitizations backed by intermediate asset-backed securities, arguing that each step should be viewed separately to ensure compliance to prevent the inclusion of impermissible assets such as prohibited derivatives.[1918]

In response to comments, the Agencies are modifying the proposal to provide that a securitization backed by certain intermediate asset-backed securities will qualify for the loan securitization exclusion. The Agencies recognize that securitization structures that use these types of intermediate asset-backed securities are essentially loan securitization transactions, because the intermediate asset-backed securities in the asset pool are created solely for the purpose of facilitating a securitization [1919] and once created, are issued directly into a securitization vehicle rather than to any third party investor.

Under the final rule, a loan securitization that is excluded from the definition of covered fund may include SUBIs or collateral certificates, provided that four conditions are met.[1920] First, the special purpose vehicle issuing the SUBI or collateral certificate itself must meet the conditions of the loan securitization exclusion, as adopted in the final rule.[1921] Under this provision, for example, the special purpose vehicle, in addition to the issuing entity, may hold an interest rate or foreign exchange derivative or other assets only if the derivative or asset is permitted to be held in accordance with the requirements for derivatives in respect of the loan securitization exclusion. Second, the SUBI or collateral certificate must be used for the sole purpose of transferring economic risks and benefits of the loans (and other permissible assets) [1922] to the issuing entity for the securitization and may not directly or indirectly transfer any interest in any other economic or financial exposures. Third, the SUBI or collateral certificate must be created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization. Fourth, the special purpose vehicle issuing the SUBI or collateral certificate and the issuing entity for the excluded loan securitization transaction must be established under the direction of the same entity that initiated the loan securitization transaction. The Agencies believe that the fourth condition will ensure that the resecuritizations of asset-backed securities purchased in the secondary market, which the Agencies do not believe would constitute a loan securitization, will not be able to use these special provisions tailored only for transactions utilizing SUBIs and collateral certificates in order to fall within the loan securitization exclusion.

The Agencies believe that these conditions provide that only securitizations backed by SUBIs and collateral certificates involving loans—and not other types of securities or other types of assets—will be able to use the loan securitization exclusion. These conditions are intended to assure that for purposes of the loan securitization exclusion that only SUBI and collateral certificates that essentially represent the underlying loans are included consistent with the terms and the purpose of section 13 of the BHC Act, while also not adversely affecting

[1911] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[1912] *See* Occupy. This commenter argued that covered funds should only be permitted to engage in hedging activity in accordance with the proposed exemption for hedging activity.

[1913] For example, a banking entity may hold an ownership interest in a covered fund in order to hedge employee compensation risks. Because securitizations do not have employees, such a hedging exemption would not be applicable to a securitization structure.

[1914] *See* Occupy.

[1915] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); GE (Aug. 2012); PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1916] *See* SIFMA (Securitization) (Feb. 2012).

[1917] *See, e.g.,* ASF (Feb. 2012). UK RMBS master trusts also use a master trust structure. *See* AFME *et al.;* ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012).

[1918] *See* Occupy.

[1919] The use of SUBIs, for example, allows the sponsor to avoid administrative expenses in retitling the physical property underlying the leases.

[1920] *See* final rule § 75.10(c)(8)(v).

[1921] The provision will allow for the existing practice of a master trust to hold a collateral certificate issued by a legacy master trust.

[1922] This would include a collateral certificate issued by a legacy master trust that meets the requirements of the loan securitization exclusion.

securitization of ''loans'' as defined in the final rule.[1923] The Agencies believe that the limitation of the types of asset-backed securities permitted in an excluded loan securitization (only SUBIs and collateral certificates) and the restrictions placed on those SUBIs and collateral certificates that are permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

v. Impermissible Assets

As discussed above, commenters on the loan securitization proposals argued that various types of assets should be included within the definition of loan or otherwise permitted to be held by the loan securitization that would be entitled to rely on the proposed exemptions.

After considering comments, the Agencies have determined to retain the narrower scope of the permitted assets in a loan securitization that is eligible for the loan securitization exclusion. The Agencies have revised the language regarding loan securitizations from the proposal to specify certain types of assets or holdings that a loan securitization would not be able to hold if it were eligible to rely on the exclusion from the definition of covered fund for loan securitizations.[1924] The Agencies recognize that securitization structures vary significantly and, accordingly, the loan securitization exclusion as adopted in the final rule accommodates a wider range of securitization practices. The Agencies believe that these limitations provide that only securitizations backed by loans—and not securities, derivatives or other types of assets—will be able to use the loan securitization exclusion consistent with the terms and the purpose of section 13 of the BHC Act.[1925] The Agencies believe that the limitation of the types of assets permitted in an excluded loan securitization will avoid loan securitizations that contain other types of assets from being excluded from the definition of covered fund.

Under the final rule, in order to be excluded from the definition of covered fund, a loan securitization may not hold (i) a security, including an asset-backed security, or an interest in an equity or debt security (unless specifically permitted, such as with respect to a SUBI or collateral certificate as described above), (ii) a derivative other than an interest rate or foreign exchange derivative that meets the requirements described above,[1926] or (iii) a commodity forward contract.[1927] The Agencies have determined that a loan securitization relying on the loan securitization exclusion may not include a commodity forward contract because a commodity forward contract is not a loan.[1928]

9. Asset-Backed Commercial Paper Conduits

Under the proposed rule, certain securitization vehicles, including ABCP conduits, would not have been covered by the loan securitization exclusion and, therefore, would have been deemed to be a covered fund.[1929] ABCP is a type of liability that is typically issued by a special purpose vehicle (commonly referred to as a ''conduit'') sponsored by a financial institution or other entity. The short term asset-backed securities issued by the conduit are supported by a managed pool of assets, which may change over the life of the entity. Depending on the type of ABCP conduit, the securitized assets ultimately supporting the short term asset-backed securities may consist of a wide range of assets including automobile loans, commercial loans, trade receivables, credit card receivables, student loans, and other loans in addition to asset-backed securities supported by such assets. The term of ABCP typically is short, and the liabilities are ''rolled'' (*i.e.,* replaced or refinanced) at regular intervals. Thus, ABCP conduits generally fund longer-term assets with shorter-term liabilities.[1930] In this regard, in the proposing release, the Agencies requested comment on the proposed rule's definition of ''covered fund'' with respect to asset-backed securities and/or securitization vehicles [1931] and received numerous comments requesting a variety of exemptions for ABCP conduits.[1932]

A number of commenters requested that the final rule exclude ABCP conduits from the definition of covered fund [1933] or that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act [1934] to similar effect.[1935] One commenter argued that ABCP conduits do not have the characteristics of a private equity fund or hedge fund,[1936] even though they typically rely on the exemptions set forth in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Another commenter argued that the proposed rule's definition of covered fund would negatively impact asset-backed securitizations (including ABCP conduits), and suggested that the Agencies define covered funds, in part, as those that both (i) rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act and (ii) have the traditional characteristics of private equity funds or hedge funds.[1937] Another commenter stated that the rule of construction set forth in section 13(g)(2) of the BHC Act [1938] is a clear indication that section 13 of the BHC Act was not intended to apply to securitization vehicles such as ABCP conduits.[1939] Another commenter stated that the lending that occurs through ABCP conduits is the type of activity that Congress and the Executive Branch have urged banks to expand in order to support economic growth and job creation,[1940] while another commenter stated that ABCP conduits provide low cost, reliable financing for registered investment companies, which poses little risk to the safety and soundness of banks because Federal law requires registered investment companies to

[1923] *See, e.g.,* rule 190 under the Securities Act. *See also, e.g.,* ASF (Feb. 2012) (noting that certain rules under the Securities Act and staff interpretations have carved out SUBIs and collateral certificates from certain disclosure and other requirements).

[1924] *See* final rule § 75.10(c)(8)(ii).

[1925] The Agencies discuss earlier in this Part the permissible assets an excluded loan securitization may hold and the Agencies' belief that excluding loan securitizations as defined in the final rule is consistent with the terms and the purpose of section 13 of the BHC Act, including the rule of construction in section 13(g)(2). *See, e.g., supra* note 1871 and accompanying and following text.

[1926] *See* final rule § 75.10(c)(8)(iv); *see also* 7 U.S.C. 27(a)–(b).

[1927] See the discussion above in Part VI.B.1.c.8 of this **SUPPLEMENTARY INFORMATION.**

[1928] For a discussion of commodity forward contracts, see Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208 (Aug. 13, 2012) (Release Nos. 33–9338 and 34–67453, July 18, 2012).

[1929] *See* proposed rule § 75.13(d).

[1930] Structured investment vehicles (''SIVs'') and securities arbitrage ABCP programs both purchase securities (rather than receivables and loans). SIVs typically lack liquidity facilities covering all of these liabilities issued by the SIV, while securities arbitrage ABCP programs typically have such liquidity coverage, though the terms are more limited than those of the ABCP conduits eligible for the exclusion pursuant to the final rule.

[1931] *See* Joint Proposal, 76 FR at 68899.

[1932] *See, e.g.,* ASF (Feb. 2012); BoA; Capital Group; Eaton Vance; Fidelity; ICI (Feb. 2012); Japanese Bankers Ass'n.; PNC; RBC.

[1933] *See, e.g.,* ICI (Feb. 2012); PNC *et al.;* SIFMA (May 2012).

[1934] *See* 12 U.S.C. 1851(d)(1)(J).

[1935] *See* ICI (Feb. 2012).

[1936] *See* PNC.

[1937] *See* Barclays.

[1938] *See* 12 U.S.C. 1851(g)(2).

[1939] *See* ICI (Feb. 2012).

[1940] *See* Credit Suisse (Williams).

maintain prescribed asset coverage in connection with borrowings.[1941]

Two commenters contended that, while certain issuers of asset-backed securities may rely on section 3(c)(5) of the Investment Company Act or rule 3a–7 thereunder, and, therefore, not be brought under the proposed rule's definition of covered fund, ABCP conduits typically cannot rely on this section or rule either because to do so would be too restrictive (in the case of section 3(c)(5)) or because they cannot meet the rule's requirements.[1942]

One commenter, employing ABCP conduits as an example, stated that failing to exempt securitization vehicles from the covered fund prohibitions would preclude banking entities from engaging in activities that have long been recognized as permissible activities for banking entities and that are vital to the normal functioning of the securitization markets, and will have a significant and negative impact on the securitization markets and on the ability of banking entities and other companies to provide credit to their customers.[1943] This commenter further stated that ABCP conduits are an efficient and attractive way for banking entities to lend their own credit-worthiness to expand the pool of possible lenders willing to finance key economic activity while maintaining a low cost of funding for consumers, and because of the liquidity support provided by the sponsoring banking entity, the sponsoring banking entity to the ABCP conduit has full exposure to the assets acquired by or securing the amounts lent by the ABCP conduit and the banking entity subjects those assets and the obligors to the same analysis as it would engage in if the bank were lending directly against those assets.[1944] Another commenter stated that the provision of credit to companies to finance receivables through ABCP conduits is an area of traditional banking activity that should be distinguished from the type of high-risk, conflict-ridden financial activities that Congress sought to restrict under section 13 of the BHC Act.[1945]

To this end, commenters proposed several means to exclude ABCP conduits from the proposed rule's restrictions and requirements, including an expansion of the loan securitization exemption to treat two-step securitization transactions as a single loan securitization,[1946] a separate exclusion for ABCP conduits,[1947] an expansion of the definition of loan,[1948] or as part of a broad exclusion for all issuers of asset-backed securities.[1949] In order to allow ABCP conduits to qualify as loan securitizations, commenters suggested that the loan securitization exclusion should permit a limited amount of securities purchased in the secondary market.[1950] Commenters also proposed changes to the permissible assets such as allowing a loan securitization to hold liquidity and support commitments, asset-backed securities and certain financial assets in addition to loans that by their terms convert to cash within a finite period of time.[1951] Another commenter argued that the loan securitization exemption should allow banking entities to sponsor, control, and invest in ABCP conduits that facilitate the securitization of customer loans and receivables.[1952] In contrast, one commenter supported the restriction of the loan securitization exemption to the plain meaning of what constitutes a loan and advocated that the Agencies not include ABCP conduits under the exemption.[1953]

In addition to the effect the proposed rule's definition of covered fund would have on ABCP conduits, commenters also noted that section 13(f) of the BHC Act[1954] would prohibit certain transactions between a banking entity sponsor and a covered fund securitization.[1955] Two commenters requested a specific exemption from § 75.16 of the proposed rule for ABCP conduits based on the interpretation that the proposed rule subjects covered funds exempted under the loan securitization exemption or other exemptions to § 75.16.[1956] Commenters argued that without liquidity and credit support, ABCP conduits are not viable,[1957] cannot effectively operate,[1958] could not function,[1959] or would not be marketable.[1960] One commenter argued that prohibiting a banking entity from providing liquidity facilities to ABCP conduits is tantamount to requiring the banking entity to wind down the operation of such ABCP conduits.[1961]

In response to the comments received and in light of the rule of construction contained in section 13(g)(2) of the BHC Act, the Agencies have determined in the final rule to exclude from the definition of covered fund an ABCP conduit that is a ''qualifying asset-backed commercial paper conduit'' as defined in the final rule is excluded from the definition of covered fund.[1962]

[1941] *See* Eaton Vance.

[1942] *See* RBC; ASF (Feb. 2012).

[1943] *See* Credit Suisse (Williams).

[1944] *Id.*

[1945] *See* ICI (Feb. 2012). This commenter emphasized the importance of the ABCP conduit market to money market funds, noting that as of November 2011, taxable money market funds held $126 billion of the $348.1 billion of securities issued by ABCP conduits outstanding, which represented approximately 5.4% of taxable money market funds' total assets. Another commenter noted that approximately $66.7 billion of automobile loans and leases, $52.1 billion of student loans, $22.3 billion of credit card charges, $49.4 billion of loans to commercial borrowers and $50.7 billion of trade receivables were financed by the U.S. ABCP conduit market as of October 31, 2011, and that the total outstanding amount of securities sold by ABCP conduits in the U.S. market was $344.5 billion as of January 18, 2012. *See* ASF (Feb. 2012).

[1946] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); PNC; SIFMA (Securitization) (Feb. 2012).

[1947] *See* ASF (Feb. 2012); Capital Group (alleging that ABCP does not pose the risks that the rule is meant to combat); GE (Feb. 2012). One commenter proposed an exemption for ABCP conduits that included a requirement of 100% liquidity support from a regulated, affiliated entity, and such liquidity support may be conditional or unconditional. *See* RBC.

[1948] *See* Credit Suisse (Williams) (alleging that ABCP conduits acquire ownership of loans indirectly through the purchase of variable funding notes, trust certificates, asset-backed securities, repurchase agreements and other instruments that may be considered securities, all of which economically are consistent with providing funding or extensions of credit to customers); ICI (Feb. 2012) (requesting that the definition of loan include the broad array of receivables that back ABCP).

[1949] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012).

[1950] *See* ASF (Feb. 2012) (requesting that ABCP conduits be permitted to own asset-backed securities purchased on the secondary market only if the aggregate principal amount of such securities does not exceed 5% of the aggregate principal or face amount of all assets held by the ABCP conduit in order to diversify their asset base and avoid the negative consequences of divestiture of such assets); RBC (requesting that loan securitizations be permitted to hold cash equivalents and assets, other than loans, which, by their terms, convert to cash within a finite period of time so long as such assets comprise no more than 10% of their total assets based on book value).

[1951] *See* ASF (Feb. 2012) (arguing that the loans, receivables, leases, or other assets purchased by the ABCP conduit might have fit the definition of loan in the proposed rules but for the proposal's express assertion that the definition of loan does not include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans). *See* Joint Proposal, 76 FR at 68865; GE (Feb. 2012); RBC.

[1952] *See* PNC.

[1953] *See* Public Citizen.

[1954] *See* 12 U.S.C. 1851(f); *see also* § 75.16 of the proposed rule.

[1955] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); Credit Suisse (Williams); Fidelity; IIB/EBF; JPMC; PNC; RBC; SIFMA (Securitization) (Feb. 2012).

[1956] *See* ICI (Feb. 2012); Fidelity.

[1957] *See* JPMC.

[1958] *See* ASF (Mar. 2012).

[1959] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1960] *See* ASF (Feb. 2012); Fidelity.

[1961] *See* ASF (Mar. 2012).

[1962] *See* final rule § 75.10(c)(9)(i). The rule of construction contained in section 13(g)(2) of the BHC Act provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner that is otherwise

Under the final rule, a qualifying asset-backed commercial paper conduit is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization [1963] and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.[1964] In addition, a qualifying asset-backed commercial paper conduit must issue only asset-backed securities, comprising of a residual and securities with a term of 397 days or less and in addition, a ''regulated liquidity provider,'' as defined in the final rule, must provide a legally binding commitment to provide full and unconditional liquidity coverage with respect to all the outstanding short term asset-backed securities issued by the qualifying asset-backed commercial paper conduit in the event that funds are required to redeem the maturing securities.[1965]

Under the final rule, a regulated liquidity provider is (i) a depository institution as defined in section 3 of the Federal Deposit Insurance Act; [1966] (ii) a bank holding company or a subsidiary thereof; [1967] (iii) a savings and loan holding company,[1968] provided all or substantially all of the holding company's activities are permissible for a financial holding company,[1969] or a subsidiary thereof; (iv) a foreign bank whose home country supervisor as defined in section 211.21 of the Federal Reserve Board's Regulation K [1970] has adopted capital standards consistent with the Capital Accord of the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or (v) a sovereign nation.[1971] In order for a sovereign nation to qualify as a regulated liquidity provider, the liquidity provided must be unconditionally guaranteed by the sovereign, which would include its departments and ministries, including the central bank.

In this regard, under the final rule, the exclusion from the definition of covered fund in respect of ABCP conduits is only available to an issuer of short-term asset-backed securities supported by loans and certain asset-backed securities supported by loans that were issued or initially sold to the ABCP conduit, and the short term asset-backed securities issued by the ABCP conduit are supported by a liquidity facility that provides 100 percent liquidity coverage from a regulated liquidity provider. The exclusion, therefore, is not available to ABCP conduits that lack 100 percent liquidity coverage. The liquidity coverage may be provided in the form of a lending facility, an asset purchase agreement, a repurchase agreement, or similar arrangement and 100 percent liquidity coverage means that, in the event the qualifying asset-backed commercial paper conduit is unable for any reason to repay maturing asset-backed securities issued by the issuing entity, the total amount for which the regulated liquidity provider may be obligated is equal to 100 percent of the amount of asset-backed securities outstanding plus accrued and unpaid interest. In addition, amounts due pursuant to the required liquidity coverage may not be subject to the credit performance of the asset-backed securities held by the qualifying asset-backed commercial paper conduit or reduced by the amount of credit support provided to the qualifying asset-backed commercial paper conduit. Under the final rule, liquidity coverage that only funds an amount determined by reference to the amount of performing loans, receivables, or asset-backed securities will not be permitted to satisfy the liquidity requirement for a qualifying asset-backed commercial paper conduit.

As discussed above, the final rule defines a qualifying asset-backed commercial paper conduit as having certain elements. First, a qualifying asset-backed commercial paper conduit must issue only a residual interest and short-term asset-backed securities. This requirement distinguishes ABCP conduits from covered funds that issue partnership interests and mitigates the potential that a qualifying ABCP conduit would be used for evasion of the covered fund prohibitions. The Agencies chose a maximum term of 397 days for these securities because this time frame corresponds to the maximum maturity of securities allowed to be purchased by money market funds under Rule 2a-7 of the Investment Company Act.

Second, the asset-backed securities issued by the ABCP conduit must be supported only by loans and certain asset-backed securities that meet the requirements of the loan securitization exclusion. By placing restrictions on the assets permitted to be held by an excluded loan securitization, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for qualifying ABCP conduits is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banks to continue to engage in securitizations of loans. Including all types of securities and other assets within the scope of permitted assets in a qualifying ABCP conduit, as with loan securitizations, would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction.

Third, the asset-backed securities supporting a qualifying asset-backed commercial paper conduit must be purchased as part of the initial issuance of such asset-backed securities. Asset-backed securities purchased by an ABCP conduit in the secondary market will not be permitted because such a purchase would not be part of an initial issuance and the banking entity that established and manages the ABCP conduit would not have participated in the negotiation of the terms of such asset-backed securities. Without a more direct connection between the banking entity and the ABCP conduit, the purchase of such asset-backed securities in the secondary market would resemble investments in securities.

Fourth, under the final rule, the ABCP conduit exclusion will not be available to ABCP conduits that lack 100 percent liquidity coverage. The Agencies believe that the 100 percent liquidity coverage requirement distinguishes the conduits eligible for the exemption, which sometimes hold and securitize a customer's loans through an intervening special-purpose vehicle instead of holding the loans directly, and are supported by a 100 percent liquidity guarantee, from other types of conduits with partial liquidity guarantees (such as structured investment vehicles) that have sometimes been operated by banking entities for the purpose of financing portfolios of securities acquired or retained as part of their activities in the securities markets.

The Agencies recognize that ABCP conduits that do not satisfy the elements of the ABCP conduit exclusion may be covered funds and therefore would be subject to section 13(f) of the BHC

permitted by law. As noted above and explained below, a qualifying asset-backed commercial paper conduit under the final rule is an ABCP conduit that holds only (i) loans or other assets that would be permissible in a loan securitization and (ii) asset-backed securities that are supported solely by assets permissible for a loan securitization and are acquired by the conduit as part of an initial issuance directly from the issuer or directly from an underwriter engaged in the distribution of the securities.

[1963] *See* final rule § 75.10(c)(8).

[1964] *See* final rule § 75.10(c)(9)(i)(B).

[1965] *See* final rule § 75.10(c)(9)(ii) and (iii).

[1966] *See* 12 U.S.C. 1813.

[1967] *See* 12 U.S.C. 1841.

[1968] *See* 12 U.S.C. 1467a.

[1969] *See* 12 U.S.C. 1843(k).

[1970] *See* 12 CFR 211.21.

[1971] *See* final rule § 75.10(c)(9)(iii).

Act.[1972] As a result of section 13(f) of the BHC Act, which prohibits certain transactions between banking entities and a covered fund securitization that the banking entity sponsors or for which it provides investment management services, the banking entity would be prohibited from providing liquidity support for the ABCP conduit.

Similarly, while some commenters requested that the loan securitization exclusion permit the holding of a limited amount of securities purchased in the secondary market, the final rule does not provide for this in the context of ABCP conduits. The Agencies believe that the limitations on the types of securities that a qualifying asset-backed commercial paper conduit may invest in are needed to avoid the possibility that a banking entity could use a qualifying asset-backed commercial paper conduit to securitize non-loan assets or to engage in proprietary trading of such securities prohibited under the final rule. Thus this limitation reduces the potential for evasion of the covered fund provisions of section 13 of the BHC Act. In developing the exclusion from the definition of covered fund for qualifying asset-backed commercial paper conduits in the final rule, the Agencies considered the factors set forth in sections 13(g)(2) and 13(h)(2) of the BHC Act. The final rule includes conditions designed to ensure that an ABCP conduit established and managed by a banking entity serves as a means of facilitating that banking entity's loan securitization activity rather than financing that banking entity's capital market investments. The final rule distinguishes between qualifying asset-backed commercial paper conduits and other ABCP conduits in order to adhere to the tenets of section 13 of the BHC Act while accommodating the market practices discussed by the commenters by facilitating reasonable access to credit by consumers and businesses through the issuance of ABCP backed by consumer and business receivables. As discussed above, the Agencies understand that some existing ABCP conduits may need to be restructured to conform to the requirements of the ABCP conduit exclusion.

To the extent that the definition of covered fund, the loan securitization exclusion and the ABCP conduit exclusion do not eliminate the applicability of the final rule provisions to certain covered funds, there may be adverse effects on the provision of capital to customers,[1973] to securitization markets,[1974] and to the creation of new securitization products to meet investor demands that Congress may not have contemplated. [1975] However, financial institutions that are not banking entities and therefore are not subject to the restrictions on ownership can continue to engage in activities relating to securitization, including those securitizations that fall under the definition of covered fund. Furthermore, new securitizations may be structured so as to qualify for the loan securitization exclusion or other exclusions under the final rule. For these reasons, the impact on securitizations that are not excluded under the final rule may be mitigated.

The Agencies believe that the final rule excludes from the definition of covered fund typical structures used in the most common loan securitizations representing a significant majority of the current securitization market, such as residential mortgages, commercial mortgages, student loans, credit card receivables, auto loans, auto leases and equipment leases. Additionally, the Agencies believe that esoteric asset classes supported by loans may also be able to rely on the loan securitization exclusion, such as time share loans, container leases and servicer advances.

10. Covered Bonds

Several commenters called for covered bond structures to be excluded from the definition of covered fund.[1976] They indicated that the proposed rule may interfere with and restrict non-U.S. banks' ability to establish or issue covered bonds. As described by several commenters, covered bonds are full recourse debt instruments typically issued by a non-U.S. entity that are fully secured or ''covered'' by a pool of high-quality collateral (*e.g.,* residential or commercial mortgage loans or public sector loans).[1977] Certain of these covered bond structures utilize a special purpose vehicle (''SPV'') that holds a collateral pool. As such, under the proposed rule, an SPV could be a covered fund that relies on the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.

According to one commenter, the majority of covered bonds are issued under specific legislative frameworks which define permitted characteristics for covered bond issuances, including the kinds and quality of collateral that may be included in cover pools, the specific legal framework for issuance of covered bonds, and the procedures for resolution in the event that the issuer becomes insolvent.[1978] Some commenters expressed concern about the possibility that certain covered bond structures could fall within the definition of covered fund, as proposed. In particular, commenters expressed concern about covered bond structures in the United Kingdom that also would be relevant in principle with respect to covered bond structures used in other European Union (''EU'') jurisdictions (*e.g.,* the Netherlands and Italy) and certain non-EU jurisdictions (*e.g.,* Canada, Australia, and New Zealand).[1979] Another commenter indicated that covered bonds issued by certain French entities that hold a revolving pool of loans may be impacted by the proposed rule.[1980]

Certain commenters argued that in order to achieve the intended economic effect of providing recourse to both the bank issuing covered bonds and to the collateral pool, the issuing bank may enter into a number of agreements with the SPV that holds the collateral. This includes transactions where the bank takes on credit exposure to the SPV (*e.g.,* through derivatives and securities lending, provision of loans, and/or investments in securities of the SPV).[1981] The issuing bank typically also provides asset and liability management services to the SPV and may also repurchase certain assets from the SPV.[1982] Commenters also contended that under certain legislative frameworks, the SPV issues the covered bonds and holds the collateral, and a sponsoring bank lends money to the SPV.[1983] According to commenters, the

[1972] *See* 12 U.S.C. 1851(f); *see also* § 75.16 of the proposed rule.

[1973] *See, e.g.,* ASF (Feb. 2012).

[1974] *See* Credit Suisse (Williams) (employing ABCP conduits as an example); ASF (Feb. 2012) (describing the constriction of the market for asset-backed securities if banking entities are restricted from owning debt classes of new asset backed securities).

[1975] *See* RBC; ASF (Feb. 2012).

[1976] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012).

[1977] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); FSA (Apr. 2012); UKRCBC.

[1978] *See* UKRCBC. For example, a commenter indicated that in the European Union, Article 52(4) of the EU UCITS Directive sets out the defining characteristics of covered bonds, and this directive is implemented by specific legislative frameworks.

[1979] *See* UKRCBC; FSA (Apr. 2012). One commenter argued that there are two main models used for covered bond structures in Europe—the integrated model (where the collateral pool continues to be owned directly by the bank issuer and is segregated by special legislation) and the structured model (where the pool is transferred to a special purpose vehicle and is segregated by operation of legal principles). *See* UKRCBC.

[1980] *See* Allen & Overy (on behalf of Foreign Bank Group).

[1981] *See* FSA (Apr. 2012).

[1982] *See* UKRCBC.

[1983] *See* Allen & Overy (on behalf of Foreign Bank Group).

broad definition of covered fund in the proposed rule could capture an SPV that holds the collateral, so transactions between an SPV and the issuing bank or sponsor bank may be prohibited.[1984] These commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule, would have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1985]

According to certain commenters, SPVs whose sole function is as part of an offering of covered bonds should be excluded from the definition of covered fund in the final rule. These commenters provided that the proposed rule was not clear on whether these SPVs, which effectively function as collateral devices for the covered bond, would be excluded from the definition of covered fund.[1986] One commenter indicated that the key concern was primarily due to the wide definition of covered fund in the proposed rule.[1987] Other commenters indicated that the final rule should not apply to covered bond transactions because they are not traditionally recognized or regulated as asset-backed securities transactions, and they are not the type of transactions that the rule was intended to address.[1988]

As a result of comments received on covered bond vehicles, the final rule specifically excludes from the definition of covered fund certain entities that own or hold a dynamic or fixed pool of assets that covers the payment obligations of covered bonds. In order to qualify for the exclusion, the assets or holdings in the cover pool must satisfy the conditions in the loan securitization exclusion, except for the requirement that the securities they issue are asset-backed securities (the ''permitted cover pool'').[1989] The Agencies believe this approach is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act. The rule of construction in section 13(g)(2) of the BHC Act specifically refers to the ''sale and securitization of loans'' and the Agencies would not want a banking entity to use an excluded cover pool to engage in proprietary trading of such securities prohibited under the final rule. The Agencies believe this restriction reduces the potential for evasion of the final rule.

By placing restrictions on the assets permitted to be held by a cover pool, the potential for evasion of the covered fund prohibitions is reduced. The exclusion for cover pools is intended, as contemplated by the rule of construction in section 13(g)(2) of the BHC Act, to permit banking entities to continue to engage in lending activities and the financing those lending activities. Including all types of securities and other assets within the scope of permitted assets in a cover pools would expand the exclusion beyond the scope of the definition of loan in the final rule that is intended to implement the rule of construction. Additionally, because the exclusion for cover pools is only available to foreign banking organizations, allowing such cover pools to hold securities would provide unequal treatment of covered bonds as compared to a loan securitization sponsored by a U.S. banking entity.

Under the definition of covered bond in the final rule, the debt obligation may be issued directly by a foreign banking organization or by an entity that owns a permitted cover pool. In both cases, the payment obligations of the debt obligation must be fully and unconditionally guaranteed. If the debt obligation is issued by a foreign banking organization, such debt obligation will be a ''covered bond'' under the final rule if the payment obligations are fully and unconditionally guaranteed by an entity that owns a permitted cover pool.[1990] If the debt obligation is issued by an entity that owns a permitted cover pool, such debt obligation will be a ''covered bond'' under the final rule if (i) the payment obligations are fully and unconditionally guaranteed by a foreign banking organization and (ii) the issuer of the debt obligation is a wholly-owned subsidiary (as defined) by such foreign banking organization.[1991] Thus, under the final rule, a covered bond structure in which an entity holds the cover pool and issues securities that are fully and unconditionally guaranteed by a foreign banking organization may also be able to rely on the loan securitization exclusion if it meets all of the requirements of that exclusion.

The Agencies recognize that many covered bond programs may involve foreign covered bond programs (and their related cover pools) that are permitted by their respective laws to own residential mortgage-backed securities and other non-loan assets. As a result, the exclusion for covered bonds in the final rule may not be available to many of the existing cover pools that support outstanding covered bonds. The Agencies recognize that this approach may not exclude all foreign covered bond programs. Although certain commenters argued that including covered bond structures in the definition of covered fund is inconsistent with the legislative intent of the rule,[1992] the Agencies believe that the exclusion for qualifying covered bonds, including the limitations on the types of securities that a loan securitization can hold, is consistent with the rule of construction contained in section 13(g)(2) of the BHC Act and appropriate for the reasons discussed directly above and under ''Definition of Loan.'' The Agencies also recognize that commenters argued that including covered bonds as covered funds could have a negative and disproportionate effect on foreign banks, markets and economies and would give rise to potential conflicts with such foreign legislative frameworks.[1993] The Agencies note that, although they do not know the composition of the cover pools, the Agencies believe that foreign banking organizations should be able to look at the composition of their cover pools to evaluate how to meet the requirements of the exclusion — and thus to avoid or mitigate the adverse effects commenters asserted would occur—as they determine appropriate.

11. Certain Permissible Public Welfare and Similar Funds

Section 13(d)(1)(E) of the BHC Act permits a banking entity to make and retain: (i) Investments in one or more small business investment companies (''SBICs''), as defined in section 103(3) of the Small Business Investment Act of 1958 (SBA) (15 U.S.C. 662) [1994]; (ii)

[1984] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012).

[1985] *See* Allen & Overy (on behalf of Foreign Bank Group); UKRCBC; FSA (Apr. 2012); ASF (Feb. 2012); AFME *et al.* For a discussion of possible economic effects, *see* FSA (Feb. 2012); UKRCBC; Allen & Overy (on behalf of Foreign Bank Group).

[1986] *See* ASF (Feb. 2012); AFME *et al.;* UKRCBC.

[1987] *See* UKRCBC.

[1988] *See, e.g.,* AFME *et al.*

[1989] *See* final rule § 75.10(c)(10).

[1990] *See* final rule § 75.10(c)(10)(ii)(A).

[1991] *See* final rule § 75.10(c)(10)(ii)(B). As discussed above in the section describing the wholly-owned subsidiary exclusion from the definition of covered fund, the Agencies are permitting 0.5 of a wholly-owned subsidiary to be owned by an unaffiliated party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

[1992] *See supra* note 1985 and accompanying text.

[1993] *Id.*

[1994] The Agencies note that section 13(d)(1)(E) of the BHC Act incorrectly provides that the term ''small business investment company'' is defined in section 102 of the SBA, while the definition is in fact contained in section 103(3) of the SBA as codified at 15 U.S.C. 662. The statute includes the correct citation to 15 U.S.C. 662. The Agencies are correcting this technical error in the final rule by updating the reference to section 102 to section 103(3).

investments that are designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24); and (iii) investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[1995] The proposed rule permitted banking entities to invest in and act as sponsor [1996] to these entities, but did not explicitly exclude them from the definition of covered fund.[1997]

Commenters generally supported the proposed exemption for investments in and sponsorship of funds designed to promote the public welfare, SBICs, and other tax credit funds given the valuable funding and assistance these investments provide in facilitating community and economic priorities and the role these investments play in the ability of banking entities, especially community and regional banks, to achieve their financial and Community Reinvestment Act (''CRA'') goals. However, commenters raised some issues with respect to the proposed exemption and sought clarification on its application to specific investments.[1998] Of primary concern to commenters was the impact of the prohibition in section 13(f) of the BHC Act on the ability of a banking entity sponsoring a tax credit fund or its affiliate to guarantee certain obligations of the fund in order to provide assurance to investors that the investment has been properly structured to enable the investor to receive the tax benefits on which the investment are sold.[1999] Some commenters noted that failure to address this issue in the final rule would damage a large segment of this market and therefore urged the Agencies to exempt these investments from the application of section 13(f) or, in the alternative, from the definition of covered fund.[2000]

In addition, commenters requested clarification that specific types of public welfare, SBIC, and other tax credit investments would be eligible for the exemption, including Low Income Housing Tax Credits, Renewable Energy Tax Credits, New Markets Tax Credits, and Rural Business Investment Companies.[2001] One commenter requested that applicants for an SBIC license that have received permission from the Small Business Administration to file a formal SBIC license application be viewed the same as an SBIC.[2002] Other commenters sought coverage of investments in non-SBIC funds that provide capital to small and middle-market companies,[2003] investments in any state administered tax credit program,[2004] and investments outside the United States that are of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24).[2005]

In light of the comments received, the final rule excludes from the definition of covered fund an issuer that is an SBIC (or that has received from the Small Business Administration notice to proceed to qualify for a license as an SBIC, which notice or license has not been revoked) or the business of which is to make investments that are: (i) Designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or (ii) qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[2006]

By excluding SBICs and other public interest funds from the definition of covered fund—rather than provide a permitted activity exemption as proposed—the Agencies addressed commenters' concerns regarding the burdens imposed by section 13(f). The Agencies believe that excluding these investments from the definition of covered fund addresses the issues many commenters raised with respect to the application of section 13(f) of the BHC Act, and gives effect to the statutory exemption of these investments in a way that appropriately facilitates national community and economic development objectives. The Agencies believe that permitting a banking entity to sponsor and invest in these types of public interest entities will result in banking entities being able to provide valuable expertise and services to these entities and to provide funding and assistance to small businesses and low- and moderate-income communities. The Agencies believe that providing the exclusion will also allow banking entities to continue to provide capital to community-improving projects and in some instances promote capital formation.

12. Registered Investment Companies and Excluded Entities

The proposed rule did not specifically include registered investment companies (including mutual funds) or business development companies within the definition of covered fund.[2007] As explained above, the statute references funds that rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Registered investment companies and business development companies do not rely on either section 3(c)(1) or 3(c)(7) of the Investment Company Act and are instead registered or regulated in accordance with the Investment Company Act.

Many commenters argued that registered investment companies and business development companies would be treated as covered funds under the proposed definition if commodity pools are treated as covered funds.[2008] A few commenters argued that the final rule should specifically provide that all SEC-

[1995] *See* 12 U.S.C. 1851(d)(1)(E).

[1996] The proposal implemented a proposed determination by the Agencies under 13(d)(1)(J) ''that a banking entity may not only invest in such entities as provided under section 13(d)(1)(E) of the BHC Act, but also may sponsor an entity described in that paragraph and that such activity, since it generally would facilitate investment in small businesses and support the public welfare, would promote and protect the safety and soundness of banking entities and the financial stability of the United States.'' Joint Proposal, 76 FR at 68908 n.292.

[1997] *See* proposed rule § 75.13(a).

[1998] *See* Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); PNC; Raymond James; SIFMA et al. (Covered Funds) (Feb. 2012); SBIA.

[1999] *See* AHIC; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SBIA; Union Bank; U.S. Bancorp.

[2000] *See* ABA (Keating); Lone Star; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC); SVB; U.S. Bancorp.

[2001] *See* NCHSA; SBIA; Novogradac (LIHTC); Novogradac (NMTC); Novogradac (RETC).

[2002] *See* SBIA; *see also* SEC Rule 3c-2.

[2003] *See* ABA (Keating); PNC.

[2004] *See* USAA.

[2005] *See* JPMC; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2006] *See* final rule § 75.10(c)(11). This provision would cover any issuer that engages in the business of making tax credit investments (*e.g.,* Low Income Housing Tax Credit, New Markets Tax Credit, Renewable Energy Tax Credit, Rural Business Investment Company) that are either designed to promote the public welfare of the type permitted under 12 U.S.C. 24 (Eleventh) or are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as provided for under § 75.10(c)(11).

[2007] *See* proposed rule § 75.10(b)(1).

[2008] *See, e.g.,* Arnold & Porter; BoA; Goldman (Covered Funds); ICI (Feb. 2012); Putnam; TCW; Vanguard. According to these commenters, a registered investment company may use security or commodity futures, swaps, or other commodity interests in various ways to manage its investment portfolio and be swept into the broad definition of ''commodity pool'' contained in the Commodity Exchange Act.

registered funds are excluded from the definition of covered fund (and the definition of banking entity) to avoid any uncertainty about whether section 13 applies to these types of funds.[2009]

Commenters also requested that the final rule exclude from the definition of covered fund entities formed to establish registered investment companies during the seeding period. These commenters contended that, during the early stages of forming and seeding a registered investment company, an entity relying on section 3(c)(1) or (3)(c)(7) may be created to facilitate the development of a track record for the registered investment company so that it may be marketed to unaffiliated investors.[2010]

Section 13's definition of private equity fund and hedge fund by reference to section 3(c)(1) and 3(c)(7) of the Investment Company Act appears to reflect Congress' concerns about banking entities' exposure to and relationships with investment funds that explicitly are excluded from SEC regulation as investment companies. The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which are regulated by the SEC as investment companies. The Agencies believe that the proposed rule's inclusion of commodity pools would have resulted in some registered investment companies and business development companies being covered funds, a result the Agencies did not intend. The Agencies, in addition to narrowing the commodity pools that will be included as covered funds as discussed above, have also modified the final rule to exclude SEC-registered investment companies and business development companies from the definition of covered fund.[2011]

The Agencies also recognize that an entity that becomes a registered investment company or business development company might, during its seeding period, rely on section 3(c)(1) or 3(c)(7). The Agencies have determined to exclude these seeding vehicles from the covered fund definition for the same reasons the Agencies determined to exclude entities that are operating as registered investment companies or business development companies as discussed above.

In order to prevent banking entities from purporting to use this exclusion for vehicles that the banking entity does not reasonably expect to become a registered investment company or business development company, the exclusion is available only with respect to a vehicle that the banking entity operates (i) pursuant to a written plan, developed in accordance with the banking entity's compliance program, that reflects the banking entity's determination that the vehicle will become a registered investment company or business development company within the time period provided by the final rule for seeding a covered fund; (ii) consistently with the leverage requirements under the Investment Company Act of 1940 that are applicable to registered investment companies and SEC-regulated business development companies.[2012] A banking entity that seeds a covered fund for any purpose other than to register it as an investment company or establish a business development company must comply with the requirements of section 13(d)(1)(G) of the BHC Act and § 75.11 of the final rule as described above. The Agencies will monitor this seeding activity for attempts to use this exclusion to evade the requirements governing the ownership of and relationships with covered funds under section 13 of the BHC Act and the final rule.[2013]

13. Other Excluded Entities

Section 13(h)(2) permits the Agencies to include similar funds within the definition of covered fund, but the proposal did not contain a process for excluding from the definition of covered fund other entities that do not engage in the investment activities contemplated by section 13. Many commenters argued that the breadth of entities that may be required to rely on the exclusions in section 3(c)(1) or 3(c)(7) of the Investment Company Act could result in additional unidentified entities becoming subject to the definition of covered fund.[2014] In order to ensure that the final rule effectively addresses the full scope of entities that may inadvertently be included within the definition of covered fund, a number of commenters urged that the final rule include a mechanism to exclude other entities from the term ''covered fund'' by rule or order if the Agencies determine such an exclusion is appropriate.[2015]

As evidenced by the extensive comments discussed above identifying the many types of corporate structures and other vehicles (not just investment funds) that rely on sections 3(c)(1) and 3(c)(7) but do not engage in investment activities of the type contemplated by section 13, the scope of an overly broad definition of covered fund may impose significant burdens on banking entities that are in conflict with the purposes of section 13 of the BHC Act. In response to commenters' concerns and to address the potential that the final rule's definition of covered fund might encompass entities that do not engage in the investment activities contemplated by section 13, the final rule includes a provision that provides that the Agencies may jointly determine to exclude an issuer from the definition of covered fund if the exclusion is consistent with the purposes of section 13 of the BHC Act.[2016]

As noted above, the statute permits the Agencies to act by rule to modify the definition of covered fund. After issuing the proposed rule and receiving comment on it, the final rule provides that the Agencies may act jointly to provide an exclusion.[2017] The Agencies are working to establish a process within which to evaluate requests for exclusions and expect to provide additional guidance on this matter as the Agencies gain experience with the final rule.[2018] As a result, the definition of covered fund would remain unified and consistent. The final rule also provides that a determination by the Agencies to exclude an entity from the definition of covered fund will be promptly made public in order to ensure that both banking entities and the public may understand what entities are and are not included within the definition of covered fund.

[2009] *See* Arnold & Porter; Goldman (Covered Funds); *see also* SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); ABA (Keating); BoA; ICI (Feb. 2012); JPMC (requesting clarification that registered investment companies are not banking entities); TCW.

[2010] *See* ICI (Feb. 2012); TCW.

[2011] *See* final rule § 75.10(c)(12).

[2012] *See* final rule §§ 75.10(c)(12)(i); 10(c)(12)(iii); 75.20(e).

[2013] The Agencies also note that banking entities with more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years must maintain records that include, among other things, documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity in determining that such fund is not a covered fund. *See* final rule § 75.20(e).

[2014] *See also* FSOC study.

[2015] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams); GE (Feb. 2012).

[2016] *See* final rule § 75.10(c)(14).

[2017] As discussed above, the Agencies also may determine jointly that an entity excluded from the definition of covered fund under § 75.10(c) is in fact a covered fund, and consequently banking entities' investments in and transactions with such fund would be subject to limitations and/or divestiture. The Agencies intend to utilize this authority to monitor for and address, as appropriate, instances of evasion. *See, e.g.,* 12 U.S.C. 1851(e)(2).

[2018] A joint determination specified under § 75.10(c)(14) may take a variety of forms.

d. Entities Not Specifically Excluded From the Definition of Covered Fund

In addition to the entities identified above which are excluded from the definition of covered fund under the final rule, commenters argued that a number of other entities such as financial market utilities, venture capital funds, credit funds, cash management vehicles or cash collateral pools may also be an investment company but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act and requested that these entities expressly be excluded from the final rule's definition of covered fund. The Agencies have considered carefully the comments received on each of these entities but, for the reasons explained below, have declined to provide a separate exclusion for them from the definition of covered fund at this time. As discussed below, some of these entities are not covered funds for various reasons or may, with relatively little cost, conform to the terms of an exclusion or exemption from the definition of covered fund. As noted above, to the extent that one of these entities qualifies for one or more of the other exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

A number of commenters requested that certain existing covered funds be either excluded from the definition of covered fund or grandfathered and not be subject to the limitations of section 13 of the BHC Act.[2019] The Agencies note, however, that section 13 specifically addresses a banking entity's preexisting investments in covered funds by providing a conformance period, which banking entities may use to bring their activities and investments into compliance with the requirements of section 13 and the final rule. To the extent that section 13 could be interpreted to permit the Agencies to take a different approach, despite addressing banking entities' preexisting covered fund investments directly, the Agencies believe it would be inconsistent with the purposes of section 13 to permit banking entities to continue to hold ownership interests in covered funds beyond the conformance period provided by the statute. Section 13's prohibition on banking entities' investments in and relationships with covered funds and the requirement that banking entities divest or conform these investments appear to reflect the statutory purpose that banking entities be limited in their ability to continue to be exposed to these investments outside of the statutorily-provided conformance period. The Agencies believe that permitting banking entities to hold ownership interests indefinitely beyond the conformance period provided by the statute appears inconsistent with this purpose.

1. Financial Market Utilities

Several commenters contended that financial market utilities (''FMUs'') could be covered funds because they might rely on section 3(c)(1) or 3(c)(7) for an exclusion from the definition of investment company under the Investment Company Act and may not qualify for an alternative exemption.[2020] These commenters argued that banking entities have long been investors in domestic and foreign FMUs, such as securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems. These commenters expressed concern that, unless FMUs are expressly excluded from the definition of covered fund, banking entities could be prohibited from entering into any new covered transactions with related FMUs and would be required to divest their investments in FMUs, thereby disrupting the operations of those FMUs and financial markets generally.

After carefully considering commenters' concerns, the Agencies believe that FMUs are not investment vehicles of the type section 13 of the BHC Act was designed to address, but rather entities that generally engage in other activities, including acting as central counterparties that reduce counterparty risk in clearing and settlement activities. Congress recognized, in the Payment, Clearing, and Settlement Supervision Act of 2010 (title VIII of the Dodd-Frank Act),[2021] that properly designed, operated, and supervised financial market utilities as defined in that Act mitigate systemic risk and promote financial stability.[2022]

However, the Agencies have not provided an exclusion from the covered fund definition for FMUs because these kinds of entities do not generally appear to rely on section 3(c)(1) or 3(c)(7) of the Investment Company Act, and therefore do not appear to need an exclusion. For example, section 3(b)(1) of the Investment Company Act excludes from the definition of investment company—and thus from the definition of a covered fund—entities primarily engaged in a business other than that of an investment company.[2023] If an FMU is primarily engaged in a business other than those that would make it an investment company, for example, if the FMU is primarily engaged in transferring, clearing, or settling payments, securities, or other financial transactions among or between financial institutions,[2024] the FMU could rely on the exclusion to the definition of investment company provided by section 3(b)(1) and would not need to rely on section 3(c)(1) or 3(c)(7) and, as such, would not be a covered fund.

2. Cash Collateral Pools

Some commenters expressed concern that cash collateral pools, which are part of securities lending programs, could be included in the definition of covered fund.[2025] According to these commenters, banking entities, including bank custodians acting as lending agent for customer's securities lending activities, typically manage these pools as fiduciaries for their customers.[2026] These commenters argued that collateral pools are part of a banks' traditional custody and advisory services and have been an integral part of any lending agent's role (whether custodial or non-custodial) for years.[2027]

Cash collateral pools are typically formed when, as part of a securities lending program, a customer of a bank authorizes the bank to take securities from the customer's account and lend them in the open market. The agent bank then lends those securities and receives collateral in return from the borrower; a securities lending customer of a bank typically elects to have cash collateral provided by a borrower pooled by the agent bank with other cash collateral provided to other clients.[2028] These investment pools may exist in the form of trusts, partnerships, limited liability companies, or separate

[2019] *See, e.g.,* PNC; SVB; SIFMA (Securitization) (Feb. 2012); AFME *et al.;* BoA. *See also, e.g.,* Credit Suisse (Williams).

[2020] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2021] 12 USC 5461 *et seq.*

[2022] *See id.*

[2023] Section 3(b)(1) of the Investment Company Act excludes from the definition of investment company ''[a]ny issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.''

[2024] *See* 12 U.S.C. 1562(6); 12 CFR Part 234.

[2025] *See* RMA; State Street (Feb. 2012); *see also* BNY Mellon *et al.*

[2026] *See* RMA; State Street (Feb. 2012).

[2027] *See* RMA; BNY Mellon *et al.* (citing Comptroller's Handbook: Custody Services (Jan. 2002)).

[2028] *See* RMA.

accounts maintained by more than one party and these structures may rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act to avoid being an investment company.[2029] While their ownership interest may be nominal in amount, the agent banks may hold a general partnership, limited liability company membership or trustee interest in the cash collateral pool.[2030] As part of these arrangements, custodian banks routinely offer borrower default indemnifications to the securities lender in a securities lending transactions.

Commenters raised concerns that these indemnification agreements could be considered a covered transaction prohibited by section 13(f) of the BHC Act.[2031] Since some cash collateral pools are established outside of the United States, commenters requested that the final rule permit banking entities to have interests in and relationships with both U.S. and non-U.S. cash collateral pools.[2032] These commenters suggested that cash collateral pools be excluded from the definition of covered fund or, in the alternative, that the Agencies make clear that cash collateral pools managed by agent banks qualify for the exemption in § 75.11 of the proposed rule for organizing and offering a covered fund and that the prime brokerage exemption from the restrictions of section 13(f) would permit the indemnification and income or settlement services agent banks typically provide to the pools.[2033] These commenters also suggested that the Agencies use their authority under section 13(d)(1)(J) to provide an exemption for banking entities to continue to have interests in and provide services to these types of pools.[2034]

After carefully considering comments received, the final rule does not provide a specific exclusion from the definition of covered fund for cash collateral pools. The Agencies have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for cash collateral pools.

The Agencies note, however, that some cash collateral pools may not be covered funds because they rely on an exclusion from the definition of investment company other than those contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2035] Banking entities may determine to register cash collateral pools with the SEC as investment companies or to operate them as separate accounts to exclude the pools from the covered fund definition or, if the pools remain covered funds, to organize and offer them in compliance with the requirements of § 75.11 of the final rule.

In response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not a covered transaction subject to 13(f) or a guarantee of the performance or obligations of a covered fund prohibited under § 75.11 of the final rule. Those restrictions apply to transactions with the covered fund or guarantees of the covered fund's performance. Borrower default indemnifications are provided to the bank's securities lending customer, not to the cash collateral pool.

3. Pass-Through REITS

Some banking entities may issue real estate investment trust (''REIT'') preferred securities to the public directly from a subsidiary that qualifies for the exclusion in section 3(c)(5) or section 3(c)(6) of the Investment Company Act. These entities would not be considered a ''covered fund'' because they may rely on an exclusion from the definition of an investment company other than the exclusion in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2036] However, in order to meet the demands of customers and avoid undesirable tax consequences, some banking entities structure their REIT offerings by using a passive, pass-through statutory trust between the banking entity and the REIT to issue REIT preferred securities to the public.[2037] Because the pass-through trust holds the preferred securities of the underlying REIT (which would itself not be a covered fund), as well as provides administrative and ministerial functions for the REIT (including passing through dividends from the underlying REIT), the pass-through trust may not itself rely on the exclusion contained in section 3(c)(5) or 3(c)(6) and, thus, typically relies on section 3(c)(1) or 3(c)(7).[2038]

Some commenters urged the Agencies to provide an exclusion for pass-through REITS from the definition of covered fund.[2039] These commenters argued that because the pass-through trust exists as a corporate convenience as part of issuing REIT preferred securities to the banking entity and its customers, it is not the type of entity that the covered fund prohibition in section 13 of the BHC Act was intended to address. These commenters also argued that pass-through REITs enable banking entities to offer preferable tax treatment to holders of the REIT preferred securities and that if pass-through REITs were included as covered funds, because of the limitations on covered transactions contained in section 13(f), the minority interests in the preferred securities issued by the REIT would no longer be able to be included in a banking entity's tier 1 capital, thereby negatively impacting the safety and soundness of the banking entity.[2040]

The Agencies are not providing a specific exclusion from the definition of covered fund for pass-through REITs because the Agencies are concerned that such an exclusion could enable banking entities to structure non-loan securitization transactions using a pass-through entity in a manner inconsistent with the final rule's treatment of similar vehicles that invest in securities.

[2029] *See* RMA.

[2030] *See* RMA.

[2031] *See* State Street; RMA. Commenters also argued that as part of offering pooled cash collateral management, agent banks have traditionally provided short-term extensions of credit and contractual income and settlement services to lending clients and cash collateral pools to facilitate trade settlement and related cash collateral investment activities. *See* RMA. One commenter further argued that if banks are required to ''outsource'' cash collateral pools and/or the related short-term credit services provided to the pools, ''participation in securities lending programs would only be cost effective for the largest lending clients'' and, as a result, ''many small and intermediate securities lending clients would be denied the incremental revenue securities lending can provide''; ''securities lending programs could lose significant diversification in lending clients, lendable assets, borrowers and agent banks''; and, as a result of lost revenues, ''the actual costs of [ ] custodial or other services provided to clients that no longer participate in lending would increase.'' *Id.*

[2032] *See* RMA.

[2033] *See* RMA.

[2034] *See* RMA.

[2035] For instance, the Agencies understand that a banking entity may set up a cash collateral pool in reliance on the exclusion contained in section 3(c)(3) of the Investment Company Act, or may be able to structure these pools as SEC-registered money market funds operated in accordance with rule 2a–7 under the Investment Company Act.

[2036] *See* PNC.

[2037] *See* PNC.

[2038] *See* ABA (Keating); PNC.

[2039] *See* ABA (Keating); PNC.

[2040] *See* PNC; ABA (Keating). These commenters argued that most REIT preferred securities contain a conditional exchange provision that allows the primary regulator to direct that the preferred securities be automatically exchanged for preferred shares of the bank or parent BHC upon occurrence of a conditional exchange event. Because this arrangement involves the purchase of securities issued by an affiliate or the purchase of assets, it would be prohibited under section 13(f) of the BHC Act if the pass-through REIT were a covered fund.

Furthermore, banking entities have alternative manners in which they may issue or hold REIT preferred securities, including through REITs directly, which do not raise the same concerns about evasion.[2041]

4. Municipal Securities Tender Option Bond Transactions

The Agencies received a number of comments addressing how the final rule should treat municipal securities tender option bond vehicles. A number of commenters argued that issuers of municipal securities tender option bonds would fall under the definition of covered fund in the proposed rule because these issuers typically rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act.[2042] According to commenters, a typical tender option bond transaction consists of the deposit of a single issue of highly-rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security (the ''floaters''), and an inverse floating rate security (the ''residual'') with no tranching involved. According to commenters, the holders of the floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par. The put right is supported by a liquidity facility delivered by a highly-rated provider (in many cases, the banking entity sponsoring the trust) and allows the floaters to be treated as a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer-term investor (in many cases the banking entity sponsoring the trust, or an insurance company, mutual fund, or hedge fund). According to commenters, the residual investors take all of the market and structural risk related to the tender option bonds structure, with the investors in floaters taking only limited, well-defined insolvency and default risks associated with the underlying municipal bonds generally equivalent to the risks associated with investing in the municipal bonds directly. According to commenters, the structure of tender option bond transactions is governed by certain provisions of the Internal Revenue Code in order to preserve the tax-exempt treatment of the underlying municipal securities.

Many commenters requested a specific exclusion for municipal tender option bond vehicles from the definition of a covered fund.[2043] These commenters argued that, without an exclusion from the definition of covered fund, banking entities would be prohibited from owning or sponsoring tender option bonds and from providing credit enhancement, liquidity support, remarketing, and other services required in connection with a tender option bond program.[2044] Commenters argued that tender option bond vehicles should be excluded because section 13(d)(1)(A) of the BHC Act already allows banking entities to own and dispose of municipal securities directly,[2045] tender option bonds are economically similar to repurchase agreements, which are expressly excluded from the proprietary trading restrictions of the proposed rule, and, because they are safe and low risk are similar to the types of transactions that the proposed rule would have exempted.[2046] Commenters also argued that tender option bonds are different from other covered funds that rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act[2047] and play an important role in the municipal bond markets.[2048] Commenters requested that the Agencies use their authority under section 13(d)(1)(J) of the BHC Act to exclude tender option bonds because they argued that tender option bonds promote the safety and soundness of banking entities and the financial stability of the United States by providing for a deeper, richer pool of potential investors, a larger and more liquid market for municipal securities that results in lower borrowing costs for municipalities and other issuers of municipal securities, and greater efficiency and risk diversification.[2049] Commenters also suggested a number of other ways to exclude tender option bonds, including defining ownership interest to exclude any interest in a tender option bond transaction;[2050] defining banking entity to exclude tender option bond issuers;[2051] expanding the loan securitization exclusion to include tender option bond issuers;[2052] and revising the definition of sponsor to exclude sponsors of tender option bond vehicles.[2053] One commenter urged the Commission to consider amending the exemption under rule 3a–7 under the Investment Company Act or providing formal guidance regarding the status of tender option bond programs.[2054] In addition, some commenters requested an exclusion for tender option bond transactions from the provisions of section 13(f) of the BHC Act.[2055]

After carefully considering the comments received, the final rule does not provide a specific exclusion from the definition of covered fund or from the prohibitions and requirements of the final rule for tender option bond vehicles.[2056] The Agencies have determined to provide specific exclusions for entities that they believe fall within the rule of construction contained in section 13(g)(2) of the BHC Act, which expressly relates to the sale and securitization of loans,[2057] do not

[2041] The Agencies recognize that banking entities may have relied on pass-through REIT structures to issue preferred securities in the past and prohibiting such transactions may pose inefficiencies. Furthermore, it may not be possible to unwind or conform past issuances without significant effort by the banking entity and negotiation with the holders of the preferred securities. As noted above, in these circumstances, section 13 provides a conformance period which banking entities may take advantage of in order to bring their activities and investments into compliance with the requirements of section 13 and the final rule.

[2042] *See, e.g.,* Ashurst; SIFMA (Municipal Securities) (Feb. 2012); Citigroup (Jan. 2012); Cadwalader (Municipal Securities); Vanguard; ICI (Feb. 2012); ASF (Feb. 2012); Fidelity; Wells Fargo (Covered Funds). Commenters also noted that tender option bond programs as currently structured may not meet the requirements of section 3(a)(5) of the Investment Company Act or rule 3a–7 thereunder, or any other exclusion or exemption under the Investment Company Act. *See* Ashurst; RBC; ASF (Feb. 2012).

[2043] *See, e.g.,* ASF (Feb. 2012); BDA (Feb. 2012); Eaton Vance; Fidelity; ICI (Feb. 2012); RBC; SIFMA (Municipal Securities) (Feb. 2012); SIFMA (May 2012); State Street (Feb. 2012); Vanguard.

[2044] *See* Ashurst; ASF (Feb. 2012).

[2045] *See* ASF (Feb. 2012); SIFMA (Municipal Securities) (Feb. 13, 2012); Citigroup (Jan. 2012). *See also* Cadwalader (Municipal Securities) (alleging that the legislative history of section 13 of the BHC Act suggests that the exemption relating to municipal securities should not be construed to apply only to the section of the rule pertaining to the proprietary trading prohibitions); BDA (Feb. 2012) (arguing that any fund or trust the assets of which are entirely invested in any of the obligations that are excluded from the proprietary trading prohibitions should also be excluded from the definition of covered fund).

[2046] *See, e.g.,* Ashurst; Cadwalader (Municipal Securities); Eaton Vance; Nuveen Asset Mgmt.; SIFMA (Municipal Securities) (Feb. 13, 2012); State Street (Feb. 2012); Vanguard; Wells Fargo (Covered Funds); Citigroup (Jan. 2012).

[2047] *See, e.g.,* ASF (Feb. 2012); State Street (Feb. 2012); Citigroup (Jan. 2012); Vanguard; Wells Fargo (Covered Funds); Cadwalader (Municipal Securities); Ashurst.

[2048] *See* Cadwalader (Municipal Securities); ICI (Feb. 2012); Ashurst; ASF (Feb. 2012).

[2049] *See* Cadwalader (Municipal Securities).

[2050] *See* RBC.

[2051] *See* ICI (Feb. 2012).

[2052] *See* ASF (Feb. 2012).

[2053] *See* RBC.

[2054] *See* Ashurst.

[2055] *See, e.g.,* RBC; ASF (Mar. 2012); ASF (Feb. 2012).

[2056] The Agencies received a variety of requests requesting specific treatment of tender option bond transactions. *See, e.g., supra* notes 2050–2055. As discussed above, the Agencies believe that, in light of the comments received, tender option bond vehicles do not fall within the rule of construction contained in section 13(g)(2) of the BHC Act and, as a result, the final rule does not provide such treatment.

[2057] *See* 12 U.S.C. 1851(g)(2).

function as investment funds, consistent with the intent of section 13's restrictions, or in response to other unique considerations. The Agencies do not believe that these considerations support a separate exclusion for tender option bond vehicles, which have municipal securities as underlying assets and not loans.

The Agencies recognize commenters' concerns about the treatment of tender option bonds under the final rule, as discussed above. However, as there is no corresponding rule of construction in section 13 of the BHC Act for financial instruments other than loans, the Agencies do not believe that the resecuritization of municipal debt instruments should be treated differently than the resecuritization of other debt instruments.[2058] Notwithstanding the statutory treatment of municipal securities for purposes of the proprietary trading restrictions, the Agencies also do not believe that tender option bond vehicles fall within the rule of construction contained in section 13(g)(2) of the BHC Act, because, in light of commenters' descriptions of these vehicles, tender option bond vehicles are more in the nature of other types of bond repackaging securitizations and other non-excluded securitization vehicles.[2059] The final rule, however, does not prevent a banking entity from owning or otherwise participating in a tender option bond vehicle; it requires that these activities be conducted in the same manner as with other covered funds.

In this regard, under the final rule, a banking entity would need to evaluate whether a tender option bond vehicle is a covered fund as defined in the final rule. If a tender option bond vehicle is a covered fund and an exclusion from that definition is not available, then banking entities sponsoring such a vehicle will be subject to the prohibitions in § 75.14 of the final rule and the provisions of section 13(f) of the BHC Act.[2060]

As tender option bond vehicles are considered issuers of asset-backed securities subject to the risk retention requirements of section 15G of the Exchange Act, banking entities may look to the provisions of the final rule governing the limits applicable to banking entities' interests in and relationships with those funds. Under the final rule, as in the statute, a banking entity that conducts the activities described in section 13(f) of the BHC Act is subject to the restrictions on transactions with a tender option bond vehicle, including guaranteeing or insuring the performance of the tender option bond vehicle, contained in section 13(f) of the BHC Act. As a result, a banking entity is not permitted to provide credit enhancement, liquidity support, and other similar services if it serves in a capacity covered by section 13(f) with the tender option bond program.[2061] An unaffiliated third party may provide such services if it does not have a relationship with the tender option bond vehicle that triggers application of section 13(f). The extent to which the final rule causes a disruption to the securitization of, and market for, municipal tender option bonds may also affect the economic burden and effects on the municipal bond market and its participants, including money market mutual funds[2062] and issuers of municipal securities. The Agencies recognize that a potential economic burden may be an increase in financing costs to municipalities as a result of a decrease in demand for the types of municipal securities customarily included in municipal tender option bond vehicles[2063] and therefore potential effects on the depth and liquidity of the market for certain types of municipal securities.[2064]

5. Venture Capital Funds

Some private equity funds that make investments in early-stage start-up companies or other companies with significant growth potential (''venture capital funds'') would be investment companies but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. Venture capital funds would therefore qualify as a covered fund under the proposal. The proposal specifically requested comment on whether venture capital funds should be excluded from the definition of ''covered fund.''

Some commenters argued that venture capital funds should be treated differently than other covered funds and excluded from the definition. These commenters argued that, unlike conventional hedge funds and private equity funds, venture capital funds do not possess high leverage and do not engage in risky trading activities of the type section 13 of the BHC Act was designed to address.[2065] These commenters contended that investments and relationships by banking entities in venture capital funds would be consistent with safety and soundness; provide important funding and expertise and other services to start-up companies; and provide positive benefits to employment, GDP, growth, and innovation.[2066] These commenters argued that restricting banking entities' ability to invest in or sponsor venture capital funds would have a negative impact on companies and the U.S. economy generally.[2067] Some commenters asserted that bank investments in venture capital funds are important to the success of venture capital,[2068] with some citing a consulting firm's data indicating that approximately 7 percent of all venture capital is provided by banks.[2069] One commenter argued, therefore, that ''preventing banks from investing in venture thus could depress U.S. GDP by roughly 1.5% (or $215 billion annually) and eliminate nearly 1% of all U.S. private sector employment over the long term,'' and the funding gap that would result if banks could not invest in venture capital funds would not be met

[2058] For these same reasons, and based on the definitions of sponsor and banking entity in section 13, the Agencies have not modified those definitions in the final rule to exclude sponsors of tender options bonds and tender bond issuers, respectively, as some commenters requested. *See supra* notes 2051 and 2053 and accompanying text.

[2059] Commenters also argued that to the extent tender option bond programs are not excluded from the definition of covered fund, the definition of ownership interest should exclude any interest in a tender option bond program (*see* RBC) or that where a third party owns the residual, the banking entity should not be treated as having an ownership interest, even when it owns a small interest for tax purposes or becomes the owner through liquidity or remarketing agreements (*see* Cadwalader (Municipal Securities)). The definition of ownership interest in the final rule focuses on the attributes of the interest, as discussed below, and not the particular type of covered fund involved. The Agencies are not providing separate definitions of or exclusions from the ownership interest definition based on the type of vehicle or financing involved. *See infra* note 2103 and preceding and following text. Banking entities will need to evaluate whether the interests they may acquire are ownership interests as defined under the final rule.

[2060] *See* 12 U.S.C. 1851(f).

[2061] As discussed above, while commenters requested treatment of municipal tender option bond vehicles that would cause section 13(f) of the BHC Act not to apply to them, the final rule does not exclude these vehicles from the definition of covered fund or the prohibitions relating to covered funds. As a result, section 13(f) of the BHC Act will apply to a banking entity that is sponsoring a tender option bond vehicle.

[2062] *See* ASF (Feb. 2012); Nuveen Asset Mgmt.

[2063] *See* Ashurst.

[2064] *See* Eaton Vance.

[2065] *See* SVB; NVCA; Rep. Eshoo; Sen. Boxer; Rep. Goodlatte; Rep. Schweikert; Rep. Speier; Rep. Honda; Rep. Lofgren; Rep. Peters *et al.*

[2066] *See, e.g.,* NVCA; SVB; Scale.

[2067] *See, e.g.,* SVB; Scale; Sen. Boxer; SIFMA *et al.* (Covered Funds) (Feb. 2012) (citing a colloquy between Sen. Dodd and Sen. Boxer supporting an exemption for venture capital funds (156 Cong. Rec. H5226 (daily ed., June 30, 2010)).

[2068] *See* River Cities; Scale. *See also* Sofinnova; Canaan (Young); Canaan (Ahrens); Canaan (Kamra); Mohr Davidow; ATV; BlueRun; Westly; Charles River; Flybridge; SVB.

[2069] *See, e.g.,* SVB.

by other market participants if bank investments in venture capital were restricted.[2070] Several commenters recommended that venture capital funds be excluded if they: (i) Do not fundamentally engage in proprietary trading; (ii) do not use leverage to increase investment returns; and (iii) typically invest in high-growth start-up companies as compared to more mature publicly traded companies.[2071]

Conversely, one commenter alleged that there was no credible way to exclude venture capital funds without providing a means to circumvent the requirements of section 13 and the final rule.[2072] Another commenter argued that venture capital funds do in fact engage in risky activities and that, instead of making investments in venture capital funds, banking entities may directly extend credit to start-up companies in a safe and sound manner.[2073]

The final rule does not provide an exclusion for venture capital funds. The Agencies believe that the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund. Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act and accorded distinct treatment for venture capital fund advisers by exempting them from registration requirements under the Investment Advisers Act.[2074] This indicates that Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so.[2075] No such distinction appears in section 13 of the BHC Act. Because Congress chose to distinguish between private equity and venture capital in one part of the Dodd-Frank Act, but chose not to do so for purposes of section 13, the Agencies believe it is appropriate to follow this Congressional determination.

In addition to the language of the statute, it appears to the Agencies that the activities and risk profiles for banking entities regarding sponsorship of, and investment in, venture capital funds and private equity funds are not readily distinguishable. Many key structural and operational characteristics of venture capital funds are substantially similar to those of hedge funds and private equity funds, thereby making it difficult to define venture capital funds in a manner that would not provide banking entities with an opportunity to evade the restrictions of section 13 of the BHC Act.

For instance, in addition to relying on the same exemptions under the Securities Act,[2076] venture capital funds, private equity funds and hedge funds all rely on the exclusion in section 3(c)(1) or 3(c)(7) from the definition of investment company under the Investment Company Act. Moreover, like private equity funds, venture capital funds pool funds from multiple investors and invest those funds in interests of portfolio companies for the purpose of profiting from the resale of those interests. Indeed, funds that are called ''venture capital funds'' may invest in the very same entities and to the same extent as do funds that call themselves private equity funds. Venture capital funds, like private equity funds, also typically charge incentive compensation to fund investors based on the price appreciation achieved on the investments held by the fund and provide a return of principal plus gains at specific times during the limited life of the fund. Not including venture capital funds in the definition of covered fund, therefore, could allow banking entities, either directly or indirectly, to engage in the type of activities section 13 was designed to address.

While the final rule does not provide a separate exclusion for venture capital funds from the definition of covered fund, the Agencies recognize that certain venture capital investments by banking entities provide capital and funding to nascent or early-stage companies and small businesses and also may provide these companies expertise and other services.[2077] Other provisions of the final rule or the statute may facilitate, or at least not impede, other forms of investing that may provide the same or similar benefits. For example, in addition to permitting a banking entity to organize and offer a covered fund in section 13(d)(1)(G), section 13 of the BHC Act does not prohibit a banking entity, to the extent otherwise permitted under applicable law, from making a venture capital-style investment in a company or business so long as that investment is not through or in a covered fund, such as through a direct investment made pursuant to merchant banking authority[2078] or through business development companies which are not covered funds and, like venture capital funds, often invest in small, early-stage companies.[2079]

Thus, to the extent that banking entities are required to reduce their investments in venture capital funds, certain of these investments may be redirected to the types of entities in which venture capital funds invest through alternative means. To the extent that banking entities may reduce their investments in venture capital funds that are covered funds, the potential funding gap for venture capital funds may also be offset, in whole or in part, by investments from firms that are not banking entities and thus not subject to section 13's restrictions.

6. Credit Funds

Several commenters requested that the final rule explicitly exclude from the definition of covered fund entities that are generally formed as partnerships with third-party capital and invest in loans or make loans or otherwise extend the type of credit that banks are

[2070] *See* SVB.

[2071] *See, e.g.,* SVB (arguing that the definition of ''venture capital fund'' in section 203(l)–1 of the Investment Advisers Act and the SEC's Form PF reporting requirements for investment advisers to private funds would be instructive for defining an exclusion for venture capital funds for purposes of section 13 of the BHC Act).

[2072] *See* Occupy.

[2073] *See* Sens. Merkley & Levin (Feb. 2012).

[2074] *See* S. Rep. No. 111–176, at 71–3 (2010) (''S. Rep. No. 111–176''); H. Rep. No. 111–517, at 866 (2010) (''H. Rep. No. 111–517''). H. Rep. No. 111–517 contains the conference report accompanying the version of H.R. 4173 that was debated in conference. *See* S. Rep. No. 111–176, at 74 (''The Committee believes that venture capital funds, a subset of private investment funds specializing in long-term equity investment in small or start-up businesses, do not present the same risks as the large private funds whose advisers are required to register with the SEC under this title.''). *Compare* Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. Sec. 408 (2010) (as passed by the Senate) with The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009) (as passed by the House) (''H.R. 4173'') and Dodd-Frank Act (2010).

[2075] *But see* Rep. Honda.

[2076] These funds all typically offer their shares on an unregistered basis in reliance on section 4(a)(2) of the Securities Act of 1933 or Regulation D thereunder (17 CFR 230.500 through 230.508).

[2077] As noted above, some commenters quantified the importance of banking entities to the provision of venture capital by providing information indicating that approximately 7 percent of all venture capital is provided by banks. *See, e.g.,* SVB (citing ''The Venture Capital Industry: A Preqin Special Report,'' published by Preqin, Ltd. (Oct. 2010)). The 7% estimate commenters identified includes information on investors based in North America, Europe, and Asia; thus, although potentially indicative of the extent of venture capital investing by banking entities in venture capital funds, the estimate does not specifically address the proportion of investment by banking entities in venture capital funds that are covered funds, as those terms are defined in the final rule.

[2078] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq.*

[2079] *See* 15 U.S.C. 80a–54. Companies that have elected to be treated as a business development company are subject to limits under the Investment Company Act, including: (i) Limits on how much debt the business development company may incur; (ii) prohibitions on certain affiliated transactions; (iii) regulation and examination by the SEC; and (iv) registration and filing requirements.

authorized to undertake on their own balance sheet (''credit funds'').[2080] Two commenters contended that the language of section 13(g)(2) indicates that Congress did not intend section 13 of the BHC Act to limit a banking entity's ability to extend credit.[2081] They argued that lending is a fundamental banking activity, whether accomplished through direct loans or through a fund structure. These commenters argued that credit funds functioned like syndicated loans that enable borrowers to secure credit during periods of market distress and reduce the concentration of risk for both individual banking entities and the banking system as a whole.

Commenters suggested different approaches for excluding credit funds from the definition of covered fund. One commenter recommended excluding an entity that would otherwise be a covered fund if more than 50 percent of its assets consist of loans.[2082] Another commenter proposed defining a credit fund as an entity that met a number of criteria designed to ensure the entity only held loans or otherwise engaged in prudent lending activity.[2083] Another commenter requested that the Agencies use their authority under section 13(d)(1)(J) to permit a banking entity to sponsor, invest in, or enter into covered transactions with related credit funds that are covered funds.[2084]

The Agencies, however, are unable effectively to distinguish credit funds from other types of private equity funds or hedge funds in a manner that would give effect to the language and purpose of section 13 and not raise concerns about banking entities being able to evade the requirements of section 13. Moreover, the Agencies also believe that the final rule largely addresses commenters' concerns in other ways because some credit funds may be able to rely on another exclusion from the definition of covered fund in the final rule such as the exclusion for joint ventures or the exclusion, discussed above, for loan securitizations. To the extent that a credit fund may rely on another exclusion from the definition of covered fund, it would not be a covered fund under section 13 of the BHC Act.

7. Employee Securities Companies

Several commenters argued that employee securities companies (''ESCs'') should be explicitly excluded from the definition of covered fund.[2085] One commenter alleged that, though many ESCs could qualify for the exemption in section 6(b) of the Investment Company Act, they often opt to rely on section 3(c)(1) or 3(c)(7) instead due to the fact that the section 6(b) exemption is available only upon application to the SEC.[2086] According to this commenter, the limitations contained in section 13 on employee investments and intercompany transactions with covered funds would severely limit the ability of a banking entity to design competitive employee compensation arrangements.[2087] This commenter also argued that an exclusion should be provided for any investment vehicle that satisfies the definition of an ESC under section 2(a)(13) of the Investment Company Act.

After considering carefully the comments received on the proposed rule, the final rule does not provide a specific exclusion for ESCs because the Agencies believe that these vehicles may avoid being a covered fund by either complying with the conditions of another exclusion from the definition of covered fund or seeking and receiving an exemption available under section 6(b) of the Investment Company Act. As such, the Agencies believe a banking entity has a reasonable alternative to design competitive employee compensation arrangements. The Agencies recognize that preparing an application under section 6(b) of the Investment Company Act or modifying an ESC's activities to meet the terms of another exclusion from the covered fund definition is not without costs, but have determined to provide specific exclusions for entities that do not function as investment funds, consistent with the purpose of section 13, or in response to other unique considerations (*e.g.,* to provide consistent treatment for certain foreign and domestic pension plans). These considerations do not support a separate exclusion for ESCs.

The Agencies also note that non-qualified plans are not exempt from the Investment Company Act under 3(c)(11) and thus would be covered funds if they are operating in reliance on section 3(c)(1) or 3(c)(7) of the Investment Company Act. Some of these non-qualified plans may be formed as employees' securities companies, however, and could qualify for an exemption under section 6(b) of the Investment Company Act for employees' securities companies as discussed above.

e. Definition of ''Ownership Interest''

The proposed rule defined ''ownership interest'' in a covered fund to mean any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, as well as any derivative of such an interest.[2088] This definition focused on the attributes of the interest and whether it provided a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. The proposal thus would also have included a debt security or other interest in a covered fund as an ownership interest if it exhibited substantially the same characteristics as an equity or other ownership interest (*e.g.,* provides the holder with voting rights, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments).[2089] As described further below, the proposed rule excluded carried interest (termed ''restricted profit interest'' in the final rule) from the definition of ownership interest.

Many commenters argued that the proposed definition of ownership interest was too broad and urged excluding one or more types of interests from the definition. A number of commenters raised concerns regarding the difficulty of applying the ownership interest definition to securitization structures and questioned whether the definition of ownership interest might apply to a debt security issued by, or a debt interest in, a covered fund that has some characteristics similar to an equity

[2080] *See, e.g.,* Goldman (Covered Funds); ABA (Keating); Credit Suisse (Williams); Comm. on Capital Markets Regulation; Chamber (Feb. 2012).

[2081] *See* ABA (Keating); Goldman (Covered Funds).

[2082] *See* Credit Suisse (Williams).

[2083] *See* Goldman (Covered Funds).

[2084] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also.* ABA (Keating); Chamber (Feb. 2012).

[2085] *See, e.g.,* ABA (Keating), Credit Suisse (Williams), Arnold & Porter (as it relates to commodity pools). Section 2(a)(13) of the Investment Company Act generally defines an ESC as ''any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned'' by employees and certain related persons (*e.g.,* employees' immediate family members).

[2086] Section 6(b) of the Investment Company Act provides, in part, that ''[u]pon application by any employees' security company, the Commission shall by order exempt such company from the provisions of this title and of the rules and regulations hereunder, if and to the extent that such exemption is consistent with the protection of investors.''

[2087] *See* Credit Suisse (Williams).

[2088] *See* proposed rule § 75.10(b)(3).

[2089] *See* Joint Proposal, 76 FR at 68897.

or other ownership interest.[2090] One commenter argued that the ownership interest definition should not include debt instruments with equity features unless the Agencies determine with respect to a particular debt instrument, after appropriate notice and opportunity for hearing, that the equity features are so pervasive that the debt instrument is the functional equivalent of an equity interest or partnership interest and was structured to evade the prohibitions and restrictions in the proposal.[2091] Several commenters argued that the Agencies should explicitly exclude certain debt instruments with equity features from the ownership interest definition.[2092] Finally, certain commenters argued that, because the application of the ownership interest definition to securitization structures was problematic, alternative regulatory treatment was appropriate.[2093]

One commenter expressed concern over the proposal's inclusion of ''derivatives'' of ownership interests in the definition of ownership interest and recommended certain derivative interests of ownership interests in hedge funds and private equity funds not be included within the definition of ownership interest.[2094] This commenter also recommended that the Agencies expressly exclude from the definition of ownership interest lending arrangements with a covered fund that contain protective covenants linking the interest rate on the loan to the profits of the borrowing fund.[2095]

As discussed in detail below, the Agencies are adopting the definition of ''ownership interest'' largely as proposed but clarifying the scope of that definition, including with respect to the inclusion of interests that are linked to profits and losses of a covered fund and the exclusion for a restricted profit interest in a covered fund.[2096] The definition is centered on equity interests, partnership interests, membership interests, trust certificates, and similar interests, and would not generally cover typical extensions of credit the terms of which provide for payment of stated principal and interest calculated at a fixed rate or at a floating rate based on an index or interbank rate. However, as under the proposal, to the extent that a debt security or other interest in a covered fund exhibits specified characteristics that are similar to those of equity or other ownership interests (*e.g.,* provides the holder with the ability to participate in the election or removal of a party with investment discretion, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments), the instrument would be an ownership interest under the final rule.

In response to commenters and in order to provide clarity about the types of interests that would be considered within the scope of ownership interest, the Agencies have revised the definition of ''ownership interest'' to define the term more clearly. The Agencies are not explicitly excluding or including debt securities, instruments or interests with equity features as requested by some commenters, but are instead identifying certain specific characteristics that would cause a particular interest, regardless of the name or legal form of that interest, to be included within the definition of ownership interest. The Agencies believe that this elaboration on the characteristics of an ownership interest will enable parties, including securitization structures, to more easily analyze whether their interest is an ownership interest, regardless of the type of legal entity or the name of the particular interest.

As adopted, the final rule provides that an ownership interest would be any interest in or security issued by a covered fund that exhibits any of the following features or characteristics on a current, future, or contingent basis:[2097]

- has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund. For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or

[2090] *See* AFME *et al.;* AFR *et al.* (Feb. 2012); ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); Credit Suisse (Williams); Deutsche Bank (Repackaging Transactions); Occupy; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); TCW. For example, securitization structures generally provide that either the most senior or the most junior tranche notes have controlling voting rights. One commenter argued that under the proposed ownership interest definition, a banking entity could be deemed to have an ownership interest in an entity it does not own or sponsor simply due to its obtaining voting rights. *See* ASF (Feb. 2012). As a further example, one commenter alleged that securitization structures generally are not viewed as providing economic exposure to the profits and losses of the issuer in the same manner as equity interests in hedge funds and private equity funds. This commenter argued that the ownership interest definition should include only those interests that permit the banking entity to share without limit in the profits and losses or that earn a return that is based on the performance of the underlying assets. *See* SIFMA (Securitization) (Feb. 2012).

[2091] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2092] *See* AFME *et al.;* ASF (Feb. 2012); BoA; Cadwalader (Municipal Securities); RBC; SIFMA (Securitization) (Feb. 2012). These commenters argued that the ownership interest definition should not include tender option bond programs and other debt asset-backed securities. Two of these commenters argued that debt asset-backed securities should not be viewed as ownership interests because: (i) they are not typically viewed as having economic exposure to profits and losses of an ABS Issuer; (ii) they have a limited life, periodic fixed or fluctuating cumulative payments, and are senior to equity of the issuer should the issuer fail; (iii) they do not have perpetual life with broad voting rights, appreciation in the market value of the issuer and non-cumulative dividends, and subordination to the claims of debt holders if the issuer fails; and (iv) their limited voting rights (such as the rights to replace a servicer or manager) and such rights are protective in nature and similar to voting rights that accompany securities traditionally classified by the Agencies as debt securities (including securities formally structured as equity). *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012). One of these commenters argued that the ownership interest definition should be limited to those interests that share in the profits or losses of the relevant entity on an unlimited basis or that otherwise earn a return that is specifically based upon the performance of the underlying assets because the senior tranche in an asset-based securities transaction often has substantial voting rights and banking entities should not be penalized for requiring or otherwise obtaining voting rights that protect their interests. This commenter also expressed the view that banking entities should not be restricted from owning debt classes of new asset-backed securities because ''doing so would substantially constrict the market for asset-backed securities.'' *See* ASF (Feb. 2012).

[2093] *See* AFR *et al.* (Feb. 2012); Credit Suisse (Williams); Occupy. One of these commenters argued that any general statement about what instruments would be considered an ''ownership interest'' for purposes of securitization structures would be problematic and easy to evade because transaction documents underlying securitization structures are not standardized. This commenter suggested as an alternative using a safe harbor for standardized, pre-specified securitization structures. *See* AFR *et al.* (Feb. 2012). Another of these commenters argued that ''it is difficult to characterize holders of ABS securities in most securitization structures as having 'ownership interests' in any common understanding of the term'' and the concept of ownership interest is a ''poor fit for the securitization market, underscoring the benefits of excluding securitization issuers from the definition of covered fund entirely.'' *See* Credit Suisse (Williams).

[2094] *See* Credit Suisse (Williams).

[2095] *See* Credit Suisse (Williams) (arguing that such arrangements are a fundamental part of a bank's lending activities).

[2096] *See* final rule § 75.10(d)(6). The concept of a restricted profit share was referred to as ''carried interest'' in the proposed rule, a term that is often used as a generic reference to performance-based allocations or compensation. The Agencies have instead used the term ''restricted profit interest'' in the final rule to avoid any confusion that could result from using a term that is also used in other contexts. The final rule focuses only on whether a profit interest is excluded from the definition of ownership interest under section 13, and the final rule does not address in any way the treatment of such profit interests under other laws, including under Federal income tax law.

[2097] Each of these factors are designed to clarify the interests identified in the proposed definition of ownership interest as noted above.

similar rights arising due to an acceleration event;

• has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund. This would apply regardless of whether the right is pro rata with other owners or holders of interests; [2098]

• has the right to receive the underlying assets of the covered fund, after all other interests have been redeemed and/or paid in full (commonly known as the ''residual'' in securitizations). For purposes of the rule, this would not include the rights of a creditor to exercise remedies upon the occurrence of an event of default or similar rights arising due to an acceleration event;

• has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests); [2099]

• provides that the amounts payable by the covered fund with respect to the interest could, under the terms of the interest, be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest; [2100]

• receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund.[2101] This provision would not include an interest that is entitled to receive dividend amounts calculated at a fixed or at a floating rate based on an index or interbank rate such as LIBOR; or

• any synthetic right to have, receive or be allocated any of the rights above. This provision would not permit banking entities to obtain synthetic or derivative exposure to any of the characteristics identified above in order to avoid being considered to have an ownership interest in the covered fund.

This definition of ''ownership interest'' is intended to address commenters' concerns regarding the applicability of the ownership interest definition to different types of interests. The Agencies believe defining ''ownership interest'' in this way will allow existing as well as potential holders of interests in covered funds, including securitizations, to effectively determine whether they have an ownership interest. As an example, this definition would include preferred stock, as well as a lending arrangement with a covered fund in which the interest or other payments are calculated by reference to the profits of the fund. As a contrasting example, the Agencies believe that a loan that provides for a step-up in interest rate margin when a covered fund has fallen below or breached a NAV trigger or other negotiated covenant would not generally be an ownership interest. Banking entities will be expected to evaluate the specific terms of their interests to determine whether any of the specified characteristics exist. In this manner, the Agencies believe that the definition of ownership interest in the final rule is clearer than under the proposal and thus should be less burdensome for banking entities in their determination of whether certain rights would cause an interest to be an ownership interest for purposes of compliance with the rule.

As indicated above, many commenters on securitizations under the proposed rule made arguments regarding the difficulty of applying the proposal's definition of ownership interest to securitization structures, contending that the definition should not include debt instruments with equity features, or that the final rule should provide a safe harbor under which the use of a standardized, pre-specified securitization structure would not give rise to an ownership interest.[2102] The Agencies are not adopting a separate definition of ownership interest for securitization transactions, providing for differing treatment of financial instruments, or providing a safe harbor as requested by some commenters. The revised definition of ownership interest will apply regardless of the type of legal entity or the name or legal form of the particular interest. The determination of whether an interest is an ownership interest under the final rule will depend on the features and characteristics of the particular interest, including the rights the particular interest provides its holder, including not only voting rights but also the right to receive a share of the income, gains, or profits of a covered fund, the right to receive a residual, the right to receive excess spread, and any synthetic or derivative that would provide similar rights. While some commenters argued that securities issued in asset-backed securities transactions and by tender option bond issuers should not be viewed as ownership interests due to the nature of the securities issued or the possible lack of exposure to profits and losses,[2103] the Agencies do not believe that the type of covered fund involved or the type of security issued is an appropriate basis for determining whether there is an ownership interest for purposes of the restrictions contained in section 13(a)(1)(B) of the BHC Act. The Agencies believe that making distinctions in the definition of ownership interest based on the type of entity or the type of security, in which many of the same rights exist as for other types of ownership interests, would not be consistent with the statutory restrictions on ownership. Similarly, while some commenters argued that including a safe harbor for standardized securitization structures would be more effective in identifying an ownership interest in securitizations, the Agencies believe that the type of interest and the rights associated with the interest are more appropriate to determine whether an interest is an ownership interest and is necessary to avoid potential evasion of the ownership restrictions contained in section 13 of the BHC Act.

The Agencies understand that the definition of ownership interest in the final rule may include interests in a covered fund that might not be considered an ownership interest or equity interest in other contexts. For instance, it may include loans with an interest rate determined by reference to the performance of a covered fund or senior debt interests issued in a securitization. While the definition of ownership interest may affect the ability of a banking entity to hold such interests, whether existing or in the future, the Agencies believe that the definition of ownership interest as

[2098] This characteristic exists for both multi-class and single-class covered funds. In the context of an entity that issues shares, this right could cover, for example, common shares, as well as preferred shares the dividend payments of which are determined by reference to the performance of the covered fund.

[2099] The reference to ''all or a portion of excess spread'' is meant to include within the definition of ownership interest the right to receive any excess spread which remains after the excess spread is used to pay expenses, maintain credit enhancement such as overcollateralization or is otherwise reduced.

[2100] This characteristic does not refer to any reduction in the stated claim to principal or interest of a holder of an interest that occurs either as a result of a *bona fide* subsequent renegotiation of the terms of an interest or as a result of a bankruptcy, insolvency, or similar proceeding.

[2101] This provision is not intended to encompass derivative transactions entered into in connection with typical prime brokerage activities of banking entities. However, the activities of banking entities are subject to the anti-evasion provisions.

[2102] *See supra* note 2090.

[2103] *See supra* note 2092.

adopted in the final rule is more effective in preventing possible evasion of section 13 by capturing interests that may be characterized as debt but confer benefits of ownership, including voting rights and/or the ability to participate in profits or losses of the covered fund.

The definition of ownership interest in the final rule, like the proposed rule, includes derivatives of the interests described above. Derivatives of ownership interests provide holders with economic exposure to the profits and losses of the covered fund or an ability to earn a return based on the performance of the fund's underlying holdings or investments in a manner substantially similar to an ownership interest. The Agencies believe the final rule's approach appropriately addresses the statutory purpose to limit a banking entity's economic exposure to covered funds, irrespective of the legal form, name, or issuer of that ownership interest.

As noted above, the proposed definition of ownership interest did not include carried interest (termed ''restricted profit interest'' in the final rule). The proposal recognized that many banking entities that serve as investment adviser or provide other services to a covered fund are routinely compensated for services they provide to the fund through receipt of carried interest. As a result, the proposed rule provided that an ownership interest with respect to a covered fund did not include an interest held by a banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the banking entity (or an affiliate, subsidiary or employee thereof) served as investment manager, investment adviser, or commodity trading advisor, so long as certain enumerated conditions were met.[2104]

The enumerated conditions contained in the proposal were designed to narrow the scope of the exclusion of carried interest from the definition of ''ownership interest'' so as to distinguish between an investor's economic risks and a service provider's performance-based compensation. This was designed to limit the ability of a banking entity to structure carried interest in a manner that would evade section 13's restriction on the amount of ownership interests a banking entity may have as an investment in a covered fund.

Commenters disagreed over whether the definition of ownership interest should exclude carried interest. For instance, some commenters did not support excluding carried interest from the definition of ownership interest, arguing that such an exclusion was too permissive and inconsistent with the statute because, for instance, carried interest derives its value in part by tracking gains on price movements of investments by the fund.[2105] One commenter argued that, despite the fact that carried interest is typically provided as compensation for services provided to a fund, carried interest is a form of investment and therefore should be included as an ownership interest.[2106] Another commenter argued that permitting banking entities to hold an unrestricted amount of carried interest could create an indirect and undesirable link between prohibited proprietary trading and covered fund activities.[2107] These commenters also argued that treating carried interest as compensation for providing services would be inconsistent with the manner in which carried interest is treated for tax purposes.[2108]

Other commenters, however, supported excluding carried interest from the definition of an ownership interest and argued the exclusion was consistent with the words and purpose of section 13.[2109] One commenter argued that carried interest is readily distinguished from an investment in a covered fund because carried interest normally does not expose a banking entity to a covered fund's losses (other than in limited instances such as when a ''clawback'' provision is triggered).[2110] Another commenter argued that permitting a banking entity to receive carried interest without being subject to the requirements of section 13 regarding ownership interests better aligns the interest of the investment manager with that of the fund and its investors.[2111] Another commenter supported expanding the definition of carried interest to include an interest received by a banking entity in return for qualifying services (*e.g.,* lending, placement, distribution, or equity financing) provided to the investment manager of the fund, but not directly provided to the fund itself.[2112]

The proposal established four criteria that must be met in order for carried interest to be excluded from the definition of ownership interest. First, the proposal required that carried interest have the sole purpose and effect of permitting the banking entity or an employee thereof to share in the covered fund's profits as performance compensation for services provided to the fund. While most commenters did not object to this criterion, one commenter argued that the wording of this approach would appear to prohibit an employee of the banking entity from retaining a carried interest after the employee has changed employment.[2113] This commenter argued that the determination of the carried interest's purpose should be made only at the time the interest is granted, thereby enabling an employee to retain the carried interest if and when the employee no longer provides investment management, investment advisory, or similar services to the fund or is no longer employed at the banking entity.

Second, the proposal required that carried interest, once allocated, be distributed to the banking entity promptly after it is earned or, if not so distributed, not share in the subsequent profits and losses of the covered fund. One commenter urged the Agencies to allow the ''reserve'' portion of carried interest that for tax purposes is allocated to the investment manager or investment adviser, but invested alongside the fund and not formally allocated or distributed by the fund, also to qualify for the exclusion as carried interest.[2114] This commenter also suggested that this criterion should not affect the common European structure in which allocated carried interest may share in the subsequent losses, but not the profits, of the fund.

Third, under the proposal a banking entity (including its affiliates or employees) was not permitted to provide funds to the covered fund in connection with receiving a carried interest. The proposal specifically requested comment on whether the exemption for carried interest, including this requirement, was consistent with the current tax treatment and requirements of carried interest arrangements.[2115] Commenters urged the Agencies to relax or amend this criterion so that banking entities, including their affiliates and employees, whether directly or indirectly through a fund vehicle, would be permitted to make minimal capital contributions to the fund (typically less than 1 percent) in connection with the receipt of carried interest to the extent that such contributions provide the basis for

[2104] *See* proposed rule § 75.10(b)(3)(ii).

[2105] *See, e.g.,* Occupy; AFR *et al.* (Feb. 2012).

[2106] *See* Public Citizens; *see also* Occupy.

[2107] *See* AFR *et al.* (Feb. 2012).

[2108] *See* Occupy; Public Citizens; AFR *et al.* (Feb. 2012).

[2109] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Credit Suisse (Williams); SVB.

[2110] *See* Credit Suisse (Williams).

[2111] *See* TCW.

[2112] *See* Credit Suisse (Williams).

[2113] *See* TCW.

[2114] *See* Credit Suisse (Williams).

[2115] Joint Proposal, 76 FR at 68899.

treating the interest as carried interest for tax purposes.[2116] However, these commenters supported the proposal's requirement that any amount contributed by a banking entity in connection with receiving a carried interest should be aggregated with the banking entity's ownership interests for purposes of the 3 percent investment limits.

Fourth, the proposal provided that carried interest may not be transferable by the banking entity (or the affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary of the banking entity. Commenters generally urged removing the proposal's limitations on transferability and argued, among other things, that this criterion could prevent a banking entity (or its affiliate or employee) from transferring the carried interest in connection with selling or otherwise transferring the provision of advisory or other services that gave rise to the carried interest.[2117] Similarly, one commenter argued that the final rule should not require carried interest to be re-characterized as an ownership interest if it is transferred among employees, family members of employees or to estate planning vehicles upon an employee's death.[2118]

After considering carefully comments received on the proposal, the Agencies have determined to retain in the final rule the exclusion from the definition of ''ownership interest'' for a restricted profit interest (termed ''carried interest'' in the proposed rule [2119]) largely as provided in the proposed rule. The final rule, like the proposal, recognizes that banking entities that serve as investment adviser or provide other services to a covered fund are routinely compensated for such services through receipt of a restricted profit interest. The final rule, also like the proposal, generally excludes restricted profit interest from the definition of ownership interest subject to conditions designed to distinguish restricted profit interest, which serves as a form of compensation, from an investment in the fund prohibited (or limited) by section 13. As explained in detail below, the definition of restricted profit interest in the final rule has been modified from the proposal in several aspects to respond to commenters' concerns and to more effectively capture the types of compensation that is often granted in exchange for services provided to a fund. However, like the proposal, the final rule continues to contain a number of requirements designed to ensure that restricted profit interest functions as compensation for providing certain services to a covered fund and does not permit a banking entity to evade the investment limitations or other requirements of section 13.

Under the final rule, restricted profit interest is defined to include an interest held by an entity (or employee or former employee thereof) that serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as: (i) The sole purpose and effect of the interest is to allow the entity (or an employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received; (ii) all such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in subsequent investment gains of the covered fund; (iii) any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the investment limitations of § 75.12; and (iv) the interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.[2120] The final rule, like the proposal, permits any entity (or the affiliate or employee thereof) to receive or hold restricted profit interest if the entity (or the affiliate or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider to the covered fund. For example, an entity that provides services to the covered fund in a capacity as sub-adviser or placement agent would be eligible to receive or hold restricted profit interest.

As requested by commenters, the first condition in the final rule, in contrast to the proposal, permits an employee or former employee to retain a restricted profit interest after a change in employment status so long as the restricted profit interest was originally received as compensation for qualifying services provided to the covered fund.

Also in response to issues raised by commenters, the second condition in the final rule has been modified to permit so-called ''clawback'' features whereby restricted profit interest that has been provided to an investment manager, investment adviser, commodity trading advisor, or similar service provider may be taken back if certain subsequent events occur, such as if the fund fails to achieve a specified preferred rate of return or if liabilities or subsequent losses are incurred by the fund. Under these circumstances, the Agencies believe it is appropriate to allow the allocated but undistributed profits to be clawed back from the service provider's performance compensation, and the final rule has been amended to allow this practice. The final rule makes clear, however, that the undistributed profits may only be held in the fund in connection with such a clawback arrangement. Undistributed profits that remain in the covered fund after they have been allocated without connection to such an arrangement would be deemed to be an investment in the fund and would be an ownership interest under the final rule. Importantly, the final rule also retains the limitation in the proposal that undistributed profit may not share in subsequent investment gains of the covered fund. This limitation (together with the limited circumstances under which the undistributed profit may be retained in the fund) appears necessary in order to distinguish restricted profit interest, which functions as performance compensation and is not intended to be a form of investment, from an ownership interest, which is designed to be an investment. The Agencies believe that this approach achieves an appropriate balance between accommodating receipt of restricted profit interest, including such

[2116] *See* TCW; SIFMA (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2117] *See* ASF (Feb. 2012); *see also* Credit Suisse (Williams); SVB.

[2118] *See* TCW.

[2119] *See supra* note 2096 and accompanying text.

[2120] *See* final rule § 75.10(d)(6)(ii).

amounts held in ''reserve,''[2121] and limiting the ability of a banking entity to evade the investment limitations of section 13. The Agencies expect to review restricted profit interests to ensure banking entities do not use the exclusion for restricted profit interest in a manner that functions as an evasion of section 13.

As noted above, the Agencies understand that entities that provide investment management, investment advisory, commodity trading advisory or other services to a covered fund may, in connection with receiving restricted profit interest, be required to hold a small amount of ownership interests in a fund to provide the basis for desired tax treatment of restricted profit interest. Accordingly, the third condition of the final rule allows an entity that provides qualifying services to a fund to contribute funds to, and have an ownership interest in, the fund in connection with receiving restricted profit interest. As under the proposal, the amount of the contribution must be counted toward the investment limits under section 13(d)(4) and § 75.12 of the final rule. This would include attribution to the banking entity of sums invested by employees in connection with obtaining a restricted profit interest. Thus, the final rule permits a banking entity that provides investment management, investment advisory, or commodity trading advisory services to have both an ownership interest in, and receive restricted profit interest from, the covered fund, so long as the aggregate of the sums invested in all ownership interests acquired or retained by the banking entity (including a general partnership interest), either in connection with receiving the restricted profit interest or as an investment, are within the investment limitations in section 13(d)(4) and § 75.12 of the final rule. The Agencies believe this more appropriately implements the requirements of section 13 of the BHC Act by permitting banking entities to continue to provide customer-driven investment management services through organizing and offering covered funds, while also abiding by the investment limitations of section 13.

In response to comments, the fourth condition of the final rule permits the transfer of a restricted profit interest in connection with a sale to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund. In response to comments, the final rule also permits the transfer of a restricted profit interest to immediate family members of the banking entity's employees or former employees that provide investment management, investment advisory, commodity trading advisory, or other services to the covered fund, or in connection with the death of such employee. Also in response to comments, the final rule permits the transfer of a restricted profit interest to an affiliate or employee that provides investment management, investment advisory, commodity trading advisory, or other services to the covered fund. However, the final rule, like the proposed rule, would treat a restricted profit interest as an ownership interest if the restricted profit interest is otherwise transferable. This remaining restriction recognizes that a freely transferable restricted profit interest has the same economic benefits as an ownership interest and is essential to differentiating a restricted profit interest from an ownership interest.

f. Definition of ''Resident of the United States''

Section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' The statute does not define this term.

Under the proposed rule, the term ''resident of the United States'' was used in the context of the exemptions for covered trading and covered fund activities. As proposed, the definition of resident of the United States was similar, but not identical, to the SEC's definition of U.S. person in Regulation S, which governs offerings of securities outside of the United States.[2122] The Agencies proposed this approach in order to promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S.

Some commenters supported the proposed definition of resident of the United States.[2123] One commenter suggested that the proposed rule defined resident of the United States too broadly and inappropriately precluded investments in U.S. funds by foreign banking entities.[2124]

Other commenters generally argued that the final rule should adopt the definition of ''U.S. person'' under the SEC's Regulation S without the modifications in the proposed rule.[2125] According to many commenters, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S.[2126] They argued that, to the extent that the definitions of ''resident of the United States'' under section 13 and ''U.S. person'' under Regulation S differ, this would create unnecessary uncertainty and increase compliance burdens associated with monitoring multiple definitions.[2127] Other commenters urged the Agencies not to depart from the treatment of international parties and organizations (*e.g.,* the International Monetary Fund and the World Bank) under the SEC's Regulation S.[2128]

Many commenters contended that, because the definition of resident of the United States in the proposal was generally broader than the definition of U.S. person under Regulation S, many additional types of persons, entities and investors would be deemed residents of the United States for purposes of the foreign activity exemptions. Commenters argued that this would limit the potential for foreign banking entities to effectively use those statutorily provided exemptions. A few commenters noted that using a definition in the foreign fund exemption that differs from the definition in Regulation S loses the advantage of using a term that is already understood by market participants and that avoids confusion and limits compliance costs.[2129]

Other commenters suggested that defining resident of the United States as proposed presented problems for investment funds managed by U.S. investment advisers, even those without U.S. investors.[2130] Some commenters argued that, under the proposed

[2121] The Agencies believe that this addresses a commenter's concern regarding the ''reserve'' portion of carried interest discussed above; however such amounts may not share in subsequent investment gains of the covered fund for the reasons also discussed above.

[2122] *See* proposed rule § 75.2(t); 17 CFR 230.901—230.905.

[2123] *See, e.g.,* Occupy.

[2124] *See* Sens. Merkley & Levin (Feb. 2012) (citing 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley)).

[2125] *See, e.g.,* Union Asset; EFAMA; BVI; AFME *et al.;* IIB/EBF; Credit Suisse (Williams); Hong Kong Inv. Funds Ass'n.; PEGCC; UBS; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); AFG.

[2126] *See* PEGCC; Allen & Overy (on behalf of Canadian Banks); Allen & Overy (on behalf of Foreign Bank Group); ICI (Feb. 2012); Credit Suisse (Williams).

[2127] *See* IIB/EBF; Credit Suisse (Williams); ICI (Feb. 2012); ICI Global; PEGCC.

[2128] *See* IIB/EBF; ICI Global; Credit Suisse (Williams).

[2129] *See* Allen & Overy (on behalf of Foreign Bank Group); IIB/EBF; PEGCC; Union Asset.

[2130] *See, e.g.,* MFA; TCW.

definition, a foreign fund managed by a U.S. investment adviser or sub-adviser that is not otherwise subject to section 13 might be deemed a resident of the United States, thereby disqualifying the fund from relying on the foreign funds exemption, a result inconsistent with the purpose of section 13 and the statutory exemption in section 13(d)(1)(I).[2131]

Commenters also argued that the proposed definition raised issues for compensation plans of international organizations that are subject to section 13 of the BHC Act. Several commenters argued that U.S. employees of a foreign banking entity should not be considered residents of the United States if they invest in a non-U.S. covered fund pursuant to a *bona fide* employee investment, retirement or compensation program.[2132] The Agencies have carefully considered the comments received on the definition of resident of the United States, and have determined to modify the final rule as discussed below. The term ''resident of the United States'' is not defined in the statute and is used by the statute to clarify when foreign activity or investment of a foreign banking entity qualifies for the foreign funds exemption in section 13(d)(1)(I). The purpose of this exemption is to enable foreign banking entities to continue to engage in foreign funds activities and investments that do not have a sufficient nexus to the United States so as to present risk to U.S. investors or the U.S. financial system.[2133] The purpose of Regulation S is to provide a safe harbor from the registration provisions under the Securities Act for offerings that take place outside of the United States.[2134]

The Agencies believe that, because the covered funds provisions of the final rule involve sponsoring covered funds and offering and selling securities issued by funds (as compared to counterparty transactional relationships), the securities law framework reflected in Regulation S would most effectively achieve the purpose of the foreign funds exemption. As noted by commenters and discussed above, market participants are familiar with and rely upon the body of law interpreting U.S. Person under Regulation S, and differing definitions under section 13 and Regulation S could create uncertainty and increase compliance burdens associated with monitoring multiple definitions. The Agencies therefore have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in Regulation S.[2135]

In addition, as explained in detail below in Part VI.B.4.b.3. of this **SUPPLEMENTARY INFORMATION**, the final rule provides that an ownership interest is offered for sale or sold to a resident of the United States if it is sold in an offering that ''targets'' residents of the United States.[2136] As explained in more detail in that section, this approach is consistent with Regulation S.

g. Definition of ''Sponsor''

Section 13(h)(5) of the BHC Act defines ''sponsor'' to mean: (i) serving as a general partner, managing member, or trustee of a covered fund; (ii) in any manner selecting or controlling (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) sharing with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2137] Sponsor is a key definition because it defines, in part, the scope of activities to which the prohibition in section 13(a)(1) applies.[2138]

Under the proposal, the term sponsor would have been defined largely as in the statute.[2139] Nearly all commenters who addressed the definition of sponsor argued that the definition was too broad and suggested various ways to narrow or limit the definition.[2140] Commenters generally expressed concerns that a sponsor to a covered fund became subject to the restrictions of section 13(f), limiting the relationships of the banking entity with the covered fund. Commenters argued this would prevent banking entities from providing many customary services to covered funds.[2141]

The proposal excluded from the definition of ''trustee'' as used in the term sponsor a trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee's Retirement Income Security Act (''ERISA'') (29 U.S.C. 1103(a)(1)).[2142] On the other hand, the proposal provided that any banking entity that directs a directed trustee, or that possesses authority and discretion to manage and control the assets of a covered fund for which a directed trustee serves as trustee, would be considered a trustee of the covered fund.

Commenters generally supported the exception for directed trustees in the proposed rule but argued that the exception was too narrow because it only referred to directed trustees under section 403(a)(1) of the ERISA and did not include other similar custodial or administrative arrangements that may not meet those requirements or be subject to ERISA.[2143] These commenters argued that banking entities that serve as trustees or custodians of covered funds may provide a limited range of ministerial services or exercise limited fiduciary duties that, while not subject to ERISA or beyond those permitted for a directed trustee under ERISA, nevertheless do not involve the exercise of investment discretion or control over the operations of the covered fund in the same manner as a general partner or managing member. Some of these commenters advocated defining ''directed trustee'' more expansively to include any situation in which a banking entity serves solely in a directed, fiduciary, or administrative role where a third-party and not the banking entity exercises investment discretion.

In particular, some commenters also argued that a trustee should not be viewed as having investment discretion, and therefore should not be treated as a sponsor, if it possesses only the authority to terminate an investment adviser to a covered fund and to appoint another unaffiliated investment adviser

[2131] *See* AFG; BVI. *See also* MFA; TCW. Similarly, these commenters argued that although treated as a non-U.S. person under Regulation S, a non-U.S. fund organized as a trust in accordance with local law with a limited number of U.S. investors would have been a resident of the United States. Under the proposal, this foreign fund could not invest in another foreign covered fund seeking to rely on the exemption for covered fund activities or investments that occur solely outside of the United States.

[2132] *See* IIB/EBF; Credit Suisse (Williams); UBS; JPMC.

[2133] *See* 156 Cong. Reg. S.5894–5895 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2134] Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990) 55 FR 18306 (May 2, 1990).

[2135] *See* final rule § 75.10(d)(8).

[2136] *See infra* Part VI.B.4.b.3.

[2137] *See* 12 U.S.C. 1851(h)(5).

[2138] *See* 12 U.S.C. 1851(a)(1).

[2139] *See* proposed rule 75.10(b)(5).

[2140] A number of comments received regarding the definition of sponsor relate to securitization structures and are addressed below. There also were a few comments urging that insurance companies not be considered to sponsor their separate accounts. *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide. The Agencies believe these concerns should be addressed by the exclusion of separate accounts from the definition of covered fund, as discussed in Part VI.B.1.c.6. of this **SUPPLEMENTARY INFORMATION**.

[2141] *See, e.g.,* ASF (Feb. 2012); BNY Mellon *et al.;* Credit Suisse (Williams).

[2142] *See* proposed rule § 75.10(b)(6); *see also* 29 U.S.C. 1103(a)(1).

[2143] *See, e.g.,* Arnold & Porter; Ass'n. of Global Custodians; BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); *see also* Fin. Services Roundtable (June 14, 2011) (recommending the definition of directed trustee under the Board's Regulation R be used, which defines directed trustee to mean ''a trustee that does not exercise investment discretion with respect to the account'').

in order to fulfill a demonstrable legal or contractual obligation of the trustee, or the formal but unexercised power to make investment decisions for a covered fund in circumstances where one or more unaffiliated investment advisers have been appointed to manage fund assets. Some commenters argued in favor of excluding trustees serving under non-U.S. trust arrangements pursuant to which they may have legal or contractual authority to, but in fact do not, exercise investment discretion (*i.e.,* the entity has the formal authority to appoint an investment adviser to a trust but does so only in extraordinary circumstances such as appointing a successor investment adviser).[2144]

A few commenters requested confirmation that a banking entity acting as a custodian should not be considered a sponsor of a covered fund.[2145] One commenter argued that traditional client trust accounts for which a bank serves as discretionary trustee should not, by implication, themselves become ''covered funds'' that are ''sponsored'' by the bank.[2146]

One commenter argued that any person performing similar functions to a directed trustee (such as a fund management company established under Irish law), regardless of its formal title or position, also should be excluded if the person does not exercise investment discretion.[2147] Some commenters argued more generally for an exclusion from the definition of trustee (and therefore from the definition of sponsor) for entities that act as service providers (such as custodians, trustees, or administrators) to non-U.S. regulated funds, arguing that European laws already impose significant obligations on entities serving in these roles.[2148]

Under both section 13 of the BHC Act and the proposal, the definition of sponsor also included the ability to select or control (or to have employees, officers, directors, or agents who constitute) a majority of the directors, trustees or management of a covered fund. Some commenters argued that an entity should not be treated as a sponsor of a covered fund when it selects a majority of the initial directors, trustees or management of a covered fund that are independent of the banking entity, so long as the banking entity may not remove or replace the directors, trustees, or management and directors are subsequently either chosen by others or self-perpetuating.[2149] One of these commenters argued similarly that a banking entity should not be deemed to sponsor a covered fund if it selects an independent general partner, managing member or trustee of a new fund, so long as the general partner, managing member or trustee may not be terminated and replaced by the banking entity.[2150] Commenters argued that initial selection of these parties was inherently part of, and necessary to allow, the formation of a covered fund and would not provide a banking entity with ongoing control over the fund to a degree that the banking entity should be considered to be a sponsor.

The statute and proposed rule also defined the term sponsor to include an entity that shares, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name, with a covered fund. One commenter argued in favor of a narrower interpretation of this statutory provision.[2151] This commenter argued that a covered fund should be permitted to share the name of the asset manager that advises the fund without the asset manager becoming a sponsor so long as the asset manager does not share the same name as an affiliated insured depository institution or the ultimate parent of an affiliated insured depository institution.[2152] Another commenter argued that the proposal would put U.S. banking entities at a competitive disadvantage relative to non-banking entities and foreign banks.[2153] These commenters argued that the costs of rebranding covered funds or an asset manager would far outweigh any potential benefit in terms of reducing the risk that a banking entity may be pressured to ''bail out'' a covered fund with a name similar to its investment manager.[2154] One commenter also requested clarification that the name sharing prohibition does not apply in the context of offering documents that carry the names of the manager, sponsor, distributor, as well as the name of the fund itself.[2155] This commenter also advocated that, because of the costs associated with changing a fund name, the Agencies give specific guidance regarding how similar a name may be so as not to be a ''variation of the same name'' for purposes of the definition of sponsor and the activities permitted under section 13(d)(1)(G) and § 75.11 of the rule.

The Agencies have carefully considered comments received in light of the terms of the statute. Section 13(h)(5) of the BHC Act specifically defines the term ''sponsor'' for purposes of section 13. The Agencies recognize that the broad definition of sponsor in the statute will result in some of the effects commenters identified, as discussed above.

The final rule generally retains the definition of ''sponsor'' in the statute and the proposed rule, although with certain modifications and clarifications to respond to comments received regarding the exclusion for ''directed trustees.'' As in the proposed rule, the definition of sponsor in the final rule covers an entity that (i) serves as general partner, managing member, or trustee of a covered fund, or that serves as a commodity pool operator of a covered fund as defined in § 75.10(b)(1)(ii) of the final rule, (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (iii) shares with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[2156]

[2144] *See* BNY Mellon *et al.* (providing proposed rule text or suggesting in the alternative clarification regarding the phrase ''exercise investment discretion'' in the final rule preamble); Ass'n. of Global Custodians; ICI Global; State Street (Feb. 2012).

[2145] *See* Ass'n. of Global Custodians; SIFMA *et al.* (Covered Funds) (Feb. 2012); ABA (Keating); AFG; AFTI; BNY Mellon *et al.;* EFAMA; IMA; State Street (Feb. 2012).

[2146] *See* Arnold & Porter. To the extent that a client trust account would not be an investment company but for the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, such as the exclusion for common trust funds under section 3(c)(3) of that Act, it would not be a covered fund regardless of whether a banking entity acts as trustee.

[2147] *See* BNY Mellon *et al.*

[2148] *See* EFAMA; F&C; IRSG; Union Asset.

[2149] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012) (recommending the Agencies adopt independence guidelines similar to the FDIC's guidelines for determining whether audit committee members of insured depository institutions are ''independent'' of management); Credit Suisse (Williams).

[2150] *See* Credit Suisse (Williams) (arguing that such an approach would be consistent with the existing BHC Act concept of control with respect to funds).

[2151] A number of comments were also received regarding the restriction on name sharing that is one of the requirements of section 13(d)(1)(G) and § 75.11 of the proposed rule. These comments are discussed in Part VI.B.2.a.5. of this **SUPPLEMENTARY INFORMATION**.

[2152] *See* Credit Suisse (Williams); *see also* ABA (Keating); BlackRock; Goldman (Covered Funds); SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW (proposing similarly to limit the name-sharing restriction to the insured depository institution in context of section 13(d)(1)(G)).

[2153] *See* Goldman (Covered Funds).

[2154] *See* Credit Suisse (Williams); *see also* Goldman (Covered Funds).

[2155] *See* Credit Suisse (Williams).

[2156] *See* final rule § 75.10(d)(9). Some commenters asserted that custodians and service providers should not treated as sponsors under the final rule. The Agencies note, however, that a banking entity is not a sponsor under the final rule unless it serves in one or more of the capacities specified in the definition; controls or makes up the fund's board of directors or management as described in the final rule; or shares the same name or a variation of the same name with the fund as described in the final

While commenters urged the Agencies to provide an exemption from the definition of sponsor for a banking entity that selects the initial directors, trustees, or management of a fund,[2157] the final rule has not been modified in this manner because the initial selection of the directors, trustees or management of a fund is an action characteristic of a sponsor and is essential to the creation of a covered fund. The Agencies note, however, that the statute and the final rule allow banking entities to sponsor covered funds, including selecting the initial board of directors, trustees and management, so long as the banking entity observes certain requirements and conforms any initial investment in the covered fund to the limits in the statute and regulation during the relevant conformance period as discussed in Part VI.B.3.b. of this **SUPPLEMENTARY INFORMATION**.[2158] Moreover, a banking entity that does not continue to select or control a majority of the board of directors would not be considered to be a sponsor under this part of the definition once that role or control terminates. In the case of a covered fund that will have a self-perpetuating board of directors or a board selected by the fund's shareholders, this would not be considered to have occurred until the board has held its first re-selection of directors or first shareholder vote on directors without selection or control by the banking entity.

As explained below, the Agencies believe that, in context, the term trustee in the definition of the term sponsor refers to a trustee with investment discretion. Consistent with this view, commenters urged the Agencies to exclude from the definition of sponsor certain trustees and parties commenters asserted acted in a similar capacity, as discussed above.[2159] The final rule therefore has been modified to exclude from the definition of trustee: (i) a trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or (ii) a trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (i).[2160] Under the final rule, a trustee would be excluded if the trustee does not have any investment discretion, but is required to ensure that the underlying assets are appropriately segregated for the benefit of the trust. Similarly, a trustee would be excluded if the trustee has no investment discretion but is authorized to replace an investment adviser with an unaffiliated party when the investment adviser resigns. With respect to an issuing entity of asset-backed securities and as explained below, a directed trustee excluded from the definition of sponsor would include a person that conducts their actions solely in accordance with directions prepared by an unaffiliated party.

The Agencies believe that this exclusion is appropriate because the relevant prong of the definition of sponsor (*i.e.,* serving as general partner, managing member, or trustee) specifies entities that have the ongoing ability to exercise control over a fund; directed trustees excluded from definition of sponsor in the final rule do not appear to have this ability and thus do not appear to be the type of entity that this prong of the definition of sponsor was intended to capture. If a trustee were itself to assume the role of investment adviser, or have the ability to exercise investment discretion with respect to the covered fund, the trustee would not qualify for this exclusion. The final rule does not include within the definition of sponsor custodians or administrators of covered funds unless they otherwise meet the definitional qualifications set forth in section 13 and the final rule.

The definition of sponsor will continue to cover entities that share the same name or variation of the same name of a covered fund for corporate, marketing, promotional, or other purposes, consistent with the definition of sponsor in section 13(h)(5). The Agencies recognize that some commenters urged the Agencies to modify this aspect of the definition of sponsor, and that the name-sharing prohibition included in the definition of sponsor (and in the conditions for the organize and offer exemption) will require some banking entities to rebrand their covered funds, which may prove expensive and will limit the extent to which banking entities may continue to benefit from brand equity they have developed.[2161] The costs a banking entity would incur to rebrand its covered funds would depend on the cost to rebrand the banking entity's current funds, as well as the banking entity's ability to attract new investor capital to its current and future covered funds. The total burden per banking entity, therefore, would depend on the brand equity as well as the number of covered funds that share a similar name.[2162] One commenter argued that, as a result, banking entities subject to section 13 may be at a competitive disadvantage to other firms that are not subject to these or similar restrictions.[2163] The Agencies believe that the final rule addresses some commenters' concerns to an extent by adopting a more tailored definition of covered, including a focused definition of foreign funds that will be covered funds and an exclusion for foreign public funds.[2164] In addition, to the extent that a banking entity would otherwise come under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that bears the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity this assistance could pose.

1. Definition of Sponsor With Respect to Securitizations

Commenters on the definition of sponsor in the context of securitization vehicles generally argued that the proposed definition of sponsor was too broad and requested clarification that various roles that banking entities might serve within a securitization structure would be excluded from the definition of sponsor, including servicers;[2165] backup servicers and master servicers;[2166] collateral agents and

rule. *See, e.g., supra* note 2156 and accompanying text. *See also infra* note 2160.

[2157] *See supra* note 2149 and accompanying text.

[2158] Similarly, a banking entity may share the same name or a variation of the same name with a covered fund so long as the banking entity does not organize and offer the covered fund in accordance with section 13(d)(1)(G) and § 75.11.

[2159] *See, e.g., supra* notes 2143–2144 and accompanying text. *See also supra* note 2156.

[2160] *See* final rule § 75.10(d)(10). With respect to the concept of a ''directed trustee'' under foreign law, commenters generally requested changes only if non-U.S. mutual fund equivalents were not excluded from the definition of covered fund. As discussed above, the final rule explicitly excludes foreign public funds from the definition of covered fund, which should address these commenters concerns. *See* final rule § 75.10(c)(1).

[2161] *See supra* notes 2151–2155 and accompanying text.

[2162] *See infra* note 2164.

[2163] *See supra* note 2153 and accompanying text.

[2164] For example, one commenter argued that it would need to rebrand approximately 500 established funds under the rule proposal if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2165] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commenters argued that servicers will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012). Another commenter stated that servicers do not have the authority to select assets or make investment decisions on behalf of investors. *See* PNC.

[2166] *See* ASF (Feb. 2012).

administrators;[2167] custodians;[2168] indenture trustees;[2169] underwriters, distributors, placement agents;[2170] arrangers, structuring agents;[2171] originators, depositors, securitizers;[2172] ''sponsors'' under the SEC's Regulation AB;[2173] administrative agents;[2174] and securities administrators and remarketing agents.[2175] Commenters argued that these parties should not be included in the definition of sponsor because such parties have clearly defined and extremely limited authority and discretion,[2176] do not have the right to control the decision-making and operational functions of the issuer,[2177] and would not have ''control'' under BHC Act control precedent.[2178] Conversely, one commentator supported defining sponsor under the proposed rule to include the Regulation AB sponsor, the servicer and the investment manager.[2179] Commenters also made arguments regarding the potential detrimental effects to securitization and credit markets if banking entities are prohibited from acting as sponsors of securitizations.[2180]

Commenters disagreed as to whether or not a sponsor under the final rule should include a party with any investment discretion, some investment discretion or complete investment discretion. Some commenters argued that certain parties should not be considered a sponsor because they were not an investment advisor or did not have investment discretion.[2181] Other commenters argued that an entity should not be considered a sponsor even though it has limited investment discretion,[2182] while others argued that investment advisers and parties with investment discretion should not be included in the definition of sponsor.[2183]

After considering comments received and the language and purpose of section 13, the Agencies have determined not to adopt a separate definition of sponsor for issuers of covered funds that are issuers of an asset-backed security. As described above and consistent with the statute, the definition of sponsor only includes parties that: (i) Serve as a general partner, managing member, or trustee (other than a directed trustee) of a covered fund; (ii) have the right to select or control a majority of the directors, trustees, or management of a covered fund; or (iii) share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name. If the parties that commenters described do not serve in those capacities for a covered fund, do not have those rights with respect to a covered fund or do not share a name with a covered fund, such parties would not be a sponsor for purposes of the final rule, and, therefore, they would not be subject to the restrictions applicable to the sponsor of a covered fund, including the restrictions contained in section 13(f).[2184]

Additionally, the Agencies believe that the exclusion of loan securitizations from the definition of covered fund under the final rule addresses many of the commenters' concerns about the sponsor definition because this exclusion limits the types of securitizations that are covered funds and subject to the final rule. Similarly, the exclusion of certain ABCP conduits from the definition of covered fund will mean that the restrictions under section 13(f) will not apply to qualifying asset-backed commercial paper conduits.

As with any other covered fund under the final rule, the term sponsor would include a trustee that has the right to exercise any investment discretion for the securitization. For issuers of asset-backed securities, this would generally not include a trustee that executes decision-making, including investment of funds prior to the occurrence of an event of default, solely according to the provisions of a written contract or at the written direction of an unaffiliated party. In addition, under the rule as adopted a trustee with investment discretion may avoid characterization as a sponsor if it irrevocably delegates all of its investment discretion to another unaffiliated party with respect to the covered fund. The Agencies believe that these considerations regarding when a trustee is a sponsor responds to commenters' concerns regarding the roles of trustees in securitizations.[2185]

[2167] *Id.*

[2168] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012).

[2169] *Id.*

[2170] *See* Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); Wells Fargo (Covered Funds). One of these commentators argued that placement agents and underwriters will not have the right to control the decision-making and operational functions of the issuer. *See* SIFMA (Securitization) (Feb. 2012).

[2171] *See* Cleary Gottlieb (''party that structures the asset-backed securities''); SIFMA (Securitization) (Feb. 2012).

[2172] *See* Credit Suisse (Williams); Wells Fargo (Covered Funds).

[2173] *See* SIFMA (Securitization) (Feb. 2012) (arguing that Regulation AB sponsors will not have the right to control the decision-making and operational functions of the issuer after they deposit the assets).

[2174] *See* Credit Suisse (Williams).

[2175] *See* ASF (Feb. 2012); Wells Fargo (Covered Funds).

[2176] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2177] *See* SIFMA (Securitization) (Feb. 2012).

[2178] *See* Credit Suisse (Williams).

[2179] *See* Occupy.

[2180] *See* ASF (Feb. 2012); Credit Suisse (Williams).

[2181] *See* ASF (Feb. 2012) (arguing that service providers, including trustees, custodians, collateral agents, servicers, master servicers, backup servicers, securities administrators, remarketing agents and collateral administrators, should not be considered the sponsor or investment manager of a fund under section 13 of the BHC Act because they have roles that are principally ministerial in nature and do not generally involve investment discretion or management and control activities); PNC (arguing that a banking entity should not be deemed a sponsor simply by serving as underwriter, distributor, placement agent, originator, depositor, investment adviser, servicer, administrative agent, securitizer or similar role because these parties do not have the authority to select assets or make investment decisions on behalf of investors).

[2182] *See* Allen & Overy (on behalf of Foreign Bank Group); ASF (Feb. 2012); SIFMA (Securitization) (Feb. 2012). One commenter argued that the limited discretion that a servicer, trustee or custodian may have to either invest funds within certain parameters, liquidate assets following a default on the asset or the securitization default, or mitigate losses subject to a servicing standard, should not be considered a sponsor because these entities do not exercise the level of management and control exercised by the general partner or managing member of a hedge fund or private equity fund. Another commenter argued that to the extent that any of these parties exercises discretion, such discretion (A) involves decisions made after another party defaults (*e.g.,* post-event of default collateral sale), (B) prescribed by the transaction documents (*e.g.,* choosing among a limited number of eligible investments) and (C) governed by standards of care (*e.g.,* the servicing standards). *See* ASF (Feb. 2012). Another commenter requested clarification that the exclusion of trustees that do not exercise investment discretion would also cover trustees that (A) direct investment of amounts in accordance with the applicable transaction documents, (B) act as servicer pending the appointment of a successor or (C) liquidate collateral. *See* SIFMA (Securitization) (Feb. 2012). One commenter argued that the definition of sponsor should not include an investment manager unless the investment manager (A) serves in one of the capacities designated in the definition of sponsor and can be replaced at the discretion of one or more entities serving in such capacity or with or without cause by the security holders or (B) has the ''discretion to acquire or dispose of assets in the securitization for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.'' *Id.*

[2183] *See* Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); TCW (arguing that the investment manager is typically unaffiliated with the general partner or equivalent of such fund, does not control the board of directors, is not responsible for the operations or books and records of the fund and generally does not perform any other significant function for the fund, such as acting as transfer agent).

[2184] As discussed above, commenters argued that that various roles that banking entities might serve within a securitization structure should be excluded from the definition of sponsor. *See supra* notes 2165–2175 and accompanying text.

[2185] The Agencies also note that, while the entities commenters identified may not fall into the definition of sponsor, the ability of a banking entity to acquire and retain an interest in a securitization that is a covered fund will depend on whether it conducts its activity in a manner permitted under one of the exemptions contained in section 13(d)(1) of the BHC Act, such as the exemption for organizing and offering a covered fund.

2. Section 75.11: Activities Permitted in Connection With Organizing and Offering a Covered Fund

Section 13(d)(1)(G) of the BHC Act permits a banking entity to make investments in and sponsor covered funds within certain limits in connection with organizing and offering the covered fund.[2186] Section 75.11 of the final rule implements this statutory exemption, and includes several changes from the proposed rule in response to concerns raised by commenters as described in detail below.[2187]

a. Scope of Exemption

Section 75.11 of the proposed rule described the conditions that must be met in order to qualify for the exemption provided by section 13(d)(1)(G) for covered fund activities conducted in connection with organizing and offering a covered fund.[2188] These conditions generally mirrored section 13(d)(1)(G) of the statute, and included: (i) The banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;[2189] (ii) the covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except in accordance with the limitations on amounts and value of those interests as permitted under subpart C of the proposed rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under § 75.16 of the proposed rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and may not use the word ''bank'' in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; (viii) the banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in § 75.11(h) of the proposed rule; and (ix) the banking entity must comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[2190]

Commenters raised concern that the proposed rule could be read to extend the prohibition on covered fund activities beyond the scope intended by the statute.[2191] Because the proposed exemption was applicable to banking entities engaged in ''organizing and offering'' a covered fund, commenters were concerned that the proposed rule might be interpreted to prohibit a banking entity from engaging in activities that are part of organizing and offering a covered fund but that are not prohibited under the covered fund prohibition. In this regard, commenters contended that the activity of ''organizing and offering'' a covered fund would include serving as investment adviser, distributor, broker, and other activities not prohibited by section 13 of the BHC Act and not involving the acquisition or retention of an ownership interest in or sponsorship of a covered fund as those terms are defined in section 13.[2192]

The Agencies have modified the final rule to address this concern, which reflects a reading of the proposal not intended by the Agencies. Section 13(d)(1)(G) of the BHC Act by its terms provides an exemption from section 13(a) of the BHC Act, which prohibits a banking entity from acquiring or retaining an equity, partnership or other ownership interest in or sponsoring a covered fund. To the extent that an activity is not prohibited by section 13(a), no exemption to that statutory prohibition is needed to conduct that activity. However, it is common for prohibited and non-prohibited activities to be conducted together in connection with offering and organizing a covered fund. For example, an entity that provides investment advisory services to a covered fund (an activity not itself prohibited by section 13(a)(1)(B) of the BHC Act) often acquires an ownership interest in a covered fund and/or appoints a majority of management of the covered fund (which is included in the definition of sponsor under the statute), both of which are covered by the statutory prohibition in section 13(a)(1)(B). In that case, the banking entity may engage in the prohibited activity as part of organizing and offering a covered fund only if the prohibited activity is conducted in accordance with the requirements in the exemption in section 13(d)(1)(G) or some other exemption.

The final rule reflects this view in that it permits a banking entity to invest in or sponsor a covered fund in connection with organizing and offering the fund, which may involve activities that are not prohibited by section 13. Under the final rule, a banking entity that serves as an investment adviser to a covered fund (including a sub-adviser), for example, may permissibly invest in the covered fund to the extent the banking entity complies with the requirements of section 13(d)(1)(G) of the Act. An entity that serves only as investment adviser, without making any investment or conducting any activity covered by the prohibition in section 13(a), would not be covered by the prohibition in section 13(a) and thus would not need to rely on section 13(d)(1)(G) and § 75.11 of the final rule to conduct that investment advisory activity.

As described in more detail below, a number of commenters expressed concern about applying the requirements of section 13(d)(1)(G) and the final rule outside of the United States, including with respect to foreign public funds organized and offered by foreign banking entities, particularly in situations where requirements in foreign jurisdictions may conflict with the requirements of section 13 of the BHC Act and implementing regulations.[2193]

[2186] 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) (arguing that section 13 permits a banking entity to engage in a certain level of traditional asset management business).

[2187] *See* final rule § 75.11; proposed rule § 75.11.

[2188] *See* proposed rule §§ 75.11(a)—(h).

[2189] While section 13(d)(1)(G) of the BHC Act does not explicitly mention ''commodity trading advisory services,'' the Agencies proposed to treat commodity trading advisory services in the same way as investment advisory services because the proposed rule would have included commodity pools within the definition of ''covered fund.'' One commenter argued that a covered banking entity should not be permitted to qualify for the exemption in section 13(d)(1)(G) based on providing commodity trading advisory services. *See* Occupy. The Agencies believe that commodity trading advisors provide services to commodity pools that are similar to the services an investment adviser provides to a hedge fund or private equity fund. Because certain commodity pools are included within the definition of covered fund, banking entities may organize and offer these commodity pools as a means of providing these services to customers.

[2190] *See* proposed rule § 75.11(a)–(h).

[2191] *See, e.g.,* Arnold & Porter.

[2192] *See* Arnold & Porter; F&C.

[2193] *See, e.g.,* EFAMA; ICI Global; JPMC.

The Agencies believe that many of the concerns raised with respect to applying section 13(d)(1)(G) and the proposed rule outside the United States have been addressed through the revised definition of covered fund described above and revisions to the exemption provided for activities conducted solely outside the United States. In particular, the revised definition of covered fund makes clear that a foreign fund offered outside the United States is only a covered fund under specified circumstances with respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized or established under the laws of the United States or of any State.[2194] Furthermore, foreign public funds are excluded from the definition of covered fund in the final rule.[2195] Consequently, a foreign banking entity may invest in or organize and offer a variety of funds outside of the United States without becoming subject to the requirements of section 13(d)(1)(G) and § 75.11 of the final rule, such as the name-sharing restriction or limitations on director and employee investments.

1. Fiduciary Services

In order to qualify for the exemption for activities related to organizing and offering a covered fund, section 13(d)(1)(G) generally requires that a banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, that the covered fund be organized and offered in connection with providing these services, and that the banking entity providing those services offer the covered fund only to persons that are customers of those services of the banking entity.[2196] These requirements were largely mirrored in the proposed rule. Requiring a customer relationship in connection with organizing and offering a covered fund helps to ensure that a banking entity is engaging in the covered fund activity for others and not on the banking entity's own behalf.[2197]

As noted in the proposal, section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the Agencies explained in the proposal that the customer relationship may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer. This application of the customer requirement is consistent with the manner in which these services are provided by banking entities. The proposed rule also required that a banking entity relying on the authority contained in § 75.11 adopt a credible plan or similar documentation outlining how the banking entity intended to provide advisory or similar services to its customers through organizing and offering such fund.

Several commenters indicated support for this customer requirement and, in particular, the Agencies' view that the customer relationship need not be a preexisting one.[2198] A few commenters contended that the statute required that a banking entity have a pre-existing customer relationship, and may not solicit investors outside of its existing asset management customers.[2199] One of these commenters argued that this would place banking entities at a competitive disadvantage compared to investment advisers that are not banking entities (and thus not subject to the requirements of section 13 and the final rule), but argued that this is a necessary result of section 13.[2200]

The final rule adopts the language largely as proposed, and the Agencies continue to believe that the customer relationship required under section 13(d)(1)(G) and the final rule may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to the customer.[2201] The final rule requires that a covered fund be organized and offered pursuant to a written plan or similar documentation outlining how the banking entity (or an affiliate thereof) intends to provide advisory or similar services to its customers through organizing and offering the fund. As part of this requirement, the plan must be credible and indicate that the banking entity has conducted reasonable analysis to show that the fund is organized and offered for the purpose of providing *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to customers of the banking entity (or an affiliate thereof) and not to evade the restrictions of section 13 of the BHC Act.

The language of the final rule also adopts the statutory requirements (and modifications related to commodity pools as discussed above) that the banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and that the covered fund be organized and offered only in connection with the provision of those services. Banking entities provide a wide range of customer-oriented services which may qualify as *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.[2202] Historically, banking entities have used covered funds as a method of providing these services to customers in a manner that is both cost efficient for the customer and allows customers to benefit from access to advice and services that might not otherwise be available to them. These benefits apply to long-established customers as well as individuals or entities that have no pre-existing relationship with the banking entity but choose to obtain the benefit of trust, fiduciary, investment advisory, or commodity trading advisory services through participation in the covered fund. Covered funds also allow customers to gauge the historical record of the banking entity in providing these services by reviewing the funds' past performance.

The statute does not require that a covered fund be offered only to pre-existing customers of the banking entity, and the Agencies believe that imposing such a requirement would not improve the quality of the trust, fiduciary, investment advisory, or commodity trading advisory service, enhance the safety and soundness of the banking entity, or reduce the risks to the customers or the banking entity. In each case, the banking entity provides trust, fiduciary or advisory services to a covered fund for the benefit of the banking entity's customers, and the statute recognizes that organizing and offering a covered fund is a legitimate method for providing that service. In addition, the banking entity must abide by all the statutory and prudential

[2194] *See* final rule § 75.10(b)(1)(iii).

[2195] *See* final rule § 75.10(c)(1).

[2196] *See* 12 U.S.C. 1851(d)(1)(G)(i); proposed rule § 75.11(a).

[2197] *See* 156 Cong. Rec. at S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2198] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); JPMC.

[2199] *See* Sens. Merkley & Levin (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Public Citizen.

[2200] *See* Sens. Merkley & Levin.

[2201] *See* final rule § 75.11(a)(1)–(2). *See* Part VI.B.2.b. below for a discussion of these requirements in the context of a banking entity that organizes and offers a covered fund that is an issuing entity of asset-backed securities.

[2202] *See, e.g.,* 12 U.S.C. 1843(c)(4), (c)(8), (K), 12 CFR 225.28(b)(5) and (6), 12 CFR 225.86, 12 CFR 225.125 (with respect to a bank holding company); 12 U.S.C. 24(Seventh), 92a, 12 CFR Part 9 (with respect to a national bank); 12 U.S.C. Part 362 (with respect to a state non-member bank).

requirements imposed by section 13 and the entity's supervisors on the provision of those services. The Agencies do not believe that a pre-existing customer relationship requirement would be meaningful because it could easily be satisfied by a prospective customer seeking to invest in a covered fund by first establishing an account with a banking entity or purchasing another product (*e.g.,* a brokerage account or shares of a mutual fund).

2. Compliance With Investment Limitations

Section 13(d)(1)(G)(iii) of the BHC Act limits the ability of a banking entity that organizes and offers a covered fund to acquire or retain an ownership interest in that covered fund as an investment.[2203] Both the proposed rule and the final rule implement this provision by requiring that a banking entity limit its investments in a covered fund that the banking entity organizes and offers as provided in § 75.12.[2204] Comments received on investment limitations in the proposed rule, and modifications made to the final rule implementing these limitations, are described in Part VI.B.3. below.

3. Compliance With Section 13(f) of the BHC Act

Section 75.11(d) of the proposed rule required that the banking entity comply with the limitations on relationships with covered funds imposed by section 13(f) of the BHC Act.[2205] The final rule adopts this requirement and provides that the banking entity (and its affiliates) must comply with the requirements of § 75.14. Section 13(f) of the BHC Act prohibits certain transactions or relationships that would be covered by section 23A of the Federal Reserve Act, and provides that any permitted transaction is subject to section 23B of the Federal Reserve Act, in each instance as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2206] These limitations apply in several contexts, and are contained in § 75.14 of the final rule, discussed in detail below in Part VI.B.5.

4. No Guarantees or Insurance of Fund Performance

Section 75.11(e) of the proposed rule prohibited a banking entity that organizes and offers a covered fund from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which such covered fund invests.[2207] This prong implemented section 13(d)(1)(G)(iv) of the BHC Act and was intended to prevent a banking entity from engaging in bailouts of a covered fund in which the banking entity has an interest.[2208]

There were only a few comments received on this aspect of the proposal. One commenter supported the restriction on guarantees as effective and consistent with the statute.[2209]

One commenter argued that the final rule should not prohibit borrower default indemnification services (*i.e.,* the guarantee of collateral sufficiency upon a securities borrower's default) provided to lending clients by agent banks in connection with securities lending transactions involving a covered fund.[2210] This commenter argued that borrower default indemnification services guarantee only the deficit between the mark to market value of cash collateral received and the amount of any borrower default, and are therefore different from and more limited than the type of general investment performance or obligation guarantee that section 13 was designed to prevent.

The Agencies believe that the statute does not permit either full or partial guarantees of the obligations of a covered fund that the banking entity organizes and offers. Accordingly, the final rule, like the proposed rule, continues to mirror the statutory restriction on direct or indirect guarantees of the obligations or performance of a covered fund by a banking entity in connection with reliance on the exemption provided in section 13(d)(1)(G) of the BHC Act. However, in response to comments received on the proposal, the Agencies note that the provision of a borrower default indemnification by a banking entity to a lending client in connection with securities lending transactions involving a covered fund is not prohibited. This type of indemnification is not a guarantee of the performance or obligations of a covered fund because it represents a guarantee to the customer or borrower of the obligation of the counterparty to perform and not a guarantee of the performance or underlying obligations of the covered fund. The requirement of the final rule that a banking entity and its affiliates not guarantee the obligations or performance of a covered fund that it organizes and offers therefore does not prohibit a banking entity from providing borrower default indemnifications to customers.

5. Limitation on Name Sharing With a Covered Fund

Section 75.11(f) of the proposed rule prohibited the covered fund from sharing the same name or a variation of the same name with the banking entity that relies on the exemption in section 13(d)(1)(G) of the BHC Act.[2211] The proposed rule also prohibited the covered fund from using the word ''bank'' in its name.[2212]

The name-sharing restriction was one of the most commented upon aspects of § 75.11. A number of commenters on this section expressed the view that the name-sharing restriction in section 13(d)(1)(G)(vi) of the BHC Act and the proposed rule was too strict. In particular, a number of commenters argued that the name-sharing restriction should allow an asset manager to share its name with a sponsored covered fund so long as the covered fund does not share the name of the insured depository institution or its affiliated holding company or use the word ''bank.''[2213]

Commenters argued that the name-sharing restriction as proposed would impose significant business and branding burdens on the industry without providing incremental benefit to the public.[2214] These commenters argued that it would be unduly burdensome and costly for funds currently affiliated with banking entities or managers that are themselves banking entities to change the name of their affiliated funds and that many of these funds have developed a reputation in the marketplace based on the current name of the fund and/or fund manager.

[2203] *See* 12 U.S.C. 1851(d)(1)(G)(iii).

[2204] *See* proposed rule and final rule § 75.12.

[2205] 12 U.S.C. 1851(d)(1)(G)(iv); proposed rule § 75.11(d).

[2206] *See* Part VI.B.5. below. The comments received on section 13(f) and § 75.16 of the proposed rule are described below.

[2207] 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § 75.11(e).

[2208] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2209] *See* Occupy.

[2210] *See* RMA.

[2211] 12 U.S.C. 1851(d)(1)(G)(vi); proposed rule § 75.11(f).

[2212] Similar restrictions on a fund sharing the same name, or variation of the same name, with an insured depository institution or company that controls an insured depository institution or having the word ''bank'' in its name, have been used previously in order to prevent customer confusion regarding the relationship between such companies and a fund. *See, e.g., Bank of Ireland,* 82 Fed. Res. Bull. 1129 (1996).

[2213] *See* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; EFAMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); TCW; Katten (on behalf of Int'l Clients); Union Asset.

[2214] *See, e.g.,* ABA (Keating); Ass'n of Institutional Investors (Feb. 2012); Blackrock; *see also* SVB; Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012); UBS.

Some of these commenters argued that the name-sharing restriction would place asset managers and funds affiliated with banking entities at a competitive disadvantage to other asset managers and funds.[2215]

A few commenters argued that the rationale for the name-sharing restriction (*i.e.,* to discourage bailing out funds) was already addressed under other restrictions of section 13(d)(1)(G) and the proposed rule that prohibit a banking entity from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or of any covered fund in which such covered fund invested and that require disclosure that investments in the covered fund are not insured by the Federal Deposit Insurance Corporation.[2216] These commenters questioned the necessity for the name-sharing restriction when a prohibition on bailing out funds is already in place and where there is disclosure that investors bear the risk of loss in the fund. Some of these commenters contended it was unlikely that investors in a covered fund with an SEC-registered investment adviser that has a name unrelated to the name of an insured depository institution would be misled to believe that the fund would be backed in any way by a related insured depository institution or the Federal Deposit Insurance Corporation.[2217] One of these commenters argued that the name-sharing restriction should not apply to organizations where insured depository institutions represent a *de minimis* component of the organization's operations.[2218]

Other commenters recommended that the name-sharing restriction not be applied to covered funds that rely on the exemption for covered fund activities and investments that occur solely outside of the United States.[2219] A few commenters expressed concern that the name-sharing restriction could be incompatible with regulatory requirements in certain foreign jurisdictions that a covered fund's name must indicate the fund's connection with the fund sponsor.[2220] One commenter argued that it is common practice in Germany to disclose the designation of the sponsoring investment manager in the fund name in order to provide transparency to investors, while a few commenters contended that European jurisdictions, including the U.K., require an authorized fund to have a name representative of the authorized investment manager to avoid misleading fund investors.[2221] Commenters also argued that the name-sharing restriction was inconsistent with the laws of Ireland and Hong Kong.[2222] Certain commenters argued that the impact of the name-sharing restriction would be particularly unfair to non-U.S. retail funds like European UCITS if such funds are not allowed to use the name of the bank while U.S. mutual funds would not be subject to the same restriction.[2223]

By contrast, some commenters supported the name-sharing restriction. For example, one commenter indicated that the use of the word ''bank'' or a shared name in the fund's name was already strongly discouraged by prior guidance.[2224] Another commenter supported the name-sharing restriction but argued it did not go far enough because it did not apply to funds that a banking entity was permissibly allowed to sponsor and invest in under other provisions of section 13.[2225] According to this commenter, covered funds permitted under other exemptions should not be allowed to share the same name with the banking entity.[2226]

After carefully considering comments and the express terms of the statute, the final rule includes the name-sharing restriction as proposed.[2227] The name-sharing restriction is imposed by the statute and prohibits a banking entity from sharing the same name or variation of the same name with a covered fund. The statute also defines the scope of the prohibition by defining the term ''banking entity'' to generally include any affiliate or subsidiary of an insured depository institution or any company that controls an insured depository institution.[2228]

However, the Agencies believe that many of the concerns raised by commenters with respect to this provision should be addressed through the revised definition of covered fund in the final rule, and modifications to the exemption for covered fund activities and investments that occur solely outside of the United States.[2229] For example, as discussed in greater detail above in Part VI.B.1.c.1., foreign public funds sold outside the United States are excluded from the definition of covered fund.[2230] In addition, pursuant to the definition of covered fund in the final rule, a foreign fund only becomes a covered fund with respect to a U.S. banking entity (including a foreign affiliate of that U.S. banking entity) that acts as sponsor to, or has an ownership interest in, the fund. Moreover, numerous funds operate successfully with names that differ from the name of the fund sponsor or adviser.

The Agencies recognize, however, that the statutory name-sharing restriction may affect some entities that will be covered funds and that cannot rely on another permitted activity exemption under section 13(d)(1) and the final rule. The name-sharing restriction may result in certain costs and other economic burdens for banking entities that advise these funds, as discussed in greater detail in Part VI.B.1.g. above.[2231] However, as the Agencies also note above, to the extent that the restriction results in a banking entity not otherwise coming under pressure for reputational reasons to directly or indirectly assist a covered fund under distress that shares the banking entity's name, the name-sharing prohibition could reduce the risk to the banking entity that this assistance might pose. The Agencies also expect that the conformance period, both for compliance with section 13 of the BHC Act generally and for funds that are illiquid funds, should be sufficient to allow covered funds to take the steps necessary to comply with the name-sharing restriction in the statute and final rule.

6. Limitation on Ownership by Directors and Employees

Section 75.11(g) of the proposed rule implemented section 13(d)(1)(G)(vii) of the BHC Act. That statutory provision prohibits any director or employee of

[2215] *See* Ass'n of Institutional Investors (Feb. 2012); Katten (on behalf of Int'l Clients); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2216] *See* Ass'n of Institutional Investors (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012); T. Rowe Price; TCW.

[2217] *See* TCW; Union Asset.

[2218] *See* T. Rowe Price.

[2219] *See, e.g.,* UBS.

[2220] *See* Credit Suisse (Williams); EFAMA; JPMC; Katten (on behalf of Int'l Clients); Union Asset; IAA; ICI Global; UBS; SIFMA *et al.* (Covered Funds) (Feb. 2012) (*citing* Directive 2004/39/EC of the European Parliament and Council).

[2221] *See* BVI; EFAMA; JPMC; UBS; Union Asset; ICI Global; IAA.

[2222] *See* UBS; Union Asset; ICI Global.

[2223] *See, e.g.,* AFG; ICI Global; JPMC.

[2224] *See* Arnold & Porter (citing SEC Division of Investment Management, Letter to Registrants (May 13, 1993); Memorandum to SEC Chairman Breeden from Division of Investment Management (May 6, 1993); FDIC, Board, OCC, OTS, Interagency Statement on Retail Sales of Non-Deposit Investment Products (Feb. 14, 1994)).

[2225] *See* Occupy the SEC at 165.

[2226] *See id.*

[2227] *See* final rule § 75.11(f).

[2228] *See* 12 U.S.C. 1851(d)(1)(G)(vi) and (h)(1).

[2229] For example, one commenter alleged that it would need to rebrand approximately 500 established funds if the final rule was not modified to exclude established and regulated funds in foreign jurisdictions. *See* Goldman (Covered Funds).

[2230] *See* final rule § 75.10(b)(1)(ii) and (c)(1).

[2231] *See* Part VI.B.1.g.

the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[2232] This allows an individual employed by a banking entity, who also acts as fund manager or adviser (for example), to acquire or retain an ownership interest in a covered fund that aligns the manager or adviser's incentives with those of the banking entity's customers.[2233]

One commenter argued that only employees or directors who provide investment advisory services should be allowed to make an investment in the fund and that the rule should not allow employees or directors who provide other, unspecified services to invest in a fund.[2234] This commenter argued that the proposed rule would allow non-adviser banking entity employees who have no need to maintain ''skin in the game'' to earn profit on the fund's performance. According to another commenter, fiduciary clients of banking organizations often are less interested in whether the fund manager or other service providers have money in the fund than whether the client's own account manager, and those individuals above him/her who are responsible for investment decisions, have allocated his or her own assets in the same way and into the same general asset classes and funds as the client's fiduciary account is being allocated.[2235]

The more prevalent view among commenters was that the proposed rule should be revised and expanded to permit investments in a sponsored fund by a broader group of banking entity directors, officers, and employees, directly or indirectly through employee benefit programs or trust and fiduciary accounts, regardless of whether the individual provides services to the covered fund.[2236] Some commenters argued that narrowly limiting permissible director and employee investments could put asset managers affiliated with an insured depository institution at a competitive disadvantage relative to managers that are not affiliated with an insured depository institution,[2237] as well as make it more difficult for banking entities to offer their U.S. and non-U.S. employees similar choices in retirement plans.[2238]

Two commenters urged that the supervisors of a fund's portfolio managers or investment advisers should be permitted to invest.[2239] These commenters also argued that individuals who provide support services to the fund, including administrative, oversight and risk management, legal compliance, regulatory, product structuring, deal sourcing and origination, deal evaluation and diligence, investor relations, sales and marketing, tax, accounting, valuation and other operational support services, should be permitted to invest in the fund. These commenters also requested confirmation that any director, including an individual serving on the board or investment committee of a fund or its manager, should be permitted to invest.[2240] Another commenter argued that employees and directors should be permitted to make their own individual investment decisions independently without regard to whether they provide services to the covered fund.[2241] One commenter contended that a grandfathering approach is necessary to address situations where a pre-existing covered fund already has investments from directors and employees who do not directly provide services to the fund because the fund may be unable to force those individuals out of the fund.[2242]

A number of commenters argued that, if defined too narrowly, this restriction may conflict with the laws of other jurisdictions that require advisers and/or their directors and employees to invest in the funds they manage.[2243] For example, several commenters argued that this requirement will directly conflict with the European Alternative Investment Fund Managers Directive.[2244] Two commenters contended that certain jurisdictions, including the Netherlands, require directors and other personnel of fund managers to hold fund units or shares of funds managed by the fund manager as part of their pensions.[2245]

The final rule retains the requirement limiting the ownership of a covered fund by directors and employees of a banking entity (or an affiliate thereof) relying on the exemption in section 13(d)(1)(G) of the BHC Act.[2246] This limitation is imposed by statute on banking entities that rely on this exemption. If a director or employee does not provide services to the fund, they may not invest in that fund. As in the statute, the final rule allows employees who provide services to the fund other than investment advisory services to invest in the fund. Under the final rule, directors or employees who provide investment advice or investment management services to the fund may invest in that fund. Similarly, directors or employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services, may also invest in the fund. In response to comments, the final rule has been modified to make clear that a former director or employee may retain an interest in a covered fund if the director or employee acquired the interest while serving as a director or employee of the banking entity and providing investment advisory or other services to the covered fund.

The Agencies believe that many of the concerns raised by commenters regarding the effects of this limitation on foreign funds are addressed through the scope of foreign funds that will be covered funds, and revisions to the exemption provided for covered fund activities and investments that occur solely outside of the United States. Moreover, the final rule excludes foreign public funds and broad-based foreign pension funds from the definition of covered fund and they are thus not subject to the restrictions of section 13 or the final rule.[2247]

Section 13 clearly contemplates investments by certain employees and directors of the banking entity.[2248] However, the Agencies continue to believe that certain director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in section 13(d)(4) of the BHC Act and the final rule. In order to address this concern, the final rule attributes an ownership interest in a

[2232] *See* 12 U.S.C. 1851(d)(1)(G)(vii); proposed rule § 75.11(g).

[2233] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2234] *See* Occupy.

[2235] *See* Arnold & Porter.

[2236] *See* Arnold & Porter; BOK, Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011); PEGCC; T. Rowe Price.

[2237] *See* Credit Suisse (Williams).

[2238] *See* T. Rowe Price.

[2239] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2240] *See* Credit Suisse (Williams); Fin. Services Roundtable (Jun. 14, 2011).

[2241] *See* BOK (citing proposed rule at § 75.17); Arnold & Porter.

[2242] *See* SVB.

[2243] *See* EFAMA; BVI; IAA; ICI Global; JPMC; Union Asset.

[2244] *See* Annex II para. 1(m). Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers.

[2245] *See* EFAMA; Union Asset.

[2246] *See* final rule § 75.11(g).

[2247] *See* final rule §§ 75.10(c)(1) and 75.10(c)(5).

[2248] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

covered fund acquired or retained by a director or employee to a banking entity for purposes of the investment limits in section 13(d)(4) under certain circumstances. This attribution is discussed in detail below in Part VI.B.3.f.

7. Disclosure Requirements

Section 75.11(h) of the proposed rule required that, in connection with organizing and offering a covered fund, the banking entity clearly and conspicuously disclose, in writing, to prospective and actual investors in the covered fund that any losses in the covered fund will be borne solely by investors in the covered fund and not by the banking entity and its affiliates or subsidiaries; and that the banking entity's and its affiliates' or subsidiaries' losses in the covered fund will be limited to losses attributable to the ownership interests in the covered fund held by the banking entity and its affiliates or subsidiaries in their capacity as investors in the covered fund. In addition, the proposed rule required that a banking entity disclose, in writing: (i) that each investor should read the fund offering documents before investing in the covered fund; (ii) that the ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case); and (iii) the role of the banking entity and its affiliates, subsidiaries, and employees in sponsoring or providing any services to the covered fund. The proposed rule also required banking entities to comply with any additional rules of the appropriate Agency designed to ensure that losses in any covered fund are borne solely by the investors in the covered fund and not by the banking entity.[2249] In proposing the rule, the Agencies indicated that a banking entity may satisfy these disclosure requirements by making the required disclosures in the covered fund's offering documents.[2250]

A few commenters supported the disclosure requirement as effective and consistent with the statute.[2251] One commenter stated that the disclosures required in section 13(d)(1)(G)(viii) of the Act and the proposed rule are consistent with disclosures in the banking agencies' February 1994 ''Interagency Statement on Retail Sales of Non-deposit Investment Products'' and other FINRA and SEC guidance.[2252] One commenter suggested that the rule include a requirement that the disclosures be issued in plain English.[2253]

Another commenter argued that the Agencies should revise the disclosure requirements under the proposal so that offering materials of non-U.S. funds provided to non-U.S. investors outside the United States need not include the specified disclosures nor refer to the FDIC or other specific U.S. agencies.[2254] This commenter argued that a non-U.S. person investing in a non-U.S. fund offered or sponsored by a non-U.S. banking entity has no expectation that the fund or its interests would be insured by the FDIC. The Agencies believe this concern is addressed through the revised definition of covered fund, which generally provides that a foreign fund offered outside of the United States will only be a covered fund with respect to a U.S. banking entity (including a foreign affiliate of the U.S. banking entity) that acts as sponsor to, or invests in, the fund.[2255]

The final rule adopts the proposed disclosure requirements substantially as proposed. As explained above, these disclosures are largely required by the statute.[2256] The proposed requirement to disclose that ownership interests in a covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity (unless that happens to be the case) is not expressly required by the statute. However, section 13(d)(1)(G)(iii) permits the Agencies to impose additional rules designed to ensure that losses in a covered fund are borne solely by investors in the fund and not by a banking entity. The Agencies believe that requiring a banking entity to make this disclosure as part of organizing and offering a covered fund furthers this purpose by removing the potential for misperception that a covered fund sponsored by a banking entity (which by definition must be affiliated with a depository institution insured by the FDIC) is guaranteed by that insured institution or the FDIC. Moreover, as noted above, this disclosure is already commonly provided by banking entities.

b. Organizing and Offering an Issuing Entity of Asset-Backed Securities

To the extent that an issuing entity of asset-backed securities is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o–11) which requires a banking entity to retain and maintain a certain minimum interest in certain asset-backed securities.[2257] In order to give effect to this separate requirement under the Dodd-Frank Act, § 75.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under the provisions of that Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2258] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2259] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2260]

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides an exemption that permits a banking entity to organize and offer a

[2249] 12 U.S.C. 1851(d)(1)(G)(viii); proposed rule § 75.11(h).

[2250] To the extent that any additional rules are issued to ensure that losses in a covered fund are borne solely by the investors in the covered fund and not by the banking entity, a banking entity would be required to comply with those as well in order to satisfy the requirements of section 13(d)(1)(G)(viii) of the BHC Act.

[2251] *See, e.g.,* Occupy.

[2252] *See* Arnold & Porter.

[2253] *See* Occupy.

[2254] *See* Katten (on behalf of Int'l Clients).

[2255] *See* final rule § 75.10(b)(1)(iii).

[2256] *See* 12 U.S.C. 1851(d)(1)(G)(viii).

[2257] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. *See* Credit Risk Retention, 78 FR 57928 (Sept. 20, 2013).

[2258] *See* proposed rule § 75.14(a)(2)(iii).

[2259] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2260] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

covered fund that is an issuing entity of asset-backed securities.[2261] The Agencies have determined to provide this exemption in order to address the unique circumstances and ownership structures presented by securitizations.[2262] Under the final rule, a banking entity may permissibly organize and offer a covered fund that is an issuing entity of asset-backed securities so long as the banking entity (and its affiliates) comply with all of the requirements of § 75.11(a)(3) through (a)(8).[2263] As discussed above, the requirements of § 75.11(a)(3) through 75.11(a)(8) are that: (i) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § 75.12 of the final rule;[2264] (ii) the banking entity and its affiliates comply with the requirements of § 75.14 of the final rule; (iii) the banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (iv) the covered fund, for corporate, marketing, promotional, or other purposes, does not share the same name or variation of the same name with the banking entity (or an affiliate thereof) and does not use the word ''bank'' in its name; (v) no director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund except under the limited circumstances noted in the final rule; and (vi) the banking entity complies with the disclosure requirements regarding covered funds in the final rule.

The Agencies believe that the requirements of the exemption for organizing and offering a covered fund that is an issuing entity of asset-backed securities, which are in most aspects consistent with the exemption for organizing and offering a covered fund in section 13(d)(1)(G), provide limitations on a banking entity's securitization activities involving covered funds that are consistent with the limitations imposed with respect to organizing and offering a covered fund that is not an issuing entity of asset-backed securities. For instance, a banking entity may not share the same name as a covered fund that is an issuing entity of asset-backed securities and is prohibited from guaranteeing or otherwise ''bailing out'' a covered fund that is an issuing entity of asset-backed securities, including being required to comply with section 13(f) of the BHC Act regarding covered transactions with the covered fund. Furthermore, like a banking entity's investment in any covered fund, the final rule limits the ability of a banking entity to invest in a covered fund that is an issuing entity of asset-backed securities unless it meets the requirements of § 75.12.

Unlike many other covered funds, the Agencies understand that banking entities might not act in a fiduciary capacity when they organize and offer a covered fund that is a securitization vehicle. For instance, as part of organizing and offering a securitization vehicle, one or more parties may typically organize and initiate the securitization by selling or transferring assets, either directly or indirectly, to an issuing entity of asset-backed securities. An entity that provides these services typically does so as a service to provide investors and the entity's customers with the ability to invest in the assets in a manner and to a degree that they may otherwise be unable to do. In order to identify certain activities that would be included as organizing and offering a securitization, the final rule provides that organizing and offering an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, for the issuer, or acquiring or retaining an ownership interest in the issuer in compliance with the implementing regulations issued under section 15G of that Act.

The final rule reflects, as discussed above, that one or more parties that organize and offer an issuing entity of asset-backed securities may not provide any of the services identified in § 75.11(a)(1). In this case the banking entity is not required to comply with § 75.11(a)(1) or (a)(2). Section 75.11(b) of the final rule is designed to address situations where, as discussed above, a banking entity does not act in a fiduciary capacity when it organizes and offers a covered fund that is a securitization vehicle. With respect to any securitization vehicle that retains a collateral manager for investment advice regarding the assets of the securitization vehicle, such a collateral manager would be required to comply with all of the provisions of § 75.11(a) to acquire and retain an ownership interest in such securitization vehicle.

The final rule therefore both identifies certain activities that would be included as organizing and offering a securitization and modifies the requirements of § 75.11 to reflect differences between securitizations and other types of covered funds, as discussed above. The Agencies believe, therefore, that the final rule appropriately addresses the type of activity that is usually associated with organizing and offering a securitization and also comports with the manner in which Congress chose to define the type of parties engaged in activities that merit special attention related to issuing entities of asset-backed securities in another part of the Dodd-Frank Act.

The Agencies have determined to provide this exemption by using their authority in section 13(d)(1)(J) of the BHC Act and believe that this exemption promotes and protects the safety and soundness of banking entities and the financial stability of the United States. Many companies and other entities utilize securitization transactions to efficiently manage, allocate and distribute risks throughout the markets in a manner consistent with meeting the demands of their investors. Companies also utilize securitizations in order to help provide liquidity to certain asset classes or portions of the market that, absent this liquidity, may experience decreased liquidity and increased costs of funding. For instance, if banking entities were not permitted to organize and offer a securitization, the Agencies believe this would result in increased costs of funding or credit for many businesses of all sizes that are engaged in activities that section 13 of the BHC Act was not designed to address. Additionally, this exemption enables banking entities to acquire and retain ownership interests in a covered fund to comply with section 15G of the Exchange Act, which requires certain parties to a securitization transaction to retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. The Agencies therefore have determined that this exemption will promote and protect the safety and soundness of banking entities and the financial stability of the United States by facilitating the benefits securitizations can provide as discussed above, and also by enabling banking

[2261] *See* final rule § 75.11(b).

[2262] As used in this **SUPPLEMENTARY INFORMATION**, the term ''securitization'' means a transaction or series of transactions that result in the issuance of asset-backed securities.

[2263] *See* final rule § 75.11(b) (providing the requirements for a banking entity that is organizing and offering a covered fund that is an issuing entity of asset-backed securities by reference to the requirements of § 75.11(a), as discussed above).

[2264] As explained in detail below in Part VI.B.3. addressing the limitations on investments in covered funds by a banking entity, the final rule permits a banking entity to acquire and retain ownership interests in a covered fund in order to comply with section 15G of the Exchange Act (15 U.S.C.78o–11) in an amount that does not exceed the amount required to comply with the banking entity's chosen method of compliance under section 15G and the implementing regulations issued thereunder.

entities to comply with section 15G of the Exchange Act.

The Agencies believe it would not be consistent with the safety and soundness of banking entities or the financial stability of the United States to prevent banking entities from acquiring or retaining ownership interests in securitizations as part of the permitted activity of organizing and offering securitizations or from meeting any applicable requirements related to securitizations, including those imposed under section 15G of the Exchange Act. The Agencies note that the exemption for organizing and offering a securitization does not relieve banking entities of any requirements that they may be subject to with respect to their investments in or relationships with a securitization, such as any applicable requirements regarding conflicts of interest relating to certain securitizations under section 27B of the Securities Act of 1933.

c. Underwriting and Market Making for a Covered Fund

Section 13(d)(1)(B) permits a banking entity to purchase and sell securities and other instruments described in 13(h)(4) in connection with certain underwriting or market making-related activities.[2265] The proposal did not discuss how this exemption applied in the context of underwriting or market making of ownership interests in covered funds.

Commenters argued that the scope of the permitted activities under sections 13(d)(1)(B), (D) and (F), which respectively set out permitted activities of underwriting and market making-related activities, activities on behalf of customers, and activities by a regulated insurance company, apply to all of the activities prohibited under section 13(a), whether those activities would involve proprietary trading or ownership of or acting as a sponsor to covered funds.[2266] Commenters argued that the statutory exemption for underwriting and market making-related activities is applicable to both proprietary trading and covered fund activities, and recommended that the final rule allow banking entities to hold ownership interests and other securities of covered funds for the purpose of underwriting and engaging in market making-related activities.[2267] Commenters noted that many structured finance vehicles rely on sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and argued that, without a market making exemption for securities of covered funds, banking entities would be unable to engage in customer-driven underwriting and market making activity with respect to securities issued by entities such as collateralized loan obligation issuers and non-U.S. exchange-traded funds.[2268]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to provide a covered fund specific provision for underwriting and market making-related activities of ownership interests in covered funds. These underwriting and market making activities are within the scope of permitted activities under the final rule so long as:

- The banking entity conducts the activities in accordance with the requirements of § 75.4(a) or § 75.4(b), respectively;
- With respect to any banking entity (or an affiliate thereof) that: acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on § 75.11(a); acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § 75.11(b); or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § 75.12(a)(2)(ii) and § 75.12(d); and
- With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § 75.11, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities under § 75.11(c), are included in the calculation of all ownership interests under § 75.12(a)(2)(iii) and § 75.12(d).[2269]

The Agencies believe that providing a separate provision relating to permitted underwriting and market making-related activities for ownership interests in covered funds is supported by section 13(d)(1)(B) of the BHC Act.[2270] The exemption for underwriting and market making-related activities under section 13(d)(1)(B), by its terms, is a statutorily permitted activity and exemption from the prohibitions in section 13(a), whether on proprietary trading or on covered fund activities. Applying the statutory exemption in this manner accommodates the capital raising activities of covered funds and other issuers in accordance with the underwriting and market making provisions under the statute.

The final rule provides that a banking entity must include any ownership interests that it acquires or retains in connection with underwriting and market making-related activities for a particular covered fund for purposes of the per-fund limitation under § 75.12(a)(2)(ii) if the banking entity: (i) Acts as a sponsor, investment adviser or commodity trading advisor to the covered fund; (ii) otherwise acquires and retains an ownership interest in the covered fund as permitted under § 75.11(a); (iii) acquires and retains an ownership interest in the covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act, or is acquiring and retaining an ownership interest in the covered fund in compliance with section 15G of that Act and the implementing regulations issued thereunder each as permitted by § 75.11(b); or (iv) directly or indirectly guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests. This is designed to prevent any unintended

[2265] *See* 12 U.S.C. 1851(d)(1)(B).

[2266] *See* Cleary Gottlieb *et al.;* JPMC; Credit Suisse (Williams).

[2267] *See* BoA; Cleary Gottlieb; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Deutsche Bank (Fund-Linked Products); SIFMA (Securitization) (Feb. 2012). Other commenters argued that application of Section 13(f) of the BHC Act would prohibit the underwriting and market making by a banking entity of the securities of a covered fund that such banking entity sponsors, organizes and offers or provides investment management advice or services because Section 13(f) of the BHC Act prohibits the purchase of securities by a banking entity from such a covered fund. *See, e.g.,* ASF (Feb. 2012); Cleary Gottlieb; Credit Suisse (Williams); SIFMA (Securitization) (Feb. 2012); FSA (Feb. 2012).

[2268] *See* JPMC; Cleary Gottlieb.

[2269] *See* final rule § 75.11(c).

[2270] A discussion of the implementation of section 13(d)(1)(D) and (F) with regard to the final rule's limitations on covered fund investments and activities is provided in the section that relates to permitted covered fund interests and activities by a regulated insurance company and § 75.13(c) of the final rule.

expansion of ownership of covered funds by banking entities that are subject to the per fund limitations under § 75.12.

These banking entities will have a limited ability to engage in underwriting or market making-related activities for a covered fund for which the banking entity's investments are subject to the per-fund limitations in § 75.12 as discussed above. Such a banking entity will have more flexibility to underwrite and make a market in the ownership interests of such a covered fund in connection with organizing and offering the covered fund during the fund's seeding period, since during the seeding period a banking entity may own in excess of three percent of the covered fund, subject to the other requirements in § 75.12.

The final rule also provides that all banking entities that engage in underwriting and market-making related activities in covered funds are required to include the aggregate value of all ownership interests of the banking entity in all covered funds acquired and retained under § 75.11, including in connection with underwriting and market making-related activities under § 75.11(c), in the calculation of the aggregate covered fund ownership interest limitations under § 75.12(a)(2)(iii) (and make the associated deduction from tier one capital for purposes of calculating compliance with applicable regulatory capital requirements).[2271]

Some commenters asked that the Agencies permit banking entities to engage in market making and underwriting in non-sponsored covered fund interests.[2272] The final rule permits a banking entity that does not hold an ownership interest in the covered fund in reliance on §§ 75.11(a) or 75.11(b) of the final rule, is not a sponsor of the covered fund, is not an investment adviser or commodity trading advisor to the covered fund, and does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such fund invests to rely on the market-making and underwriting exemption in § 75.11(c) provided that the banking entity meets all of the requirements of that exemption. These conditions include the aggregate funds limitation and the capital deduction contained in § 75.12 after including all ownership interest held by the banking entity and its affiliates under § 75.11, including ownership interests acquired or retained under the exemption for underwriting and market making-related activities in § 75.11(c). In accordance with section 13(d)(1) of the BHC Act, the Agencies have determined that these restrictions on reliance on the market-making and underwriting exemption provided by section 13(d)(1)(B) are appropriate to address the purposes of section 13 of the BHC Act, which is aimed at assuring that banking entities do not bail-out a covered fund and maintain sufficient capital against the risks of ownership of covered funds. The Agencies note, however, that the guarantee restriction is not intended to prevent a banking entity from entering into arrangements with a covered fund that are not entered into for the purpose of guaranteeing the obligations or performance of the covered fund. For example, this restriction is not intended to prohibit a banking entity from entering into or providing liquidity facilities or letters of credit for covered funds; however, it would apply to arrangements such as a put of the ownership interest in the covered fund to the banking entity. The determination of whether an arrangement would fall within this guarantee restriction would depend on the facts and circumstances.

The Agencies emphasize that any banking entity that engages in underwriting or market making-related activities in covered funds must comply with all of the conditions applicable to such activity as set forth in section §§ 75.4(a) and 75.4(b).[2273] Thus, holdings of a single covered fund would be subject to limitations on risk as well as length of holding period, among other applicable limitations and requirements. These requirements are designed specifically to address a banking entity's underwriting and market making-related activities and to prohibit holding exposures in excess of reasonably expected near term demand of clients, customers and counterparties.

3. Section 75.12: Permitted Investment in a Covered Fund

a. Proposed Rule

Section 75.12 of the proposed rule implemented section 13(d)(4) of the BHC Act and described the limited circumstances under which a banking entity may acquire or retain an ownership interest in a covered fund that the banking entity (which includes its subsidiaries and affiliates) organizes and offers.[2274] Section 13(d)(4)(A) of the BHC Act permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers for the purpose of: (i) Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors; or (ii) making a *de minimis* investment in the fund, subject to several limitations. Section 13(d)(4)(B) of the BHC Act requires that investments by a banking entity in a covered fund must, not later than one year after the date of establishment of the fund, be reduced to an amount that is not more than three percent of the total outstanding ownership interests of the fund. Consistent with the statute, § 75.12 of the proposal provided that, after expiration of the seeding period, a banking entity's investment in a single covered fund may not represent more than three percent of the total outstanding ownership interests in the covered fund (the ''per-fund limitation'').[2275] In addition, as provided in the statute, the proposal provided that the total amount invested by a banking entity in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (the ''aggregate funds limitation'').[2276]

b. Duration of Seeding Period for New Covered Funds

Commenters argued that it is essential to serving their customers efficiently that a banking entity be permitted to acquire and retain an ownership interest in a covered fund that it organizes and offers as a *de minimis* investment or for the purpose of establishing the fund. A number of commenters contended that a banking entity typically invests a limited amount of its own capital in a fund (''seed capital'') as part of organizing the fund to produce investment performance as a record of the fund's investment strategy (''track record'').[2277] Once a track record for the fund is established, the banking entity markets the fund to unaffiliated investors.

Commenters argued that the one-year seeding period provided in the proposed rule would be too short to establish a track record for many types of covered funds. Commenters argued that the duration of the track record investors typically demand before investing in a new fund depends on a number of factors (*e.g.,* the type of fund,

[2271] *See* final rule § 75.11(c)(3).

[2272] *See* Cleary Gottlieb; Credit Suisse (Williams).

[2273] *See* final rule § 75.11(c)(1).

[2274] 12 U.S.C. 1851(d)(4); proposed rule § 75.12.

[2275] *See* proposed rule §§ 75.12(a)(1)(i); 75.12(a)(2)(i)(A) and (B); 75.12(b).

[2276] *See id.* at §§ 75.12(a)(1)(ii); 75.12(a)(2)(ii); 75.12(c).

[2277] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); T. Rowe Price; Credit Suisse (Williams); Allen & Overy (on behalf of Canadian Banks);TCW.

investment strategy, and potential investors). According to commenters, an inability to demonstrate a track record over multiple years may reduce the allocation of capital by investors who are unable to gain an understanding of the investment strategy, risk profile, and potential performance of the fund.[2278]

Commenters provided alternative suggestions regarding how to define the start of the seeding period for purposes of applying the statutory exception for investments during the seeding period. For example, two commenters recommended that the Agencies treat a private equity fund as being established on the date on which the fund begins its asset-acquisition phase and is closed to new investors, and a hedge fund as established on the date on which the fund has reached its target amount of funding and begins investing according to the fund's stated investment objectives.[2279] Another commenter suggested that the permitted seeding period begin on the date on which third-party investors are first admitted to the fund.[2280]

Several commenters expressed concern that the per-fund limitation could be subject to evasion unless the Agencies require that the seeding period begin at the time funds are first invested by the banking entity in the fund.[2281] Some of these commenters suggested the Agencies impose a dollar cap of $10 million on the seed capital that a banking entity may provide to a newly organized covered fund in addition to the statutory limits based on the amount of the fund's shares and the amount of the banking entity's tier 1 capital.[2282] These commenters argued that an explicit quantitative limit better accounted for the size of some banking entities, which otherwise made the potential amount of capital placed in covered funds quite large.[2283]

The Agencies have considered carefully the comments on the proposal and have made several modifications to the final rule to more clearly explain how the limitations apply during the seeding period. The final rule continues to provide that a banking entity may invest in a covered fund that it organizes and offers either in connection with establishing the fund, or as a *de minimis* investment.[2284] Importantly, the statute does not permit a banking entity to invest in a covered fund unless the banking entity organizes or offers the covered fund or qualifies for another exemption. As explained more fully in the discussion of § 75.11 above, a wide variety of activities are encompassed in organizing and offering a covered fund. Under the statute, which generally prohibits investments in covered funds, a banking entity may invest in a covered fund under the exemptions provided in section 13(d)(1) of the BHC Act, including section 13(d)(1)(G) and the provisions of section 13(d)(4), only if the banking entity engages in one or more of these permitted activities with regard to that covered fund and complies with all applicable limitations under the final rule regarding investments in a covered fund.

As noted above, the statute allows a banking entity to acquire and hold all of the ownership interests in a covered fund for the purpose of establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors.[2285] However, the statute also imposes a limit on the duration of an investment made in connection with seeding a covered fund. At the end of that period, the investment must conform to the limits on *de minimis* investments set by the statute. In keeping with the terms of the statute, the final rule, like the proposal, allows banking entities a seeding period of one-year for all covered funds. The statute also allows the Board to extend that period, upon an application by a banking entity, for two additional years if the Board finds an extension to be consistent with safety and soundness and in the public interest.[2286] As explained below, the final rule, like the proposal, incorporates this process and sets forth the factors the Board will consider when determining whether to allow an extended seeding period. The Board and the Agencies will monitor these extension requests to ensure that banking entities do not seek extensions for the purpose of evading the restrictions on covered funds or to engage in prohibited proprietary trading.

As noted above, the proposal did not specify ''date of establishment,'' and commenters suggested a variety of dates that could serve as the date of establishment for purposes of determining the duration of the seeding period and the per-fund limitations on ownership interests in a covered fund.[2287] After considering comments received on the proposal, the Agencies have modified the final rule to include a definition of ''date of establishment'' for a covered fund. In general, the date of establishment is the date on which an investment adviser or similar party begins to make investments that execute an investment or trading strategy for the covered fund. The Agencies perceive the act of making investments to execute an investment or trading strategy as demonstrating that the fund has begun its existence and is no longer simply a plan or proposal. In order to account for the unique circumstances and manner in which securitizations are established, for a covered fund that is an issuing entity of asset-backed securities, the date of establishment under the final rule is the date on which the assets are initially transferred into the issuing entity of the asset-backed securities. This is the date that the entity is formed and the securities are generally sold around this time. The Agencies believe this is the appropriate time for the date of establishment for securitizations because this is the date that the securitization risks are transferred to the owners of the securitization vehicle. Once the assets have been transferred, the securitization has been established and securities of the issuer may typically be priced in support of organizing and offering the issuer. Setting a later time, such as when the fund becomes fully subscribed or the assets have been fully assembled, could permit a banking entity to engage in prohibited proprietary trading under the guise of waiting for investors that may never materialize.[2288]

The statute also requires a banking entity to actively seek unaffiliated investors to reduce or dilute the entity's ownership interest to the amount permitted under the statute. This requirement is included in the final

[2278] *See et al.* (Covered Funds) (Feb. 2012); *see also* Ass'n of Institutional Investors (Feb. 2012); Bank of Montreal et al. (Jan. 2012); Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Japanese Bankers Ass'n; SSgA (Feb. 2012); T. Rowe Price; Union Asset. One commenter argued that this limitation would constrain portfolio composition of a covered fund due to an inability of a fund to raise sufficient capital to make larger investments. *See* Credit Suisse (Williams).

[2279] *See* AFG; Union Asset.

[2280] *See* SIFMA (Mar. 2012); *see also* Credit Suisse (Williams).

[2281] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2282] *See* Occupy; Sens. Merkley & Levin (Feb. 2012); *see also* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2283] *See, e.g.,* Public Citizen.

[2284] *See* final rule § 75.12(a)(1).

[2285] 12 U.S.C. 1851(d)(4).

[2286] *See id.* at 1851(d)(4)(C).

[2287] *See* SIFMA *et al.* (Mar. 2012); Credit Suisse (Williams); EFAMA: Hong Kong Inv. Funds Ass'n; AFG; Union Asset.

[2288] Importantly, the statute recognizes that a banking entity may need more than the automatic one-year seeding period to build a track record and/or market its interests to unaffiliated investors; therefore, a banking entity may apply for an extension of the seeding period as provided in 75.12(e) of the final rule as discussed below in Part VI.B.3.h.

rule, and underscores the nature of covered fund activities under section 13(d)(1)(G) as a method to provide investment advisory, trust and fiduciary services to customers rather than allow the banking entity to engage in prohibited proprietary trading. To effectuate the requirements of the statute, under the final rule, banking entities that organize and offer a covered fund must develop and document a plan for offering shares in the covered fund to other investors and conforming the banking entity's investments to the *de minimis* limits to help monitor and ensure compliance with this requirement.

While certain commenters requested that the final rule include a quantitative dollar limit on the amount of funds a banking entity may use to organize and offer a covered fund, the Agencies have declined to add this limitation in the final rule. This type of limit is not required by statute. Moreover, the Agencies believe that imposing a strict dollar limit may not adequately permit banking entities to employ trading or investment strategies that will attract unaffiliated investors, thereby precluding banking entities from meeting the demands of customers contrary to the purpose of section 13.

c. Limitations on Investments in a Single Covered Fund (''Per-Fund Limitation'')

Section 13(d)(4)(B) imposes limits on the amount of ownership interest a banking entity may have in any single covered fund at the end of the one year period (subject to limited extension) after the date of establishment of the fund (the ''seeding period''). In recognition of the fact that a covered fund may have multiple classes or types of ownership interests with different characteristics or values, the proposal required that a banking entity apply the limits to both the total value of and total amount of the banking entity's ownership interest in a covered fund.

The proposed rule required a banking entity to calculate the per-fund limitation using two methods. First, a banking entity was required to calculate the value of its investments and capital contributions made with respect to any ownership interest in a single covered fund as a percentage of the value of all investments and capital contributions made by all persons in that covered fund. Second, a banking entity was required to determine the total number of ownership interests held by the banking entity in a single covered fund as a percentage of the total number of ownership interests held by all persons in that covered fund.[2289] Both calculations were required to be done without regard to committed funds not yet called for investment. The proposed rule also required the banking entity to calculate the value and amount of its ownership interest in each covered fund in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests.[2290] These calculations were designed to ensure that the banking entity's investment in a covered fund could not result in more than three percent of the losses of the covered fund being allocated to the banking entity's investment.[2291]

Commenters did not generally object to calculating the per-fund limitation based on both number and value of ownership interests. Several commenters urged the Agencies to allow a banking entity to value its investment in a covered fund based on the acquisition cost of the investment, instead of fair market value, notwithstanding the manner in which the covered fund accounts for or values investments for its shareholders generally.[2292] One commenter suggested that the Agencies allow a banking entity to choose between acquisition cost and fair value so long as the chosen valuation method is applied consistently to both the numerator and denominator when calculating the per-fund limitation.[2293]

To the extent that an issuer of an asset-backed security is a covered fund, the investment limitations contained in section 13(d)(4) of the BHC Act also would limit the ability of a banking entity to acquire or retain an investment in that issuer. Section 941 of the Dodd-Frank Act added a new section 15G of the Exchange Act (15 U.S.C. 78o-11) which requires certain parties to a securitization transaction, including banking entities, to retain and maintain a certain minimum interest in certain issuers or asset-backed securities.[2294] In order to give effect to this separate requirement under the Dodd-Frank Act, § 75.14(a)(2) of the proposed rule permitted a banking entity that is a ''securitizer'' or ''originator'' under that provisions of the Act to acquire or retain an ownership interest in an issuer of asset-backed securities, in an amount (or value of economic interest) required to comply with the minimum requirements of section 15G of the Exchange Act and any implementing regulations issued thereunder.[2295] The proposal also permitted a banking entity to act as sponsor to the securitization.

Commenters expressed a variety of views on the treatment of interests in securitizations held under risk retention pursuant to the proposed rule. Some commenters argued that the proposal was effective as written and represented a reasonable way to reconcile the two sections of the Dodd-Frank Act consistent with the risk-reducing objective of section 13 of the BHC Act.[2296] Other commenters also supported the proposal's recognition that banking entities may be required to hold a certain amount of risk in a securitization that would also be a covered fund, but argued that the proposed exemption was too narrow.[2297] Some commenters argued that the exemption should be broadened to permit a banking entity to hold in excess of the minimum amount required under section 15G of the Exchange Act instead of allowing only the minimum amount required by that section.[2298] One commenter requested that the final rule permit a banking entity to hold an amount of risk in a securitization that is commensurate with what investors demand rather than the minimum required by section 15G.[2299] Some commenters argued that banking entities may be subject to similar generally applicable requirements to hold risk in securitizations under foreign law, such as Article 122a of the Capital Requirements Directive issued by the European Union, and that the final rule should permit banking entities to comply with these foreign legal requirements.[2300]

Conversely, a few commenters objected to the proposed rule's exemption for risk-retention as unclear and argued that if the exemption was

[2289] *See* proposed rule § 75.12(b)(2).

[2290] *See* proposed rule § 75.12(b)(4).

[2291] *See* Joint Proposal, 76 FR at 68904.

[2292] *See* ABA (Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2293] *See* ABA (Keating) (alleging that this is similar to the SEC's approach to the definition of venture capital fund for the purposes of being exempt from investment advisor registration).

[2294] The relevant agencies issued a proposed rule to implement the requirements of section 15G of the Exchange Act, as required under section 941 of the Dodd-Frank Act. *See* Credit Risk Retention, 76 FR 24090 (Apr. 29, 2011). Those agencies recently issued a re-proposal of the risk-retention requirements. See *Credit Risk Retention,* 78 FR 57928 (Sept. 20, 2013).

[2295] *See* proposed rule § 75.14(a)(2)(iii).

[2296] *See* Sens. Merkley & Levin (Feb. 2012); Alfred Brock.

[2297] *See, e.g.,* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2298] *See* AFME *et al.;* SIFMA (Securitization) (Feb. 2012); JPMC; BoA.

[2299] *See* BoA.

[2300] *See* AFME *et al.;* Allen & Overy (on behalf of Foreign Bank Group); SIFMA (Securitization) (Feb. 2012); BoA.

retained, the Agencies should provide that any amounts held by a banking entity in a securitization that exceed the minimum required to satisfy section 15G of the Exchange Act should count towards the aggregate funds limitation of the banking entity.[2301] One commenter argued that the final rule should impose higher capital charges for interests held in these securitizations due to concerns that securitizations involve heightened risks due to the complexity of their ownership structure.[2302]

The Agencies have carefully considered the comments received and are adopting the calculation requirements for the per-fund limitation as proposed with several modifications, including modifications designed to address the unique characteristics and ownership structure of securitizations. The final rule, like the proposal, requires that a banking entity calculate its per-fund investment limit in covered funds that are not issuing entities of asset-backed securities based on both the value of its investments and capital contributions in and to each covered fund and the total number of ownership interests it has in each covered fund. A banking entity's investment (including investments by its affiliates) may not exceed either three percent of the value of the covered fund or three percent of the number of ownership interests in the covered fund at the end of the seeding period. The Agencies continue to believe that requiring the per-fund limitation to be calculated based on these two measures best effectuates the terms and purpose of the per-fund limitation in the statute. Together, these measures ensure that a banking entity's exposure to and ownership of each covered fund is limited. Each measure alone could provide a distorted view of the banking entity's ownership interest and could be more easily manipulated, for example by issuing ownership interests with high value or special governance provisions. As discussed in more detail below, the final rule contains a separate method for calculating the value of investments in issuing entities of asset-backed securities due to the fact that these entities do not have a single class of security and thus, the valuation of the ownership interests cannot be made on a per interest or single class basis.

The per-fund limitation on ownership interests must be measured against the total ownership interests of the covered fund, as defined in § 75.10 of the final rule and as discussed above in Part VI.B.1.e. In determining the amount of ownership interests held by the banking entity and its affiliates, the banking entity must include an ownership interest permitted under §§ 75.4 and 75.11 of the final rule.[2303] Additionally, any banking entity that acts as underwriter or market-maker for ownership interests of a covered fund must do so in compliance with the limitations of §§ 75.4(a) and 75.4(b) of the final rule, including the limits on the amount, types, and risk of the underwriting position or market-maker inventory as well as in compliance with the per-fund limitation, as applicable, and the aggregate funds limitations and capital deduction in the final rule. The Agencies expect to monitor these activities to ensure that a banking entity does not engage in underwriting or market making-related activity in a manner that is inconsistent with the limitations of the statute and the final rule.[2304]

The final rule requires that the value of the ownership interests and contributions made by a banking entity in each covered fund (that is not an issuing entity of an asset-backed security) be the fair market value of the interest or contribution. The Agencies have determined to use fair market value as the measurement of value for the per-fund value limitation in order to ensure comparability with the investments made in the covered fund by others and limit the potential that the valuation measure can be manipulated (for example by altering the percentage of gains and losses that are associated with a particular ownership interest). A banking entity should determine fair market value for purposes of the final rule, including the calculation of both the per-fund and aggregate funds limitations, in a manner that is consistent with its determination of the fair market value of its assets for financial statement purposes and that fair market value would be determined in a manner consistent with the valuations reported by the relevant covered fund unless the banking entity determines otherwise for purposes of its financial statements and documents the reason for any disparity. If fair market value cannot be determined, then the value shall be the historical cost basis of all investments and capital contributions made by the banking entity to the covered fund. The final rule also requires that, once a valuation method is chosen, the banking entity calculate the value of its investments and the investments of all others in the covered fund for purposes of the per-fund limitation in the same manner and according to the same standards.[2305] This approach is intended to ensure that, for purposes of calculating the per-fund limitation, a banking entity does not calculate its investment in a covered fund in a manner more favorable to the banking entity than the method used by the covered fund for valuing the investments made by others. Under the final rule and as explained in more detail below, any ownership interest acquired or retained by an employee or director of the banking entity is attributed to the banking entity for purposes of the per-fund limitation if the banking entity financed the purchase of the ownership interest. Additionally, any amount contributed or paid by a banking entity or its employee to obtain an ownership interest in connection with obtaining the restricted profit interest must be included in calculating compliance with the per-fund and aggregate funds limitations (*See* Part VI.B.1.e. above).[2306]

In determining the per-fund limitation for purposes of § 75.12 of the final rule, the banking entity should use the same methodology for valuing its investments and capital contributions as the banking entity uses to prepare its financial statements and regulatory reports.[2307] In particular, the fair market value of a

[2301] *See* Occupy.

[2302] *See* Sens. Merkley & Levin (Feb. 2012).

[2303] As discussed above in Part VI.B.2.c., the per-fund limitation does not apply to ownership interests held by a banking entity that acts as market maker or underwriter in accordance with § 75.11(c) of the final rule, so long as the banking entity does not also organize and offer, or act as sponsor, investment adviser or commodity trading advisor to, the fund, or, with respect to ownership interests in issuing entities of asset-backed securities, is not a securitizer who continues to own ownership interests or is not an entity that holds ownership interests in compliance with Section 15G of the Exchange Act and the implementing regulations adopted thereunder; however, the banking entity that is acting as market maker or underwriter that is not subject to the per-fund limitation must still comply with the other requirements set forth in §§ 75.4(a) and 75.4(b), respectively, and any other applicable requirements set out in § 75.11(c).

[2304] The Agencies note that if a banking entity acts as investment adviser or commodity trading advisor to a covered fund and shares the same name or variation of the same name with the fund, then that banking entity would be a sponsor and therefore subject to the limitations of section 13(f).

[2305] In the context of securitizations, the final rule similarly provides that the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all other investors in the covered fund in the same manner and according to the same standards.

[2306] *See* Part VI.B.1.e.

[2307] For example, a depository institution or bank holding company should use the same methodology as used in the Report of Condition and Income (Call Report) for depository institutions and the Consolidated Financial Statements for Holding Companies (FR Y–9C) for bank holding companies, respectively.

banking entity's investments and any capital contributions made to a covered fund should be the same for purposes of § 75.12 of the final rule as reported on the banking entity's financial statements and regulatory reports. Similarly, if fair market value of all investments in and capital contributions cannot be determined for purposes of § 75.12 of the final rule, then the banking entity should use the same methodology to calculate the historical cost basis of the investments and any capital contributions as the banking entity uses to prepare its financial statements and regulatory reports. The Agencies will review carefully the methodology that a banking entity uses to calculate the value of its investments in and capital contributions made to covered funds as part of the process to monitor compliance with the final rule.

The Agencies expect that for the majority of covered funds, the party that organizes and offers the fund or otherwise exercises control over the fund will provide a standard methodology for valuing interests in the fund. However, the Agencies understand that for some covered funds, including issuing entities of asset backed securities, there may be multiple parties that organize and offer the fund that each utilize a different methodology or standard for calculating the value of ownership interests of the fund. Going forward, the Agencies expect that in these circumstances the parties that organize and offer the covered fund will work together or select a responsible party to determine a single standard by which all ownership interests in the covered fund will be valued.

One commenter suggested the Agencies count both invested funds and committed funds not yet called for investment towards the per-fund limitation.[2308] This commenter argued that a banking entity has already contractually allocated committed-yet-uncalled funds to the covered fund and that depositors face a risk of loss for such funds if the covered fund fails.

The final rule, like the proposal, does not count committed-yet-uncalled funds towards the per-fund limitation; instead, it counts funds once they are invested. This approach reflects the fact that these funds may never be called while at the same time ensuring that the banking entity must comply with the per-fund limitation once the funds are called. The Agencies note that a banking entity is prohibited from guaranteeing or bailing out a covered fund that the banking entity or one of its affiliates organizes and offers by the terms of the statute and the final rule and, accordingly, would not be permitted to provide committed funds to a covered fund in a manner inconsistent with the limitations in the statute and final rule.

After carefully considering the comments received on the proposal, as well as the language and purpose of section 13 of the BHC Act, the final rule provides that, for purposes of applying the per-fund limitation to an investment in a covered fund that is an issuing entity of an asset-backed security, the ownership interest held by the banking entity and its affiliates generally may not exceed three percent of the fair market value of the ownership interests of the fund as measured in accordance with § 75.12(b)(3), unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder. A banking entity may rely on any of the options available to it in order to meet the requirements of section 15G, but for purposes of section 13 of the BHC Act and this rule, the amount held by the banking entity may not exceed the amount required under the chosen option. Under the final rule, if a banking entity's investment in a covered fund is held pursuant to the requirements of section 15G of the Exchange Act, the banking entity must calculate the amount and value of its ownership interest for purposes of the per-fund limitation as of the date and according to the same valuation methodology applicable pursuant to the requirements of that section and the implementing regulations issued thereunder.

While the amount retained in compliance with section 15G of the Exchange Act and the implementing regulations issued thereunder may permit a banking entity to own more than three percent of the ownership interests in a securitization that is a covered fund, this approach is appropriate to reconcile the competing policies of section 13 of the BHC Act and section 15G of the Exchange Act which requires that a securitizer of certain securitizations retain a minimum of five percent of the risk of the securitization. Congress enacted these two apparently conflicting provisions in the same Act, and the Agencies believe the more specific section regarding risk retention in securitizations was intended to prevail over the more general restriction on ownership of covered funds (which applies to a broader range of entities). The Agencies believe that the risk limitation goals of section 13 of the BHC Act are met by satisfying the minimum requirement of an applicable option under section 15G of the Exchange Act as the maximum initial investment limit, and applying the other limitations discussed in this section governing aggregate investment in covered funds and capital deductions.

As under the proposal, if a banking entity does not have a minimum risk retention requirement, that banking entity would remain subject to the limitations of section 13(d)(4) of the BHC Act and § 75.12 on the amount of ownership interests it may hold in an issuing entity of asset-backed securities. A banking entity may not combine the amounts under these provisions to acquire or retain ownership interests in a securitization that exceed the aggregate permissible amounts.

Some commenters requested that the Agencies coordinate implementation of any exemption for risk-retention requirements under section 13 of the BHC Act with the issuance of rules implementing section 15G of the Exchange Act. The Agencies note that rules implementing section 15G have been proposed but not yet finalized, but the Agencies will review the interaction between the rules promulgated under section 13 of the BHC Act and section 15G of the Exchange Act once the rules under section 15G are finalized. Regardless of any action that may be taken regarding rules implementing section 15G, the final rule permits banking entities to own ownership interests in and sponsor covered funds as discussed above.

Some commenters also requested that the final rule provide an exemption to permit banking entities to comply with any risk retention requirement imposed under foreign law that is similar to section 15G of the Exchange Act. The Agencies are not revising the rule to permit banking entities to own ownership interests required to be retained pursuant to risk retention-type requirements under foreign law. The Agencies are providing the exemption for the required ownership arising from the risk retention provisions under section 15G of the Exchange Act in order to reconcile the requirements under the Dodd-Frank Act applicable to ownership of securitization interests; however, the Agencies do not believe at this time that such reconciliation is appropriate with respect to foreign law

[2308] *See* Occupy.

risk retention-type requirements and those requirements should not prevail over the purpose of section 13 of the BHC Act to reduce banking entities' exposure to risks from investments in covered funds.

The Agencies also note that the definition of covered fund has been modified to exclude certain foreign public funds and also any foreign fund that is not owned or sponsored by a U.S. banking entity. Moreover, the final rule permits foreign banking entities to engage in covered fund activities and investments that occur solely outside of the United States without regard to the investment limitations of section 13(d)(4) of the BHC Act and § 75.12 of the final rule, which may include retaining risk in a securitization to the extent required under foreign law. In these manners, the final rule permits foreign banking entities to comply with requirements under foreign law that govern their securitization activities or investments abroad. However, as noted above, section 13 of the BHC Act applies to the global operations of U.S. banking entities and, as such, U.S. banking entities' investments in foreign securitizations that are covered funds would remain subject to the investment limitations of section 13(d)(4) and § 75.12 of the final rule.

The proposed rule provided that a banking entity must comply with both measures of the per-fund limitation at all times. The preamble to the proposal explained that the Agencies expected a banking entity to calculate its per-fund limitation no less frequently than the frequency with which the fund performs such calculation or issues or redeems interests, and in no case less frequently than quarterly.[2309]

Several commenters requested that the Agencies modify the frequency of this calculation and monitoring requirement to a standard quarterly basis.[2310] These commenters argued that, although some covered funds may provide daily liquidation and redemption rights to investors, monitoring the per-fund limitation on a continuous basis would be costly and burdensome and would not provide a significant offsetting benefit.

The Agencies continue to believe that for covered funds other than issuing entities of asset-backed securities the per-fund limitations apply to investments in covered funds at all times following the end of the seeding period. However, to relieve burden and costs, while also setting a minimum recordkeeping standard, the final rule has been modified to require that a banking entity calculate the amount and value of its ownership interests in covered funds other than issuing entities of asset-backed securities quarterly.[2311] The Agencies believe that this change will assist in reducing unnecessary costs and burdens in connection with calculating the per-fund limitation, particularly for smaller banking entities, and will also facilitate consistency with the calculation for the aggregate funds limitation (which is also determined on a quarterly basis). Nevertheless, should a banking entity become aware that it has exceeded the per-fund limitation for a given fund at any time, the Agencies expect the banking entity to take steps to ensure that the banking entity complies promptly with the per-fund limitation.[2312]

The Agencies have also modified the timing and methodology of the per-fund limitation as it applies to securitizations to address the unique circumstances and ownership structure presented by securitizations, which typically wind down over time. Unlike many other covered funds, securitizations do not generally experience increases in the amount of investors or value of ownership interests during the life of the securitization; rather, they generally experience only a contraction of the investor base and reduction in the total outstanding value of ownership interests on an aggregate basis, and may do so at different rates under the terms of the transaction agreements, meaning that the percentage of ownership represented by a particular ownership interest may increase as the fund amortizes but without the banking entity adding any funds. The manner in which securitizations are organized and offered, as well as the amortization of securitizations, differs from many other covered funds; section 15G of the Exchange Act also requires that certain parties to securitization transactions, which may include banking entities, retain a minimum amount of risk in a securitization, a requirement not applicable to covered funds that are not securitizations. Therefore, for purposes of calculating a banking entity's per-fund limitation with respect to a securitization, the calculation of the per-fund limitation shall be based on whether section 15G applies and the implementing regulations are effective. In the case of an ownership interest in an issuing entity of an asset-backed security that is subject to section 15G of the Exchange Act and for which effective implementing regulations have been issued, the calculation of the per-fund limitation shall be made as of the date and pursuant to the methodology applicable pursuant to the requirements of section 15G of the Exchange Act and the implementing regulations issued. For securitizations executed after the effective date of the final rule and prior to the adoption and implementation of the rules promulgated under section 15G of the Exchange Act and for securitizations for which a fair valuation calculation is not required by the implementing rules promulgated under section 15G of the Exchange Act, the per fund limitation is calculated as of the date on which the assets are initially transferred into the issuing entity of the asset-backed securities or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered fund.[2313] This calculation for issuers of asset backed securities is only required to be performed once on the date noted above, and thereafter only upon the date on which the price of additional securities of the covered fund to be sold to third parties is determined.

As noted above, the per-fund limitations for ownership interests in issuing entities of asset-backed securities are calculated based only on the value of the ownership interest in relation to the value of all ownership interests in the issuing entity of the asset-backed security and are not calculated on a class by class, or tranche by tranche basis. For purposes of the valuation, the aggregate value of all the assets that are transferred to the issuing entity of the asset-backed securities, and any assets otherwise held by the issuing entity, are determined based on the valuation methodology used for determining the value of the assets for financial statement purposes. This valuation will be the value of the ownership interests in the issuing entity for purposes of the calculation. A banking entity will need to determine

[2309] *See* proposed rule § 75.12(b); Joint Proposal, 76 FR at 68904.

[2310] *See, e.g.,* ABA (Keating); Credit Suisse (Williams); JPMC.

[2311] *See* final rule § 75.12(b)(2)(i) and (ii). For covered funds that are an issuing entity of asset-backed securities, recalculation of the banking entity's permitted ownership for purposes of the per-fund limitation is not required unless the covered fund sells additional securities.

[2312] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(I).

[2313] In addition, although some commenters requested that banking entities be able to hold more than the minimum required by section 15G, the Agencies are not revising the per fund limitation in that manner. One of the purposes of section 13 of the BHC Act is to reduce banking entities' exposure to risks from investments in covered funds, and the Agencies believe at this time that permitting banking entities to retain risk exposure to the covered fund in excess of the minimum required to be retained would contradict the purposes of section 13 of the BHC Act.

its percentage ownership in the issuing entity based on the its contributions to the entity in relation to the contributions of all parties and after taking into account the value of any residual interest in the issuing entity. In addition, for purposes of the final rule, the asset valuation is as of the date of establishment (the date of the asset transfer to the issuing entity of the asset-backed securities).

d. Limitation on Aggregate Permitted Investments in All Covered funds (''Aggregate Funds Limitation'')

In addition to the per-fund limitation, section 13(d)(4) of the BHC Act provides that the aggregate of a banking entity's investments in all covered funds may not exceed three percent of the tier 1 capital of the banking entity (referred to above as the ''aggregate funds limitation'').[2314] To implement this limitation, the proposed rule required a banking entity to determine the aggregate value of the banking entity's investments in covered funds by calculating the sum of the value of each investment in a covered fund, as determined in accordance with applicable accounting standards. This amount was then measured as a percentage of the tier 1 capital of the banking entity for purposes of determining compliance with the aggregate funds limitation. For purposes of applying the limit, a banking entity that is subject to regulatory capital requirements was required under the proposed rule to measure tier 1 capital in accordance with those regulatory capital requirements; a banking entity that is not a subsidiary of a reporting banking entity and that is not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency was required by the proposed rule to calculate its tier 1 capital based on the total amount of shareholders' equity of the top-tier entity as of the last day of the most recent calendar quarter, as determined under applicable accounting standards.

Commenters expressed a variety of views regarding the aggregate funds limitation. One commenter argued that basing the aggregate funds limitation on the size of tier 1 capital of a banking entity provides an advantage to the largest institutions with large absolute capital bases and disadvantages smaller banks that are well capitalized but have a smaller absolute capital base.[2315] This commenter urged the Agencies to permit all banking entities to invest in covered funds in an amount that is, in the aggregate, the greater of $1 billion (subject to prudential investment limitations and safety and soundness concerns), or three percent of tier 1 capital.[2316]

In contrast, other commenters urged the Agencies to decrease the statutory limit in order to prevent the largest banking entities from investing amounts that, while within the statutory limit, could be very large in absolute terms.[2317] One commenter argued that a loss of three percent of tier 1 capital would be a material loss reflected in a change in stock price.[2318] Another commenter suggested the Agencies consider whether the investment supports a large flow of management fees linked to market volatility or has significant embedded leverage.[2319]

Some commenters argued that the final rule should calculate the value of covered fund investments based on acquisition cost instead of fair market value.[2320] These commenters argued that using fair value to calculate the aggregate funds limitation penalizes banking entities for organizing and investing in successful funds and, conversely, would allow banking entities to increase investments in unsuccessful funds (the value of which would decline relative to the capital of the banking entity).

In contrast, another commenter argued that valuation of a covered fund investment should include any mark-to-market increase in a banking entity's aggregate investments in order to keep pace with increases in the capital of the banking entity.[2321]

Some commenters discussing the frequency of the calculation of the aggregate funds limitation supported determining the aggregate funds limitation on the last day of each calendar quarter as required in the proposal.[2322] Other commenters argued that the statute requires compliance at all times rather than periodic calculations of compliance.[2323]

After consideration of the comments in light of the statutory provisions, the Agencies have adopted the requirements for calculating the aggregate funds limitation as proposed with several modifications as explained below. Under the final rule, the aggregate value is the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in each covered fund (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), as measured on a historical cost basis. This aggregate value is measured against the total applicable tier 1 capital for the banking entity as explained below.

For purposes of determining the aggregate funds limitation, the final rule requires that the value of investments made by a banking entity be calculated on a historical cost basis. This approach limits the aggregate amount of funds a banking entity may provide to covered funds as a percentage of the banking entity's capital as required by statute. At the same time, this approach does not permit a banking entity to increase its exposure to covered funds in the event any investment in a particular covered fund declines in value as a result of the fund's investment activities. Permitting a banking entity to increase its aggregate investments as covered funds lose value would permit the banking entity both to increase its exposure to covered funds at the same time the covered funds it already owns are losing value and to effectively bail-out investors by providing additional capital to troubled covered funds. Neither of these actions is consistent with the purposes of section 13 of the BHC Act. Moreover and as explained below, because the final rule requires that the banking entity deduct from the entity's capital the greater of historical cost (plus earnings) or fair market value of its investments in covered funds, the deduction accounts for any profits resulting from investments in covered funds.

Historical cost basis means, with respect to a banking entity's ownership interest in a covered fund, the sum of all amounts paid or contributed by the banking entity to a covered fund in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest)), less any amounts received as a redemption, sale or distribution of such ownership interest or restricted profit interest. Under the final rule, any reduction of the historical cost would not generally include gains or losses, fees, income, expenses or similar items. However, as noted above, the final rule also requires that a banking entity deduct any earnings from its tier 1 capital even if it values its ownership interests in a covered fund pursuant to historical cost.

The concern expressed by commenters that the aggregate funds

[2314] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(II).

[2315] *See* ABA (Abernathy).

[2316] *See, e.g.,* ABA (Abernathy).

[2317] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2318] *See* Public Citizen.

[2319] *See* AFR *et al.* (Feb. 2012).

[2320] *See* ABA(Keating); BoA; Arnold & Porter; BOK; Scale; SVB.

[2321] *See* Occupy.

[2322] *See* ABA (Keating).

[2323] *See* AFR *et al.* (Feb. 2012); Occupy.

limitation should account for increases in the fair market value of covered funds is addressed in other ways under the final rule. In particular, the final rule requires that for purposes of calculating compliance with regulatory capital requirements the banking entity deduct from the entity's capital the greater of fair market value (or historical cost plus earnings) of its investment in each covered fund; thus, profits resulting from investments in covered funds will not inflate the capital of the banking entity for regulatory compliance purposes. Moreover, as explained above, the per-fund limitation is generally based on fair market value, which maintains the relative level of a banking entity's investment in each covered fund.

As noted above, the aggregate funds limitation applies to all investments by a banking entity in a covered fund that the banking entity or an affiliate thereof holds under §§ 75.4 and 75.11 of the final rule. The limitation would also apply to investments by a banking entity made or held during the seeding period as part of organizing and offering a covered fund, including ownership interests held in order to satisfy the requirements of section 15G of the Exchange Act, as well as ownership interests held by a banking entity in the capacity of acting as underwriter or market-maker.

As under the proposal, this calculation must be made as of the last day of each calendar quarter, consistent with when tier 1 capital is reported by banking entities to the Agencies. Because compliance with the aggregate funds limitations is calculated based on tier 1 capital, the Agencies believe it is more appropriate to require the calculation to be performed on the same schedule as tier 1 capital is reported. While the aggregate funds limitation must be calculated on a quarterly basis, the Agencies expect banking entities to monitor investments in covered funds regularly and remain in compliance with the limitations on covered fund investments throughout the quarter. The Agencies intend, through their respective supervisory processes, to monitor covered fund investment activity to ensure that a banking entity is not attempting to evade the requirements of section 13.

The Agencies recognize that banks with large absolute capital bases will be able to place a greater amount of capital in covered funds compared to banks with small absolute capital bases. However, the amount of risk exposure to a covered fund, despite their different investment strategies, will be relatively similar across banking entities, which is consistent with the language and risk-limiting purpose of section 13.

e. Capital Treatment of an Investment in a Covered Fund

Section 13(d)(4)(B)(iii) of the BHC Act provides that, for purposes of determining compliance with applicable capital standards under section 13(d)(3) of that Act, the aggregate amount of outstanding investments by a banking entity under section 13(d)(4), including retained earnings, must be deducted from the assets and tangible equity of the banking entity, and the amount of the deduction must increase commensurate with the leverage of the covered fund.[2324] Section 13(d)(3) authorizes the Agencies, by rule, to impose additional capital requirements and quantitative limitations, including diversification requirements on any of the activities permitted under section 13 of the BHC Act if the Agencies determine that such additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities engaged in such activities.[2325]

The proposed rule implemented the capital deduction provided for under section 13(d)(4)(B)(iii) of the BHC Act by requiring a banking entity to deduct the aggregate fair value of its investments in covered funds, including any attributed profits, from tier 1 capital. As in the statute, the proposed rule applied the capital deduction to ownership interests in covered funds held as an investment by a banking entity pursuant to the provisions of section 13(d)(4) of the BHC Act, and not to ownership interests acquired under other permitted authorities, such as a risk-mitigating hedge under section 13 of the BHC Act. The proposed rule required the deduction to be calculated consistent with the method for calculating other deductions under the applicable risk-based capital rules. The proposed rule did not otherwise adopt additional capital requirements and quantitative limitations under section 13(d)(3) of the BHC Act.

Some commenters supported the proposed dollar-for-dollar deduction from tier 1 capital of a banking entity's aggregate investments in covered funds and asserted it is consistent with the statute.[2326] One of these commenters urged the Agencies to rely on their authority under section 13(d)(3) of the BHC Act to apply the capital deduction to other permitted ownership interests in covered funds to protect the safety and soundness of the banking entity.[2327] In contrast, other commenters urged the Agencies to eliminate the capital deduction for investments in covered funds and questioned the Agencies' statutory authority to impose the capital deduction.[2328] These commenters argued that the statute does not authorize or require the Agencies to require banking entities to deduct their investments in covered funds for purposes of calculating capital pursuant to the applicable capital rules. According to these commenters, section 13 only requires deductions for purposes of determining compliance with applicable capital standards under section 13 and argued the Agencies did not make the necessary safety and soundness findings under section 13(d)(3) to impose additional capital requirements on any activities permitted under section 13(d)(1).[2329] One commenter urged the Agencies to make any capital adjustment as part of the banking agencies' broader efforts to implement the Basel III capital framework.[2330] Another commenter urged the Agencies to apply the capital deduction only for purposes of determining a banking entity's compliance with the aggregate funds limitation and not for other regulatory capital purposes.[2331] This commenter also argued that a capital deduction is normally not required for assets reflected on a bank's consolidated balance sheet, and that the Agencies should not require a deduction for a covered fund investment that is not consolidated with the banking entity for financial reporting purposes under GAAP.[2332] Some commenters urged the Agencies to apply the capital deduction only to a banking entity's investment in a covered fund that the banking entity organizes and offers and not to ownership interests otherwise permitted to be held under section 13 of the BHC Act.[2333]

Several commenters addressed the manner for valuing an investment subject to the deduction. One commenter urged the Agencies to permit a banking entity to calculate the deduction based on the acquisition cost, instead of the fair market value, of the banking entity's ownership interest in

[2324] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[2325] *Id.* at 1851(d)(3).

[2326] *See* Occupy.

[2327] *See* Occupy.

[2328] *See* ABA (Keating); BNY Mellon *et al.;* PNC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2329] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2330] *Id.*

[2331] *See* ABA (Keating).

[2332] *See* ABA (Keating); *see also* letter from PNC.

[2333] *See* Arnold & Porter; SVB.

the covered fund.[2334] This commenter emphasized that valuing the investment at fair market value would penalize a banking entity if the covered fund performs well by reducing the amount of capital available for additional covered fund investments but reduce the capital charge against troubled investments. One commenter argued that the Agencies did not perform an appropriate cost-benefit analysis of the deduction in the proposed rules.[2335]

Other commenters sought clarification on how the capital deduction would apply to a foreign banking organization. Several commenters argued that the capital deduction should not apply to a foreign banking entity that calculates its tier 1 capital under the standards of its home country.[2336] These commenters argued that imposing a capital deduction requirement on foreign banks would not be consistent with past practices on the application of U.S. risk-based capital requirements to foreign banking organizations.

The Agencies have carefully considered the comments in light of the statutory provisions requiring a capital deduction. The statute requires that the aggregate amount of outstanding investments by a banking entity, including retained earnings, be deducted from the assets and tangible equity of the banking entity.[2337] This requirement is independent of the minimum regulatory capital requirements in the final capital rule published by the Federal Banking agencies in 2013 (''regulatory capital rule'').[2338]

The Federal Banking agencies recognize that the regulatory capital rule imposes risk weights and deductions that do not correspond to the deduction for covered fund investments imposed by section 13 of the BHC Act. The Federal Banking agencies intend to review the interaction between the requirements of this rule and the requirements of the regulatory capital rule and expect to propose steps to reconcile the two rules.

At the same time, the Agencies believe that the dollar-for-dollar deduction of the fair market value of a banking entity's investment in a covered fund is appropriate to protect the safety and soundness of the banking entity, as provided in section 13(d) of the BHC Act. This approach ensures that a banking entity can withstand the failure of a covered fund without causing the banking entity to breach the minimum regulatory capital requirements. Consistent with the language and purpose of section 13 of the BHC Act, this deduction will help provide that a banking entity has sufficient capital to absorb losses that may occur from covered fund investments without endangering the safety and soundness of the banking entity or the financial stability of the United States.

Accordingly, under the final rule, a banking entity must, for purposes of determining compliance with applicable regulatory capital requirements, deduct the greater of (i) the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(b)(6)(ii)), on a historical cost basis, including earnings or (ii) the fair market value of the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(b)(6)(ii)), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.[2339] This deduction must be made whenever the banking entity calculates its tier 1 capital, either quarterly or at such other time at which the appropriate Federal banking agency may request such a calculation. Requiring a banking entity to deduct the greater of historical cost or fair market value of all covered fund investments made by a banking entity from the entity's tier 1 capital should result in an appropriate deduction that is consistent with the manner in which the banking entity accounts for its covered fund investments. For instance, if a banking entity accounts for its investments in covered funds using fair market value, then any changes in the fair market value of the banking entity's investment in a covered fund should similarly be reflected in the banking entity's tier 1 capital. Thus, this deduction should not unduly penalize banking entities for making successful investments or allow more investments in troubled covered funds.

The final rule does not require a foreign banking entity that makes a covered fund investment in the United States, either directly or through a branch or agency, to deduct the aggregate value of the investment from the foreign bank's tier 1 capital calculated under applicable home country standards. However, any U.S. subsidiary of a foreign banking entity that is required to calculate tier 1 capital under U.S. risk based capital regulations must deduct the aggregate value of investment held through that subsidiary from its tier 1 capital.

While some commenters requested that additional capital charges be imposed on banking entity's interests in securitizations, the Agencies have declined to do so at this time. Under the final rule, the banking entity must deduct the value of its investment in a securitization that is a covered fund from its tier 1 capital for purposes of determining compliance with the applicable regulatory capital requirements. This requirement already requires the banking entity to adjust its capital for the possibility of losses on the full amount of its investment. The Agencies do not believe that it is appropriate to impose additional capital charges on these securitizations because it would act as a disincentive to retain risk in securitizations for which the banking entity acts as issuer or sponsor, a result that would contradict the purpose of section 15G of the Exchange Act. Additionally and as noted in the proposal, permitting a banking entity to retain the minimum level of economic interest and risk in a securitization will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

The Agencies have also declined to impose additional quantitative limitations or diversification requirements on covered fund investments at this time. The Agencies believe that the per-fund and aggregate funds limitations, as well as the capital deduction required by the rule, acting together with the other limitations on covered fund activities, establish an appropriate framework for ensuring that the covered fund investments and activities of banking entities are conducted in a manner that is safe and sound and consistent with financial stability. The Agencies will continue to monitor these activities and investments

[2334] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2335] *Id.*

[2336] *See* IIB/EBF.

[2337] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[2338] *See* 78 FR 62018, 62072 (Oct. 11, 2013) (Board/OCC/FDIC Basel III Final Rule); 78 FR 55340, 55391 (Sept. 10, 2013) (FDIC Basel III interim final rule).

[2339] *See* 12 CFR part 208, subpart D and appendixes A, B, E, and F; 12 CFR part 217 (to be codified), and 12 CFR part 225, appendixes A, D, E, and G; *see also* 12 CFR 240.15c3–1 (net capital requirements for brokers or dealers).

to determine whether other limitations are appropriate over time.

f. Attribution of Ownership Interests to a Banking Entity

The proposed rule attributed an ownership interest to a banking entity based on whether or not the banking entity held the interest through a controlled entity. The proposed rule required that any ownership interest held by any entity that is controlled, directly or indirectly, by a banking entity be included in the amount and value of the banking entity's permitted investments in a single covered fund. The proposed rule required that the *pro rata* share of any ownership interest held by any covered fund that is not controlled by the banking entity, but in which the banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares, be included in the amount and value of the banking entity's permitted investments in a single covered fund.

Many commenters expressed concerns regarding the proposed attribution requirements.[2340] These commenters argued that the proposed *pro rata* attribution requirements are not required or permitted by the statute, have unintended and inconsistent consequences for covered fund investments, impose heavy compliance costs on banking entities, and would impede the ability of funds sponsored by banking entities to invest in third-party funds for the benefit of clients. Some commenters argued that the costs and complexity of determining whether a banking entity ''controls'' another banking entity under the BHC Act and the Board's precedent are high and urged the Agencies to adopt a simpler test.[2341] For example, some commenters urged that shares of a company be attributed to a banking entity only when the banking entity maintains ownership of 25 percent or more of voting shares of the company.[2342]

Several commenters maintained that applying the attribution requirements to fund-of-funds structures and parallel or master-feeder structures would be unworkable.[2343] Commenters contended that the proposed attribution rules could result in a banking entity calculating the per-fund limitation in a way that exceeds the banking entity's actual loss exposure if the attribution rule for controlled investments is interpreted to require that 100 percent of all investments made by controlled entities be attributed to the banking entity.[2344]

In addition, several commenters argued that the *pro rata* attribution of investments held through non-controlled structures is not consistent with the Board's rules and practices for purposes of the activity and investment limits in other sections of the BHC Act. Commenters also maintained that this *pro rata* attribution for non-controlled entities would be impracticable because a banking entity has only a limited ability to monitor, direct, or restrain investments of a covered fund that it does not control.[2345]

Conversely, one commenter supported the *pro rata* attribution requirement in the proposal. This commenter argued that this requirement reduced opportunities for evasion through subsidiaries, affiliates or related entities.[2346]

The final rule has been modified in light of the comments. Under the final rule, a banking entity must account for an investment in a covered fund for purposes of the per-fund and aggregate funds limitations only if the investment is made by the banking entity or another entity controlled by the banking entity. Accordingly, the final rule does not generally require that a banking entity include the *pro rata* share of any ownership interest held by any entity that is not controlled by the banking entity, and thus reduces the potential compliance costs of the final rule. The Agencies believe that this concept of attribution is more consistent with how the Board has historically applied the concept of ''control'' under the BHC Act for purposes of determining whether a company subject to that Act is engaged in an activity or whether to attribute an investment to that company. Furthermore, because a banking entity does not control a non-affiliate and typically has less access to information about the holdings of a non-affiliate, this change is unlikely to present opportunity for circumvention of the per-fund and aggregate funds limitations. The Agencies will monitor these limitations for practices that appear to be attempts to circumvent them.[2347]

Whether a banking entity controls another entity under the BHC Act may vary depending on the type of entity in question. As noted above in Part VI.B.1.b.3., the Board's regulations and orders have long recognized that the concept of control is different for funds than for operating companies.[2348] In contrast to the proposal, the final rule incorporates these different concepts of control in part by providing that, for purposes of section 13 of the BHC Act and the final rule, a registered investment company, SEC-regulated business development company, and a foreign public fund as described in § 75.10(c)(1) of the final rule will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority.[2349]

In response to commenter concerns regarding the workability of the proposed rule, the final rule has been modified to address how ownership interests would be attributed to a banking entity when those interests are held in a fund-of-funds or multi-tiered fund structures. For instance, banking entities may use a variety of structures to satisfy operational needs or meet the investment needs of customers of their trust, fiduciary, investment advisory or commodity trading advisory services.

First, except as explained for purposes of calculating a banking entity's permitted investment in multi-tier fund structures, the final rule does not generally attribute to a banking entity ownership interests held by a covered fund so long as the banking

[2340] *See* ABA (Keating); Arnold & Porter; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012).

[2341] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BlackRock; Arnold & Porter.

[2342] *See* ABA (Keating); Arnold & Porter.

[2343] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); SSgA (Feb. 2012). These commenters argued that banking entities traditionally utilize a fund-of-funds structure to offer customers the opportunity to invest indirectly in a portfolio of other funds (including some funds sponsored and managed by one or more third parties) and that these structures provide customers with certain risk-mitigating benefits and allow customers to gain exposure to a diverse portfolio without having to satisfy the minimum investment requirements of each fund directly. They also argued that parallel and feeder entities are established for a variety of client-driven reasons, including to accommodate tax needs of clients and that these entities should be viewed as a single investment program in which the master fund holds and manages investments in portfolio assets and the feeder fund typically makes no investments other than in the master fund.

[2344] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA; Arnold & Porter; SSgA (Feb. 2012).

[2345] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2346] *See* Occupy.

[2347] The Agencies note that other provisions of the BHC Act and Savings and Loan Holding Company Act would prohibit a banking entity that is a bank holding company or savings and loan holding company from acquiring 5 percent or more of a covered fund that is itself a bank holding company or a savings and loan holding company, respectively, without regulatory approval. *See* 12 U.S.C. 1842(a); 12 U.S.C. 1467a(e).

[2348] *See, e.g.,* First Union Letter.

[2349] *Id. See* final rule § 75.12(b)(1)(ii).

entity's investment in the covered fund meets the per-fund limitation in the final rule.[2350] Absent unusual circumstances or structures, a banking entity would not control a covered fund in which the banking entity has an ownership interest that conforms to the per-fund and aggregate funds limitations contained in the final rule. Thus, the interests held by that covered fund would not be attributed to the banking entity for the reasons discussed above.

The final rule also explains how the investment limitations apply to investments of a banking entity in multi-tier fund structures. The Agencies believe that master-feeder fund structures typically constitute a single investment program in which the master fund holds and manages investments and the feeder funds typically make no investments other than in the master fund and exist as a convenience for customers of the trust, fiduciary, investment advisory, or commodity trading advisory services of the banking entity. Similarly, trust, fiduciary, or advisory customers of a banking entity may desire to obtain diversified exposure to a variety of funds or investments through investing in a fund-of-funds structure that the banking entity organizes and offers.

In order to meet the demands of these customers, the final rule provides that if the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the per-fund limitation the banking entity's permitted investment shall be measured only at the master fund. However, in order to appropriately capture the banking entity's amount of investment in the master fund, a banking entity must include in this calculation any investment held by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund.[2351]

Similarly, regarding fund-of-funds structures, the final rule provides that if a banking entity organizes and offers a covered fund pursuant to § 75.11 for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity organizes and offers, then the banking entity's permitted investment in that other covered fund shall include any investment held by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the other fund that is held through the fund of funds. The banking entity's investment in the fund of funds must also meet the investment limitations contained in § 75.12. In these manners, the final rule permit a banking entity to meet the demands of customers of their trust, fiduciary, or advisory services while also limiting the ability of a banking entity to be exposed to more than the amount of risk of a covered fund contemplated by section 13.

As described above in the discussion of organizing and offering a covered fund, other provisions of section 13 contemplate investments by employees and directors of the banking entity that provide qualifying services to a covered fund.[2352] The Agencies recognized in the proposal that employee and director investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire in a covered fund.[2353] In order to address this concern, the proposal attributed an ownership interest in a covered fund acquired or retained by a director or employee to the person's employing banking entity if the banking entity either extends credit for the purposes of allowing the director or employee to acquire the ownership interest, guaranteed the director or employee's purchase, or guarantees the director or employee against loss on the investment.

One commenter supported the way the proposal addressed evasion concerns by attributing an ownership interest in a covered fund acquired or retained by a director or employee to a banking entity.[2354] A different commenter urged the Agencies to attribute any employee investments in a covered fund to the banking entity itself, regardless of the source of funds.[2355] Another commenter argued that the statute prohibits a banking entity from guaranteeing an investment by an employee or director.[2356]

After considering the comments and the language of the statute, the Agencies have determined to retain the requirement that all director or employee investments in a covered fund be attributed to the banking entity for purposes of the per-fund limitation and the aggregate funds limitation whenever the banking entity provides the employee or director funding for the purpose of acquiring the ownership interest. Specifically, under the final rule, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.[2357] It is also important to note that the statute prohibits a banking entity from guaranteeing the obligations or performance of a covered fund in which it acts as investment adviser, investment manager or sponsor, or organizes and offers.[2358]

As discussed above in the definition of ownership interest, the final rule also attributes to the banking entity any amounts contributed by an employee or director when made in order to receive a restricted profit interest, whether or not funded or guaranteed by the banking entity. This approach ensures that all funding provided by the banking entity—whether directly or through its employees or directors—and all exposures of the banking entity—whether directly or through a guarantee provided to or on behalf of an employee or director—is counted against the limits on exposure contained in the statute and final rule. At the same time, this approach recognizes that employees and directors may use their own resources, not protected by the banking entity, to invest in a covered fund. Employees of investment advisers in particular often invest their own resources in covered funds they advise, both by choice and as a method to align their personal financial interests with those of other investors in the covered fund. So long as these investments are truly with personal resources, and are not funded by the banking entity, these personal investments would not expose the banking entity to loss and would not be attributed by the final rule to the banking entity. This approach is also consistent with the terms of the statute, which expressly contemplates investments by directors or employees of a banking entity in their individual capacity.[2359]

The Agencies intend to monitor investments by directors and employees of a banking entity to ensure that employee ownership interests are not

[2350] *See* final rule § 75.12(b)(1)(iii).

[2351] *See* final rule § 75.12(b)(34).

[2352] *See* 12 U.S.C. 1851(d)(1)(G)(vii); final rule § 75.11(g).

[2353] *See* Joint Proposal, 76 FR at 68902.

[2354] *See* Ass'n. of Institutional Investors (Feb. 2012).

[2355] *See* Occupy.

[2356] *See* Arnold & Porter.

[2357] *See* final rule § 75.12(b)(1)(iv).

[2358] *See* 12 U.S.C. 1851(f)(1).

[2359] *See* 12 U.S.C. 1851(d)(1)(G)(vii).

used to circumvent the per-fund and aggregate funds limitations in section 13. Among the factors the Agencies will consider, in addition to financing and guarantee arrangements, are whether the benefits of the acquisition and retention, such as dividends, inure to the benefit of the director or employee and not the banking entity; the voting or control of the ownership interests is subject to the direction of, or otherwise controlled by, the banking entity; and the employee or director, rather than the banking entity, determines whether the employee or director should make the investment.

The proposed rule contained a provision intended to curb potential evasion of the per-fund limitation and aggregate limitation through parallel investments by banking entities that were not otherwise subject to section 13 of the BHC Act. Specifically, the proposed rule provided that, to the extent that a banking entity is contractually obligated to invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment must be included in the calculation of a banking entity's per-fund limitation.

Several commenters objected to this requirement and argued that it was not consistent with the statute. These commenters argued that section 13 of the BHC Act restricts a banking entity's investments in covered funds, and not direct investments by a banking entity in individual companies under other authorities, such as the merchant banking investment authority in section 4(k)(4)(H) of the BHC Act.[2360] Some commenters argued that prohibiting or limiting direct investments could cause a conflict between a banking entity's fiduciary duty to its clients to manage their covered fund investments and the banking entity's duty to its shareholders to pursue legitimate merchant banking investments.[2361] Some commenters urged the Agencies not to attribute any parallel co-investment alongside a covered fund to a banking entity unless there is a pattern of evasion, and some requested that there be prior notice and an opportunity for a hearing to determine whether such a pattern has occurred.[2362] Another commenter recommended the Agencies provide a safe harbor for situations where a bank trustee is acting on behalf of customers.[2363]

In contrast, other commenters contended that the risks of direct investments, such as those made under merchant banking authority, are similar to those of many investments in covered funds. These commenters urged the Agencies to restrict direct investments in the underlying holdings or assets of a covered fund in the same manner as direct investments in covered funds.[2364]

After carefully considering the comments and the language of the statute, the Agencies have determined not to adopt the proposed prohibition on parallel investments in the final rule. As illustrated by commenters, banking entities rely on a number of investment authorities and structures to meet the needs of their clients and make investments under a variety of authorities that are not coordinated with investments made by covered funds owned or advised by the banking entity. The Agencies believe that many investments made by banking entities are made for the purpose of serving the legitimate needs of customers and shareholders, and not for the purpose of circumventing the per-fund and aggregate funds limitations in section 13.

Nevertheless, the Agencies continue to believe that the potential for evasion of these limitations may be present where a banking entity coordinates its direct investment decisions with the investments of covered funds that it owns or sponsors. For instance, the Agencies understand that it is relatively common for the sponsor of a covered fund in connection with a privately negotiated investment to offer investors co-investment opportunities when the general partner or investment manager for the covered fund determines that the covered fund does not have sufficient capital available to make the entire investment in the target portfolio company or determines that it would not be suitable for the covered fund to take the entire available investment. In such circumstances, a banking entity that sponsors the covered fund should not itself make any additional side by side co-investment with the covered fund in a privately negotiated investment unless the value of such co-investment is less than 3% of the value of the total amount co-invested by other investors in such investment. Further, if the co-investment is made through a co-investment vehicle that is itself a covered fund (a ''co-investment fund''), the sum of the banking entity's ownership interests in the co-investment fund and the related covered fund should not exceed 3% of the sum of the ownership interests held by all investors in the co-investment fund and related covered fund. Finally, the Agencies note that if a banking entity makes investments side by side in substantially the same positions as the covered fund, then the value of such investments shall be included for purposes of determining the value of the banking entity's investment in the covered fund.

g. Calculation of Tier 1 Capital

The proposal explained that tier 1 capital is a banking law concept that, in the United States, is calculated and reported by certain depository institutions and bank holding companies in order to determine their compliance with regulatory capital standards. Accordingly, the proposed rule clarified that for purposes of the aggregate funds limitation in § 75.12, a banking entity that is a bank, a bank holding company, a company that controls an insured depository institution that reports tier 1 capital, or uninsured trust company that reports tier 1 capital (each a ''reporting banking entity'') needed to use the reporting banking entity's tier 1 capital as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.

The proposal also recognizes that not all entities subject to section 13 of the BHC Act calculate and report tier 1 capital. In order to provide a measure of equality related to the aggregate funds limitation contained in section 13(d)(4)(B)(ii)(II) of the BHC Act and § 75.12(c) of the proposed rule, the proposed rule clarified how the aggregate funds limitation should be calculated for entities that are not required to calculate and report tier 1 capital in order to determine compliance with regulatory capital standards. Under the proposed rule, with respect to any banking entity that is not affiliated with a reporting banking entity and not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency, the banking entity's tier 1 capital for purposes of the aggregate funds limitation was the total amount of shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting

[2360] *See* 12 U.S.C. 1843(k)(4)(H); 12 CFR 225.170 *et seq. See* ABA (Keating); BoA; BOK; SIFMA *et al.* (Covered Funds) (Feb. 2012); SVB.

[2361] *See* ABA (Keating).

[2362] *See* BOK; SVB; ABA (Keating); BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2363] *See* BOK.

[2364] *See* Public Citizen; Sens. Merkley & Levin (Feb. 2012).

standards.[2365] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank), the aggregate funds limitation was the amount of tier 1 capital reported by such depository institution.[2366] For a banking entity that was not itself required to report tier 1 capital but was a subsidiary of a reporting banking entity that is not a depository institution (*e.g.,* a nonbank subsidiary of a bank holding company), the aggregate funds limitation was the amount of tier 1 capital reported by the top-tier affiliate of such banking entity that holds and reports tier 1 capital under the proposal.[2367]

Commenters did not generally object to the proposed approach for determining the applicable tier 1 capital for banking entities. One commenter advocated calculating the aggregate funds limitation based on the tier 1 capital of the banking entity making the covered fund investment instead of the tier 1 capital of the consolidated banking entity.[2368] In addition, the commenter urged the Agencies to require banking entities to divest any portions of the investment that exceeds 3 percent of that entity's tier 1 capital.

The final rule provides that any banking entity that is required to calculate and report tier 1 capital (a ''reporting banking entity'') must calculate the aggregate funds limitation using the tier 1 capital amount reported by the entity as of the last day of the most recent calendar quarter as reported to the relevant Federal banking agency. A non-depository institution subsidiary of a reporting banking entity may rely on the consolidated tier 1 capital of the reporting banking entity for purposes of calculating compliance with the aggregate funds limitation. In the case of a depository institution that is itself a reporting banking entity and that is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in covered funds held by the depository institution (including the investments by its subsidiaries) may not exceed three percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution. The final rule also provides that any banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is a depository institution (*e.g.,* a subsidiary of a national bank) may compute compliance with the aggregate funds limitations using the amount of tier 1 capital reported by such depository institution.

Several commenters argued that foreign banking organizations should be permitted to use the consolidated tier 1 capital at the top-tier foreign banking organization level, as calculated under applicable home country capital standards, to calculate compliance with the aggregate funds limitation.[2369] One commenter noted that the tier 1 capital of a banking entity may fluctuate based on specific conditions relevant only to the banking entity, and urged the Agencies to consider an alternative measure of capital, although this commenter did not suggest any alternative.[2370]

After considering the comments received and that purpose and language of section 13 of the BHC Act, the Agencies have determined that for foreign banking organizations, the aggregate funds limitation would be based on the consolidated tier 1 capital of the foreign banking organization, as calculated under applicable home country standards. However, a U.S. bank holding company or U.S. savings and loan holding company that is controlled by a foreign banking entity must separately meet the per-fund and aggregate funds limitations for each and all (respectively) covered fund investments made by the U.S. holding company, based on the tier 1 capital of the U.S. bank holding company or U.S. savings and loan holding company. The Federal banking agencies may revisit this approach in light of the manner in which the Board implements the enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies, including the proposed U.S. intermediate holding company requirements under that rule.[2371]

h. Extension of Time To Divest Ownership Interest in a Single Fund

The proposed rule provided that the Board may, upon application by a banking entity, extend the period of time that a banking entity may have to conform an investment to the 3 percent per-fund limitation. As in the statute, the proposed rule permitted the Board to grant up to an additional two years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. The proposal required a banking entity to submit an application for extension to the Board, and set forth the factors that the Board would consider in reviewing an application for extension, including a requirement that the Board consult with the primary Federal supervisory agency for the banking entity prior to acting on an application.

Some commenters argued that the final rule should be modified to extend automatically the one-year statutory period for complying with the per-fund limitation by an additional two years without application or approval on a case-by-case basis and to apply the extended conformance period to the aggregate funds limitations.[2372] Some of these commenters suggested that Congress explicitly recognized the need for a banking entity to have a sufficient seeding period following establishment of a fund, and that funds often require more than one year to attract enough unaffiliated investors to enable the sponsoring banking entity to reduce its ownership interests in the fund to the level required by section 13(d)(4).

Other commenters argued that the amount of a banking entity's own capital involved in seeding a fund is typically ''small'' and suggested that, in order to prevent banking entities from engaging in prohibited proprietary trading through a fund, the Board should condition the ability of a banking entity to qualify for an extension of the one-year statutory period on several requirements, including a requirement that the banking entity not have provided more than $10 million in seed capital as part of establishing the covered fund.[2373]

The Agencies have carefully considered comments received on the proposal and have determined instead to adopt the process and standards governing requests for extensions of time to divest an ownership interest in a single covered fund largely as proposed. The Agencies believe that this approach is consistent with the process and standards set out under the statute.

As under the proposal, the final rule requires any banking entity that seeks an extension of the conformance period provided for the per-funds limitation to submit a written request to the Board. Any such request must be submitted to the Board at least 90 days prior to the

[2365] *See* proposed rule § 75.12(c)(2)(ii)(B)(2).

[2366] *See* proposed rule § 75.12(c)(2)(ii)(A).

[2367] *See* proposed rule § 75.12(c)(1)(B(2)(ii)(B)(1).

[2368] *See* Occupy.

[2369] *See* Credit Suisse (Williams); IIB/EBF.

[2370] *See* Japanese Bankers Ass'n.

[2371] *See* Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, 77 FR 76628, 76637 (Dec. 28, 2012).

[2372] *See, e.g.,* SIFMA et al. (Covered Funds) (Feb. 2012); SSgA (Feb. 2012); TCW; Credit Suisse (Williams).

[2373] *See, e.g.,* Occupy; Sens. Merkley & Levin (Feb. 2012).

expiration of the applicable time period and provide the reasons why the banking entity believes the extension should be granted. In addition, the request must explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods to the limits imposed by the final rule. To allow the Board to assess the factors provided in the statute, the final rule provides that any extension request by a banking entity must address: (i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (ii) the contractual terms governing the banking entity's interest in the covered fund; (iii) the total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States; (iv) the cost to the banking entity of divesting or disposing of the investment within the applicable period; (v) whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty; (vi) the banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund; (vii) market conditions; and (viii) any other factor that the Board believes appropriate. In contrast to the proposal, the final rule does not require information on whether the extension would pose a threat to safety and soundness of the covered banking entity or to financial stability of the United States. The categories of information in final rule have been modified in order to eliminate redundancies.

The final rule continues to permit the Board to impose conditions on granting any extension granted if the Board determines conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or otherwise unsound practices, or to otherwise further the purposes of section 13 of the BHC Act and the final rule. In cases where the banking entity is primarily supervised by another Agency, the Board will consult with such Agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period. While some commenters requested that the Board modify the final rule to permit a banking entity to have covered fund investments in excess of the aggregate funds limitation,[2374] the final rule does not contain such a provision. As noted in the release for the proposed rule, the statutory grant of authority to provide extensions of time to comply with the investment limits refers specifically and only to the period for conforming a seeding investment to the per-fund limitation.[2375]

As noted in the proposed rule, the Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through misuse of requests for extension of the seeding period for covered funds. Therefore, the Board and the Agencies will monitor requests for extensions of the seeding period for activity in covered funds that is inconsistent with the requirements of section 13 of the BHC Act.

4. Section 75.13: Other Permitted Covered Fund Activities

a. Permitted Risk-Mitigating Hedging Activities

Section 13(d)(1)(C) of the BHC Act provides an exemption for certain risk-mitigating hedging activities.[2376] In the context of covered fund activities, the proposed rule implemented this authority narrowly and permitted a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge only in two situations: (i) When acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate exposure by the customer to the profits and losses of the covered fund; and (ii) with respect to a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.[2377] The proposed rule imposed specific requirements on a banking entity seeking to rely on this exemption.[2378]

The Agencies received a range of comments on the proposed risk-mitigating hedging exemption for ownership interests in covered funds. Some commenters objected to the limited applicability of the statutory risk-mitigating hedging exemption in the covered funds context and urged the Agencies to allow ownership interests in covered funds to be used in any appropriate risk-mitigating hedging.[2379] In contrast, other commenters urged the Agencies to delete one or both of the risk-mitigating hedging exemptions as the commenters argued they were inconsistent with the statute or otherwise inappropriate.[2380] Commenters also argued that a separate risk-mitigating hedging exemption for covered funds is unnecessary because the statute provides a single risk-mitigating hedging exemption.[2381]

Some commenters argued that the proposed rule would impede banking entities from offering covered-fund linked products to customers, including hedging these products, and would, in particular, impair the ability of banking entities to hedge the risks of fund-linked derivatives with fund-linked swaps or shares of covered funds referenced in fund-linked products.[2382] These commenters argued this limitation would increase risks at banking entities and was inconsistent with the purpose of the risk-mitigating hedging exemption. Commenters also proposed modifying the proposal to permit risk-mitigating hedging activities that facilitate a customer's exposure to profits and/or losses of the covered fund, to permit portfolio or dynamic hedging strategies involving covered fund interests, and to eliminate the proposed condition that a customer would not itself be a banking entity.[2383] Some commenters also urged the Agencies to grandfather existing risk-mitigating hedging activities with respect to any covered-fund linked products that comply with the hedging

[2374] *See* ABA (Keating).

[2375] *See* 12 U.S.C. 1851(d)(4)(C).

[2376] *See* 12 U.S.C. 1851(d)(1)(C).

[2377] *See* proposed rule § 75.13(b)(1)(i)(A) and (B).

[2378] These requirements were substantially similar to the requirements for the risk-mitigating hedging exemption for trading activities contained in proposed § 75.5. In addition, proposed § 75.13(b) also required that: (i) The hedge represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund arising out of the transaction to accommodate a specific customer request or directly connected to the banking entity's compensation arrangement with an employee; and (ii) the banking entity document, at the time the transaction is executed, the hedging rationale for all hedging transactions involving an ownership interest in a covered fund.

[2379] *See* BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2380] *See* AFR *et al.* (Feb. 2012); Occupy; Public Citizen; Sens. Merkley & Levin (Feb. 2012).

[2381] *See* BoA.

[2382] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); ISDA (Feb. 2012); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2383] *See, e.g.,* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Deutsche Bank (Fund-Linked Products).

requirements for proprietary trading under § 75.5 of the proposed rule.[2384]

In contrast, other commenters objected to the exemption for hedging covered fund-linked products sold to customers. These commenters asserted that this activity would authorize investment in covered funds in a manner that would not be subject to the three percent per-fund limitation;[2385] or would be inconsistent with the statutory requirement that a banking entity actively seek additional investors for a fund.[2386]

Some commenters urged the Agencies to expand the hedging exemption to allow banking entities to invest in covered funds in order to hedge obligations relating to deferred compensation plans for employees who do not directly provide services to the covered fund for which the hedge relates.[2387] Another commenter argued that banking entities should be permitted to hedge compensation investment accounts for executive officers who are not involved in the management of the investment accounts.[2388] In contrast, other commenters objected to the hedging exemption for compensation arrangements, arguing that it may increase risk to banking entities,[2389] is unnecessary,[2390] or may provide banking entities with an opportunity to evade the limitations on the amount of ownership interests they may have as an investment in a covered fund.[2391]

After review of the comments, the Agencies believe at this time that permitting only limited risk-mitigating hedging activities involving ownership interests in covered funds is consistent with the safe and sound conduct of banking entities, and that increased use of ownership interests in covered funds could result in exposure to higher risks.[2392]

In particular, the Agencies have determined that transactions by a banking entity to act as principal in providing exposure to the profits and losses of a covered fund for a customer, even if hedged by the entity with ownership interests of the covered fund, is a high risk strategy that could threaten the safety and soundness of the banking entity. These transactions expose the banking entity to the risk that the customer will fail to perform, thereby effectively exposing the banking entity to the risks of the covered fund. Furthermore, a customer's failure to perform may be concurrent with a decline in value of the covered fund, which could expose the banking entity to additional losses. Accordingly, the Agencies believe that these transactions pose a significant potential to expose banking entities to the same or similar economic risks that section 13 of the BHC Act sought to eliminate, and have not adopted the proposed exemption for using ownership interests in covered funds to hedge these types of transactions in the final rule.

As argued by some commenters, modifying the proposal to eliminate the exemption for permitting banking entities to acquire covered fund interests in connection with customer facilitation may impact banking entities ability to hedge the risks of fund-linked derivatives through the use of fund-linked swaps or shares of covered funds referenced by fund-linked products.[2393] Some commenters on the proposal argued that innovation of financial products may potentially be reduced if the final rule does not permit this type of activity related to fund-linked products.[2394] The Agencies recognize that U.S. banking entities may no longer be able to participate in offering certain customer facilitation products relating to covered funds, but believe it is consistent with the purposes of section 13 to restrict these activities.

The final rule maintains the proposed exemption for hedging employee compensation arrangements with several changes. To ensure that exempt hedging activities are designed to reduce one or more specific risks, as required by section 13(d)(1)(C) of the BHC Act, the proposed rule required that permitted hedging activity be designed to reduce the specific risks to the banking entity in connection with and related to its obligations or liabilities. The final rule permits a banking entity to acquire or retain an ownership interest in a covered fund provided that the ownership interest is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee who directly provides investment advisory or other services to the covered fund. Under the final rule, a banking entity may not use as a hedge ownership interests of a covered fund for which the employee does not provide services. The requirement under the final rule that the hedging activity be designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity is consistent with the requirement in § 75.5 of the final rule, as discussed above in Part VI.A.4. The final rule permits a banking entity to hedge its exposures to price and other risks based on fund performance that arise from restricted profit interest and other performance based compensation arrangements with its investment managers.

Section 13(a)(2) of the final rule describes the criteria a banking entity must meet in order to rely on the risk-mitigating hedging exemption for covered funds. These requirements, which are based on the requirements for the risk-mitigating hedging exemption for trading activities under § 75.5 of the final rule and which are discussed in detail above in Part VI.A.4, have been modified from the proposal to reflect the more limited scope of this section.[2395] In particular, the final rule permits a banking entity to engage in risk-mitigating hedging activities involving ownership interests in a covered fund only if the banking entity has established and implements, maintains and enforces an internal compliance program that is reasonably designed to ensure the covered banking entity's compliance with the requirements of the hedging exemption, including reasonably designed written policies and procedures and internal controls and ongoing monitoring and authorization procedures, and has acquired or retained the ownership interest in accordance with these written policies, procedures and internal controls. Furthermore, the acquisition or retention of an ownership interest must demonstrably reduce or otherwise significantly mitigate, at the inception of the hedge, one or more specific, identifiable risks arising in connection with the compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund. The acquisition or retention also may not, at the inception of the hedge, result in any significant new or additional risk that is not itself hedged contemporaneously in accordance with the hedging exemption, and the hedge must be subject to continuing review, monitoring and management by the banking entity.

[2384] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); BoA.

[2385] *See* Sens. Merkley & Levin (Feb. 2012).

[2386] *See* AFR *et al.* (Feb. 2012).

[2387] *See* Arnold & Porter.

[2388] *See* BOK.

[2389] *See* Occupy.

[2390] *See* AFR *et al.* (Feb. 2012); Public Citizen.

[2391] *See* Occupy.

[2392] *See* 12 U.S.C. 1851(d)(2).

[2393] *See* ISDA (Feb. 2012); BoA; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2394] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Credit Suisse (Williams).

[2395] *See* final rule § 75.13(a)(2).

The final rule also permits a banking entity to engage in risk-mitigating hedging activities in connection with a compensation arrangement, subject to the conditions noted above, only if the compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate thereof has acquired an ownership interest and the losses on such ownership interest are offset by corresponding decreases in the amounts payable in connection with the related employee compensation arrangement.[2396]

b. Permitted Covered Fund Activities and Investments Outside of the United States

Section 13(d)(1)(I) of the BHC Act[2397] permits foreign banking entities to acquire or retain an ownership interest in, or act as sponsor to, covered funds, so long as those activities and investments occur solely outside the United States and certain other conditions are met (the ''foreign fund exemption'').[2398] As described in the proposal, the purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities and investments, while preserving national treatment and competitive equality among U.S. and foreign banking entities within the United States.[2399] The statute does not explicitly define what is meant by ''solely outside of the United States.''

The proposed rule allowed foreign banking entities that met certain qualifications to engage in covered fund activities, including owning, organizing and offering, and sponsoring funds outside the United States. The proposed rule defined both the type of foreign banking entity that is eligible for the exemption and when an activity or investment would occur ''solely outside of the United States.'' The proposed rule allowed a qualifying foreign banking entity to acquire or retain an ownership interest in, or act as sponsor to, a covered fund under the exemption only if no subsidiary, affiliate or employee of the banking entity that's incorporated or physically located in the United States engaged in offering or selling the covered fund. The proposed rule also implemented the statutory requirement that prohibited an ownership interest in the covered fund from being offered for sale or sold to a resident of the United States.

Commenters generally expressed support for an exemption to allow foreign banking entities to conduct foreign covered fund activities and make investments outside the United States.[2400] A number of commenters also expressed concerns that the proposed foreign fund exemption was too narrow and would not be effective in permitting foreign banking entities to engage in covered fund activities and investments outside of the United States. For instance, many commenters argued that several of the proposal's restrictions on the exemption were not required by statute and were inconsistent with congressional intent to limit the extraterritorial impact of section 13 of the BHC Act.[2401] These commenters argued that the foreign funds exemption should focus on whether a prohibited activity, such as sponsoring or investing in a covered fund, involves principal risk taken or held by the foreign banking entity that poses risk to U.S. banking entities or the financial stability of the United States.[2402] Commenters also argued that a broader exemption would better recognize the regulation and supervision of the home country supervisor of the foreign banking entity and of its covered fund activities.[2403]

Some commenters contended that the proposal represented an improper extraterritorial application of U.S. law that could be found to violate international treaty obligations of the United States, such as those under the North American Free Trade Agreement, and might result in retaliation by foreign countries in their treatment of U.S. banking entities abroad.[2404] Commenters also alleged that the proposal would impose significant compliance costs on the foreign operations of foreign banking entities conducting activity pursuant to this exemption.[2405] These commenters argued that foreign banking entities relying on the foreign fund exemption should not be subject to the compliance program requirements contained in Appendix C with respect to their non-U.S. operations.[2406]

Several commenters argued that the restrictions of section 13(f), which limits transactions between a banking entity and certain covered funds, would not apply to activities and investments made in reliance on the foreign fund exemption.[2407] Some commenters argued that the Agencies should grandfather all existing foreign covered funds and argued that failure to provide relief for existing relationships could cause substantial disruption to foreign covered funds and significantly harm investors in existing funds without producing a clear offsetting benefit.[2408]

[2396] *See* final rule § 75.13(a)(2)(iii).

[2397] Section 13(d)(1)(I) of the BHC Act permits a banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund notwithstanding the restrictions on investments in, and relationships with, a covered fund, if: (i) Such activity or investment is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (ii) the activity occurs solely outside of the United States; (iii) no ownership interest in such fund is offered for sale or sold to a resident of the United States; and (iv) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(I).

[2398] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the final rule's implementation of section 13(d)(1)(I) of the BHC Act, and does not affect a banking entity's obligation to comply with additional or different requirements under applicable securities, banking, or other laws.

[2399] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley) (''Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs seek to maintain a level playing field by prohibiting a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.'').

[2400] *See, e.g.,* IIB/EBF; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Occupy.

[2401] *See* Ass'n. of German Banks; BVI; Allen & Overy (on behalf of Canadian Banks); EFAMA; F&C; HSBC; IIB/EBF; ICSA; PEGCC; Société Générale; Union Asset; Ass'n. of Banks in Malaysia; EBF; Credit Suisse (Williams); Cadwalader (on behalf of Thai Banks).

[2402] *See* IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); Katten (on behalf of Int'l Clients).

[2403] *See* Credit Suisse (Williams); PEGCC; *see also* Commissioner Barnier.

[2404] *See e.g.,* Norinchukin; Cadwalader (on behalf of Thai Banks); Barclays; EBF; Ass'n. of German Banks; Société Générale; Chamber (Feb. 2012).

[2405] *See* BaFin/Deutsche Bundesbank; Norinchukin; IIF; Allen & Overy (on behalf of Canadian Banks); ICFR; BoA. As discussed below in Part VI.C.1, other parts of the final rule address commenters' concerns regarding the compliance burden on foreign banking entities.

[2406] *See* AFG; Ass'n. of German Banks; BVI; Comm. on Capital Markets Regulation; IIB/EBF; Japanese Bankers Ass'n.; Norinchukin; Union Asset. As discussed in greater detail below in Part VI.C.1, activities and investments of a foreign bank that are conducted under the foreign funds exemption are generally not subject to the specific requirements of § 75.20 and Appendices A and B. The U.S. operations of foreign banking entities are expected to have policies and procedures in place to ensure that they conduct activities under this part in full compliance with this part.

[2407] *See* Australian Bankers Ass'n.; AFMA; Allen & Overy (on behalf of Foreign Bank Group); British Bankers' Ass'n.; F&C; French Banking Fed'n.; IIB/EBF; Japanese Bankers Ass'n; Katten (on behalf of Int'l Clients); Union Asset. *See also infra* Part VI.B.5.

[2408] *See* BVI; Credit Suisse (Williams); EFAMA; IIB/EBF; PEGCC; Union Asset. *See supra* Part II for a discussion regarding the conformance period.

In response to comments received on the proposal, the final rule contains a number of modifications to more effectively implement the foreign fund exemption in light of the language and purpose of the statute. Importantly, as explained in the section defining covered funds, the Agencies also believe that the more circumscribed definition of covered fund, including the exclusion for foreign public funds, should alleviate many of the concerns raised and potential burdens identified by commenters with respect to the funds activities of foreign banking entities.[2409]

1. Foreign Banking Entities Eligible for the Exemption

The statutory language of section 13(d)(1)(I) provides that, in order to be eligible for the foreign funds exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. Consistent with this statutory language, the proposed rule limited the scope of the exemption to banking entities that are organized under foreign law and, as applicable, controlled only by entities organized under foreign law.

The Agencies did not receive substantive comment on this aspect of the proposal related to the foreign fund exemption, though some commenters offered suggestions to clarify various parts of the wording of the scope of the definition of banking entities that may qualify for the exemption. The final rule makes only minor, technical changes to more fully carry out the purposes of the statute.

Consistent with the statutory language and purpose of section 13(d)(1)(I) of the BHC Act, the final rule provides that the exemption is available only if the banking entity is not organized under[2410] or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. As noted above, section 13(d)(1)(I) of the BHC Act specifically provides that its exemption is available only to a banking entity that is not ''directly or indirectly'' controlled by a banking entity that is organized under the laws of the United States or of one or more States.[2411] Because of this express statutory requirement, a foreign subsidiary controlled, directly or indirectly, by a banking entity organized under the laws of the United States or one of its States, and a foreign branch office of a banking entity organized under the laws of the United States or one of the States, may not take advantage of this exemption.

Like the proposal, the final rule incorporates the statutory requirement that the banking entity conduct its sponsorship or investment activities pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act. The final rule retains the tests in the proposed rule for determining when a banking entity would meet that requirement. The final rule also provides qualifying criteria for both a banking entity that is a qualifying foreign banking organization under the Board's Regulation K and a banking entity that is not a foreign banking organization for purposes of Regulation K.[2412]

Section 4(c)(9) of the BHC Act applies to any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[2413] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[2414] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to act pursuant to that authority.[2415] The qualifying conditions and requirements include, for example, that the foreign banking organization demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.[2416] Under the final rule a banking entity that is a qualifying foreign banking organization for purposes of the Board's Regulation K, other than a foreign bank as defined in section 1(b)(7) of the International Banking Act of 1978 that is organized under the laws of any commonwealth, territory, or possession of the United States, will qualify for the foreign fund exemption.[2417]

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but that are not subject to the

[2409] For instance, many commenters raised concerns regarding the treatment of foreign public funds such as UCITS. As discussed in greater detail above in Part VI.B.1, the definition of covered fund under the final rule has been modified from the proposal and tailored to include only the types of foreign funds that the Agencies believe are intended to be the focus of the statute (*e.g.,* certain foreign funds that are established by U.S. banking entities). Foreign public funds are also excluded from the definition of covered fund under the final rule. The modifications in the final rule in part address commenters' request that foreign funds be grandfathered. To the extent that an entity qualifies for one or more of the exclusions from the definition of covered fund, that entity would not be a covered fund under the final rule. Moreover, any entity that would be a covered fund would still be able to rely on the conformance period in order to come into compliance with the requirements of section 13 and the final rule.

[2410] The final rule clarifies the eligibility requirements for banking entities seeking to rely on the foreign fund exemption. Section 13(d)(1)(I) of the BHC Act and § 75.13(c)(1)(i) of the proposal require that a banking entity seeking to rely on the foreign fund exemption not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more states. For clarification purposes, in addition to the eligibility requirement in Section 13(d)(1)(I) of the BHC Act and the proposal, the final rule also expressly requires that the banking entity not itself be organized under the laws of the United States.

[2411] *See* 12 U.S.C. 1851(d)(1)(I).

[2412] Section 75.13(b)(2) only addresses when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has to date applied the general authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(I) of the BHC Act, are unable to rely on the foreign funds exemption.

[2413] *See* 12 U.S.C. 1843(c)(9).

[2414] *See* 12 CFR 211.20 *et seq.*

[2415] Some commenters argued that the Board's Regulation K contains a number of limitations that may not be appropriate to include as part of the requirements of the foreign fund exemption. For example, subpart B of the Board's Regulation K includes various approval requirements and interstate office location restrictions. *See* Allen & Overy (on behalf of Foreign Bank Group); HSBC Life. The final rule does not retain the proposal's requirement that the activity be conducted in compliance with all of subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30). However, the foreign fund exemption in section 13(d)(1)(I) of the BHC Act and the final rule operates as an exemption and is not a separate grant of authority to engage in an otherwise impermissible activity. To the extent a banking entity is a foreign banking organization, it remains subject to the Board's Regulation K and must, as a separate matter, comply with any and all applicable rules and requirements of that regulation.

[2416] *See* 12 CFR 211.23(a), (c), and (e). The proposed rule only referenced the qualifying test under section 211.23(a) of the Board's Regulation K; however, because there are two other methods by which a foreign banking organization may meet the requirements to be considered a qualified foreign banking organization, the final rule incorporates a reference to those provisions as well.

[2417] This modification to the definition of foreign banking organization from the proposed definition is necessary because, under the International Banking Act and the Board's Regulation K, depository institutions that are located in, or organized under the laws of a commonwealth, territory, or possession of the United States, are foreign banking organizations. However, for purposes of the Federal securities laws and certain banking statutes, such as section 2(c)(1) of the BHC Act and section 3 of the FDI Act, these same entities are defined to be and treated as domestic entities. For instance, these entities act as domestic broker-dealers under U.S. securities laws and their deposits are insured by the FDIC. Because one of the purposes of section 13 is to protect insured depository institutions and the U.S. financial system from the perceived risks of proprietary trading and covered fund activities, the Agencies believe that these entities should be considered to be located within the United States for purposes of section 13. The final rule includes within the definition of State any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the final rule also provides that a foreign banking entity that is not a foreign banking organization would be considered to be conducting activities ''pursuant to section 4(c)(9)'' for purposes of the foreign fund exemption [2418] if the entity, on a fully-consolidated basis,[2419] meets at least two of three requirements that evaluate the extent to which the foreign banking entity's business is conducted outside the United States, as measured by assets, revenues, and income.[2420] This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and § 211.23(a), (c), or (e) of the Board's Regulation K, except that the test does not require the foreign entity to demonstrate that more than half of its banking business is outside the United States.[2421] This difference reflects the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms. A requirement that such firms also demonstrate that more than half of their banking business is outside the United States would likely make the exemption unavailable to such firms and subject their global activities to the restrictions on covered fund activities and investments, a result that the Agencies do not believe was intended.

2. Activities or Investments Solely Outside of the United States

As noted above, the proposed rule adopted a transaction-based approach to implementing the foreign fund exemption and focused on the extent to which the foreign fund transactions occur within, or are carried out by personnel, subsidiaries or affiliates within, the United States. In particular, § 75.13(c)(3) of the proposed rule provided that a transaction or activity be considered to have occurred solely outside of the United States only if: (i) The transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States; (ii) no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and (iii) no ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

Commenters suggested that, like the foreign trading exemption, the foreign fund exemption should focus on the location of activities that a banking entity engages in as principal.[2422] These commenters argued that the location of sales activities of a fund should not determine whether a banking entity has sponsored or acquired an ownership interest in a covered fund solely outside of the United States. Commenters also argued that foreign banking entities typically locate marketing and sales personnel for foreign funds in the United States in order to serve customers, including those that are not residents of the United States, and that the proposal would needlessly force all covered fund sales activities to shift outside of the United States. These commenters alleged that the restrictions under the proposal would cause foreign banking entities to relocate their personnel from the United States to overseas, diminishing U.S. jobs with no concomitant benefit.[2423]

Many commenters requested removal of the proposal's prohibition on a U.S. subsidiary, affiliate, or employee of the foreign banking entity offering or selling fund interests in order to qualify for the foreign fund exemption.[2424] Commenters argued that this limitation was not included in the statute and that the limited involvement of persons located in the U.S. in the distribution of ownership interests in a foreign covered fund should not, by itself, disqualify the banking entity from relying on the foreign fund exemption so long as the fund is offered only outside the United States.[2425] These commenters argued that organizing and offering a fund is not a prohibited activity so long as it is not accompanied by ownership or sponsorship of the covered fund. One commenter urged that the final rule permit U.S. personnel of a foreign banking entity to engage in non-selling activities related to a covered fund, including acting as investment advisor, establishing fund vehicles, conducting back-office functions such as day-to-day management and deal sourcing tax structuring, obtaining licenses, interfacing with regulators, and other related activities that do not involve U.S. sales activity.[2426]

Instead of the proposal's transaction-based approach to implementing the foreign fund exemption, many commenters suggested the final rule adopt a risk-based approach.[2427] These commenters argued that a risk-based approach would prohibit or significantly limit the amount of financial risk from such activities that could be transferred to the United States by the foreign activity of foreign banking entities in line with the purpose of the statue.[2428] Commenters also contended that foreign activities of most foreign banking entities are already subject to activities limitations, capital requirements, and other prudential requirements of their home-country supervisor(s).[2429]

In response to commenters' concerns and in order to more effectively implement both the statutory prohibition as well as the foreign fund exemption, the final rule has been modified to better reflect the purpose of the statute by ensuring that the principal risks of covered fund investments and sponsorship by foreign banking entities permitted under the foreign funds exemption occur and remain solely outside of the United States. One of the principal purposes of section 13 is to limit the risks that covered fund investments and activities pose to the safety and soundness of U.S. banking entities and the U.S. financial

[2418] This clarification would be applicable *solely* in the context of section 13(d)(1) of the BHC Act. The application of section 4(c)(9) to foreign companies in other contexts is likely to involve different legal and policy issues and may therefore merit different approaches.

[2419] For clarification purposes, the final rule has been modified from the proposal to provide that the requirements for this provision must be met on a fully-consolidated basis.

[2420] *See* final rule § 75.13(b)(2)(ii)(B). For purposes of determining whether, on a fully consolidated basis, it meets the requirements under § 75.13(b)(2)(ii)(B), a foreign banking entity that is not a foreign banking organization should base its calculation on the consolidated global assets, revenues, and income of the top-tier affiliate within the foreign banking entity's structure.

[2421] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a), (c), and (e); final rule § 75.13(b)(2)(ii)(B).

[2422] *See* Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2423] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Société Générale; Union Asset.

[2424] *See* Allen & Overy (on behalf of Foreign Bank Group); Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients); TCW; Union Asset.

[2425] *See* IIB/EBF; Société Générale; TCW; Union Asset; Credit Suisse (Williams); *see also* Katten (on behalf of Int'l Clients) (recommending that, similar to the SEC's Regulation S (17 CFR 230.901 through 230.905), the final rule provide that involvement of persons located in the United States in the distribution of a non-U.S. covered fund's securities to potential purchasers outside of the United States not affect the analysis of whether a non-U.S. banking entity's investment or sponsorship occurs outside the United States).

[2426] *See* Allen & Overy (on behalf of Foreign Bank Group).

[2427] *See* BaFin/Deutsche Bundesbank; ICSA; IIB/EBF; EBF; Allen & Overy (on behalf of Canadian Banks); Credit Suisse (Williams); George Osborne.

[2428] *See* IIB/EBF.

[2429] *See* IIB/EBF.

system. Another purpose of the foreign fund exemption was to limit the extraterritorial application of section 13 as it applies to foreign banking entities subject to section 13.

To accomplish these purposes in light of the structure and purpose of the statute and in response to commenters, the final rule adopts a risk-based approach rather than a transaction approach to the foreign fund exemption. In order to ensure these risks remain solely outside of the United States, the final rule also includes several conditions on the availability of the foreign fund exemption. Specifically, the final rule provides that an activity or investment occurs solely outside the United States for purposes of the foreign fund exemption only if:

- The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and it not controlled directly or indirectly by, a banking entity that is located in the United States or established under the laws of the United States or of any State;
- The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;
- The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and
- No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.[2430]

These requirements are designed to ensure that any foreign banking entity engaging in activity under the foreign fund exemption does so in a manner that ensures the risk and sponsorship of the activity or investment occurs and resides solely outside of the United States.

The final rule has been modified from the proposal to specifically recognize that, for purposes of the foreign fund exemption, a U.S. branch, agency, or subsidiary of a foreign bank, is located in the United States; however, a foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.[2431] A subsidiary (wherever located) of a U.S. branch, agency, or subsidiary of a foreign bank is also considered itself to be located in the United States. This provision helps give effect to the statutory language limiting the foreign fund exemption to activities of foreign banking entities that occur ''solely outside of the United States'' by clarifying that the U.S. operations of foreign banking entities may not sponsor or acquire or retain an ownership interest in a covered fund as principal based on this exemption.

Because so-called ''back office'' activities do not involve sponsoring or acquiring or retaining an ownership interest in a covered fund, the final rule does not impose restrictions on U.S. personnel of a foreign banking entity engaging in these activities in connection with one or more covered funds. This allows providing administrative services or similar functions to the covered fund as an incident to the activity conducted under the foreign fund exemption (such as clearing and settlement, maintaining and preserving records of the fund, furnishing statistical and research data, or providing clerical support for the fund).

The foreign fund exemption in the final rule also permits the U.S. personnel and operations of a foreign banking entity to act as investment adviser to a covered fund in certain circumstances. For instance, the U.S. personnel of a foreign banking entity may provide investment advice and recommend investment selections to the manager or general partner of a covered fund so long as that investment advisory activity in the United States does not result in the U.S. personnel participating in the control of the covered fund or offering or selling an ownership interest to a resident of the United States. As explained above, the final rule also explicitly provides that acquiring or retaining an ownership interest does not include acquiring or retaining an ownership interest in a covered fund by a banking entity acting solely as agent, broker, or custodian, subject to certain conditions, or acting on behalf of customers as a trustee, or in a similar fiduciary capacity for a customer that is not a covered fund, so long as the activity is conducted for the account of the customer and the banking entity and its affiliates do not have or retain beneficial ownership of the ownership interest.[2432] The final rule would thus allow a foreign bank to engage in any of these capacities in the U.S. without the need to rely on the foreign fund exemption.

3. Offered for Sale or Sold to a Resident of the United States

The proposed rule provided that no ownership interest in the covered fund be offered for sale or sold to a resident of the United States, a requirement of the statute.[2433] Numerous commenters focused on the definition of ''resident of the United States'' in the proposed rule and the manner in which the restriction on offers and sales to such persons would interrelate with Regulation S under the Securities Act of 1933. Commenters asserted that, since market participants have long conducted offerings of foreign funds in reliance on Regulation S [2434] in order to comply with U.S. securities law obligations, these same securities law principles should be applied to determine whether a person is a resident of the United States for purposes of section 13 and the final rule to determine whether an offer or sale is made to residents of the United States.[2435]

Certain commenters argued that because of the way the restriction in the statute and proposed rule was written, it was unclear whether the restriction on offering for sale to a resident of the United States applied to the foreign banking entity or to any third party that establishes a fund.[2436] Commenters argued the prohibition against offers or sales of ownership interests to residents of the United States should apply only to offers and sales of covered funds organized and offered by the foreign banking entity but not to covered funds established by unaffiliated third parties.[2437] These commenters reasoned that a foreign banking entity should be permitted to make a passive investment in a covered fund sponsored and controlled by an unaffiliated third party that has U.S. investors as long as the foreign banking entity does not itself offer or sell ownership interest in the covered fund to residents of the United

[2430] *See* final rule § 75.13(b)(4).

[2431] *See* final rule § 75.13(b)(5).

[2432] *See* final rule § 75.10(a)(2).

[2433] *See* proposed rule § 75.13(c)(1)(iii).

[2434] *See* 17 CFR 230.901–905.

[2435] *See* IIB/EBF; EFAMA; ICI Global.

[2436] *See* Cadwalader (on behalf of Thai Banks); Grosvenor; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2437] *See* Ass'n. of German Banks; BAROC; Cadwalader (on behalf of Thai Banks); Comm. on Capital Markets Regulation; Credit Suisse (Williams); IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); PEGCC.

States.[2438] Commenters contended that this interpretation would be consistent with section 13's purpose to prevent foreign banks from using the foreign fund exemption to market and sell covered funds to U.S. investors, while simultaneously limiting the extraterritorial impact of section 13.[2439] Commenters argued that the proposal's foreign fund exemption would negatively impact U.S. asset managers unaffiliated with any banking entity because they would either be forced to exclude foreign banking entities from investing in their funds or would need to ensure that no residents of the United States hold ownership interests in funds offered to these entities.[2440] Commenters also contended that foreign banking entities, including sovereign wealth funds that own or control foreign banking organizations, invest tens of billions of dollars in U.S. covered funds and that if these types of investments were not permitted under the foreign fund exemption an important source of foreign investment in the U.S. could be eliminated.[2441]

Commenters argued that an investment by a foreign banking entity in a third-party unaffiliated fund does not pose any risk to a U.S. banking entity or to the U.S. financial system. Moreover, commenters argued that a foreign banking entity that has invested in a fund sponsored and advised by a third party has no control over whether—and may have no knowledge—that the third party has determined to offer or sell the fund to U.S. residents.[2442]

As noted above, one of the purposes of section 13 is to limit the risk to banking entities and the financial system of the United States. Another purpose of the statute appears to be to permit foreign banking entities to engage in foreign activities without being subject to the restrictions of section 13 while also ensuring that these foreign entities do not receive a competitive advantage over U.S. banking entities with respect to offering and selling their covered fund services in the United States.[2443] As such, the final rule does not prohibit a foreign banking entity from making an investment in or sponsoring a foreign fund. However, a foreign banking entity would not be permitted under the foreign fund exemption to invest in, or engage in the sponsorship of, a U.S. or foreign covered fund that offers ownership interests to residents in the United States unless it does so pursuant to and subject to the limitations of the permitted activity exemption for organizing and offering a covered fund, for example, which has the same effect for U.S. banking entities. The final rule ensures that the risk of the sponsoring and investing in non-U.S. covered funds by foreign banking entities remains outside of the United States and that the foreign fund exemption does not advantage foreign banking entities relative to U.S. banking entities with respect to providing their covered fund services in the United States by prohibiting the offer or sale of ownership interests in related covered funds to residents of the United States.

Commenters also argued that foreign investors in a foreign covered fund should not be treated as residents of the United States for purposes of the final rule if, after purchasing their interest in the covered fund, they relocate to the U.S.,[2444] or travel to the U.S. on a temporary basis.[2445] Commenters also argued that non-U.S. investors in a fund offered by a foreign banking entity should not be prohibited from transferring their interests to residents of the United States in the secondary market.[2446] One commenter alleged that, notwithstanding the reasonable efforts of foreign banking entities to prevent residents of the United States from investing in their foreign covered funds, investors may find ways to circumvent and invest in covered funds without knowledge or assistance from the foreign banking entity.[2447]

Certain commenters argued that there was a substantial risk that foreign funds offered by foreign banking entities would not be able to rely on the exemption due to the presence of a limited number of investors who are residents of the United States.[2448] A few commenters suggested that the final rule should require that, for both related and unrelated covered funds, a banking entity need only have a reasonable belief that an ownership interest in a covered fund is not offered or sold to residents of the United States in order to qualify for the foreign fund exemption. Commenters argued that only active targeting or marketing towards a resident of the United States by the foreign banking entity should be prohibited by the final rule, and that the incidental presence of a limited number of investors that are residents of the United States in a foreign covered fund offered by a foreign banking entity should not prohibit the foreign banking entity from relying on the foreign fund exemption.[2449] One commenter argued that, for certain complex fund structures (*e.g.,* a structure with a master fund and multiple feeder funds that investors invest in or a parallel fund structure both managed by the same fund manager), eligibility for the foreign fund exemption should not be precluded for a fund with no ownership interests offered for sale or sold to U.S. residents even if a related covered fund is offered to residents of the United States.[2450]

After considering comments received on the proposal, the final rule retains the statutory requirement that no ownership interest in the covered fund be offered for sale to a resident of the United States.[2451] The final rule provides that an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of the foreign fund exemption only if it is sold or has been sold pursuant to an offering that targets residents of the United States.[2452]

Absent circumstances otherwise indicating a nexus with residents of the United States, the sponsor of a foreign fund would not be viewed as targeting U.S. residents for purposes of the foreign fund exemption if it conducts an offering directed to residents of one or more countries other than the United States; includes in the offering materials a prominent disclaimer that the securities are not being offered in the United States or to residents of the United States; and includes other reasonable procedures to restrict access to offering and subscription materials to persons that are not residents of the United States.[2453] If ownership interests

[2438] *See* Grosvenor; IIB/EBF; Japanese Bankers Ass'n.; Katten (on behalf of Int'l Clients); Sens. Merkley & Levin (Feb.2012); Norinchukin; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2439] *See* BAROC; Credit Suisse (Williams); Grosvenor; IIB/EBF.

[2440] *See* Comm. on Capital Markets Regulation; Credit Suisse (Williams); PEGCC.

[2441] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Grosvenor; PEGCC.

[2442] *See* AFG; BAROC; Cadwalader (on behalf of Thai Banks); Japanese Bankers Ass'n.

[2443] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[2444] *See* IIB/EBF; Katten (on behalf of Int'l Clients); Union Asset.

[2445] *See* IFIC; *see also* Allen & Overy (on behalf of Canadian Banks).

[2446] *See* Ass'n. of German Banks; Credit Suisse (Williams); IIB/EBF; Katten (on behalf of Int'l Clients).

[2447] *See* Credit Suisse (Williams).

[2448] *See* BVI; EFAMA; Union Asset.

[2449] *See* AFG; Union Asset; *see also* BVI; Allen & Overy (on behalf of Canadian Banks); Katten (on behalf of Int'l Clients).

[2450] *See* Japanese Bankers Ass'n.

[2451] *See* final rule § 75.13(b)(1)(iii).

[2452] *See* final rule § 75.13(b)(3).

[2453] *See* Statement of the Commission Regarding Use of Internet Web sites to Offer Securities, Solicit Securities Transactions or Advertise Investment Services Offshore, Securities Act Release No. 7516 (Mar. 23, 1998). Reliance on these principles only applies with respect to whether an ownership interest in a covered fund is offered for sale or sold to a resident of the United States for purposes of

that are issued in a foreign offering are listed on a foreign exchange, secondary market transactions could be undertaken by the banking entity outside the United States in accordance with Regulation S under the foreign fund exemption.[2454] Foreign banking entities should use precautions not to send offering materials into the United States or conduct discussions with persons located in the United States (other than to or with a person known to be a dealer or other professional fiduciary acting on behalf of a discretionary account or similar account for a person who is not a resident of the United States).[2455] In order to comply with the rule as adopted, sponsors of covered funds established outside of the United States must examine the facts and circumstances of their particular offerings and confirm that the offering does not target residents of the United States.

With respect to the treatment of multi-tiered fund structures under the foreign fund exemption, the Agencies expect that activities related to certain complex fund structures should be integrated in order to determine whether an ownership interest in a covered fund is offered for sale to a resident of the United States. For example, a banking entity may not be able to rely on the foreign fund exemption to sponsor or invest in an initial covered fund (that is offered for sale only overseas and not to residents of the United States) that is itself organized or operated for the purpose of investing in another covered fund (that is sold pursuant to an offering that targets U.S. residents) and that is either organized and offered or is advised by that banking entity.

4. Definition of ''Resident of the United States''

As discussed in greater detail above in Part VI.B.1, section 13(d)(1)(I) of the BHC Act provides that a foreign banking entity may acquire or retain an ownership interest in or act as sponsor to a covered fund, but only if that activity is conducted according to the requirements of the statute, including that no ownership interest in the covered fund is offered for sale or sold to a ''resident of the United States.'' As noted above in Part VI.B.1.f describing the definition of ''resident of the United States,'' the statute does not define this term.

After carefully considering comments received, the Agencies have defined the term ''resident of the United States'' in the final rule to mean a ''U.S. person'' as defined in the SEC's Regulation S.[2456] The Agencies note, however, that it would not be permissible under the foreign fund exemption for a foreign banking entity to facilitate or participate in the formation of a non-U.S. investment vehicle for a person or entity that is itself a U.S. person for the specific purpose of investing in a foreign fund. The Agencies believe that this type of activity would constitute an evasion of the requirements of section 13 of the BHC Act.

c. Permitted Covered Fund Interests and Activities by a Regulated Insurance Company

As discussed above, section 13(d)(1)(F) of the BHC Act permits a banking entity that is a regulated insurance company acting for its general account, or an affiliate of an insurance company acting for the insurance company's general account, to purchase or sell a financial instrument subject to certain conditions.[2457] Section 13(d)(1)(D) of the Act permits a banking entity to purchase or sell a financial instrument on behalf of customers.[2458] The proposal implemented these exemptions with respect to the proprietary trading activities of insurance companies by permitting a banking entity that is an insurance company to purchase or sell a financial instrument for the general account of the insurance company or for a separate account, in each case subject to certain restrictions.[2459] The proposal did not apply these exemptions to covered fund activities or investments.

A number of commenters argued that section 13 was designed to accommodate the business of insurance by exempting both the proprietary trading and covered fund activities of insurance companies.[2460] These commenters argued that providing an exemption for covered fund activities and investments through both the general account and separate accounts of an insurance company was integral to the business of insurance and that, absent an exemption from the covered fund provisions, insurance companies would lack an effective means to diversify their holdings and obtain adequate rates of return in order to maintain affordable premiums for customers.[2461]

Some commenters argued that section 13 of the BHC Act specifically provides exemptions from both the covered fund prohibition of section 13(a)(1), and the prohibition on proprietary trading.[2462] Commenters contended that the exemptions in section 13(d)(1)(F) (referencing activity in general accounts of insurance companies) and 13(d)(1)(D) (referencing activities on behalf of customers) cross-reference the instruments described in section 13(h)(4) and not activity described in section 13(h)(4). On this basis, commenters argued the statute exempts both proprietary trading in these instruments described in section 13(h)(4) and investments in those instruments (including when those instruments are ownership interests in covered funds).[2463]

Alternatively, commenters argued that the Agencies should use their authority in section 13(d)(1)(J) of the BHC Act to provide an exemption for the covered fund activities and investments of insurance companies.[2464] These commenters argued that exempting covered funds activities and investments of insurance companies would promote and protect the safety and soundness of the banking entity and financial stability of the United States and provide certain benefits to the U.S. financial system by allowing insurance companies to access important asset classes (for better investment diversity and returns), provide more diverse product offerings to customers, better manage their investment risks through diversification and more closely matching the maturity of their assets

section 13 of the BHC Act. In addition, reliance would not be appropriate if a foreign fund engages in a private placement of ownership interests in the United States in reliance on Section 4(a)(2) of the Securities Act of 1933 or Regulation D (17 CFR 230.501–230.506).

[2454] An offer or sale is made in an ''offshore transaction'' under Regulation S if, among other conditions, the transaction is executed in, on or through the facilities of a ''designated offshore securities market'' as described in Regulation S, which includes a number of foreign stock exchanges and markets and any others the SEC designates. *See* Securities Act rule 902(h).

[2455] *See* Securities Act rule 902(k)(2).

[2456] *See* final rule § 75.10(d)(8).

[2457] *See* 12 U.S.C. 1851(d)(1)(F).

[2458] *See* 12 U.S.C. 1851(d)(1)(D).

[2459] *See* proposed rule §§ 75.6(b)(2)(iii); 75.6(c).

[2460] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers); ACLI (Jan. 2012); Country Fin. *et al.;* Nationwide; NAMIC; Fin. Services Roundtable (Feb. 3, 2012) (citing FSOC study at 71); HSBC Life; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; *see also* Rep. McCarthy *et al.;* Sen. Nelson; Sen. Hagan; Sens. Brown & Harkin.

[2461] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); Sutherland (on behalf of Comm. of Annuity Insurers); USAA (citing FSOC study at 71); HSBC Life; ACLI; NAMIC; Nationwide.

[2462] *See* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide; *see also* Rep. McCarthy *et al.;* Sens. Brown & Harkin.

[2463] *See, e.g.,* Fin. Services Roundtable (Feb. 3, 2012); USAA; HSBC Life; Country Fin. *et al.;* Sutherland (on behalf of Comm. of Annuity Insurers); Nationwide (discussing the exemption for the general account of an insurance company); ACLI; Nationwide (discussing the exemption for separate accounts).

[2464] *See, e.g.,* Sutherland (on behalf of Comm. of Annuity Insurers).

and liabilities, contribute liquidity to capital markets, and support economic growth through the provision of capital to entrepreneurs and businesses.[2465] Commenters also argued that an exemption for insurance companies from the covered fund prohibitions was necessary to permit insurance companies that are banking entities to effectively compete with insurance companies not affiliated with an insured depository institution.[2466] Commenters alleged that insurance companies are already subject to extensive regulation under state insurance laws that specifically include provisions designed to diversify risk among investment categories, limit exposure to particular types of asset classes including covered fund investments, and protect the safety and soundness of the insurance company.[2467]

After careful review of the comments in light of the statutory provisions, the final rule has been modified to permit an insurance company or its affiliate[2468] to acquire or retain an ownership interest in, or act as sponsor to, a covered fund for either the general account of the insurance company or one or more separate accounts established by the insurance company.[2469]

These activities are only permitted under the final rule so long as: (1) The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company; (2) the acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which the insurance company is domiciled; and (3) the appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and relevant foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in § 75.13(c)(2) of the final rule is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.[2470]

The Agencies believe that exempting insurance activities and investments from the covered fund restrictions is supported by the language of sections 13(d)(1)(D) and (F) of the BHC Act,[2471] and more fully carries out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2472] Section 13(d)(1)(F) of the statute specifically exempts general accounts of insurance companies, and, as explained above in Part VI.A.7, separate accounts are managed and maintained on behalf of customers, an activity exempt under section 13(d)(1)(D) of the statute. By their terms, these are statutory exemptions from the prohibitions in section 13(a), which includes both the prohibition on proprietary trading and the prohibition on covered fund investments and sponsorship. Moreover, the statutory language of sections 13(d)(1)(D) and 13(d)(1)(F), both cross-reference the instruments described in section 13(h)(4) and not activity described in section 13(h)(4). These instruments are ''any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative or contract or any other security or financial instrument that [the Agencies determine by rule.]'' This reference covers an ownership interest in a covered fund. The Agencies believe these exemptions as modified more fully carry out Congressional intent and the statutory purpose of appropriately accommodating the business of insurance within an insurance company.[2473] Insurance companies are already subject to a robust regulatory regime including limitations on their investment activities.

5. Section 75.14: Limitations on Relationships With a Covered Fund

Section 13(f) of the BHC Act generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section 13(d)(1)(G) of the BHC Act) from entering into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act (''FR Act'').[2474] The statute also provides an exemption for prime brokerage transactions between a banking entity and a covered fund in which a covered fund managed, sponsored, or advised by that banking entity has taken an ownership interest. Section 13(f) subjects any transaction permitted under section 13(f) of the BHC Act (including a permitted prime brokerage transaction) between the banking entity and covered fund to section 23B of the FR Act.[2475] In general, section 23B of the FR Act requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party. Section 75.16 of the proposed rule implemented these provisions.[2476]

a. Scope of Application

Section 13(f) of the BHC Act and the related provisions of the proposal were among the most commented upon aspects of the covered funds section. The majority of commenters argued that the broad definition of ''covered fund'' under the proposal made the proposed implementation of section 13(f) unworkable and disruptive to existing market practices because it would

[2465] *See* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012); USAA; HSBC Life; ACLI (Jan. 2012); NAMIC; Nationwide.

[2466] *See, e.g.,* Nationwide.

[2467] *See, e.g.,* ACLI (Jan. 2012); Fin. Services Roundtable (Feb. 3, 2012); USAA; Chamber (Feb. 2012); Country Fin. *et al.;* Mutual of Omaha; NAMIC; Nationwide; Rep. McCarthy *et al. See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that activities of insurance companies ''are heavily regulated by State insurance regulators, and in most cases do not pose the same level of risk as other proprietary trading'').

[2468] Some commenters urged the Agencies to provide that an affiliate or subsidiary of an insurance company could purchase covered funds for the insurance company's general account or a separate account. *See e.g.,* Fin. Services Roundtable (Feb. 3, 2012); TIAA–CREF (Feb. 13, 2012). The Agencies note that the final rule provides (as does the statute) an exemption that permits an insurance company or its affiliate to acquire and retain an ownership interest in a covered fund solely for the insurance's company general account (or one or more of its separate account); such an affiliate or subsidiary also may be a wholly-owned subsidiary, as defined in the final rule.

[2469] The final rule defines the terms ''general account'' and ''separate account'' largely as proposed, and includes the new defined term ''insurance company,'' defined as a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act. *Cf.* section 2(a)(17) of the Investment Company Act (defining the term insurance company).

[2470] *See* final rule § 75.13(c).

[2471] *See* 12 U.S.C. 1851(d)(1)(D), (F).

[2472] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2473] *See* 12 U.S.C. 1851(b)(1)(F). *See also* 156 Cong. Reg. S. 5896 (daily ed. July 15, 2010) (statement of Sen. Merkley) (arguing that ''section 13 of the BHC Act] was never meant to affect the ordinary business of insurance'').

[2474] 12 U.S.C. 371c. The Agencies note that this does not alter the applicability of section 23A of the FR Act and the Board's Regulation W to covered transactions between insured depository institutions and their affiliates.

[2475] 12 U.S.C. 371c–1.

[2476] *See* proposed rule § 75.16.

prohibit corporate funding transactions with ordinary corporate entities that do not engage in hedge fund or private equity activities.[2477] Commenters also argued that activities that the proposal appeared to permit as a permitted activity exemption (*e.g.,* investments in public welfare funds) would be prohibited by the restrictions in 13(f)[2478] and that the Agencies should construe section 13(d)(1)(J) of the BHC Act as allowing them to permit banking entities to enter into covered transactions with a covered fund, if those activities would promote and protect the safety and soundness of banking entities and the financial stability of the United States.[2479] However, many of the comments discussed above and some of the economic burdens noted by these commenters have been addressed by revisions discussed above in Part VI.B.1 to the definition of covered fund.[2480] A number of these and related comments are also addressed by portions of the final rule that provide that the prohibitions of section 13 do not apply to interests acquired, for example, as agent, broker, custodian, in satisfaction of a debt previously contracted, through a pension fund, or as trustee or fiduciary (all within the limits defined in the final rule).

Several commenters argued that applying the restrictions in section 13(f) to foreign activities of foreign banking entities would be inconsistent with the presumption against extraterritorial application of U.S. law and principles of international comity, including deference to home-country regulation.[2481] For example, one commenter expressed concern that rules being developed around custody obligations in the European Union may require a prime broker or custodian to indirectly guarantee assets of a fund, which would directly conflict with the prohibition on guarantees in section 13(f) of the BHC Act.[2482] As explained above, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds.[2483] These changes substantially address the issues raised by commenters regarding the applicability of section 13(f) of the BHC Act to foreign funds.

Commenters also raised a number of other issues. For instance, some commenters argued that applying section 13(f) to securitization entities would in some instances run counter to the rule of construction contained in section 13(g)(2) regarding the sale and securitization of loans.[2484] These commenters recommended that the final rule, at a minimum, grandfather pre-existing relationships between banking entities and existing securitization vehicles to reduce the potential effects of the final rule on agreements and positions entered into before the enactment of the statute.[2485]

One commenter argued that a banking entity that delegates its responsibility for acting as sponsor, investment manager, or investment adviser to an unaffiliated entity should no longer be subject to the restrictions of section 13(f).[2486] By its terms, section 13(f) of the BHC Act applies to a banking entity that, directly or indirectly, serves as investment manager, investment adviser, or sponsor to a covered fund (or that relies on section 13(d)(1)(G) of the BHC Act in connection with organizing and offering a covered fund). The Agencies believe that a banking entity that delegates its responsibility to act as sponsor, investment manager, or investment adviser to an unaffiliated party would still be subject to the limitations of section 13(f) if the banking entity retains the ability to select, remove, direct, or otherwise exert control over the sponsor, investment manager, or investment adviser designee. In addition, the unaffiliated party designated as sponsor, investment manager, or investment adviser would be subject to the restrictions of section 13(f) if the third party is a banking entity.

b. Transactions That Would Be a ''Covered Transaction''

Section 13(f) of the BHC Act prohibits covered transactions as defined in section 23A of the FR Act between a banking entity that serves as investment manager, investment advisor or sponsor to a covered fund or that relies on the exemption in section 13(d)(1)(G) and a covered fund.[2487] A number of commenters contended that the definition of ''covered transaction'' in section 13(f) of the BHC Act should incorporate the exemptions available under section 23A and the Board's Regulation W.[2488] These commenters alleged that the statute's general reference to section 23A suggests that the term ''covered transaction'' should be construed in light of section 23A as a whole, including the exemptions in subsection (d) of that Act and as implemented in the Board's Regulation W.[2489] These commenters also argued that the Board's authority to interpret and issue rules pursuant to section 23A of the FR Act and section 5(b) of the BHC Act, the general rule-making authority contained in section 13(b) of the BHC Act, and the exemptive authority in section 13(d)(1)(J) all

[2477] *See, e.g.,* Allen & Overy (on behalf of Foreign Bank Group); BoA; Barclays; Credit Suisse (Williams); Deutsche Bank (Fund-Linked Products); GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI Global; ISDA (Feb. 2012); RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2478] *See* SunTrust; AHIC; SBIA.

[2479] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2480] *See* final rule § 75.10(b). *See supra* Part VI.B.1.

[2481] *See* IIB/EBF; Katten (on behalf of Int'l Clients); EBF; EFAMA; French Banking Fed'n.; Japanese Bankers Ass'n.

[2482] *See* AIMA.

[2483] *See* final rule § 75.10(b)(1)(ii) and (c)(1). *See supra* Part VI.B.1.

[2484] Section 75.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. As discussed in greater detail above in Part VI.B.2.b, a banking entity that continues to hold interests in a securitization in reliance on this exemption must comply with certain requirements, including the requirements of § 75.14. Accordingly, § 75.14 of the final rule has also been modified from the proposal to prohibit a banking entity that continues to hold an ownership interest in accordance with § 75.11(b), and its affiliates, from entering into a covered transaction with a covered fund, subject to certain exceptions.

[2485] *See* AFME *et al.:* ASF (Feb. 2012); Ashurst; BoA; Barclays; Cadwalader (Municipal Securities); Credit Suisse (Williams); Commercial Real Estate Fin. Council; Deutsche Bank (Fund-Linked Products); Fidelity; GE (Feb. 2012); Goldman Sachs (Covered Funds); ICI (Feb. 2012); IIB/EBF; ISDA (Feb. 2012); JPMC; PNC *et al.;* PNC; RBC; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA (Securitization) (Feb. 2012); Chamber (Feb. 2012). These comments are addressed above in Part II regarding availability of the conformance period provisions of section 13 of the BHC Act.

[2486] *See* Katten (on behalf of Int'l Clients).

[2487] The term ''covered transaction'' is defined in section 23A of the FR Act to mean, with respect to an affiliate of a member bank: (i) A loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase; (ii) a purchase of or an investment in securities issued by the affiliate; (iii) a purchase of assets from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation; (iv) the acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit to any person or company; (v) the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; (vi) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate; or (vii) a derivative transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States (12 U.S.C. 84(b)), with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate. *See* 12 U.S.C. 371c(b)(7), as amended by section 608 of the Dodd-Frank Act.

[2488] *See* 12 U.S.C. 371c(d); 12 CFR 223.42; ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Allen & Overy (on behalf of Foreign Bank Group).

[2489] *See* ABA (Keating); Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012).

provide a basis for providing such exemptions.[2490]

In particular, commenters argued that intraday extensions of credit;[2491] transactions fully secured by cash or U.S. government securities;[2492] purchases of liquid assets and marketable securities from covered funds;[2493] and riskless principal transactions with covered funds all should be exempt from the restrictions in section 13(f) of the BHC Act.[2494] These commenters argued that providing an exemption for intraday extensions of credit in particular was necessary to allow a banking entity to continue to provide affiliated covered funds with standard custody, clearing, and settlement services that include intra-day or overnight overdrafts necessary to facilitate securities settlement, contractual settlement, pre-determined income, or similar custody-related transactions. Some commenters argued that transactions fully secured by cash or U.S. government securities do not expose banking entities to inappropriate risks, are permitted in unlimited amounts under section 23A, and should not be entirely prohibited under the rule.[2495] A few commenters argued that the proposal would prohibit securities lending transactions and argued that borrower default indemnifications by a banking entity in agency securities lending arrangements should not be prohibited under section 13(f).[2496] Some commenters argued that a banking entity should be allowed to accept the shares of a sponsored covered fund as collateral for a loan to any person or entity, in particular where the loan is not for the purpose of purchasing interests in the covered fund.[2497]

One commenter argued that no exceptions should be granted to the definition of covered transaction, and financing of covered funds would relate to greater fund risk.[2498] In addition, that commenter contended that the Agencies should prohibit a sale of securities by a banking entity to a covered fund even though these transactions are not within the definition of covered transaction for purposes of section 23A of the FR Act.[2499]

The final rule continues to apply the same definition of covered transaction as the proposal. Section 13(f) refers to a covered transaction, as defined in section 23A of the FR Act. Section 13(f) of the BHC Act does not incorporate or reference the exemptions contained in section 23A of the FR Act or the Board's Regulation W. Indeed, the exemptions for these transactions are not included in the definition of covered transactions in section 23A; the exemptions are instead in a different subsection of section 23A and provide an exemption from only some (but not all) of the provisions of section 23A governing covered transactions.[2500] Therefore, the final rule does not incorporate the exemptions in section 23A.

Similarly, the final rule incorporates the statutory restriction as written, which provides that a banking entity that serves in certain specified roles may not enter into a transaction with a covered fund that would be a covered transaction as defined in section 23A of the FR Act as if the banking entity were a member bank and the covered fund were an affiliate thereof. There are certain occasions when the restrictions of section 23A apply to transactions that involve a third party other than an affiliate of a member bank. For example, section 23A would apply to an extension of credit by a member bank to a customer where the extension of credit is secured by shares of an affiliate. The Agencies believe that these transactions between a banking entity and a third party that is not a covered fund are not covered by the terms of section 13(f), which (as discussed above) make specific reference to transactions by the banking entity *with* the covered fund. A contrary reading would prohibit securities margin lending, which Congress has specifically addressed (and permitted) in other statutes. There is no indication in the legislative history that Congress intended section 13(f) to prohibit margin lending that occurs in accordance with other specific statutes. Thus, section 13(f) does not prohibit a banking entity from extending credit to a customer secured by shares of a covered fund (as well as, perhaps, other securities) held in a margin account. However, the Agencies expect banking entities not to structure transactions with third parties in an attempt to evade the restrictions on transactions with covered funds, and the Agencies will use their supervisory authority to monitor and restrict transactions that appear to be evasions of section 13(f).

c. Certain Transactions and Relationships Permitted

While section 13(f)(1) of the BHC Act generally prohibits a banking entity from entering into a transaction with a related covered fund that would be a covered transaction as defined under section 23A of the FR Act, other specific portions of the statute permit a banking entity to engage in certain transactions or relationships with such funds.

1. Permitted Investments and Ownerships Interests

The proposed rule permitted a banking entity to acquire or retain an ownership interest in a covered fund in accordance with the requirements of section 13.[2501] This was consistent with the text of section 13(f), which by its terms is triggered by the presence of certain ownership interests. This view also resolved an apparent conflict between the text of section 13(f) and the reference in section 13(f) prohibiting covered transactions under section 23A of the FR Act, which includes acquiring or retaining an interest in securities issued by an affiliate.

Several commenters supported this aspect of the proposal.[2502] There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section. Moreover, a contrary reading would make these more specific sections that permit covered transactions between a banking entity and a covered fund mere surplusage. Therefore, the final rule adopts this provision as proposed.[2503]

2. Prime Brokerage Transactions

Section 13(f) provides an exception from the prohibition on covered transactions with a covered fund for any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored, or advised by a banking entity has taken an ownership interest (a ''second-tier fund''). However, the statute does not define

[2490] *See* BNY Mellon *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Credit Suisse (Williams).

[2491] *See* ABA (Keating); AFG; Ass'n. of Institutional Investors (Feb. 2012); BoA; BNY Mellon *et al.;* Credit Suisse (Williams); EFAMA; French Treasury *et al.;* JPMC; IMA; RMA; SIFMA *et al.* (Covered Funds) (Feb. 2012); State Street (Feb. 2012); SSgA (Feb. 2012); Vanguard.

[2492] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2493] *See* Credit Suisse (Williams).

[2494] *See, e.g.,* Credit Suisse (Williams).

[2495] *See* BoA; Credit Suisse (Williams); SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2496] *See* State Street (Feb. 2012); RMA.

[2497] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); *see also* Katten (on behalf of Int'l Clients).

[2498] *See* Occupy.

[2499] *See* 12 U.S.C. 371c(b)(7); *see also* 12 U.S.C. 371c–1(a)(2)(B) (including the sale of securities or other assets to an affiliate as a transaction subject to section 23B).

[2500] *See* 12 U.S.C. 371c(d).

[2501] *See* proposed rule § 75.16(a)(2)(i).

[2502] *See, e.g.,* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2503] The final rule modifies the proposal to clarify that a banking entity may acquire and retain an ownership interest in a covered fund by express reference to the permitted activities described in §§ 75.11, 75.12 and 75.13.

prime brokerage transaction. The proposed rule defined prime brokerage transaction to include providing one or more products or services, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.[2504]

A few commenters argued that the proposed definition of prime brokerage transaction was overly broad and should not permit securities lending or borrowing services. These commenters argued that securities lending and borrowing (and certain other services) could increase leverage by covered funds and the risk that a banking entity would bailout these funds.[2505]

Other commenters argued that the proposed definition of prime brokerage transaction was confusing because it included transactions (such as data or portfolio management support) that were not ''covered transactions'' under section 23A of the FR Act and thus not prohibited as an initial matter by section 13(f). These commenters argued that including otherwise permissible transactions within the definition of prime brokerage transaction created uncertainty about the permissibility of other transactions or services that are not expressly covered transactions under section 23A of the FR Act and thus not prohibited under section 13(f). One commenter proposed defining prime brokerage transaction as any ''covered transaction'' entered into by a banking entity with a covered fund ''for purposes of custody, clearance, securities borrowing or lending services, trade execution and settlement, financing and related hedging, intermediation, or a similar purpose.'' [2506]

A few commenters supported expanding the definition of prime brokerage transaction to include any service or transaction ''related to'' a specific list of permissible transactions. For instance, one commenter argued that acting as agent in providing contractual income and settlement services and intraday and overnight overdraft protection should expressly be included within the definition of prime brokerage transaction.[2507] This commenter also urged that borrower default indemnification should be included as a prime brokerage transaction to the extent it would be a covered transaction that is prohibited by section 13(f).[2508] Another commenter recommended that the definition of prime brokerage transaction expressly include transactions in commodities, futures and foreign exchange, as well as securities, and transactions effected through OTC derivatives, including, without limitation, contracts for differences, various swaps and security-based swaps, foreign exchange swaps and forwards and ''FX prime brokerage''.[2509]

Based on review of the comments, the definition of prime brokerage transaction has been modified in several ways. For purposes of the final rule, prime brokerage transaction is defined to mean any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the FR Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support. The definition of prime brokerage transaction under the final rule generally recognizes the same relationships that were considered when defining prime brokerage transaction under the proposal,[2510] without certain of the modifications suggested by some commenters that are discussed above. The Agencies carefully considered comments received on the definition of prime brokerage transaction. As noted above, certain commenters requested that various types of transactions be included in or omitted from the definition. The Agencies believe it appropriate to include within the definition of prime brokerage transaction those transactions that the Agencies believe generally constitute the typical type of prime brokerage transactions provided in the market. Including this list of relationships provides clarity and certainty for transactions that are commonly considered to be prime brokerage transactions.

The final rule incorporates within the definition of prime brokerage transaction a reference to covered transactions under section 23A(b)(7) of the FR Act. This change aligns the final rules with section 13(f) of the BHC Act and is designed to eliminate confusion and provide certainty regarding both the breath of the prohibition on covered transactions in section 13(f) and the scope of the exception for prime brokerage transactions. Thus, a transaction or relationship that is not a covered transaction under section 13(f) of the BHC Act is not prohibited in the first instance (unless prohibited elsewhere in section 13). Within the category of transactions prohibited by section 13(f), transactions within the definition of prime brokerage transaction are permitted.

Some commenters argued that the Agencies should provide an exemption for prime brokerage transactions with a broader array of funds than the proposal permitted. For instance, some commenters argued that the Agencies should permit a banking entity to enter into a prime brokerage transaction with any covered fund or fund structure that the banking entity organizes and offers or for which it directly serves as investment manager, investment adviser, or sponsor, and should not limit the exception for prime brokerage transactions to only a second-tier covered fund.[2511] Conversely, a few commenters argued that the prime brokerage exemption should only permit a banking entity to provide these services to a third-party fund in order to ensure that the provision of prime brokerage services does not give rise to the same risks that section 13 was designed more generally to limit.[2512]

The Agencies note that the statute by its terms does not restrict prime brokerage transactions generally. As noted above, section 13(f)(3)(A) of the BHC Act provides that a banking entity may enter into any prime brokerage transaction with a second-tier fund. The statute by its terms permits a banking entity with a relationship to a covered fund described in section 13(f) to engage in prime brokerage transactions (that are covered transactions) only with second-tier funds and does not extend to covered funds more generally. Neither the statute nor the final rule limit covered transactions between a banking entity and a covered fund for which the banking entity does not serve as investment manager, investment adviser, or sponsor (as defined in section 13 of the BHC Act) or have an interest in reliance on section 13(d)(1)(G) of the BHC Act. Under the statute, the exemption for prime brokerage transactions is available only so long as certain enumerated conditions are satisfied.[2513] The conditions are that (i) the chief executive officer (or equivalent officer) of the banking entity certifies in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the

[2504] *See* proposed rule § 75.10(b)(4).

[2505] *See, e.g.,* Occupy; Public Citizen.

[2506] *See* SIFMA *et al.* (Mar. 2012).

[2507] *See* RMA.

[2508] *See* RMA.

[2509] *See* Katten (on behalf of Int'l Clients).

[2510] *See* final rule § 75.10(d)(5).

[2511] *See* RMA; Katten (on behalf of Int'l Clients); EFAMA; *see also* Hong Kong Inv. Funds Ass'n.; IMA; Union Asset.

[2512] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2513] *See* 12 U.S.C. 1851(f)(3).

covered fund or of any covered fund in which such covered fund invests, and (ii) the Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity. The proposed rule incorporated each of these provisions. The final rule provides that this certification be made to the appropriate Federal supervisor for the banking entity.

A few commenters argued that the proposal did not adequately address how the CEO attestation requirement in section 13(f) would apply to foreign banking organizations. They argued that a senior officer with authority for the U.S. operations of the foreign bank should be permitted to make the required attestation.[2514]

The statute allows the attestation for purposes of the prime brokerage exception in section 13(f) of the BHC Act to be from the chief executive officer or ''equivalent officer.'' [2515] In the case of the U.S. operations of foreign banking entities, the senior officer of the foreign banking entity's U.S. operations or the chief executive officer of the U.S. banking entity may provide the required attestation.

d. Restrictions on Transactions With Any Permitted Covered Fund

Sections 13(f)(2) and 13(f)(3)(B) of the BHC Act apply section 23B of the FR Act [2516] to certain transactions and investments between a banking entity and a covered fund as if such banking entity were a member bank and such covered fund were an affiliate thereof.[2517] Section 23B provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the banking entity as those prevailing at the time for comparable transactions with or involving unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.[2518]

Mirroring the statute, the proposal applied this requirement to transactions between a banking entity that serves as investment manager, investment adviser, or sponsor to a covered fund and that fund and any other fund controlled by that fund. It also applied this condition to a permissible prime brokerage transaction in which a banking entity may engage under the proposal.

Commenters generally did not raise any issues regarding the proposal's implementation of section 13(f)(2) and 13(f)(3)(B). The final rule generally implements these requirements in the same manner as the proposal.[2519]

6. Section 75.15: Other Limitations on Permitted Covered Fund Activities

Like § 75.8, § 75.17 of the proposed rule implemented section 13(d)(2) of the BHC Act, which places certain limitations on the permitted covered fund activities and investments in which a banking entity may engage. Consistent with the statute and § 75.8 of the proposed rule, § 75.17 provided that no transaction, class of transactions, or activity was permissible under §§ 75.11 through 75.14 and § 75.16 of the proposed rule if the transaction, class of transactions, or activity would: (i) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; (ii) result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or (iii) pose a threat to the safety and soundness of the banking entity or the financial stability of the United States.

Section 75.17 of the proposed rule defined ''material conflict of interest,'' ''high-risk assets,'' and ''high-risk trading strategies'' for these purposes in a fashion identical to the definitions of the same terms for purposes of § 75.8 of the proposed rule related to proprietary trading. In the final rule, other than the permitted activities to which §§ 75.7 and 75.15 apply, §§ 75.7 and 75.15 are also identical. Comments received on the definitions in these sections, as well as the treatment of these concepts under the final rule, are described in detail in Part VI.A.9 above.

The Agencies also note that some concerns identified by commenters regarding the rule's extraterritorial application are addressed by modifications in the final rule to the definition of a covered fund under § 75.10. As noted above, commenters requested that the Agencies clarify that the limitations in §§ 75.8 or 75.17 of the proposed rule apply only to a foreign banking entity's U.S. activities and affiliates.[2520] As discussed in greater detail above in Part VI.B.1, the final rule has been modified to more narrowly focus the scope of the definition of covered fund as it applies to foreign funds. Pursuant to the definition of a covered fund in § 75.10(b)(1), a foreign fund may be a covered fund with respect to the U.S. banking entity that sponsors the fund, but not be a covered fund with respect to a foreign bank that invests in the fund solely outside the United States. Foreign public funds, as defined in § 75.10(c)(1) of the final rule, are also excluded from the definition of a covered fund. By excluding foreign public funds from the definition of covered fund and by narrowing the scope of the definition of a covered fund with respect to foreign funds, the Agencies have addressed some commenters' concerns regarding the burdens imposed by proposed rule § 75.17.

C. Subpart D and Appendices A and B—Compliance Program, Reporting, and Violations

Subpart D of the proposed rule implemented section 13(e)(1) of the BHC Act and required certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on activities and investments set forth in section 13 and the proposed rule.[2521]

As explained in detail below, in response to comments on the compliance program requirements and Appendix C (Minimum Standards for Programmatic Compliance) and to conform to modifications to other sections of the proposed rule, the Agencies are adopting a variety of modifications to Subpart D of the proposed rule, which requires certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and

[2514] *See* proposed rule § 75.16(a)(2)(ii); IIB/EBF; Credit Suisse (Williams).

[2515] *See* 12 U.S.C. 1851(f)(3)(A)(ii).

[2516] 12 U.S.C. 371c–1.

[2517] *See* proposed rule § 75.16(b).

[2518] 12 U.S.C. 371c–1(a); 12 CFR 223.51.

[2519] *See* final rule § 75.14(b). As discussed above, § 75.11(b) of the final rule provides that for purposes of securitizations, organizing and offering includes acting as the securitizer. A banking entity that continues to own interests in a securitization in reliance on this exemption must comply, among other things, with the requirements of § 75.14. Accordingly, § 75.14(b) of the final rule has been modified to require that a banking entity that continues to hold an ownership interest in accordance with § 75.11(b) is subject to section 23B of the Federal Reserve Act, as if such banking entity were a member bank and the covered fund were an affiliate.

[2520] *See* EBF; Ass'n. of German Banks.

[2521] For Commission registrants that are swap dealers and to which this rule applies, it is noted that the compliance requirements of subpart D are included in the Commission's regulations that are to be addressed as part of the chief compliance officer duties and requirements under CFTC regulation 3.3.

covered fund activities and investments set forth in section 13 of the BHC Act and the final rule. As described above, this compliance program requirement forms a key part of the multi-faceted approach to implementing section 13 of the BHC Act, and is intended to ensure that banking entities establish, maintain and enforce compliance procedures and controls to prevent violation or evasion of the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments.

The proposal adopted a tiered approach to implementing the compliance program mandate, requiring a banking entity engaged in proprietary trading activities or covered fund activities and investments to establish a compliance program that contained specific elements and, if the banking entity's activities were significant, meet a number of more detailed minimum standards. If a banking entity did not engage in proprietary trading activities and covered fund activities and investments, it was required to ensure that its existing compliance policies and procedures included measures that were designed to prevent the banking entity from becoming engaged in such activities and making such investments and to develop and provide for the required program under § 75.20(a) of the proposed rule prior to engaging in such activities or making such investments, but was not otherwise required to meet the requirements of subpart D of the proposed rule.

1. Section 75.20: Compliance Program Mandate

a. Program Requirement

A number of commenters argued that the compliance program requirements of the proposal were overly specific, too prescriptive and complex to be workable, and not justified by the costs and benefits of having a compliance program.[2522] For instance, one commenter expressed concern that the complexity of the proposed compliance regime would undermine compliance efforts because the requirements were overlapping, imprecise, and did not provide sufficient clarity to traders or banking entities as to what types or levels of activities would be viewed as permissible trading.[2523] Some commenters argued that the compliance program would be challenging to enforce or administer with any consistency across different banking entities and jurisdictions.[2524] A few commenters objected to any attempt to identify every possible instance of prohibited proprietary trading in otherwise permitted activity.[2525] By contrast, some commenters supported the proposed compliance program as effective and consistent with the statute but also suggested a number of ways that the proposal's compliance program could be improved.[2526]

A few commenters argued that the proposed compliance program should be replaced with a more principles-based framework that provides banking entities the discretion and flexibility to customize compliance programs tailored to the structure and activities of their organizations.[2527] A few commenters argued that building on compliance regimes that already exist at banking entities, including risk limits, risk management systems, board-level governance protocols, and the level at which compliance is monitored, would reduce the costs and complexity of the proposal while also enabling a robust compliance mechanism for section 13.[2528]

Another commenter suggested that the focus of the compliance program be on the key goal of reducing risk at banking entities by requiring each banking entity to establish a risk architecture that prescribes a customer-focused business model for market making-related activities including a comprehensive set of risk limits that focuses on servicing customers and ensuring safety and soundness.[2529] This commenter suggested the proposal's compliance requirements be replaced by a simpler compliance framework that could be harmonized with the broader systemic capital and risk management framework under the Basel accord. This commenter argued such a framework would increase transparency as well as reduce overall complexity and costs of regulation, and that information relevant to the compliance infrastructure, including customer orientation policies and procedures, target customer and product lists, trade histories, and risk limit calibration methodology and analyses, should all be made available to examiners.[2530] Another commenter urged that the compliance program could be generally improved by having a greater focus on the compensation incentives within the compliance program of banking entities.[2531]

A number of other commenters requested certain types of banking entities be specifically excluded from having to implement the requirements of the compliance program. For example, some commenters urged that the details required in proposed Appendix C apply only to those banking entities and business lines within a banking group that have ''significant'' covered funds or trading activities and not apply to an affiliate of a banking entity that does not engage in the types of activities section 13 is designed to address (*e.g.,* an industrial affiliate that manufactures machinery).[2532] One commenter argued that the final rule should not impose a compliance program requirement on a banking entity that owns 50 percent or less of another banking entity in order to ensure the compliance program did not discourage joint ventures or other arrangements where a banking entity does not have actual control over an affiliate.[2533] As discussed in Part VI.B.4.c. above,[2534] other commenters argued that the reporting and recordkeeping and compliance requirements of the rule should not apply to permitted insurance company investment activities because insurance companies are already subject to comprehensive regulation of the kinds

[2522] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading); *see also* Barclays; BlackRock; Chamber (Dec. 2011); Comm. on Capital Markets Regulation; Credit Suisse (Williams); FIA; Goldman (Covered Funds); Investure; NYSE Euronext; RBC; STANY; Wedbush; *see also* Northern Trust; Chamber (Feb. 2012).

[2523] *See* Citigroup (Feb. 2012).

[2524] *See* ABA (Abernathy); IIB/EBF; ICFR. While the Agencies recognize these issues, the Agencies believe the final rule's modifications to the proposal—for example, providing for simplified programs for smaller, less active banking entities and increasing the asset threshold that triggers enhanced compliance requirements—helps balance enforceability and consistency concerns with implementing a program that helps to ensure compliance consistent with section 13(e)(1) of the BHC Act. *See* 12 U.S.C. 1851(e)(1).

[2525] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); RBC; STANY; *see also* Barclays.

[2526] *See* AFR (Nov. 2012); Occupy; Sens. Merkley & Levin (Feb. 2012)

[2527] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); *see also* NYSE Euronext; Stephen Roach.

[2528] *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ABA (Abernathy); Paul Volcker.

[2529] *See* Citigroup (Feb. 2012); *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2530] *See* Citigroup (Feb. 2012).

[2531] *See* Occupy.

[2532] *See, e.g.,* Credit Suisse (Williams); GE (Feb. 2012); *see also* NAIB *et al.;* Chamber (Feb. 2012).

[2533] *See* GE (Feb. 2012). Under the BHC Act, an entity would generally be considered an affiliate of a banking entity, and therefore a banking entity itself, if it controls, is controlled by, or is under common control with an insured depository institution. Pursuant to the BHC Act, a company controls another company if, for instance, the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per cent or more of any class of voting securities of the company. *See* 12 U.S.C. 1841(a)(2). The compliance program requirement applies to all banking entities in order to ensure their compliance with the final rule.

[2534] *See* Part VI.B.4.c.

and amounts of investments they can make under State or foreign insurance laws and regulations.[2535] However, another commenter suggested that insurance company affiliates of banking entities expressly be made subject to data collection and reporting requirements to prevent possible evasion of the restrictions of section 13 and the final rule using their insurance affiliates.[2536]

A few commenters argued that requiring securitization vehicles to establish even the minimal requirements set forth in § 75.20(d) would impose unnecessary costs and burdens on these entities.[2537] By contrast, another commenter argued that, because of the perceived risks of these entities, securitization vehicles related to a banking entity should be required to comply fully with the proposed rule regardless of how such compliance procedures are funded by the banking entity.[2538]

Several commenters urged that foreign activities of foreign banking entities, which are already subject to their own prudential regulation under applicable home country regulation, be excluded from the compliance program and argued that to do otherwise would be an extraterritorial expansion of U.S. law.[2539] These commenters contended that the compliance program requirements for foreign banking entities should, in any event, be narrowly circumscribed.[2540] One commenter proposed that the foreign activity of foreign banking entities be excluded from compliance, reporting and other obligations where the risk of the activity is outside of the United States because those risks do not pose a threat to U.S. taxpayers.[2541] Another commenter argued that only U.S. affiliates of foreign banking entities engaged in proprietary trading and covered fund activities as principal in the United States should be required to institute the compliance and reporting systems required in the proposal, and that all foreign affiliates only be required to have policies and procedures designed to prevent the banking entity from engaging in relevant trading and covered fund activities in the United States.[2542] This commenter also expressed concern that the reporting and recordkeeping requirements could be interpreted to apply to an entire trading unit, even trading activities with no U.S. nexus, if any portion of a trading unit's activities, even a single trade, would be required to rely on the market-making, hedging, underwriting or U.S. government security exemptions.[2543]

Commenters also offered thoughts on the timeframe within which banking entities must establish a compliance program. One commenter urged that reporting begin immediately,[2544] while another commenter contended that the effective date provided banking entities with sufficient time to implement the proposal's compliance program.[2545] Other commenters, however, argued that banking entities should have additional time to establish compliance programs.[2546] Some commenters argued banking entities should have one-year from the date of publication of the final rule to implement their compliance programs,[2547] while others urged that banking entities have a two-year period to build compliance systems.[2548] One commenter suggested the Board amend its conformance rule to provide U.S. banking entities with an additional year for implementing the compliance requirements with respect to their foreign operations.[2549]

After considering comments on the proposal, the final rule retains the compliance program requirement with a variety of modifications. In particular, the modifications are designed to make the compliance program requirements clearer and more tailored to the size, complexity and type of activity conducted by each banking entity.[2550] The Agencies also believe that the revisions build on the limits, procedures and elements of risk management programs that many banking entities have already developed to monitor and control the risk of existing trading and investment activities.[2551]

The final rule builds on the proposed rule's tiered approach by adjusting asset thresholds and by adding a new provision allowing a banking entity with modest covered activities to customize its compliance program. Specifically, the final rule allows banking entities with total assets below $10 billion to fold compliance measures into their existing compliance program in a manner that addresses the types and amounts of activities the entity conducts.[2552] The proposal did not contain such a provision. Similar to the proposal, the final rule requires that a banking entity that conducts no activity subject to section 13 of the BHC Act is not required to develop any compliance program until it begins conducting activities subject to section 13.[2553] The final rule further modifies the proposal by requiring that a banking entity with total assets greater than $10 billion but less than $50 billion is generally required to establish a compliance program suited to its activities which includes the six elements described in the final rule.[2554] Additionally, the final

[2535] *See, e.g.,* ACLI (Jan. 2012); Country Fin. *et al.;* NAMIC.

[2536] *See* Sens. Merkley & Levin (Feb. 2012). As noted above, the compliance program requirement applies to all banking entities, including insurance companies that are considered banking entities, in order to ensure their compliance with the final rule.

[2537] *See* ASF (Feb. 2012); AFME *et al.;* SIFMA (Securitization) (Feb. 2012); Commercial Real Estate Fin. Council.

[2538] *See* Occupy.

[2539] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *see also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2540] *See, e.g.,* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Williams); HSBC.

[2541] *See* Australian Bankers Ass'n. (Feb. 2012); *see also* RBC.

[2542] *See* IIB/EBF.

[2543] *See* IIB/EBF.

[2544] *See* Occupy.

[2545] *See* Alfred Brock.

[2546] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *see also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012).

[2547] *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); BoA; Barclays; SIFMA *et al.* (Covered Funds) (Feb. 2012); SIFMA *et al.* (Mar. 2012); Credit Suisse (Seidel); *see also* BDA (Mar. 2012).

[2548] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* GE; Credit Suisse (Williams); Goldman (Prop. Trading); Morgan Stanley; RBC; SVB.

[2549] *See* Morgan Stanley.

[2550] The Agencies believe these modifications, such as increasing the threshold that triggers enhanced compliance standards and allowing smaller banking entities to customize their compliance programs, help address concerns that the proposed requirement was too complex and unworkable. *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Citigroup (Feb. 2012); Wells Fargo (Prop. Trading).

[2551] Some commenters argued that the requirement should build on banking entities' existing compliance regimes. *See* Citigroup (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* ABA (Abernathy); Paul Volcker.

[2552] *See* final rule § 75.20(f)(2).

[2553] *See* final rule § 75.20(f)(1). In response to a few commenters, the final rule, unlike § 75.20(d) of the proposed rule, no longer requires a banking entity include measures that are designed to prevent such entity from becoming engaged in covered trading activities or covered fund investments and activities.

[2554] Under the proposal, each banking entity was required to have a compliance program that addressed the elements described in the rule, unless the banking entity did not engage in prohibited activities or investments, in which case it need only have existing policies and procedures requiring the banking entity to develop a compliance program

rule requires that the largest and most active banking entities, with total assets above $50 billion, or that are subject to the quantitative measurements requirement due to the size of their trading assets and liabilities, adopt an enhanced compliance program that addresses the six elements described in the rule plus a number of more detailed requirements described in Appendix B.[2555]

In response to commenters' concerns regarding compliance program burdens in connection with covered fund activities and investments, the final rule is further modified with respect to thresholds for covered fund activities and investments. As noted above, this and the other modifications are designed to make the compliance program requirement clearer and more tailored to the size, complexity and type of activity conducted by each banking entity. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invests in the aggregate more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total asset thresholds discussed above, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies have also modified the compliance program reporting obligations of foreign banking entities with respect to their covered trading and covered fund activities that are conducted pursuant to the exemptions contained in §§ 75.6(e) and 75.13(b).[2556]

The final rule also responds to commenters' concerns regarding the timeframe within which a banking entity must establish and implement the compliance program required for that entity under § 75.20. Under the final rule, each banking entity must establish the compliance program required for that entity under § 75.20 as soon as practicable and in no case later than the end of the conformance period.[2557] The Agencies expect that during this period a banking entity will develop and implement the compliance program requirements of the final rule as part of its good-faith efforts to fully conform its activities and investments to the requirements of section 13 and the final rule. As explained below in the discussion of the enhanced minimum standards for compliance programs under Appendix B, the final rule also requires larger and more active banking entities to report certain data regarding their trading activities. These requirements have been phased-in to provide banking entities an opportunity to develop the necessary systems to capture and report the relevant data.[2558] In addition, as explained below, the Agencies will consider, after a period to gain experience with the data, revisiting these data collections to determine their usefulness in monitoring the risk and types of activities conducted by banking entities.

b. Compliance Program Elements

Section 75.20 of the final rule specifies six elements that each compliance program required under that section must at a minimum contain. With some minor modifications, these are the same six elements that were included in the proposed rule. The changes reflect modifications made in requirements and limits in the other provisions of the rule and, in particular, acknowledge the importance of trading and hedging limits, appropriate setting, monitoring and management review of trading and hedging limits, strategies, and activities and investments, incentive compensation and other matters.

The six elements specified in § 75.20(b) are:

- Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities and covered fund activities and investments conducted by the banking entity to ensure that all activities and investments that are subject to section 13 of the BHC Act and the rule comply with section 13 of the BHC Act and the rule;[2559]
- A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and the rule and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and the rule;[2560]
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the rule and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in the rule or by management as requiring attention;[2561]
- Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;[2562]
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and

before engaging in such activities. Further, a banking entity that has trading assets and liabilities equal to or greater than $1 billion, or equal to 10% or more of total assets, would have been subject to additional standards under the proposed rule. *See* proposed rule § 75.20(a), (c), (d).

[2555] Because the Agencies have determined not to retain proposed Appendix B in the final rule, proposed Appendix C is now Appendix B under the final rule.

[2556] *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de México; Norinchukin; Cadwalader (on behalf of Thai Banks); Cadwalader (on behalf of Singapore Banks); Allen & Overy (on behalf of Canadian Banks); BAROC; Comm. on Capital Markets Regulation; Credit Suisse (Williams); EFAMA; Hong Kong Inv. Funds Ass'n.; HSBC; IIAC; IMA; Katten (on behalf of Int'l Clients); Ass'n. of Banks in Malaysia; RBC; Sumitomo Trust; *see also* AFME *et al.;* British Bankers' Ass'n.; EBF; Commissioner Barnier; French Banking Fed'n.; UBS; Union Asset.

[2557] As discussed in Part II., the Board is extending the conformance period by one year. Extension of the conformance period will, among other things, provide banking entities with additional time to establish the required compliance program. The Agencies believe the extension of the conformance period, as well as the phased-in approach to implementing the enhanced compliance program in Appendix B, address certain commenters' requests for additional time to establish a compliance program. *See* Wells Fargo (Prop. Trading); PNC *et al.;* Australian Bankers Ass'n. (Feb. 2012); SIFMA *et al.* (Prop. Trading) (Feb. 2012); ABA (Keating); AFME *et al.;* BoA; Barclays; SIFMA et al. (Covered Funds) (Feb. 2012); SIFMA et al. (Mar. 2012); Comm. on Capital Markets Regulation; Credit Suisse (Williams); T. Rowe Price; *see also* Citigroup (Feb. 2012); Société Générale; IIB/EBF; Am. Express; Arnold & Porter; BDA (Mar. 2012); Morgan Stanley.

[2558] Commenters provided a wide range of feedback regarding the timeframe for establishing a compliance program, from requesting that reporting begin immediately to requesting two years from the date of publication of the final rule. *See, e.g.,* Occupy; Alfred Brock; Wells Fargo (Prop. Trading); PNC *et al.;* SIFMA *et al.* (Prop. Trading) (Feb. 2012). The Agencies believe that the final rule's approach appropriately balances the desire for effective regulation with requests for additional time to establish a compliance program.

[2559] This requirement is substantially the same as the proposed written policies and procedures requirement. *See* proposed rule § 75.20(b)(1).

[2560] This requirement is substantially the same as the proposed internal controls requirement. *See* proposed rule § 75.20(b)(2).

[2561] The final rule modifies the proposed management framework requirement by adding that the management framework element must include appropriate management review of trading limits, strategies, hedging activities, incentive compensation, and other matters. *See* final rule § 75.20(b)(3). *See also* proposed rule § 75.20(b)(3). One commenter suggested that the compliance program requirement have a greater focus on compensation incentives. *See* Citigroup (Feb. 2012).

[2562] The final rule modifies the proposed independent testing requirement by specifying that such testing must be done ''periodically.'' *See* final rule § 75.20(b)(4). *See also* proposed rule § 75.20(b)(4). The meaning of ''independent testing'' is discussed in more detail below in Part VI.C.2.e. The reference to ''audit'' does not mean that the independent testing must be performed by a designated auditor, whether internal or external.

enforce the compliance program;[2563] and

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

Under the final rule, these six elements must be part of the compliance program of each banking entity with total consolidated assets greater than $10 billion that engages in activities covered by section 13 of the BHC Act.

As discussed above, the Agencies have moved particular elements with respect to the required compliance program for the exemptions contained in § 75.4(a), § 75.4(b), and § 75.5 into the specific requirements of these exemptions. The Agencies believe this structure more effectively conveys that satisfying the requirements of these exemptions involves specific compliance measures or, with respect to underwriting and market making, a customer-focused business model, as requested by some commenters.[2564]

In addition to the generally required compliance program elements specified in § 75.20(b), a banking entity relying on any of these exemptions should employ the specific compliance tools specified within the relevant section of this rule to facilitate compliance with the applicable exemption and should appropriately tailor the required compliance program elements to the individual trading activities and strategies of each trading desk on an ongoing basis. By specifying particular compliance program-related requirements in the exemptions, the Agencies have sought to provide additional guidance and clarity as to how a compliance program should be structured,[2565] while at the same time providing the banking entity with sufficient discretion to consider the type, size, scope and complexity of its activities and business structure in designing a compliance program to meet the requirements set forth in § 75.20(b).[2566]

For a banking entity with more than $10 billion in total consolidated assets, the compliance program requires additional documentation with respect to funds. For example, the banking entity is required to maintain records that include documentation of exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliate) in determining that such fund is not a covered fund.[2567] The banking entity is also required to maintain, with respect to each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions provided by §§ 75.10(c)(1), 75.10(c)(5), 75.10(c)(8), 75.10(c)(9), or 75.10(c)(10) of subpart C, documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions.[2568] If the banking entity operates a seeding vehicle described in §§ 75.10(c)(12)(i) or 75.10(c)(12)(iii) of subpart C that will become a registered investment company or SEC-regulated business development company, the compliance program must also include a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § 75.12(a)(2)(i)(B) of subpart C.[2569] Furthermore, for any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interest in foreign public funds as described in § 75.10(c)(1) of subpart C owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, such banking entity must include in its compliance program documentation the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized. Such calculation must be done at the end of each calendar quarter and must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters.[2570]

c. Simplified Programs for Less Active Banking Entities

The proposed rule provided that the six elements of the compliance program required by § 75.20 would apply to all banking entities engaged in covered trading activities or covered fund activities and investments and that the minimum detailed standards of Appendix C would apply to only those banking entities above specified thresholds. The application of detailed minimum standards was intended to reflect the heightened compliance risks of significant covered trading and

[2563] The final rule retains the proposed training requirement. *See* final rule § 75.20(b)(5). *See also* proposed rule § 75.20(b)(5).

[2564] One of these commenters suggested the Agencies adopt a simpler compliance framework that could be harmonized with the Basel accord. *See* Citigroup (Feb. 2012). The Agencies believe the final framework described above helps address concerns about streamlining the compliance program requirement while meeting the statutory requirement to issue regulations ''in order to insure compliance'' with section 13. 12 U.S.C. 1851(e)(1).

[2565] One commenter stated that the proposed rule did not provide sufficient clarity as to what types or levels of activities would be permissible. *See* Citigroup (Feb. 2012).

[2566] Some commenters requested a more principles-based framework that allows banking entities to customize compliance programs to the structure and activities of their organizations. *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* M&T Bank; Credit Suisse (Seidel); State Street (Feb. 2012); NYSE Euronext; Stephen Roach.

[2567] *See* final rule § 75.20(e)(1). As discussed under § 75.10 regarding entities excluded from the definition of covered fund, the Agencies recognize that the final rule's definition of covered fund does not include certain pooled investment vehicles. The Agencies expect that the types of pooled investment vehicles sponsored by the financial services industry will continue to evolve, including in response to the final rule, and the Agencies will be monitoring this evolution to determine whether excluding these and other types of entities remains appropriate. The Agencies will also monitor use of the exclusions for attempts to evade the requirements of section 13 and intend to use their authority where appropriate to prevent evasions of the rule. The Agencies are adopting this additional documentation requirement to facilitate such monitoring activities.

[2568] *See* final rule § 75.20(e)(2). The Agencies are adopting this additional documentation requirement for the same reasons discussed above with respect to § 75.20(e)(1).

[2569] *See* final rule § 75.20(e)(3). The rationale for this additional documentation requirement is provided under the discussion regarding registered investment companies and business development companies in § 75.10.

[2570] *See* final rule § 75.20(e)(4). The rationale for this additional documentation requirement is provided under the discussion regarding foreign public funds in § 75.10. For purposes of this requirement, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary. *See* final rule § 75.20(e)(5).

significant covered fund activities and investments.

The proposed rule provided that a banking entity with no covered activities or investments could satisfy the requirements of § 75.20 if its existing compliance policies and procedures were amended to include measures that were designed to prevent the banking entity from becoming engaged in such activities or making such investments and required the banking entity to develop and provide for the required compliance program prior to engaging in covered activities or making covered investments.

Several commenters expressed concern over the requirement in § 75.20(d) of the proposed rule that a banking entity that did not engage in any covered trading activities or covered fund activities or investments must ensure that its existing compliance policies and procedures include measures designed to prevent the banking entity from becoming engaged in such activities and making such investments.[2571] In particular, some commenters expressed concern that the proposal would have a burdensome impact on community banks and force community banks to hire specialists to amend their policies and procedures to ensure compliance with section 13 and the final regulations. These commenters argued that a banking entity should not be required to amend its compliance policies and procedures and set up a monitoring program if the banking entity does not engage in prohibited activities.[2572]

A few commenters argued that the Agencies should more carefully consider the burden of the compliance program on smaller institutions that engage in a modest level of permissible trading or covered fund activity.[2573] One commenter recommended that smaller banks be given the benefit of the doubt regarding compliance.[2574] For instance, one commenter recommended that banking entities with consolidated assets of $10 billion or less be permitted to engage in a limited amount of interest rate swaps and certain other traditional banking activities without being required to establish a compliance program.[2575]

The Agencies have considered carefully the comments received and, as noted above, have modified the rule in order to limit the implementation, operational or other burdens or expenses associated with the compliance requirements for a banking entity that engages in no covered activities or investments. The final rule permits banking entities that have no covered activities or investments (other than covered transactions in obligations of or guaranteed by the United States or an agency of the United States and municipal securities) to satisfy the compliance program requirements by establishing the required compliance program prior to becoming engaged in such activities or making such investments. This eliminates the burden on banking entities that do not engage in covered activities or investments.

Similarly, § 75.20(f)(2) of the final rule provides that a banking entity with total consolidated assets of $10 billion or less as measured on December 31 of the previous two years that does engage in covered activities and investments may satisfy the requirements of § 75.20 by including in its existing compliance policies and procedures references to the requirements of section 13 and subpart D as appropriate given the activities, size, scope and complexity of the banking entity.[2576] This could include appropriate references to the limits on trading activities permitted in reliance upon any of the exemptions contained in § 75.4(a), § 75.4(b) or § 75.5.

d. Threshold for Application of Enhanced Minimum Standards

Under the proposed rule, banking entities with significant covered trading activities or covered fund activities and investments were required to establish an enhanced compliance program in accordance with Appendix C, which contained detailed compliance program requirements. The proposed rule required a banking entity to implement the enhanced compliance program under Appendix C if the banking entity engaged in covered activities and investments and either: (i) Has, on a consolidated basis, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion or equals 10 percent or more of its total assets; or (ii) has, on a consolidated basis, aggregate investments in covered funds the average value of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, is equal to or greater than $1 billion, or sponsors and advises one or more covered funds the total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

In general, commenters argued that the activities and investments subject to section 13 are conducted by only a small number of the nation's largest financial firms and that the compliance program requirements should be tailored to target these firms.[2577] Some commenters urged the Agencies to raise substantially the proposed $1 billion threshold for trading assets and liabilities in § 75.20(c)(2) of the proposal to $10 billion or higher due to the high costs of implementing the enhanced compliance program. A few commenters argued that even if the threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements included in Appendix C.[2578] Some of these commenters recommended the threshold for trading assets for compliance should be increased to no less than $10 billion to mitigate the costs and impact on regional banking organizations that do not engage proprietary trading subject to the prohibition of section 13. These commenters argued that the compliance requirements of § 75.20(a)–(b) are sufficient to ensure that regional banking organizations have appropriate compliance programs.[2579] One commenter suggested the threshold for the enhanced compliance requirement be increased to $50 billion in combined

[2571] *See, e.g.,* ICBA; ABA (Keating); Conf. of State Bank Supervisors; NAIB; Ryan Kamphuis; Wisconsin Bankers Ass'n.

[2572] *See, e.g.,* ICBA; ABA (Keating).

[2573] *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB.

[2574] *See* Sens. Merkley & Levin (Feb. 2012).

[2575] *See* ICBA.

[2576] Some commenters asked the Agencies to consider the burden of the compliance program requirement on smaller institutions and recommended that small banks be given the benefit of the doubt regarding compliance. *See* Sens. Merkley & Levin (Feb. 2012); Conf. of State Bank Supervisors; Ryan Kamphuis; SVB. The Agencies decline to follow the approach suggested by another commenter to allow banking entities with assets of $10 billion or less be permitted to engage in certain limited activities without having to establish a compliance program. *See* ICBA. The Agencies believe that requiring a banking entity engaged in covered trading or covered fund activity to establish a compliance program is a fundamental part of the multi-faceted approach to implementing section 13 of the BHC Act, which requires the Agencies to implement rules ''to insure compliance with this section.'' 12 U.S.C. 1851(e)(1). Further, the Agencies believe that the final rule's modification of the proposal to allow banking entities with total assets under $10 billion to customize their compliance programs helps ease the burden of this requirement on smaller institutions.

[2577] *See, e.g.,* Sens. Merkley & Levin (Feb. 2012); PNC *et al.*

[2578] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2579] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy).

trading assets and liabilities.[2580] One commenter also argued that banking entities required to establish enhanced compliance programs should no longer be required to do so if they fall below the threshold.[2581]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which compliance program requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold triggering the enhanced compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering Appendix C.[2582] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2583] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2584] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be included in the $1 billion standard for becoming subject to any reporting and recordkeeping requirements under the final rule.[2585]

A few commenters argued that the $1 billion threshold for establishing an enhanced compliance program should not include the amount of investments in, or assets of, funds that are SBICs or similar funds that contain, SBICs or other investments specified under section 13(d)(1)(E) of the BHC Act, such as investments in and funds that qualify for low-income housing tax credits, or New Markets Tax Credits or that qualify for Federal historic tax credits or similar state programs.[2586] These commenters argued that each of these types of funds is expressly permitted by the statute and that including these investments and funds in the dollar thresholds that trigger the programmatic compliance requirements of Appendix C would provide a disincentive to banking entities investing in or sponsoring these funds, a result inconsistent with permitting these types of investments. Similarly, one commenter urged that investments by a banking entity in, and assets held by, loan securitizations not be included in these thresholds because these activities and investments are expressly excluded from coverage under the rule of construction contained in section 13(g)(2) of the BHC Act regarding the securitization of loans.[2587] Another commenter urged that this threshold not include investments in, or assets of, any securitization vehicle that would be considered a covered fund because many smaller and regional banking entities that were not intended to be subject to Appendix C likely would exceed the $1 billion threshold if these assets are included.[2588] A few commenters also argued that, during the conformance period, investments in, and relationships with, a covered fund that a banking entity is required to terminate or otherwise divest in order to comply with section 13 should not be included for purposes of calculating the compliance thresholds.[2589]

After considering comments received on the proposal and in order to implement a compliance program requirement that is consistent with the purpose and language of the statute and rule while at the same time appropriately calibrating the associated resource burden on banking entities, the final rule applies the enhanced minimum standards contained in Appendix B to only those banking entities with the most significant covered trading activities or those that meet a specified threshold of total consolidated assets. The final rule, unlike the proposal, does not require a banking entity to adopt the enhanced compliance program if the banking entity, together with its affiliates and subsidiaries, invest in the aggregate more than $1 billion in covered funds or if they sponsor or advise covered funds, the average total assets of which are equal to or greater than $1 billion. Banking entities would look to the total consolidated asset thresholds, instead of the amount of covered fund investments and activities, in determining whether they would be subject to the enhanced compliance program requirements. The Agencies believe that commenters' concerns about whether certain types of covered fund investments or activities (e.g., amounts or relationships held during the conformance period) are included for purposes of calculating the enhanced compliance thresholds are addressed because under the final rule, the enhanced compliance thresholds are based on total consolidated assets and not the amount of covered fund investments and activities. Similar to the proposed rule, which provided that a banking entity could be subject to the enhanced compliance program if the Agency deemed it appropriate, the final rule's enhanced compliance program also could apply if the Agency notifies the banking entity in writing that it must satisfy the requirements.[2590]

Section 75.20 provides that three categories of banking entities will be subject to the enhanced minimum standards contained in Appendix B. The first category is any banking entity that engages in proprietary trading and is required to report metrics regarding its trading activities to its primary Federal supervisory agency under the final rule.[2591] This category includes a banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities that equal or exceed $50 billion based on the average gross sum of trading assets and liabilities (on a worldwide consolidated basis and after excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters. A foreign banking entity with U.S. operations is required to adopt an enhanced compliance program if its total trading assets and liabilities across all its U.S. operations equal or exceed $50 billion (after excluding trading assets and liabilities involving obligations of or guaranteed by the U.S. or any agency of the U.S.). While these banking entities will be required to begin to report and record quantitative measurements by June 30, 2014, they will not be required to implement an enhanced compliance program by this date. Instead, as discussed above, a banking entity must establish a compliance program as soon as practicable and in no event later than the end of the conformance period. As explained more fully in Part VI.C.3., this category expands over time to include

[2580] *See* State Street (Feb. 2012).

[2581] *See* ABA (Keating).

[2582] *See* PNC *et al.*

[2583] *See* PNC *et al.*

[2584] *See* Northern Trust.

[2585] *See* Occupy.

[2586] *See* ABA (Keating); PNC *et al.*

[2587] *See* PNC *et al.*

[2588] *See* ASF (Feb. 2012).

[2589] *See* PNC *et al.;* SIFMA *et al.* (Covered Funds) (Feb. 2012).

[2590] *See* proposed rule § 75.20(c)(2)(iii); final rule § 75.20(c)(3).

[2591] Issues related to the threshold for reporting quantitative measurements are discussed in detail in Part VI.C.3., below.

any banking entity with trading assets and liabilities that equal or exceed $10 billion (as measured in the manner described above). For banking entities below the $50 billion threshold that become subject to the quantitative measurements requirement through the phased-in approach, they will not become subject to the enhanced compliance program until the date they are required to comply with the quantitative measurements requirement. However, these banking entities will be required to have a compliance program that meets the requirements of § 75.20(b) by the end of the conformance period. Thus, banking entities with between $25 billion and $50 billion trading assets and liabilities (as described in § 75.20(d)) will be required to implement an enhanced compliance program under Appendix B by April 30, 2016. Similarly, banking entities with between $10 billion and $25 billion trading assets and liabilities will be subject to the requirements of Appendix B by December 31, 2016.

After considering comments, the Agencies have increased the trading asset and liability thresholds triggering the enhanced compliance program requirements. The Agencies believe that banking entities with a significant amount of trading assets should have the most detailed programs for ensuring compliance with the trading and other requirements of section 13 of the BHC Act and the final rule. Specifically, consistent with the thresholds for reporting and recording quantitative measurements, the threshold will initially be $50 billion trading assets and liabilities and, over time, will be reduced to $10 billion.[2592] As noted by commenters, these thresholds will continue to capture a significant percentage of the total trading assets and liabilities in the banking system, but will reduce the burdens to smaller, less complex banking entities.[2593] With respect to this first category, the Agencies determined, in response to comments,[2594] that the threshold for proprietary trading should not include trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States. This approach reduces the burdens associated with the enhanced minimum compliance program on banking entities whose trading operations consist primarily of trading U.S. government or agency obligations, which are generally exempt from the proprietary trading prohibition under § 75.6(a)(1)(i). While some commenters argued that additional assets or liabilities, such as securitizations or investments in SBICs, should be excluded from the calculation,[2595] the Agencies believe that trading in other assets involves more complex trading activity and warrants being included in the threshold calculation for applying the enhanced compliance program requirement.

To balance the increased trading asset and liability threshold with the goal of requiring appropriate specificity and rigor for large and complex banking organizations' compliance programs, the Agencies have determined to also require an enhanced compliance program for any banking entity that has reported total consolidated assets, as of the previous calendar year-end, of $50 billion or more. Banking entities with total assets of $50 billion or more are among the most complex banking entities and have been found by Congress to pose sufficient risk to the financial stability of the United States to warrant being generally subject to enhanced prudential standards under section 165 of the Dodd-Frank Act. With respect to foreign banking entities, this threshold is calculated by reference solely to the aggregate assets of the foreign banking entity's U.S. operations, including its U.S. branches and agencies. This approach is consistent with the statute's focus on the risks posed by covered trading activities and investments within the United States and also responds to commenters' concerns regarding the level of burden placed on foreign banking entities with respect to their foreign operations.[2596]

The third category includes any banking entity that is notified by its primary Federal supervisory Agency in writing that it must satisfy the requirements and other standards contained in Appendix B. By retaining the flexibility to impose enhanced compliance requirements on a given banking entity upon specific notice to the firm, the Agencies have the ability to apply additional standards to any banking entity with a mix, level, complexity or risk of activities that, in the judgment of the relevant supervisory Agency, indicates that the firm should appropriately have in place an enhanced compliance program.

Some commenters argued that the final rule should not require a banking entity to establish the type of detailed compliance regime dictated by Appendix C for both trading and covered fund activities and investments simply because the banking entity engages in one but not the other activity.[2597]

To comply with the applicable compliance program requirements under § 75.20 and Appendix B of the final rule, banking entities should appropriately take into account the type, size, scope and complexity of their activities and business structure in determining the terms, scope and detail of the compliance program to be instituted.[2598] For example, if all of a banking entity's activities subject to the rule involve covered fund activities or investments, it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the proprietary trading provision of the rule. Similarly, if a banking entity engages only in activities that are subject to the proprietary trading provisions of the rule and does not engage in any covered fund activities or investments, it would not be expected that the banking entity would implement the same detailed compliance program under the covered funds section as would be required for its proprietary trading activities. In each of these situations, the banking entity would be expected to put in place sufficient controls to ensure that an appropriate compliance program is established before the banking entity commences a new covered activity. The

[2592] Some commenters requested raising this dollar threshold to at least $10 billion. *See* PNC *et al.;* PNC; ABA (Keating). One commenter suggested the threshold be increased to $50 billion. *See* State Street (Feb. 2012).

[2593] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy); ABA (Keating). The Agencies recognize that, at the $10 billion threshold, a significant percentage of the trading assets and liabilities in the banking industry will remain subject to the enhanced compliance program requirement. *See* PNC.

[2594] *See* PNC *et al.*

[2595] *See, e.g.,* ABA (Keating) (suggesting the threshold should not include the amount of investments in or assets of SBICs, or those that qualify for low-income housing tax credits (LIHTC) New Markets Tax Credits (NMTC), or Federal historic tax credits (HTC)); PNC *et al.* (loans); Northern Trust.

[2596] Several commenters requested that foreign activities of foreign banking entities be excluded from the compliance program requirement. *See, e.g.,* Société Générale; IIB/EBF; Australian Bankers Ass'n. (Feb. 2012); Banco de Mexico; Norinchukin. One commenter stated the only U.S. affiliates of foreign banking entities should be required to institute the proposed reporting and compliance requirements. *See* IIB/EBF.

[2597] *See, e.g.,* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2598] This is generally consistent with the proposed rule's compliance program requirement. *See* proposed rule § 75.20(a) (requiring that the banking entity's compliance program be appropriate for the size, scope and complexity of activities and business structure of the banking entity).

Agencies believe that this treatment is consistent with the statutory language regarding internal controls and recordkeeping to ensure compliance with section 13 and also reduces unnecessary costs and burdens associated with requiring banking entities to implement compliance requirements that are not appropriate to the size, scope and risk of their relevant activities.

2. Appendix B: Enhanced Minimum Standards for Compliance Programs

The proposed rule contained an appendix (Appendix C) which specified a variety of minimum standards applicable to the compliance program of a banking entity with significant covered trading activities or covered fund activities and investments. The Agencies proposed to include these minimum standards as part of the regulation itself, rather than as accompanying guidance, reflecting the compliance program's importance within the general implementation framework for the rule.

As explained above, the Agencies continue to believe that the inclusion of specified minimum standards for the compliance program within the regulation itself rather than as accompanying guidance serves to reinforce the importance of the compliance program in the implementation framework for section 13 of the BHC Act. As explained above, the Agencies believe that large banking entities and banking entities engaged in significant trading activities should establish, maintain and enforce an enhanced compliance program. The requirements for an enhanced compliance program have been consolidated in Appendix B of the final rule.

Similar to the proposed rule, section I of Appendix B provides that the enhanced compliance program must:

- Be reasonably designed to identify, document, monitor and report the covered trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and the rule;
- Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and the rule;
- Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;
- Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and CEO (or equivalent) of the banking entity review the effectiveness of the compliance program; and
- Facilitate supervision and examination by the Agencies of the banking entity's covered trading and covered fund activities and investments.

The proposed rule included several definitions within the appendix. In the final rule, all definitions have been moved to other sections of the rule or into Appendix A (governing metrics). Any banking entity subject to the enhanced minimum standards contained in Appendix B may incorporate existing policies, procedures and internal controls into the compliance program required by Appendix B to the extent that such existing policies, procedures and internal controls assist in satisfying the requirements of Appendix B.

Section II of Appendix B contains two parts: One that sets forth the enhanced minimum compliance program standards applicable to covered trading activities of a banking entity and one that sets forth the corresponding enhanced minimum compliance program standards with respect to covered fund activities and investments. As noted above, if all of a banking entity's activities subject to the final rule involve only covered trading activities (or only covered fund activities and investments), it would be expected that the banking entity would have an appropriate compliance program governing those activities (including an enhanced compliance program if applicable) and it would not be expected that the banking entity would construct the same detailed compliance program under the covered funds (or proprietary trading) provisions of the rule. As discussed below, the Agencies have determined not to include the provisions regarding enterprise-wide compliance programs.

a. Proprietary Trading Activities

Like the proposed compliance appendix, section II.a of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities.[2599] This portion of Appendix B requires a banking entity to devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its covered trading activities, and to promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program and changes in legal, regulatory or other requirements.

Similar to the proposed rule, section II.a of Appendix B requires a banking entity subject to the Appendix to: (i) Have written policies and procedures governing each trading desk that include a description of certain information specific to each trading desk that will delineate its processes, mission and strategy, risks, limits, types of clients, customers and counterparties and its compensation arrangements; (ii) include a comprehensive description of the risk management program for the trading activity of the banking entity, as well as a description of the governance, approval, reporting, escalation, review and other processes that the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and subpart B; (iii) implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and subpart B and with the banking entity's policies and procedures, and establish and enforce risk limits appropriate for the activity of each trading desk; and (iv) for any hedging activities that are conducted in reliance on the exemption contained in § 75.5, establish, maintain and enforce policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that describe the positions, techniques and strategies that each trading desk may use, the manner in which the banking entity will determine that the risks generated by each trading desk have been properly and effectively hedged, the level of the organization at which

[2599] *See* Joint Proposal, 76 FR at 68963.

hedging activity and management will occur, the management in which such hedging strategies will be monitored and the personnel responsible for such monitoring, the risk management processes used to control unhedged or residual risks, and a description of the process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § 75.5.

To the extent that any of the standards contained in Appendix B may be appropriately met by policies and procedures, internal controls and other requirements that are common to more than one trading desk, a banking entity may satisfy the requirements for the enhanced minimum standards of the compliance program by implementing such common requirements with respect to any such desks as to which they are appropriately applicable.[2600] To the extent the required elements of the compliance program apply differently to different trading desks that conduct trading in the same financial instruments, a banking entity must document the differences and adopt policies and procedures and implement internal controls specific to each of the different trading desks. Overall, the policies and procedures should provide the Agencies with a clear, comprehensive picture of a banking entity's covered trading activities that can be effectively reviewed.

Appendix B also requires that the banking entity perform robust analysis and quantitative measurement of its covered trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. In particular, the banking entity must incorporate into its compliance program any quantitative measure reported by the banking entity pursuant to Appendix A where applicable, and include at a minimum: (i) Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of the quantitative measures employed; (ii) ongoing timely monitoring and review of calculated quantitative measurements; (iii) the establishment of thresholds and trading measures for each trading desk and heightened review of any trading activity that is inconsistent with those thresholds; and (iv) review, investigation and escalation with respect to matters that suggest a reasonable likelihood that a trading desk has violated any part of section 13 of the BHC Act or the rule.[2601]

Where a banking entity is subject to the reporting requirements of Appendix A, any additional quantitative measurements developed and implemented by the banking entity under the compliance program requirement are not required to be routinely submitted to the relevant Agency as provided in Appendix A, but are subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request. Where a banking entity is not subject to the requirements of Appendix A, that banking entity would likewise not be required by this rule to routinely submit these additional quantitative measurements to the relevant Agency, but would be subject to the recordkeeping requirements set forth in subpart D, including the requirement to promptly produce such records to the relevant Agency upon request.

In addition to the other requirements that are specific to proprietary trading, the banking entity's compliance program must identify the activities of each trading desk that will be conducted in reliance on the exemptions contained in §§ 75.4 through 75.6, including an explanation of (i) how and where in the organization such activity occurs, and (ii) which exemption is being relied on and how the activity meets the specific requirements of such exemption. For trading activities that rely on an exemption contained in §§ 75.4 through 75.6, the banking entity's compliance program should include an explanation of how, and its policies, procedures and internal controls that demonstrate that, such trading activities satisfy such exemption and any other requirements of section 13 of the BHC Act and the final rule that are applicable to such activities. A foreign banking entity that engages in proprietary trading in reliance on the exemption contained in § 75.6(e) will be expected to provide information regarding the compliance program implemented to ensure compliance with the requirements of that section, including compliance by the U.S. operations of the foreign banking firm, but will only be expected to provide trading information regarding activity conducted within the United States (absent an indication of activity conducted or designed to evade the requirements of section 13 of the BHC Act of the final rule).[2602]

In addition, the compliance program must describe the process for ensuring that liquidity management activities are conducted in conformance with the limits and policies contained in § 75.3(d)(3). This includes processes for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any proprietary trading activity that may indicate potential violations of section 13 of the BHC Act and subpart B and to prevent violations of section 13 of the BHC Act and subpart B. The standards set forth in subpart D direct the banking entity to include requirements in its compliance program for documenting remediation efforts, assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the implementation of the compliance program.

b. Covered Fund Activities or Investments

Section II.b of Appendix B requires a banking entity subject to the enhanced minimum standards contained in Appendix B to establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

The enhanced compliance program requirements for covered funds and investments focus on: (i) Ensuring that the compliance program provides a process for identifying all covered funds that the banking entity sponsors, organizes or offers, and covered funds in which the banking entity invests; (ii) ensuring that the compliance program provides a method for identifying all funds and pools that the banking entity sponsors or has an interest in and the type of exemption from the Investment Company Act or Commodity Exchange Act (whether or not the fund relies on section 3(c)(1) or 3(c)(7) of the

[2600] This is consistent with proposed Appendix C, except that the term ''trading unit'' from the proposal has been replaced with the term ''trading desk.'' *See* Joint Proposal, 76 FR at 68965.

[2601] *See* Joint Proposal, 76 FR at 68965.

[2602] *See* AFME *et al.;* IIB/EBF; BaFin/Deutsche Bundesbank; Credit Suisse (Seidel); HSBC.

Investment Company Act or section 4.7 of the regulations under the Commodity Exchange Act), and the amount of ownership interest the banking entity has in those funds or pools; (iii) identifying, documenting, and mapping where any covered fund activities are permitted to be conducted within the banking entity; and (iv) including an explanation of compliance; (v) describing sponsorship activities related to covered funds; and (vi) establishing, maintaining and enforcing internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and subpart C, and (vii) monitoring of the banking entity's investments in and transactions with any covered funds.

In addition, the banking entity's compliance program must document the banking entity's plan for seeking unaffiliated investors to ensure that any investment by the banking entity in a covered fund conforms to the limits contained in the final rule or that the covered fund is registered in compliance with the securities laws within the conformance period provided in the final rule. Similarly, the compliance program must ensure that the banking entity complies with any limits on transactions or relationships with the covered fund contained in the final rule, including in situations in which the banking entity is designated as a sponsor, investment manager, investment adviser or commodity trading adviser by another banking entity.

The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity that may indicate potential violations of section 13 of the BHC Act and subpart C. The standards set forth in subpart D require the banking entity to include requirements in its compliance program for documenting remediation efforts, assessing the extent to which modification of the compliance program is warranted and providing prompt notification to appropriate management and the board of directors of material weakness or significant deficiencies in the design or implementation of the compliance program.

c. Enterprise-Wide Programs

Appendix C in the proposed rule contained a provision that permitted a banking entity to establish a compliance program on an enterprise-wide basis. Some commenters argued that a less specific and more flexible compliance regime would be essential to make the enterprise-wide compliance structures contemplated in Appendix C effective because requiring individualized policies and procedures for each business line would diminish the benefits of enterprise-wide compliance and prevent consistency of these policies and procedures within the banking entity.[2603] One of these commenters recommended the Agencies provide greater options for developing a compliance program and not limit a banking entity to a choice between a single enterprise-wide program or a separate program for each subsidiary engaged in activities covered by the proposed rule.[2604]

In contrast, one commenter argued that any enterprise-wide compliance program would only be effective if combined with additional programs at the trading unit or subsidiary level to train all employees at a banking entity.[2605] This commenter argued that each trading unit is different and suggested that it would be more efficient to mandate enterprise-wide default internal controls, but provide each individual trading unit the flexibility to tailor these requirements to its own specific business.[2606] This commenter also urged that Appendix C's elements III (internal controls), IV (responsibility and accountability) and VII (recordkeeping) should not be imposed solely at the enterprise-wide level.[2607]

After considering carefully the comments on the proposal, the Agencies have removed the reference to an enterprise-wide compliance program from the final rule; however, the Agencies acknowledge that a banking entity may establish a compliance program on an enterprise-wide basis, as long as the program satisfies the requirements of § 75.20 and, where applicable, Appendix B. A banking entity may employ common policies and procedures that are established at the enterprise-wide level or at a business-unit level to the extent that such policies and procedures are appropriately applicable to more than one trading desk or activity, as long as the required elements of Appendix B and all of the other applicable compliance-related provisions of the rule are incorporated in the compliance program and effectively administered across trading desks and banking entities within the consolidated enterprise or designated business. If a banking entity establishes an enterprise-wide program, like a non-enterprise wide program, that program will be subject to supervisory review and examination by any Agency vested with rule writing authority under section 13 of the BHC Act with respect to the compliance program and the activities or investments of each banking entity for which the Agency has such authority.[2608] The banking organization would be expected to provide each appropriate Agency with access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rule writing authority.

For similar reasons, the Agencies have determined not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13.[2609] At this time the Agencies do not believe such an approach would be consistent with the statute, which requires each Agency to adopt a rule for the types of banking entities under its jurisdiction,[2610] or effective given the different authorities and expertise of each Agency. The Agencies expect to continue to coordinate their supervisory efforts related to section 13 of the BHC Act and to share information as appropriate in order to effectively implement the requirements of that section and the final rule.[2611]

d. Responsibility and Accountability

Section III of Appendix B includes the enhanced minimum standards for responsibility and accountability. Section III contains many of the provisions contained in the proposed rule relating to responsibility and accountability, with certain modifications.[2612] Section III requires a banking entity to establish, maintain and enforce both a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and the rule. The standards in Section III focus on four key constituencies—the board of directors,

[2603] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2604] *See* Wells Fargo (Prop. Trading).

[2605] *See* Occupy.

[2606] *See* Occupy.

[2607] *See* Occupy.

[2608] *See* 12 U.S.C. 1851(b)(2)(B)(i).

[2609] *See* Barclays; Goldman (Prop. Trading); BoA; SIFMA Funds *et al.* (Prop. Trading) (Feb. 2012); Comm. on Capital Markets Regulation.

[2610] *See* 12 U.S.C. 1851(b)(2)(B).

[2611] Accordingly, the SEC's and the CFTC's final rules, unlike the applicable proposals, do not incorporate by reference the rules and interpretations of the Federal banking agencies with respect to covered fund activities or investments. *See* SEC proposed rule § 255.10(a)(2), Joint Proposal, 76 FR at 68942–68943, and CFTC Proposal, 77 FR at 8421–8423.

[2612] *See* Joint Proposal, 76 FR at 68966.

the CEO, senior management, and business line managers. Certain of the standards contained in the proposed rule relating to business management are separately covered by specific requirements contained in sections II.a and II.b of Appendix B. Section III makes it clear that the board of directors, or similar corporate body, and the CEO and senior management are responsible for creating an appropriate ''tone at the top'' by setting an appropriate culture of compliance and establishing clear policies regarding the management of the firm's trading activities and its fund activities and investments. Senior management must be made responsible for communicating and reinforcing the culture of compliance established by it and the board of directors, for the actual implementation and enforcement of the approved compliance program, and for taking corrective action where appropriate.

In response to a question in the preamble to the proposed rule regarding whether the chief executive officer or similar officer of a banking entity should be required to provide a certification regarding the compliance program requirements, a few commenters urged that the final rule should not require that the board of directors or CEO of a banking entity review or certify the effectiveness of the compliance program.[2613] These commenters argued that existing processes developed by large, complex banking entities for board of director reporting and governance processes ensure that compliance programs work appropriately, and argued that these protocols would establish appropriate management and board of directors' oversight of the section 13 compliance program.[2614] By contrast, several commenters advocated requiring CEO attestation regarding compliance with section 13.[2615] One commenter suggested that the rule require an annual assessment by management of the effectiveness of internal controls and policies and require a public accounting firm to attest to the accuracy of those annual assessments.[2616]

After considering comments received on the proposal, the Agencies have determined to include a requirement in the final rule that a banking entity's CEO annually attest in writing to the appropriate Agency for the banking entity that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix B and § 75.20 of the rule in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this rule. Although some commenters stated that existing protocols of certain banking entities would establish appropriate oversight of the rule's compliance program,[2617] the Agencies believe this requirement will better help to ensure that a strong governance framework is implemented with respect to compliance with section 13 of the BHC Act, and that it more directly underscores the importance of CEO engagement in the governance and management framework supporting compliance with the rule. In the case of the U.S. operations of a foreign banking entity, including a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the U.S. operations of the foreign banking entity who is located in the United States.

e. Independent Testing

Section IV of the Appendix B includes the enhanced minimum standards for independent testing, which are substantially similar to the proposed independent testing standards.[2618] A banking entity subject to Appendix B must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the trading desk or other organizational unit being tested, outside auditors, consultants, or other qualified independent parties. If a banking entity uses internal personnel to conduct the independent testing, the Agencies would expect that the banking entity ensure that the personnel responsible for the testing are separate from the unit and functions being tested (*e.g.,* the personnel do not report to a person who is directly responsible for the unit or involved in the functions being tested) and have knowledge of the requirements of section 13 and its implementing rules. Although an external audit is not required to meet the independent testing requirement, the Agencies would expect that, when external auditors are engaged to review compliance by a banking entity with laws and regulations, the banking entity would give appropriate consideration to the need to review the compliance program required under this rule.

While one commenter suggested the final rule prescribe the precise manner in which a banking entity must conduct its compliance testing,[2619] the Agencies believe such a requirement is unnecessary because the standards in the final rule will ensure that independent testing of the effectiveness of a banking entity's compliance program is objective and robust. The independent testing must examine both the banking entity's compliance program and its actual compliance with the rule. This testing must include not only testing of the overall adequacy and effectiveness of the compliance program and compliance efforts, but also the effectiveness of each element of the compliance program and the banking entity's compliance with each provision of the rule. This requirement is intended to ensure that a banking entity continually reviews and assesses, in an objective manner, the strength of its compliance efforts and promptly identifies and remedies any weaknesses or matters requiring attention within the compliance framework.

f. Training

Like the proposed compliance appendix, Section V of Appendix B includes the enhanced minimum standards for training.[2620] It requires that a banking entity provide adequate training to its trading personnel and managers, as well as other appropriate personnel, in order to effectively implement and enforce the compliance program. In particular, personnel engaged in covered trading activities and investments should be educated with respect to applicable prohibitions and restrictions, exemptions, and compliance program elements to an extent sufficient to permit them to make informed, day-to-day decisions that

[2613] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2614] *See* SIFMA *et al.* (Prop. Trading); *see also* Wells Fargo (Prop. Trading).

[2615] *See* Occupy; AFR *et al.* (Feb. 2012); Sens. Merkley & Levin (Feb. 2012); Public Citizen; Ralph Saul (Oct. 2011); John Reed; *see also* BEC *et al.* (Oct. 2011); Matthew Richardson.

[2616] *See* Merkley & Levin (Feb. 2012).

[2617] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Wells Fargo (Prop. Trading).

[2618] *See* Joint Proposal, 76 FR at 68967.

[2619] One commenter suggested that any compliance testing under the final rule be monitored by the Agencies and initially tested by internal audit personnel of the banking entity who are subject to a specific licensing and registration process for section 13 of the BHC Act and supplemented by an annual independent external review. *See* Occupy; *see also* proposed rule § 75.20(b)(4). The Agencies believe it would be unnecessarily burdensome to require particular licensing and registration processes for internal auditors that are specific to section 13 of the BHC Act.

[2620] *See* Joint Proposal, 76 FR at 68967.

support the banking entity's compliance with section 13 of the BHC Act and the rule. In particular, any personnel with discretionary authority to trade, in any amount, should be appropriately trained regarding the differentiation of prohibited proprietary trading and permitted trading activities and given detailed guidance regarding what types of trading activities are prohibited. Similarly, personnel providing investment management or advisory services, or acting as general partner, managing member, or trustee of a covered fund, should be appropriately trained regarding what covered fund activities and investments are permitted and prohibited.

g. Recordkeeping

Section VI of Appendix B contains the enhanced minimum standards for recordkeeping which are consistent with the proposed recordkeeping standards.[2621] Generally, a banking entity must create records sufficient to demonstrate compliance and support the operation and effectiveness of its compliance program (*i.e.,* records demonstrating the banking entity's compliance with the requirements of section 13 of the BHC Act and the rule, any scrutiny or investigation by compliance personnel or risk managers, and any remedies taken in the event of a violation or non-compliance), and retain these records for no less than five years in a form that allows the banking entity to promptly produce these records to any relevant Agency upon request. Records created and retained under the compliance program must include trading records of the trading units, including trades and positions of each such unit. Records created and retained under the enhanced compliance program must also include documentation of any exemption in the final rule relied on by the banking entity to invest in or sponsor a covered fund.

While one commenter requested that the period for retaining records be extended from 5 years to 6 years, the final rule does not make this change.[2622] The Agencies believe that 5 years is an appropriate minimum period for requiring retention of records to demonstrate compliance with the final rule. The final rule allows the Agencies to require a banking entity to retain records for a longer period if appropriate.

3. Section 75.20(d) and Appendix A: Reporting and Recordkeeping Requirements Applicable to Trading Activities

Section 75.7 of the proposed rule, which the Agencies proposed to implement in part section 13(e)(1) of the BHC Act,[2623] required certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, § 75.7 required banking entities to comply with the recordkeeping requirements in § 75.20 of the proposed rule, related to the banking entity's compliance program,[2624] as well as any other reporting or recordkeeping requirements that the relevant Agency may impose to evaluate the banking entity's compliance with the proposed rule.[2625]

Proposed Appendix A required a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The measurements varied depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contained a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of a banking entity's market-making operations, would constitute prohibited proprietary trading.[2626] Under the proposal, a banking entity was required to comply with proposed Appendix A's reporting and recordkeeping requirements only if it had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) was, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.[2627] The Agencies did not propose to extend the reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appeared that the more limited benefits of applying these requirements to such banking entities, whose trading activities are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements.

a. Approach to Reporting and Recordkeeping Requirements Under the Proposal

The proposal explained that the reporting and recordkeeping requirements of § 75.7 and Appendix A of the proposed rule were an important part of the proposed rule's multi-faceted approach to implementing the prohibition on proprietary trading. These requirements were intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading, and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. To do so, the proposed rule required certain banking entities to calculate and report detailed quantitative measurements of their trading activity, by trading unit. These measurements were meant to help banking entities and the Agencies in assessing whether such trading activity is consistent with permitted trading activities in scope, type and profile. The quantitative measurements required to be reported under the proposed rule were generally designed to reflect, and to provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful in differentiating permitted market making-related activities from prohibited proprietary trading. For example, the proposed quantitative measurements measured the size and type of revenues generated, and the types of risks taken, by a trading unit. Each of these measurements appeared to be useful in assessing whether a trading unit was (i) engaged in permitted market making-related activity or (ii) materially exposed to high-risk assets or high-risk trading strategies. Similarly, the proposed quantitative measurements also measured how much revenue was generated per such unit of risk, the volatility of a trading unit's profitability, and the extent to which a trading unit trades with customers. Each of those characteristics appeared to be useful in assessing whether a trading unit is

[2621] *See* Joint Proposal, 76 FR at 68967.

[2622] One commenter specifically urged that records for any type of compliance program be required to be kept on all hedges, rather than only those placed at a different level or trading unit as under the proposal, and that the retention period for all compliance records be changed from 5 years to 6 years in line with the statute of limitations on civil suits for fraud, contracts and collection of debt in accounts in New York State. *See* Occupy.

[2623] Section 13(e)(1) of the BHC Act requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13. *See* 12 U.S.C. 1851(e)(1). Section 75.20 and Appendix C of the proposed rule also implemented section 13(e)(1) of the BHC Act.

[2624] *See* Part III.D. of this **SUPPLEMENTARY INFORMATION**.

[2625] *See* proposed rule § 75.7.

[2626] *See supra* Part VI.A.3.c.8 (explaining why Appendix B was removed from the final rule).

[2627] *See* proposed rule § 75.7(a).

engaged in permitted market making-related activity.

However, as noted in the proposal, the Agencies recognize that no single quantitative measurement or combination of measurements can accurately identify prohibited proprietary trading without further analysis of the context, facts, and circumstances of the trading activity. In addition, certain quantitative measurements may be useful for assessing one type of trading activity, but not helpful in assessing another type of trading activity. As a result, the Agencies proposed to use a variety of quantitative measurements to help identify transactions or activities that warrant more in-depth analysis or review.

To be effective, this approach requires identification of useful quantitative measurements as well as judgment regarding the type of measurement results that suggest a further review of the trading unit's activity is warranted. The Agencies proposed to take a heuristic approach to implementation in this area that recognized that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision. In particular, the Agencies noted that, although a variety of quantitative measurements have traditionally been used by market participants and others to manage the risks associated with trading activities, these quantitative tools have not been developed, nor have they previously been utilized, for the explicit purpose of identifying trading activity that warrants additional scrutiny in differentiating prohibited proprietary trading from permitted market making-related activities.[2628]

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

In addition to the proposed quantitative measurements, the proposal explained that a banking entity may itself develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and the proposed rule and to establish, maintain, and enforce an effective compliance program, as required by § 75.20 of the proposed rule and Appendix C. The Agencies noted that the proposed quantitative measurements in Appendix A were intended to assist banking entities and Agencies in monitoring compliance with the proprietary trading restrictions and would not necessarily provide all the data necessary for the banking entity to establish an effective compliance program. The Agencies also recognized that appropriate and effective quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading unit, including types of instruments traded, trading activities and strategies, and history and experience (*e.g.,* whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities needed to ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within risk tolerances established by the banking entity, and to monitor for compliance with the proprietary trading restrictions in the proposed rule.

To the extent that data regarding measurements, as set forth in the proposed rule, are collected, the Agencies proposed to utilize the conformance period provided in section 13 of the BHC Act to carefully review that data, further study the design and utility of these measurements, and if necessary, propose changes to the reporting requirements as the Agencies believe are needed to ensure that these measurements are as effective as possible.[2629] This heuristic, gradual approach to implementing reporting requirements for quantitative measurements was intended to ensure that the requirements are formulated in a manner that maximizes their utility for identifying trading activity that warrants additional scrutiny in assessing compliance with the prohibition on proprietary trading, while limiting the risk that the use of quantitative measurements could inadvertently curtail permissible market making-related activities that provide an important service to market participants and the capital markets at large.

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

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

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $5 billion would be required the banking entity to furnish quantitative measurements for all trading units of the banking entity engaged in trading activity subject to §§ 75.4, 75.5, or 75.6(a) of the proposed

[2628] Joint Proposal, 76 FR at 68883.

[2629] *See* 12 U.S.C. 1851(c)(2); Joint Proposal, 76 FR at 68883.

rule (*i.e.,* permitted underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations). The scope of data to be furnished depended on the activity in which the trading unit was engaged. First, for the trading units of such a banking entity that are engaged in market making-related activity pursuant to § 75.4(b) of the proposed rule, proposed Appendix A required that a banking entity furnish seventeen quantitative measurements.[2630] Second, all trading units of such a banking entity engaged in trading activity subject to §§ 75.4(a), 75.5, or 75.6(a) of the proposed rule were required to report five quantitative measurements designed to measure the general risk and profitability of the trading unit.[2631] The Agencies expected that each of these general types of measurements would be useful in assessing the extent to which any permitted trading activity involves exposure to high-risk assets or high-risk trading strategies. These requirements would apply to all type of trading units engaged in underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations. These additional measurements applicable only to trading units engaged in market making-related activities were designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.

Under the proposal, any banking entity that had, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $1 billion but is less than $5 billion would be required to provide quantitative measurements to be furnished for trading units that engaged in market making-related activity subject to § 75.4(b) of the proposed rule. Trading units of such banking entities that engaged in market making-related activities needed to report eight quantitative measurements designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.[2632] The proposal applied a smaller number of measurements to a smaller universe of trading units for this class of banking entities because they are likely to pose lesser compliance risk and fewer supervisory and examination challenges. The Agencies noted in the proposal that a less burdensome reporting regime, coupled with other elements of the proposal (*e.g.,* the compliance program requirement), was likely to be equally as effective in ensuring compliance with section 13 of the BHC Act and the proposed rule for banking entities with smaller trading operations.

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

b. General Comments on the Proposed Metrics

A number of commenters were supportive of metrics. A few commenters argued that the metrics could reveal prohibited proprietary trading activity and be an appropriate and valuable tool in analyzing positions.[2633] One commenter argued that metrics are the single most valuable tool available to the Agencies for distinguishing between prohibited and permitted activities and recommended the compliance program be structured around metrics.[2634] Another commenter stated that the identification of metrics is one of the strengths of the proposed rule and offered great promise for successful implementation of the rule.[2635] One commenter expressed support for the metrics and argued that there would be substantial evasion of the rule without reporting of these measurements.[2636] Some commenters proposed a presumption of compliance so long as trading activity is conducted in a manner consistent with tailored quantitative metrics and related specific thresholds as coordinated and agreed with the relevant Agency.[2637] A few of commenters suggested that metrics not be used as a bright-line trigger and recommended flexibility in the application of metrics for assessing market-making activities.[2638] Two commenters supported metrics as part of a bright lines approach.[2639]

A number of commenters felt that some metrics might be more relevant than others, depending upon the particular asset class, activity, particular market, and unique characteristics of each banking entity.[2640] These commenters advocated an approach where banking entities and examiners would determine over time the usefulness and relevance of particular metrics.[2641] One commenter expressed support for the 5 metrics required for trading in U.S. government obligations.[2642] A number of commenters recommended that metrics be tailored to different asset classes and markets, to avoid the drawbacks of a one-size-fits-all approach.[2643] One commenter argued that application of metrics to market-making activities at different firms may produce very different results, all of which might reflect legitimate market-making.[2644] Commenters also indicated that not all metrics are meaningful and calculable

[2630] *See* proposed rule Appendix A.III.A. These seventeen quantitative measurements are discussed further below.

[2631] *See* proposed rule Appendix A.III.A. These five quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) VaR and Stress VaR; (iv) Risk Factor Sensitivities; and (v) Risk and Position Limits. Each of these and other quantitative measurements discussed in proposed Appendix A are discussed in detail below.

[2632] *See* proposed rule Appendix A.III.A. These eight quantitative measurements are: (i) Comprehensive Profit and Loss; (ii) Comprehensive Profit and Loss Attribution; (iii) Portfolio Profit and Loss; (iv) Fee Income and Expense; (v) Spread Profit and Loss; (vi) VaR; (vii) Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and (viii) Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

[2633] *See, e.g.,* Paul Volcker; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Invesco; Comm. on Capital Markets Regulation.

[2634] *See* Goldman (Prop. Trading).

[2635] *See* Sens. Merkley & Levin (Feb. 2012).

[2636] *See* Occupy.

[2637] *See* Barclays; see also BoA; Invesco; ISDA (Feb. 2012); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2638] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); NYSE Euronext; Oliver Wyman (Feb. 2012); UBS; Western Asset Mgmt.; Goldman (Prop. Trading); Northern Trust.

[2639] *See* John Reed; Public Citizen.

[2640] *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Stephen Roach.

[2641] *See* Wells Fargo (Prop. Trading); Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Stephen Roach.

[2642] *See* UBS.

[2643] *See* Goldman (Prop. Trading); Northern Trust; *see also* UBS.

[2644] *See* Comm. on Capital Markets Regulation.

for all trading units and some would be unnecessarily burdensome.[2645]

Other commenters did not support the use of metrics. These commenters argued that metrics reporting was one aspect of the complexity of the proposal that increased the cost and difficulty of distinguishing market-making from prohibited proprietary trading.[2646] One commenter argued that banking entities may avoid legitimate market making activities that would produce ''worse'' metrics results.[2647]

Several commenters expressed concern that the costs exceeded the benefits of the required quantitative metrics in the proposal. In particular, commenters argued that the 17 metrics in the proposal calculated at each trading unit was excessive, would generate an unmanageable amount of data, would yield numerous false positives, and would require the construction and programming of highly sophisticated systems that are not currently employed.[2648] A few commenters suggested that a more limited set of metrics would reduce compliance complexity.[2649] Some commenters noted that many of these metrics have not been historically reported by banking entities and some of the metrics would require substantial resources and investment infrastructure to produce some of the metrics without a clear functional purpose.[2650] According to other commenters, however, banking entities currently use all or nearly all of the proposed metrics.[2651] One commenter urged that it would be good to make metrics consistent with the banking entities' internal reporting and control systems.[2652] Some commenters argued it was critical for the Agencies to get the metrics right,[2653] while others indicated it was unclear how the Agencies could analyze such information to draw useful conclusions.[2654]

Some commenters expressed concern that metrics were vulnerable to manipulation and arbitrage.[2655] These commenters generally felt that the quantitative measurements were only appropriate for certain liquid and transparent trading activities but not meaningful for illiquid markets, including opaque securities and derivatives.[2656] These commenters also argued that the vast majority of proprietary trading would not be differentiable through analysis of the data.[2657] Other commenters expressed concern that the use of metrics not replace regulatory review of actual specific trading positions held by banking entities.[2658] One commenter argued that in relying on metrics to be elaborated upon and discussed in the examination process, the proposed rule did not meet the fundamental fair notice goal of regulation.[2659]

A few commenters also recommended creation of a central data repository or data sharing protocol that would promote consistency and accountability in oversight and regulation and suggested the Office of Financial Research (''OFR'') be given access to this data so that it can provide centralized analysis and monitoring to identify any trends that give rise to systemic risk.[2660] These commenters generally supported compliance benefits that would result from increased public disclosure of banking entities' trading and funds activities, including all of their trading positions, their valuation models, and their compliance metrics.[2661]

Some commenters expressed support for the reporting thresholds contained in Appendix A.[2662] One commenter suggested that all banking entities that engage in any trading (regardless of threshold) report certain metrics.[2663] Other commenters supported metrics reporting, but recommended the threshold for trading assets and liabilities be increased from $1 billion to $10 billion to mitigate any cost and burden impact on smaller banking entities.[2664] These commenters pointed out that even if the minimum dollar threshold were raised to $10 billion, an overwhelming percentage of trading assets and liabilities in the banking industry (approximately 98 percent) would still remain subject to heightened compliance requirements including Appendix A.[2665] One commenter suggested the threshold be raised to $50 billion in combined trading assets and liabilities.[2666]

Commenters also offered a number of suggestions for modifying the activity that would be considered in meeting the thresholds for determining which reporting requirements apply to a banking entity. Several commenters argued that certain types of trading assets or fund investments should not be included for purposes of determining whether the relevant dollar threshold for compliance was met, particularly those that are not prohibited activities or investments. For instance, some commenters urged that trading in U.S. government obligations should not count toward the calculation of whether a banking organization meets the trading threshold triggering metrics reporting.[2667] These commenters also argued that other positions or transactions that do not involve financial instruments and that may constitute trading assets and liabilities, such as loans, should be excluded from the thresholds because exempt activities should not determine the type of compliance program a banking entity must implement.[2668] One commenter urged that foreign exchange swaps and forwards be excluded from the definition of a ''derivative'' and not be subject to compliance requirements as a result.[2669] Conversely, one commenter urged that all assets and liabilities defined as trading assets for purposes of the Market Risk Capital Rule should be included in the $1 billion standard for becoming subject to any reporting and record-keeping requirements under the final rule.[2670]

A number of commenters argued that monthly reporting was too frequent because of the complexity of the process that surrounds generation of regulatory

[2645] *See* Morgan Stanley; *see also* ISDA (Feb. 2012).

[2646] *See* ABA (Keating); Barclays; Citigroup (Feb. 2012); ISDA (Feb. 2012); UBS; Oliver Wyman (Feb. 2012); Prof. Duffie; Wellington.

[2647] *See* Oliver Wyman (Feb. 2012).

[2648] *See* BoA (expressing concern about the need for new systems to distinguish bid-ask spreads from price appreciation); UBS; Wellington.

[2649] *See* BoA; Barclays; Citigroup (Feb. 2012).

[2650] *See* Credit Suisse (Seidel); Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale (arguing that many calculation questions need to be resolved before banking entities can create necessary systems to measure metrics).

[2651] *See* Occupy; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen. For example, one commenter cited a study finding that 14 out of 17 of the proposed metrics are either in wide use today or are possible to implement fairly easily using data already collected for internal risk management and profit and loss purposes. *See* AFR *et al.* (Feb. 2012) (citing John Lester and Dylan Walsh, ''The Volcker Rule Ban On Prop Trading: A Step Closer to Reality, Point of View,'' Oliver Wyman Company (Oct. 2011)).

[2652] *See* Paul Volcker.

[2653] *See, e.g.,* UBS.

[2654] *See* BoA; UBS; Wellington.

[2655] *See* AFR (Nov. 2012); *see also* Occupy; Public Citizen.

[2656] *See* Occupy; AFR (Nov. 2012); Wells Fargo (Prop. Trading).

[2657] *See* Occupy.

[2658] *See* Sens. Merkley & Levin (Feb. 2012).

[2659] *See* ISDA (Feb. 2012) (citing *Mason v. Florida Bar,* 208 F.3d 952, 958–59 (11th Cir. 2000)).

[2660] *See* Sens. Merkley & Levin (Feb. 2012); *see also* Occupy; Public Citizen.

[2661] *See* Sens. Merkley & Levin (Feb. 2012); *see also* Public Citizen; John Reed.

[2662] *See* ICBA; Occupy.

[2663] *See* Occupy (suggesting all banking entities that engage in trading be required to provide VaR Exceedance, Risk Factor Sensitivities and Risk and Position Limits).

[2664] *See* PNC *et al.;* M&T Bank; *see also* ABA (Abernathy).

[2665] *See* ABA (Keating); M&T Bank; PNC *et al.*

[2666] *See* State Street (Feb. 2012).

[2667] *See* PNC *et al.*

[2668] *See* PNC *et al.*

[2669] *See* Northern Trust.

[2670] *See* Occupy at 60.

reports and suggested that the frequency of reporting should be quarterly.[2671] One commenter supported the reporting frequency as extremely effective and said it should not be reduced in any way.[2672]

A number of comments were received on the implementation timeframe for metrics reporting. Several commenters urged allowing banking entities the use of the full conformance period for creating the systems and processes to capture and report the quantitative metrics.[2673] Some commenters suggested that metrics should not be required to be reported until one year after adoption of final regulations.[2674] A different commenter suggested that the Agencies provide a one-year period during which they determine which metrics will be employed for different asset classes and an additional one-year period during which such metrics could be reviewed so metrics would be a required component of a banking entity's compliance program no sooner than 2 years after issuance of the final rule.[2675] Another commenter suggested that banking entities and regulators use the first year of the conformance period to consult with one another and determine the usefulness and relevance of individual metrics for different activities, asset classes, and markets and the second year of the conformance period to test the metrics systems to validate the accuracy and relevance of metrics that are agreed upon the first year.[2676] One commenter suggested a subset of metrics be rolled out gradually across trading units before implementing the full suite of metrics that are ultimately adopted or metrics could be rolled out one trading unit at a time.[2677] Another commenter said the Agencies should identify key metrics that are clearly workable across all ranges of trading activity and most likely to provide useful data and require those metrics be implemented first and require other metrics to be phased in over time in consultation with the banking entity's primary Federal regulator.[2678] One commenter supported the heuristic approach of the proposal and suggested the Agencies should draw on resources and comment from the public and the industry in continuing the process of developing and building out metrics.[2679]

Another commenter requested that the final rule specify how trading assets and liabilities should be reported for savings and loan holding companies.[2680] This commenter requested clarification that positions held for hedging or liquidity management purposes should not count as trading assets or liabilities for the $5 billion threshold in Appendix A. Another commenter expressed concern that derivatives valuation may value derivatives substantially lower than their notional exposure and thereby make high reporting thresholds not meaningful or reflective of inherent risk.[2681]

Many commenters expressed concern that the smallest trading unit level was too low a level for collecting metrics data and suggested the final rule provide a higher reporting level.[2682] These commenters stated that calculating at too low of a level would be more likely to generate false positives[2683] and would be burdensome, particularly for firms with large trading operations.[2684] In addition, some commenters indicated that it would be problematic if the definition of ''trading unit'' is applied at a legal entity level and cannot be applied across multiple legal entities within the same affiliate group.[2685] By contrast, two commenters supported the collection of metrics at the trading desk level and appropriate levels above the trading desk.[2686] One of these commenters expressed concern that the rule allowed for an inappropriately large trading desk unit that could combine significantly unrelated trading desks, which would impede detection of proprietary trading and supported measurements at multiple levels of organization to combat evasion concerns.

In response to questions in the proposal about whether the Agencies should establish numerical thresholds for some or all of the proposed quantitative measurements, a number of commenters expressed opposition to establishing numerical thresholds for purposes of the rule,[2687] while others stated that thresholds should be established over time.[2688] In opposition of thresholds, one commenter expressed concern that numerical thresholds could be easily abused and evaded and may need to be constantly revised and updated as financial markets evolve.[2689] In addition, another commenter stated that numerical thresholds should not be imposed because metric levels will differ by asset class and type of activity.[2690] A few commenters suggested that numerical thresholds, based on the specific asset class or market, would be useful to provide clarity or consistency about the types of activity that are permitted under the rule.[2691] Two commenters expressed support for banking entities establishing numerical thresholds, in consultation with the relevant regulator, for different trading units based on differences between markets and asset classes.[2692]

c. Approach of the Final Rule

As explained below, the Agencies have reduced the number of metrics that banking entities must report under Appendix A from the 17 metrics in the proposal to 7 metrics in the final rule. The final rule also increases the level of activity that is required to trigger mandatory reporting of metrics data and phases in the reporting requirement over time.

Under the final rule, a banking entity engaged in significant trading activity as defined by § 75.20 must furnish the following quantitative measurements for each of its trading desks engaged in covered trading activity calculated in accordance with Appendix A:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio.

In response to comments, the final rule raises the threshold for metrics reporting from the proposal to capture only firms that engage in significant trading activity, identified at specified aggregate trading asset and liability thresholds, and delays the dates for reporting metrics through a phased-in

[2671] *See* JPMC; *see also* Stephen Roach.

[2672] *See* Occupy.

[2673] *See* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); UBS; Stephen Roach.

[2674] *See* Credit Suisse (Seidel); JPMC; Wells Fargo (Prop. Trading).

[2675] *See* BoA.

[2676] *See* Morgan Stanley; *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2677] *See* Goldman (Prop. Trading).

[2678] *See* Wells Fargo (Prop. Trading).

[2679] *See* AFR *et al.* (Feb. 2012).

[2680] *See* GE (Feb. 2012).

[2681] *See* Occupy.

[2682] *See, e.g.,* BoA; Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Morgan Stanley; RBC.

[2683] *See* JPMC; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA. *See also* Sen. Gillibrand.

[2684] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA.

[2685] *See* Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2686] *See* Sens. Merkley & Levin (Feb. 2012); Occupy.

[2687] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); Occupy; Alfred Brock.

[2688] *See* Wellington; Barclays; Goldman (Prop. Trading); CalPERS; John Reed.

[2689] *See* Occupy.

[2690] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2691] *See* Wellington; CalPERS; John Reed.

[2692] *See* Goldman (Prop. Trading); Barclays.

approach based on the size of trading assets and liabilities.[2693] Banking entities that meet the relevant thresholds must collect and report metrics for all trading desks engaged in covered trading activity beginning on the dates established in § 75.20 of the final rule. Specifically, the Agencies have delayed the reporting of metrics until June 30, 2014 for the largest banking entities that, together with their affiliates and subsidiaries, have trading assets and liabilities the average gross sum of which equal or exceed $50 billion on a worldwide consolidated basis over the previous four calendar quarters (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States). Banking entities with less than $50 billion and greater than or equal to $25 billion in trading assets and liabilities and banking entities with less than $25 billion and greater than or equal to $10 billion in trading assets and liabilities would also be required to report these metrics beginning on April 30, 2016, and December 31, 2016, respectively. The Agencies believe that these delayed dates for reporting metrics should allow firms adequate time to develop systems to calculate and report the quantitative metrics. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

Under the final rule, a banking entity required to report metrics must calculate any applicable quantitative measurement for each trading day. Each banking entity required to report must report each applicable quantitative measurement to its primary supervisory Agency on the reporting schedule established in § 75.20 unless otherwise requested by the primary supervisory Agency for the entity. The largest banking entities with $50 billion or greater in trading assets and liabilities must report the metrics on a monthly basis. Other banking entities required to report metrics must do so on a quarterly basis.[2694] All quantitative measurements for any calendar month must be reported no later than 10 days after the end of the calendar month required by § 75.20, unless another time is requested by the primary supervisory Agency for the entity except for a preliminary period when reporting will be required no later than 30 days after the end of the calendar month. Banking entities subject to quarterly reporting will be required to report quantitative measurements within 30 days of the end of the quarter, unless another time is requested by the primary supervisory Agency for the entity in writing.[2695]

The Agencies believe that together the reduced number of metrics, the higher thresholds for reporting metrics, delayed reporting dates, and modified reporting frequency reduce the costs and burden from the proposal while allowing collection of data to permit better monitoring of compliance with section 13 of the BHC Act. The Agencies also believe that the delayed dates for reporting quantitative metrics will provide banking entities with the time to develop systems to calculate and report these metrics. The Agencies are not applying these reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appears that the more limited benefits of applying these requirements to banking entities with lower levels of trading activities, which represent entities that are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements of Appendix A.

The final rule defines ''trading desk'' to replace the concept of ''trading unit'' in the proposal.[2696] Under the final rule, trading desk means the smallest discrete unit of organization of a banking entity that buys or sells financial instruments for the trading account of the banking entity or an affiliate thereof. The Agencies believe that applying quantitative measurements to a level that aggregates a variety of distinct trading activities may obscure or ''smooth'' differences between distinct lines of business, asset categories and risk management processes in a way that renders the measurement relatively uninformative because it does not adequately reflect the specific characteristics of the trading activities being conducted.

While the Agencies recognize that applying quantitative measurements at the trading desk level may result in some ''noise'' in the data and false positives, the Agencies believe it is necessary to apply the quantitative measurements at the trading desk level to enhance consistency with other provisions of the final rule. For example, because the requirements of the market-making exemption apply at the trading desk level of organization, the Agencies believe quantitative measurements used to monitor a banking entity's market making-related activities should also calculated, reported, and recorded at the trading desk level. In response to commenters' concerns that trading desk level measurements are more likely to generate false positives, the Agencies emphasize that quantitative measurements will not be used as a dispositive tool for determining compliance and, rather, will be used to monitor patterns and identify activity that may warrant further review.

Like the proposal, the final rule does not include specific numerical thresholds. Commenters did not suggest specific thresholds for particular metrics or provide data and analysis that would support particular thresholds.[2697] Given the range of financial instruments and trading activity covered by the final rule, as well as potential differences among banking entities' organizational structures, trading strategies, and level of presence in a particular market, the Agencies are concerned that numerical thresholds for specific metrics would not account for these differences and could inappropriately constrain

[2693] As noted above, a number of commenters suggested setting a higher threshold than the proposed $1 billion and $5 billion trading asset and liability thresholds because even thresholds of $10 billion to $50 billion would capture a significant percentage of the total trading assets and liabilities in the banking system. *See* ABA (Keating); M&T Bank; PNC *et al.;* State Street (Feb. 2012). The Agencies believe that the phase-in approach to the metrics requirement established in the final rule should generally address commenters' concerns about the implementation timeframe by providing time for analysis, development of systems (if needed), and implementation of the quantitative measurements requirement. *See, e.g.,* BoA; Barclays; Citigroup (Feb. 2012); Goldman (Prop. Trading); JPMC; Morgan Stanley; SIFMA *et al.* (Prop. Trading) (Feb. 2012); UBS; Stephen Roach; Credit Suisse (Seidel); Wells Fargo (Prop. Trading). The Agencies are establishing a phase-in approach, rather than requiring all banking entities above the $10 billion threshold to report metrics within the same timeframe, to strike a balance between the benefits of receiving data to help monitor compliance with the rule against the need for time to assess the effectiveness and usefulness of the quantitative measurements in practice and for some firms to develop additional systems for purposes of this requirement.

[2694] Consistent with certain commenters' requests, the final rule generally requires less frequent reporting than was proposed. However, the Agencies continue to believe that monthly reporting is appropriate for the largest banking entities above the $50 billion threshold. More frequent reporting for these firms is appropriate to allow for more effective supervision of their large-scale trading operations. *See* JPMC; Stephen Roach.

[2695] *See* final rule § 75.20(d)(3). The final rule includes a shorter period of time for reporting quantitative measurements after the end of the relevant period than was proposed for the largest banking entities. Like the monthly reporting requirement for these firms, this is intended to allow for more effective supervision of their large-scale trading operations.

[2696] *See* final rule § 75.3(e)(13); *see also supra* Parts VI.A.2.c.1.c.ii. and VI.A.3.c.1.c.i.

[2697] *See* Wellington; CalPERS; John Reed.

legitimate activity.[2698] Further, mandated thresholds for the metrics would not recognize the impact changing market conditions may have on a given trading desk's quantitative measurements. Consistent with two commenters' suggested approach, banking entities will be required to establish their own numerical thresholds for quantitative measurements under the enhanced compliance program requirement in Appendix B.[2699]

d. Proposed Quantitative Measurements and Comments on Specific Metrics

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

- *Risk-management measurements*—VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;
- *Source-of-revenue measurements*—Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;
- *Revenues-relative-to-risk measurements*—Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;
- *Customer-facing activity measurements*—Inventory Turnover, Inventory Aging, and Customer-facing Trade Ratio; and
- *Payment of fees, commissions, and spreads measurements*—Pay-to-Receive Spread Ratio.

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

Under the proposal, the first set of quantitative measurements related to risk management, and included VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits. Commenters generally supported the use of risk-management metrics as the most important measure of compliance, indicating that these metrics could potentially provide useful supervisory information.[2700]

In general, commenters supported the use of the VaR metric.[2701] One of these commenters argued that VaR was not particularly indicative of proprietary trading, but could be helpful to reveal a trading unit's overall size and risk profile.[2702] Another commenter indicated that significant, abrupt or inconsistent changes to VaR may need to be absorbed by market makers who absorb large demand and supply shocks into their inventories.[2703] This commenter contended that the six largest bank holding companies had proprietary trading losses that frequently exceeded their VaR estimates and the design and supervision of such risk measures should be revisited.

One commenter argued that the definition of VaR was not made clear in the proposal and was missing some important information regarding methodology as VaR methodologies tend to vary among banking entities.[2704] This commenter recommended the development of a standard methodology by the OFR including a central repository for historical calculation data for each asset for the purpose of ensuring standard calculation across the industry. This commenter also expressed concern that VaR calculations are heavily reliant on the quality of input data and stated that many markets are unable to provide sufficient information such that VaR calculations are meaningful, including markets for illiquid products for which accurate historical price and market information is sparse and could severely under represent true potential losses under VaR calculations.[2705]

A few commenters expressed concern about the applicability of VaR when applied to ALM activities.[2706] These commenters argued that risk management metrics such as VaR would not help to distinguish ALM and valid risk mitigating hedging activities from prohibited proprietary trading. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not marked to market but the corresponding hedge may be.

One commenter argued that the use of stress VaR would be important to guard against excessive risk taking.[2707] A few commenters suggested that additional guidance be provided for Stress VaR including linking it to the broader stress testing regime and based on extreme conditions that are not based on historic precedent.[2708] These commenters also argued that a one-day holding period assumption is inadequate, especially for less liquid asset classes, and recommended that stress be measured over a longer period. One commenter argued that Stress VaR should be removed from the list of required metrics as it is not in regular use for day-to-day risk management and provides little relevant information about the intent or proportionality

[2698] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2699] *See* Goldman (Prop. Trading); Barclays. *See also* final rule Appendix B.

[2700] *See, e.g.,* AFR et al. (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *see also* BNY Mellon *et al.* (suggesting the use of VaR measures for foreign exchange trading activity).

[2701] *See, e.g.,* Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; Public Citizen.

[2702] *See* Goldman (Prop. Trading).

[2703] *See* Prof. Duffie.

[2704] *See* Occupy.

[2705] *See* Occupy.

[2706] *See* JPMC; State Street (Feb. 2012); *see also* BoA; CH/ABASA. For instance, one of these commenters stated that the proposed reliance on VaR and Stress VaR to demonstrate bona fide hedging is misleading for ALM activities due to the typical accounting asymmetry in ALM where, for example, managed liabilities such as deposits are not mark-to-market but the corresponding hedge may be. *See* State Street (Feb. 2012).

[2707] *See* Public Citizen.

[2708] *See* AFR *et al.* (Feb. 2012); Public Citizen.

between risk assumed and client demands.[2709]

A number of commenters requested that VaR Exceedance be removed from the list of metrics. These commenters argued that the primary function of VaR Exceedance is to analyze the quality of a VaR model and that VaR backtesting is already reported to regulators as part of the supervisory process. These commenters argued that VaR Exceedance does not reveal trading intent or actual risk taken.[2710] One commenter argued that VaR Exceedance may be useful to the Agencies as an indicator of the quality of the VaR measure relative to the profit and loss of the trading unit but that a more rigorous back-testing process would serve as a better analytical tool than VaR Exceedance to evaluate the quality of the VaR model result and should be included as an additional metric.[2711] One commenter suggested that risk-based metrics should measure risk as a function of capital.[2712] Another commenter warned that risk metrics could be significantly higher during times of market stress and volatility than during normal times.[2713]

A few commenters expressed support for risk factor sensitivities as useful, supervisory information.[2714] One of these commenters suggested that risk factor sensitivities could orient regulators to a trading unit's overall size and risk profile,[2715] while another commenter stated that risk factor sensitivities would be the most useful tool for identifying the accumulation of market risk in different areas of a banking entity.[2716] One commenter suggested that several risk factor sensitivity snapshots be taken throughout the day with an average value reported at the end of day.[2717] This commenter also recommended that trading strategies that rely heavily on models to calculate risk exposures (e.g., correlation trading portfolios), should trigger additional disclosures in risk factor sensitivity reporting.[2718]

Commenters also supported risk and position limits as providing useful, supervisory information. Several commenters indicated that these limits could be helpful to orient regulators to a trading unit's overall size and risk profile.[2719] Another commenter expressed the view risk and position limits are the most comprehensive measures of risk taking and incorporate VaR, Stress VaR, and Risk Factor Sensitivities.[2720] A different commenter argued it was unclear how position limits are in fact a quantitative metric and not a description of a banking entity's internal risk policies.[2721]

After carefully considering the comments received, the final rule retains the risk-management metrics other than VaR Exceedance. The collection of information regarding Risk and Position Limits, VaR, Stress VaR, and Risk Factor Sensitivities is consistent with the aim of providing a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible activities. Moreover, a number of commenters indicated that the risk management measures would be effective at achieving these goals.[2722] The risk management measure that was not retained in the final rule, VaR Exceedance, was considered, in light of the comments, as not offering significant additional information on the overall risk profile and activities of the trading desk relative to the burden associated with computing, auditing and reporting it on an ongoing basis.[2723]

The risk-management measurements included in the final rule are widely used by banking entities to measure and manage trading risks and activities.[2724] VaR, Stress VaR, and Risk Factor Sensitivities provide internal, model-based assessments of overall risk, stated in terms of large but plausible losses that may occur or changes in revenue that would be expected to result from movements in underlying risk factors. The provided description and calculation guidance for each of these measures is consistent with both current market practice and regulatory capital requirements for banks. The final rule does not provide a prescriptive definition of each of these measurements as these measures must be flexible enough to be tailored to the specific trading activities of each trading desk. Supervisory guidance and comparisons of these measures across similarly situated trading desks at a given entity as well as across entities will be used to ensure that the provided measurements conform to the description and calculation guidance provided in Appendix A. Risk and Position Limits and Usage provide an explicit assessment of management's expectation of how much risk is required to perform permitted market-making, underwriting and hedging activities. The final rule requires that the usage of each risk and position limit be reported so that the risk taking by each trading desk can be monitored and assessed on an ongoing basis.[2725]

With the exception of Stress VaR, each of these measurements are routinely used to manage and control risk taking activities, and are also used by some banking entities for purposes of calculating regulatory capital and allocating capital internally.[2726] In the context of permitted market making-related activities, these risk management measures are useful in assessing whether the actual risk taken is consistent with the level of principal risk that a banking entity must retain in order to service the near-term demands of customers. Significant, abrupt or inconsistent changes to key risk management measures, such as VaR, that are inconsistent with prior experience, the experience of similarly situated trading desks and management's stated expectations for such measures may indicate impermissible proprietary trading, and may warrant further review. In addition, indicators of unanticipated or unusual levels of risk taken, such as breaches of internal Risk and Position Limits, may suggest behavior that is inconsistent with appropriate levels of risk and may warrant further scrutiny. The limits required under § 75.4(b)(2)(iii) and § 75.5(b)(1)(i) must meet the applicable requirements under § 75.4(b)(2)(iii) and § 75.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a

[2709] *See* JPMC.

[2710] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2711] *See* Occupy.

[2712] *See* Citigroup (Feb. 2012).

[2713] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2714] *See* Citigroup (Feb. 2012); Prof. Duffie; Occupy.

[2715] *See* Goldman (Prop. Trading).

[2716] *See* Occupy.

[2717] *See* Occupy.

[2718] *See* Occupy.

[2719] *See, e.g.,* Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading).

[2720] *See* Barclays.

[2721] *See* Occupy.

[2722] *See, e.g.,* AFR *et al.* (Feb. 2012); Barclays; Citigroup (Feb. 2012); Prof. Duffie; Goldman (Prop. Trading); Invesco; JPMC; Occupy; Public Citizen; *see also* Northern Trust; State Street (Feb. 2012).

[2723] *See* ABA (Keating); Barclays; Goldman (Prop. Trading); SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); UBS.

[2724] *See* Joint Proposal, 76 FR at 68887.

[2725] The Agencies believe this clarification responds to one commenter's question regarding how risk and position limits will be used and assessed for purposes of the rule. *See* Occupy.

[2726] *See* Joint Proposal, 76 FR at 68887.

trading desk based on the types of positions traded by, and risk exposures of, that desk.

Under the proposal, the second set of quantitative measurements related to the source of revenues, and included Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution. A few commenters expressed support for Comprehensive Profit and Loss as a reasonable contextual metric and contended that the metric could inform the analysis of whether market-making revenues are from customer transactions.[2727]

As described above, a number of commenters expressed concern about a focus on revenues as part of evaluating market-making.[2728] For instance, one commenter argued that the rule should not require, even in guidance, that market making-related permitted activities be ''designed to generate revenues from fees, commissions, bid-asks spreads or other income,'' arguing that this prejudges appropriate results for revenue metrics and implies that a *bona fide* market maker is not permitted to benefit from revenues from market movements.[2729] One commenter expressed concern that the source-of-revenue metrics are subject to manipulation as these metrics depend on correctly classifying revenue into market bid-ask spreads as opposed to other sources of revenue.[2730] One commenter stated that this metric should serve as a secondary indication of risk levels because it could be subject to manipulation.[2731] Another commenter recommended use of the sub-metric in Comprehensive P&L Attribution.[2732] A different commenter recommended the adoption of clearer metrics to distinguish customer revenues from revenues from price movements.[2733] One commenter indicated that after-the-fact application of quantitative measurements such as Comprehensive Profit and Loss may cause firms to reconsider their commitment to market making and recommended that, to the extent this metric is used, it should be applied flexibly in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2734]

A few commenters supported Portfolio Profit and Loss as a reasonable contextual metric to inform whether revenues from market-making transactions are from customer transactions.[2735] However, one of these commenters argued that this metric would not necessarily be indicative of prohibited proprietary trading and profits may reflect *bona fide* market making-related, underwriting, and hedging activities.[2736] Another commenter argued that this metric should serve as a secondary indication of risk levels and may be subject to manipulation.[2737]

Some commenters felt that Fee Income and Expense was a useful metric.[2738] One of these commenters argued this metric has the potential to help distinguish permitted activities from prohibited proprietary trading.[2739] Another commenter felt this metric would be useful in liquid markets that trade with the convention of fees and commissions but less useful, but still indicative, in other markets that use inter-dealer brokers to conduct client-related activities.[2740] One commenter argued that it would be impracticable to produce Fee Income and Expense data for foreign exchange trading, which is predominantly based on bid/offer spread.[2741]

A few commenters thought that Spread P&L could be useful.[2742] One of these commenters argued that Spread P&L has the potential to help distinguish permitted activities from prohibited proprietary trading.[2743] This commenter suggested that the final rule remove the proposal's revenue requirement as part of market-making and instead rely on revenue metrics such as Spread P&L.[2744] This commenter argued, however, that it will not always be clear how to best calculate Spread P&L and it would be critical for the Agencies to be flexible and work with banking entities to determine the appropriate proxies for spreads on an asset-class-by-asset class and trading desk-by-trading-desk basis. One commenter contended that the proposed implementation in the proposal was more difficult than necessary and suggested End of Day Spread Proxy is sufficient. Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to calculate Spread P&L.[2745]

However, the majority of commenters recommended removal of Spread P&L as a metric.[2746] These commenters argued that a meaningful measure for Spread P&L cannot be calculated in the absence of a continuous bid-ask spread, making this metric misleading especially for illiquid positions and shallow markets.

A few commenters generally expressed support for the inclusion of Comprehensive Profit and Loss Attribution.[2747] One of these commenters stated that this metric was the most comprehensive metric for measuring sources of revenue and included other metrics as sub-metrics, such as Comprehensive Profit and Loss, Portfolio Profit and Loss, and Fee Income and Expense. Another commenter contended the mention of ''customer spreads'' and ''bid-ask spreads'' was unclear and that both of these terms should be removed from the calculation guidance. Other commenters argued that the benefits of this metric do not justify the costs of generating a report of Comprehensive P&L Attribution on a daily basis.[2748] One commenter urged the Agencies to ensure that each institution be permitted to calculate this metric in a way that reflects the institution's unique characteristics.[2749]

After carefully considering the comments received, the final rule maintains only a modified version of Comprehensive P&L Attribution metric and does not retain the proposed Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income, or Spread Profit and Loss metrics. The final rule also requires volatility of comprehensive profit and loss to be reported. As pointed out by a number of

[2727] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy; *see also* Barclays.

[2728] *See supra* Part VI.A.3.c.7.b.

[2729] *See* SIFMA (May 2012).

[2730] *See* AFR (Nov. 2012).

[2731] *See* Occupy.

[2732] *See* Barclays.

[2733] *See* Public Citizen.

[2734] *See* NYSE Euronext.

[2735] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2736] *See* Goldman (Prop. Trading).

[2737] *See* Occupy.

[2738] *See* Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy.

[2739] *See* Goldman (Prop. Trading). This commenter urged that fee income and expense should be considered together with Spread P&L arguing that these two both measures of customer revenues and, in practice, may function as substitutes for each other.

[2740] *See* Occupy.

[2741] *See* Northern Trust.

[2742] *See, e.g.,* Goldman (Prop. Trading); JPMC; UBS.

[2743] *See* Goldman (Prop. Trading).

[2744] *See* Goldman (Prop. Trading); *see also* Paul Volcker (supporting a metric considering the extent to which earnings are generated by pricing spreads rather than changes in price).

[2745] *See* JPMC; UBS; *see also* SIFMA *et al.* (Prop. Trading) (Feb. 2012).

[2746] *See* ABA *et al.;* BoA; Barclays; Credit Suisse (Seidel); Japanese Bankers Ass'n; Northern Trust; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading); *see also* AFR *et al.* (Feb. 2012); Occupy.

[2747] *See* Barclays; Occupy.

[2748] *See* BOK; Goldman (Prop. Trading); SIFMA *et al.* (Prop Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2749] *See* SIFMA *et al.* (Prop Trading) (Feb. 2012).

commenters, Comprehensive Profit and Loss Attribution provides a holistic attribution of each trading desk's profit and loss and contains much of the information content that is provided by many of the other metrics, such as Fee Income and Expense.[2750] Accordingly, the use of Comprehensive Profit and Loss Attribution in the final rule greatly simplifies the metric reporting requirement and reduces burden while retaining much of the information and analysis that was provided in the full set of five metrics that were contained in the proposal. In addition, in response to commenters' concerns about the burdens of separately identifying specific revenue sources (*e.g.,* revenues from bid-ask spreads, revenues from price appreciation), the Agencies have modified the focus of the proposed source of revenue metrics to focus on when revenues are generated, rather than the specific sources of revenue.[2751] This approach should also help address one commenter's concern about the need for new, sophisticated systems to differentiate bid-ask spreads from price appreciation.[2752] The utility of this modified approach is discussed in more detail in the discussion of the market-making exemption.[2753] Finally, the Comprehensive Profit and Loss Attribution metric will ensure that all components of a trading desk's profit and loss are measured in a consistent and comprehensive fashion so that each individual component can be reliably compared against other components of a trading desk's profit and loss without being considered in isolation or taken out of context.

This measurement is intended to capture the extent, scope, and type of profits and losses generated by trading activities and provide important context for understanding how revenue is generated by trading activities. Because permitted market making-related activities seek to generate profits by providing customers with intermediation and related services while managing, and to the extent practicable minimizing, the risks associated with any asset or risk inventory required to meet customer demands, these revenue measurements would appear to provide helpful information to banking entities and the Agencies regarding whether actual revenues are consistent with these expectations.

Under the proposal, the third set of measurements related to realized risks and revenue relative to realized risks, and includes Volatility of Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss, and Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss.

A few commenters indicated support for these metrics as appropriate, contextual metrics.[2754] These commenters indicated that these metrics may serve to highlight areas requiring further investigation, since high P&L volatility may indicate a deviation from traditional client related activities and that a well-structured trading operation should be able to obtain relatively high ratios of revenue-to-risk (as measured by various metrics), low volatility, and relatively high turnover.[2755] One commenter recommended that New Trades P&L be substituted for Portfolio P&L for purposes of computing Volatility of P&L because New Trades P&L captures customer revenues more completely and is therefore more useful for distinguishing market making from proprietary trading.[2756] Another commenter indicated that Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss incorporates (and therefore obviates the need for a separate calculation of) the metric Volatility of Portfolio Profit and Loss.[2757]

One commenter urged that after-the-fact application of Comprehensive Profit and Loss to Volatility Ratio may cause firms to reconsider their commitment to market making and argued that this metric should be applied flexibly in light of market conditions prevailing during the relevant time period and as one of many factors relevant to an assessment of overall bona fide market making.[2758] One commenter supported monitoring Portfolio Profit and Loss to Volatility Ratio and argued that the Agencies should establish a clear pattern of profit and loss results of individual trading units through iterative application of the metrics.[2759]

One commenter expressed support for Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss indicating that these metrics may serve to highlight areas requiring further investigation, since a significant number of unprofitable trading days may indicate a deviation from traditional client-related activities.[2760] Another commenter suggested that these metrics be removed as they would result in market makers being less likely to take client-facing positions due to reluctance to incur unprofitable trading days that could indicate the presence of impermissible activity despite the utility of such trades in providing liquidity to customers.[2761]

One commenter requested including Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss in the metrics set as the most comprehensive metric in the revenue-relative-to-risk category making other metrics unnecessary in this area.[2762] Another commenter argued that this metric would produce inconsistent results within and across trading units and would generally not support any meaningful conclusions regarding the permissibility or risk of trading activities.[2763]

After carefully considering the comments received, the final rule does not include any of the proposed revenue-relative-to-risk measurements. Each of these measures provides information that may generally be useful for characterizing the overall risk profile of the trading activities of each trading unit and evaluating the extent to which the quantitative profile of a trading unit's activities is consistent with permissible trading activities. The broad information content of these measures, however, can largely be reproduced from transformations of information that will be provided in the Comprehensive Profit and Loss Attribution and, as noted above, volatility of comprehensive profit and loss must be reported. Analogs to the other metrics such as Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss can be computed similarly from information that will be provided in the Comprehensive Profit and Loss Attribution. Accordingly, the information contained in these metrics

[2750] *See* Barclays.

[2751] *See* JPMC; UBS; SIFMA *et al.* (Prop Trading) (Feb. 2012); ABA (Keating); BoA; Barclays; Credit Suisse (Seidel).

[2752] *See* BoA.

[2753] *See supra* Part VI.A.3.c.7.c.

[2754] *See, e.g.,* Goldman (Prop. Trading); Volcker; John S. Reed; *see also* AFR *et al.* (Feb. 2012); Sen. Merkley; Occupy; Public Citizen.

[2755] *See* Occupy; Public Citizen; Sen. Merkley.

[2756] *See* Goldman (Prop. Trading) (also suggesting that New Trades P&L be substituted for Portfolio P&L in Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio and Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on Portfolio Profit and Loss).

[2757] *See* Barclays.

[2758] *See* NYSE Euronext.

[2759] *See* AFR *et al.* (Feb. 2012).

[2760] *See* Occupy.

[2761] *See* Barclays.

[2762] *See* Barclays.

[2763] *See* Goldman (Prop. Trading).

is retained in the final rule while the burden associated with computing, auditing and reporting these additional metrics on an ongoing basis has been eliminated.

Under the proposal, the fourth set of quantitative measurements related to customer-facing activity measurements. These metrics include Inventory Risk Turnover, Inventory Aging, and Customer-facing Trade Ratio.

A few commenters supported the proposal's Inventory Risk Turnover metric though some of these commenters suggested modifications to the metric.[2764] One commenter argued that this metric could indicate whether a given trading unit holds risk and inventory consistently with the asset class in which such trading unit deals, the types of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading unit serves.[2765] Another commenter argued that the final rule should explicitly state that a trading unit's inventory management practices will be evaluated using this metric.[2766] Some commenters expressed the view that this metric might be useful in the case of liquid positions but not in the case of illiquid or difficult-to-hedge products, which naturally have lower risk turnover. Others noted support for this metric tailored on an asset-by-asset basis.[2767]

A few commenters requested that the final rule clarify that this metric will not be required to be calculated for every possible Risk Factor Sensitivity measurement for the applicable portfolio and that a banking entity and its regulator should determine one or two core risk factors per asset classes with respect to which this metric that will be calculated to strike a reasonable balance between costs of calculations and benefits of this metric.[2768] Other commenters argued the Inventory Risk Turnover Metric was difficult to measure, burdensome, and would create uncertainty for derivatives counterparties.[2769]

A few commenters supported the Inventory Aging metric. One commenter argued it should be included in the metrics set to indicate whether a given trading desk holds risk and inventory consistently within the asset class in which such trading desk deals, the type of trading activity in which the trading unit engages, and the scale and scope of the client activity that such trading desk serves.[2770] This commenter suggested tailoring the metric based on the market for a particular asset class and market conditions because aging levels may be higher in less liquid markets. A number of commenters argued that application of the Inventory Aging metric is only appropriate for cash products and should not be used for trading units engaged in transactions in financial instruments such as derivatives.[2771] Another commenter argued that the Inventory Aging metric is generally not useful for derivatives, and for non-derivatives it provides essentially similar information to Inventory Risk Turnover.[2772] One commenter requested additional guidance on how to calculate this metric.[2773]

A few commenters indicated that the Customer-Facing Trade Ratio could be helpful in distinguishing prohibited proprietary trading from market making and would be more effective than the proposal's negative presumption against interdealer trading to evaluate the amount of interdealer trading that is consistent with market making-related or hedging activity in a particular business.[2774] Some commenters suggested that the metric could be improved and argued that the number of transactions executed over a calculation period does not provide an adequate measure for the level of customer-facing trading because it does not reflect the size of transactions or the amount of risk. These commenters suggested replacing the metric with a more risk-sensitive metric or defining the ratio so that it measures notional principal risk associated with customer transactions and is appropriately tailored to the relevant asset class or market.[2775]

A number of commenters raised concerns about the definition of customer for purposes of this metric. One commenter argued that a failure to define ''customer'' to differentiate between customers and non-customers would render this metric meaningless.[2776] Another commenter contended that the metric would be appropriate as long as banking entities have the flexibility to determine who is a customer.[2777] One commenter argued that using a definition of ''customer'' that is different between the market making-related activity and the reported metric could make legitimate market making-related activity with customers appear to be prohibited proprietary trading.[2778] This commenter argued that other dealers and other registered market participants should be recognized as customers of the banking entity. A few commenters contended that this metric would be burdensome if it required a banking entity to tag individual trades as customer or non-customer.[2779] A few commenters argued that interdealer trading should be allowed as part of market making and argued this metric would not provide a useful measure of customer-facing activity.[2780] Some commenters also expressed concern about the implications of such a metric for hedging activity, which may involve relatively less customer-facing activity.[2781]

After carefully considering the comments received, the final rule retains all three of the customer-facing activity measurements from the proposal, though each measure has been modified. A number of commenters raised issues regarding the complexities associated with computing the Inventory Risk Turnover metric. In particular, as noted above, some commenters argued that computing the metric for every reported risk factor sensitivity would be burdensome and would not be informative.[2782] The inventory metric required in the final rule, Inventory Turnover, is applied at the transaction level and not at the risk factor sensitivity level. Accordingly, for a given trading desk and calculation period, *e.g.,* 30 days, there is only one value of the Inventory Turnover metric rather than one value for each risk factor sensitivity that is managed and reported by the trading desk. In this sense, the turnover metric required in the final rule is similar to more traditional and common measures of inventory turnover. Moreover, the required turnover metric is simpler and less costly to track and record while still

[2764] *See* Goldman (Prop. Trading); Barclays; John Reed; JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2765] *See* Barclays.

[2766] *See* Goldman (Prop. Trading).

[2767] *See, e.g.,* Barclays; Goldman (Prop. Trading); JPMC; John Reed.

[2768] *See* Goldman (Prop. Trading); JPMC; SIFMA *et al.* (Prop. Trading) (Feb. 2012); *see also* Morgan Stanley.

[2769] *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2770] *See* Barclays; *see also* Invesco.

[2771] *See* Barclays; Goldman (Prop. Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

[2772] *See* Goldman (Prop. Trading).

[2773] *See* Société Générale.

[2774] *See* Goldman (Prop. Trading); *see also* Invesco.

[2775] *See* Barclays; Goldman (Prop. Trading) ; JPMC; SIFMA (Prop. Trading) (Feb. 2012); UBS.

[2776] *See* Occupy.

[2777] *See* Wells Fargo (Prop. Trading).

[2778] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2779] *See* SIFMA (Prop. Trading) (Feb. 2012); *see also* Goldman (Prop Trading).

[2780] *See* Barclays; Japanese Bankers Ass'n; Oliver Wyman (Dec. 2011); SIFMA (Prop. Trading) (Feb. 2012).

[2781] *See* Barclays; Wells Fargo (Prop. Trading).

[2782] *See* Goldman (Prop. Trading); JPMC; SIFMA (Prop. Trading) (Feb. 2012).

providing banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In addition, the description of Inventory Turnover in the final rule provides explicit guidance on how to apply the metric to derivative positions.[2783]

Inventory Aging provides banking entities and Agencies with meaningful information regarding the extent to which the size and volume of trading activities are directed at servicing the demands of customers. In the case of Inventory Aging, the proposal required that the aging schedule be organized according to a specific set of age ranges (*i.e.,* 0–30 days, 30–60 days, 60–90 days, 90–180 days, 180–360 days, and more than 360 days). This requirement has not been adopted in the final rule in order to provide greater flexibility and to recognize that specific age ranges that may be relevant for one asset class may be less relevant for another asset class. Also, to address commenters' uncertainty about how this metric would apply to derivatives, the final rule's description of the Inventory Aging metric provides guidance on how to apply the metric to derivative positions.[2784]

The Customer Facing Trade Ratio provides directionally useful information regarding the extent to which trading transactions are conducted with customers. In the case of the Customer Facing Trade Ratio, the proposal required that customer trades be measured on a trade count basis. The final rule requires that the Customer Facing Trade Ratio be computed in two ways. As in the proposal, the metric must be computed by measuring trades on a trade count basis. Additionally, as suggested by some commenters, the final rule requires that the metric be computed by measuring trades on a notional value basis. The value based approach is required to reflect the fact noted by some commenters, that a trade count based measure may not accurately represent the amount of customer facing activity if customer trade sizes systematically differ from the sizes of non-customer trades. In addition, the term ''customer'' for purposes of the Customer-Facing Trade Ratio is defined in the same manner as the terms client, customer, and counterparty used for purposes of the market-making exemption. This will ensure that the information provided by this metric is useful for purposes of monitoring compliance with the market-making exemption.[2785]

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

One commenter expressed concern that after-the-fact application of the Pay-to-Receive Spread Ratio could cause firms to reconsider their commitment to market making. This commenter suggested that if this measure is used, it be applied flexibly, in light of market conditions prevailing during the relevant time period, and as one of many factors relevant to an overall assessment of bona fide market making.[2786] Another commenter suggested expanding the flexibility offered in choosing a bid-offer source to the entire process of calculating Pay-to-Receive Spread Ratio.[2787] A number of commenters argued for removing this metric because its calculation incorporates the Spread P&L metric.[2788] Some of these commenters argued that the metric requires a trade-by-trade analysis which would be expensive to compute and would not provide any additional information that is not available from other metrics. One commenter alleged that this metric was not calculable by any methodology.[2789]

The Pay-to-Receive Spread Ratio has not been retained in the final rule. As noted by some commenters, the broad information content of this metric will largely be captured in the Comprehensive Profit and Loss Attribution measurement. In addition, the Comprehensive Profit and Loss Attribution will place such factors that are related to the proposed Pay-to-Receive Spread Ratio in context with other factors that determine total profitability. Accordingly, factors relating to the payment of fees, commissions and spreads will not be considered in isolation but will be viewed in a context that is appropriate to the entirety of the trading desk's activities. Finally, using the information contained in the Comprehensive Profit and Loss Attribution to holistically assess the range of factors that determine overall profitability, rather than requiring a large number of separate and distinct measurements, will reduce the resulting compliance burden while ensuring an integrated and holistic approach to assessing the activities of each trading desk.

Commenters also suggested a number of additional metrics be added to the final rule that were not contained in the proposal. One commenter, who advocated for an alternative framework for market making supported by structural and transactional metrics, suggested that structural metrics could include the ratio of salespeople to traders and the level of resources devoted to client research and trading content.[2790] Two commenters supported the use of a counterparty risk exposure measure, not only to the risk of counterparty default but also to potential gains and losses to major counterparties for each of a list of systemically important scenarios.[2791] One of these commenters suggested that entity-wide inflation risk assessments be produced on a daily basis.[2792] This commenter also argued that an important metric that is missing is a Liquidity Gap Risk metric that estimates

[2783] The Agencies believe that this should address commenters' uncertainty with respect to how the Inventory Risk Turnover metric would work for derivatives. *See* Japanese Bankers Ass'n; SIFMA (Asset Mgmt.) (Feb. 2012); Morgan Stanley.

[2784] *See* Barclays; Goldman (Prop. Trading); Japanese Bankers Ass'n; Morgan Stanley; SIFMA (Prop. Trading) (Feb. 2012).

[2785] *See* SIFMA (Prop. Trading) (Feb. 2012).

[2786] *See* NYSE Euronext.

[2787] *See* UBS.

[2788] *See* CH/ABASA; Goldman (Prop. Trading); Japanese Bankers Ass'n; Occupy; SIFMA (Prop. Trading) (Feb. 2012); Wells Fargo (Prop. Trading).

[2789] *See* Morgan Stanley.

[2790] *See* Morgan Stanley.

[2791] *See* Prof. Duffie; Occupy.

[2792] *See* Occupy.

the price change that occurs following a sudden disruption in liquidity for a product, arguing that there needs to be an industry-wide effort to more accurately measure and account for the significant effect that liquidity and changes in its prevailing level have on the valuation of each asset.

One commenter argued that the metrics regime was well-designed for market-making but lacking in other areas like hedging. This commenter recommended the addition of additional metrics more applicable to other non-market making activities like a net profit metric for hedging.[2793] Two commenters argued that quantitative measurement for underwriting was not included in the proposal and stated that in a bona fide underwriting, unsold balances should be relatively small so a marker for potential non-bona fide underwriting should be recognized if VaR (unhedged and uncovered) of the unsold balance that is allocated to a banking entity is large relative to the expected revenue measured by the pro rata underwriting spread.[2794]

After carefully considering the comments received, these and other proposed metrics have not been included as part of the final rule. One major concern raised by a range of commenters was the degree of complexity and burden that would be required by the metrics reporting regime. In light of these comments, the final rule includes a number of quantitative measurements that are expected to provide a means of characterizing the overall risk profile of the trading activities of each trading desk and evaluating the extent to which the quantitative profile of a trading desk's activities is consistent with permissible trading activities in a cost effective and efficient manner while being appropriate for a range of different trading activities. Moreover, while many commenters suggested a number of different alternative metrics, many of these alternatives are consistent with the broad themes, risk management, sources of revenues, customer facing activity, that inform the quantitative measurements that are retained in the final rule. Finally, banking entities will be expected to develop their own metrics, as appropriate, to further inform and improve their own monitoring and understanding of their trading activities. Many of the alternative metrics that were suggested by commenters, especially those that relate to a specific market or type of instrument, may be used by banking entities as they develop their own quantitative measurements.

For each individual quantitative measurement in the final rule, Appendix A describes the measurement, provides general guidance regarding how the measurement should be calculated and specifies the period over which each calculation should be made. The proposed quantitative measurements attempt to incorporate, wherever possible, measurements already used by banking entities to manage risks associated with their trading activities. Of the measurements proposed, the Agencies expect that a large majority of measurements proposed are either (i) already routinely calculated by banking entities or (ii) based solely on underlying data that are already routinely calculated by banking entities. However, calculating these measurements according to the specifications described in Appendix A and at the trading desk level mandated by the final rule may require banking entities to implement new processes to calculate and furnish the required data.[2795]

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

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

The Agencies expect to evaluate the data collected during the compliance period both for its usefulness as a barometer of impermissible trading activity and excessive risk-taking and for its costs. This evaluation will consider, among other things, whether all of the quantitative measurements are useful for all asset classes and markets, as well as for all the trading activities subject to the metrics requirement, or if further tailoring is warranted.[2796] The Agencies propose to revisit the metrics and determine, based on a review of the data collected by September 30, 2015, whether to modify, retain or replace the metrics. To allow firms to develop systems to calculate and report these metrics, the Agencies have delayed all reporting of the metrics until July 2014, phased in the reporting requirements over a multi-year period, and reduced the category of banking entities that must report the metrics to a smaller number of firms that engage in significant trading activity. These steps, combined with the reduction in the number of metrics required to be reported, are designed to reduce the cost and burden associated with compiling and reporting the metrics while retaining the usefulness of this data collection in helping to ensure that trading activities are conducted in compliance with section 13 of the BHC Act and the final rule and in a manner that monitors, assesses and controls the risks associated with these activities.

4. Section 75.21: Termination of Activities or Investments; Authorities for Violations

Section 75.21 implements section 13(e)(2) of the BHC Act, which authorizes an Agency to order a banking entity subject to its jurisdiction to terminate activities or investments that violate or function as an evasion of section 13 of the Act.[2797] Section 13(e)(2) further provides that this paragraph shall not be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.[2798]

The proposed rule implemented section 13(e)(2) in two parts. First, § 75.21(a) of the proposal required any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the proposed rule, or in a manner that functions as an evasion of the

[2793] *See* AFR *et al.* (Feb. 2012).

[2794] *See* AFR *et al.* (Feb. 2012); *see also* Public Citizen.

[2795] *See* Credit Suisse (Seidel); Morgan Stanley; UBS; Wells Fargo (Prop. Trading); Société Générale; Occupy; Paul Volcker; AFR *et al.* (Feb. 2012); Western Asset Mgmt.; Public Citizen.

[2796] The Agencies believe this review, along with the fact that quantitative measurements will not be used as a dispositive tool for determining compliance and the removal of many of the proposed metrics, should help address commenters' concerns that some of the proposed quantitative measurements will not be as relevant for certain asset classes, markets, and activities. *See* Morgan Stanley; SIFMA *et al.* (Prop. Trading); Stephen Roach.

[2797] *See* 12 U.S.C. 1851(e)(2).

[2798] *Id.*

requirements of section 13 of the BHC Act or the proposed rule, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the proposed rule, to terminate the activity and, as relevant, dispose of the investment.[2799] Second, § 75.21(b) of the proposal provided that if, after due notice and an opportunity for hearing, the respective Agency finds reasonable cause to believe that any banking entity has engaged in an activity or made an investment described in paragraph (a), the Agency may, by order, direct the entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.[2800]

Several commenters urged the Agencies to strengthen the authorities provided for under § 75.21,[2801] with some commenters expressing concern that the proposed rule does not establish sufficient enforcement mechanisms and penalties for violations of the rule's requirements.[2802] Some commenters suggested the Agencies add language in § 75.21 authorizing the imposition of automatic and significant financial penalties—as significant as the potential gains from illegal proprietary trading—on traders, supervisors, executives, and firms for violating section 13 of the BHC Act and the final rule.[2803] These commenters suggested the Agencies incorporate reference to the Board's authority under section 8 of the BHC Act into the rule,[2804] and others encouraged the Agencies to rely on their inherent authority to impose automatic penalties and fines.[2805] A few commenters stated that traders, management, and banking entities should be held responsible for violations under certain circumstances.[2806] Finally, another commenter recommended that officers and directors of a banking entity be removed from office, be prohibited from being affiliated with a banking entity, and be subject to salary clawbacks for violations of section 13 of the BHC Act and the final rule.[2807]

The Agencies note that the authorities provided for in § 75.21 are not exclusive. The Agencies have a number of enforcement tools at their disposal to carry out their obligations to ensure compliance with section 13 of the BHC Act and the final rule, and need not reference them expressly in § 75.21 in order to exercise them. Specifically, the Agencies may rely on their inherent authorities under otherwise applicable provisions of banking, securities, and commodities laws to bring enforcement actions against banking entities, their officers and directors, and other institution-affiliated parties for violations of law.[2808] For example, a banking entity that violates section 13 of the BHC Act and the final rule may be subject to criminal and civil penalties under section 8 of the BHC Act. Banking entities may also be subject to formal enforcement actions under section 8 of the Federal Deposit Insurance Act (FDIA), such as cease and desist orders or civil money penalty actions,[2809] or safety and soundness orders under section 39 of the FDIA which may be enforceable through assessment of civil money penalties and through the Federal court system. In addition, officers, directors, and other institution-affiliated parties [2810] may be subject to civil money penalties, prohibition or removal actions, and personal cease and desist orders under section 8 of the FDIA. Submission of late, false, or misleading reports, including false statements on compliance with section 13 of the BHC Act or the final rule, may also result in actions under applicable securities, commodities, banking, and criminal laws, including imposition of civil money and criminal penalties.[2811] Therefore, the final rule is consistent with the proposal and does not mention other enforcement actions available to address violations of section 13 of the BHC Act and this final rule.

Section 13 of the BHC Act and the final rule do not limit the reach or applicability of the antifraud and other provisions of the Federal laws to banking entities, including, for example, section 17(a) of the Securities Act of 1933 or section 10(b) and 15(c) of the Exchange Act and the rules promulgated thereunder.

One commenter also suggested that the Agencies use their authority under section 13(d)(3) of the BHC Act to impose additional capital requirements and quantitative limitations on banking entities for repeat violations of the prohibition on proprietary trading.[2812] The Agencies believe they can rely on other inherent enforcement authorities to address repeat violations. The Agencies note that several other commenters also requested the Agencies to exercise their authority under section 13(d)(3).[2813] The Agencies do not believe that it is appropriate to exercise their authority under this section at this time, primarily because the capital treatment of banking entities' trading activities is currently being addressed through the Agencies' risk-based capital rulemakings.[2814] Additionally, the Agencies believe Congress intended section 13(d)(3) to serve the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider U.S. financial system. To the extent commenters

[2799] *See* proposed rule § 75.21(a). The proposal noted that the Agencies included § 75.21(a), in addition to the provisions of § 75.21(b) of the proposed rule, to clarify that the requirement to terminate an activity or, as relevant, dispose of an investment would be triggered when a banking entity discovers the violation or evasion, regardless of whether an Agency order has been issued.

[2800] *See* proposed rule § 75.21(b).

[2801] *See* Sen. Merkley; Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012); Public Citizen.

[2802] *See, e.g.,* BEC *et al.* (Jan. 2012); John Reed; Better Markets (Feb. 2012); AFR *et al.* (Feb. 2012); Occupy; Sen. Merkley; Public Citizen.

[2803] *See, e.g.,* Form Letter Type A; Form Letter Type B; Sarah McKee; David R. Wilkes; Ben Leet; Karen Michaelis; Barry Rein; Allan Richardson; Ronald Gedrim; Susan Pashkoff; Joan Budd; Frances Vreman; Lisa Kazmier; Michael Wenger; Dyanne DiRosario; Alexander Clayton; James Ofsink; Richard Leining (arguing that violators should face penalties such as seizure and discharge of the board and executives); Lee Smith; *see also* Occupy; Public Citizen.

[2804] *See* Better Markets (Feb. 2012) (contending that penalties should include specific administrative penalties, including monetary penalties, bars, cease and desist orders, strengthened penalties for recurring violations, and sanctioning of employees involved in the violation and public reporting of such sanctions); AFR *et al.* (arguing that section 8 of the BHC Act provides civil penalties for violations by a company or individual and criminal penalties for willful violations of the BHC Act). *See also* Occupy (requesting the Agencies provide penalties that are specific to this rule in addition to the general framework for criminal and civil penalties in section 8 of the BHC Act).

[2805] *See* Better Markets (Feb. 2012); Occupy; AFR *et al.* (Feb. 2012).

[2806] *See* John Reed; Better Markets (Feb. 2012). *See also* BEC *et al.* (Jan. 2012) (arguing that CEOs and CFOs should be held fully responsible for any violations of the rule by any employees above the clerical level); Occupy (recommending that traders relying on an exemption in the proposed rule be held personally liable for any losses on trading positions).

[2807] *See* Occupy.

[2808] *See* 12 U.S.C. 1851(g)(3).

[2809] *See, e.g.,* 12 U.S.C. 1818(i) (authorizing imposition of civil money penalties up to the maximum daily amount of $1,000,000 for, among other things, knowing violations of law or regulation).

[2810] *See* 12 U.S.C. 1813(u) (defining ''institution-affiliated party'').

[2811] *See, e.g.,* 12 U.S.C. 164 (authorizing imposition of civil money penalties for, among other things, submitting false or misleading reports or information to the OCC); 18 U.S.C. 1005 (authorizing imposition of fines of not more than $1,000,000 or imprisonment not more than 30 years, or both, for, among other things, making a false entry in the books, reports or statements of a bank with intent to injure, defraud or deceive).

[2812] *See* Better Markets (Feb. 2012).

[2813] *See* Sen. Merkley; Public Citizen; Better Markets (Feb. 2012); Profs. Admati & Pfleiderer.

[2814] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule, 78 FR 62017 (Friday, October 11, 2013).

suggested section 13(d)(3) be employed for a punitive purpose, the Agencies do not believe the provision was designed to serve such a purpose nor do the Agencies believe that would be an appropriate use of the provision. Thus, the Agencies believe section 13(d)(3) is more appropriately employed for the prudential purposes of bolstering the safety and soundness of individual banking entities and the wider financial stability of the U.S. financial system.

Commenters also urged the Agencies to clearly delineate in the final rule the jurisdictional authority of each of the Agencies to enforce compliance with section 13 of the BHC Act and the implementing final rule. A number of commenters recommended approaches to coordinating examinations and enforcement among the Agencies, as well as to providing interpretive guidance.[2815] For example, some commenters observed that more than one Agency would have jurisdiction over a given banking entity, and recommended that supervision and enforcement of the final rule for all entities within a banking enterprise remain completely with one Agency.[2816] Further, some commenters recommended that a single Agency be appointed to provide interpretations, supervision, and enforcement of section 13 and the rules thereunder for all banking entities.[2817] Similarly, one commenter suggested that the Board be given initial authority to supervise the implementation of the rule because it is the primary enforcer of the BHC Act and the single regulator that can currently look across a banking group's entire global businesses, regardless of legal entity. This commenter stated that the Board could then determine whether an activity should be delegated to one of the other Agencies for further examination or enforcement.[2818] In addition, with respect to interpretive authority, some commenters indicated that the Board should be given sole interpretive authority of the statute and the rules thereunder.[2819] Other commenters urged the Agencies to supervise and enforce the rule on a coordinated basis so as to minimize duplicative enforcement efforts, reduce costs, and promote certainty.[2820]

Section 13(e)(2) mandates that each Agency enforce compliance of section 13 with respect to a banking entity ''under the respective [A]gency's jurisdiction.'' [2821] This section provides the Agencies with the authority to order a banking entity to terminate activities or investments that violate or function as an evasion of section 13 of the BHC Act.[2822] Decisions about whether to issue such orders could be made after examinations or otherwise. Nothing in the final rule limits an Agency's inherent authority to conduct examinations or otherwise inspect banking entities to ensure compliance with the final rule. Section 75.1 of each Agency's proposed rule described the specific types of banking entities to which that Agency's rule applies. The Agencies acknowledge commenters' concerns about overlapping jurisdictional authority. The Agencies recognize that, on occasion, a banking entity may be subject to jurisdiction by more than one Agency. As is customary, the Agencies plan to coordinate their examination and enforcement proceedings under section 13, to the extent possible and practicable, so as to limit duplicative actions and undue costs and burdens for banking entities.[2823]

The Agencies are adopting § 75.21 substantially as proposed. Accordingly, § 75.21(a) of the final rule provides that any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the final rule or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the final rule, including through an abuse of any activity or investment permitted or expressly excluded by the terms of the final rule, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the final rule, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment. This provision allows the Agencies to enforce the rule's prohibitions against proprietary trading and sponsoring or owning interests in covered funds regardless of how banking entities classify their actions, while also providing banking entities the freedom to legitimately engage in those banking activities which are outside the scope of the statute.

VII. Administrative Law Matters

A. Paperwork Reduction Act Analysis

The Paperwork Reduction Act (''PRA'') provides that a Federal agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number issued by the Office of Management and Budget (''OMB'').[2824] This final rulemaking contains several collections of information for which the three Federal banking agencies—the Board, the OCC, and FDIC—sought control numbers at the time they proposed the same substantive requirements that the Commission later proposed.[2825]

To avoid double accounting of information collections for which control numbers were sought, the Commission did not propose and is not finalizing an information collection request for this rulemaking. Rather, as indicated in its proposed rulemaking, the Board provided that it would submit its information collection to OMB once its final rule is published, and that the submission would include burden for Federal Reserve-supervised institutions, as well as burden for OCC-, FDIC-, SEC-, and CFTC-supervised institutions under a holding company.[2826] The Board, OCC, and FDIC, as well as the SEC, are expected to adopt equivalent final rulemakings on or about the same date as the CFTC adopts its final rule. The Board, OCC, and FDIC included in

[2815] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); JPMC; Barclays; Goldman (Prop. Trading); BoA; ABA (Keating); Comm. on Capital Market Regulation; BEC *et al.;* ISDA (Apr. 2012).

[2816] *See* Barclays (arguing that ideally the umbrella Federal regulator of the enterprise should take this role); Goldman (Prop. Trading).

[2817] *See* BoA; BEC *et al.*

[2818] *See* Comm. on Capital Market Regulation.

[2819] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (recommending that the Board be responsible for resolving potentially conflicting supervisory recommendations or matters requiring attention arising from examinations as well); ISDA (Apr. 2012). *See also* ABA (Keating) (arguing that the Agencies should defer to the Board's sole authority to interpret provisions of Volcker that intersect with other statutory provisions subject to the Board's jurisdictional authority, such as Super 23A); JPMC (contending that the Agencies should adopt and seek comment on a protocol for supervision and enforcement that will ensure a given banking entity will face one set of rules and different banking entities will face the same set of rules). The Agencies decline to adopt the commenter's suggested approach of deferring to the Board's sole interpretive authority with respect to the provisions of the final rule. The Agencies believe at this time that such an approach would be neither appropriate nor effective given the different authorities and expertise of each Agency. *See* Part VI.C (discussing the Agencies' decision not to adopt some commenters' requests that a single agency be responsible for determining compliance with section 13).

[2820] *See* SIFMA *et al.* (Prop. Trading) (Feb. 2012); BoA (stating that the Agencies should issue one set of exam findings under these circumstances); ISDA (Apr. 2012).

[2821] *See* 12 U.S.C. 1851(c)(2).

[2822] *See* 12 U.S.C. 1851(e)(2) (requiring ''due notice and opportunity for hearing'').

[2823] *See* 12 U.S.C. 1844 (establishing jurisdictional boundaries for regulation of bank holding companies); *see also* 12 U.S.C. 1828a (antievasion statute empowering OCC, FDIC, and the Board to impose restrictions on relationships or transactions between banks and their subsidiaries and affiliates).

[2824] 44 U.S.C. 3501 et seq.

[2825] *See* 76 FR 68846, 68936, Nov. 7, 2011 (joint release of the Board, OCC, FDIC, and the SEC), and 77 FR 8332, 8420, Feb. 14, 2012.

[2826] 76 FR at 68936.

the Supplementary Information of their final rulemakings an overview of their PRA analyses including burden cost estimates, with further analyses to be provided in the supporting statements required to be submitted to OMB according to their regulations implementing the PRA.

In particular, section 619 of the Dodd-Frank Act provides that the banking agencies, the SEC, and the Commission engage in ''coordinated rulemaking,'' which includes all entities for which the Commission ''is the primary financial regulatory agency, as defined in section 2'' of the Dodd-Frank Act. Section 2 defines ''primary financial regulatory agency'' as a Federal banking agency with respect to certain depository institutions except as provided in other subsections of section 2. In subsection (12)(C), the Commission is designated as the primary financial regulatory agency for, among other things, ''any . . . swap dealer . . . registered with the [Commission] . . ..'' Section 4s(c)(1) of the CEA, as adopted in section 731 of the Dodd-Frank Act, provides that ''any person that is required to be registered as a swap dealer shall register with the Commission regardless of whether the person is also a depository institution.''

Accordingly, banking entities, including domestic depository institutions and branches and agencies of foreign banks subject to supervision by OCC or the Board, have registered with the Commission. It is presently not known how many additionally may register. To ensure that the Commission has access to fulfill its statutory obligations and not unduly burden its registrants with duplicative information collection requirements, and pursuant to its proposed rulemaking, the Commission will request, pursuant to 44 U.S.C. 3509, that the director of the OMB designate the banking agencies as the respective collection agencies for PRA purposes for all banking entities for which the Commission is the primary financial regulatory agency with respect to this rulemaking.

B. Regulatory Flexibility Act Analysis

In general, section 4 of the Regulatory Flexibility Act (5 U.S.C. 604) (RFA) requires an agency to prepare a final regulatory flexibility analysis (FRFA) for a final rule unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities (defined as of July 22, 2013, to include banking entities with total assets of $500 million or less (''small banking entities'').[2827] Pursuant to section 605(b) of the RFA, a FRFA is not required if an agency certifies that the final rule will not have a significant economic impact on a substantial number of small entities. The Agencies have considered the potential economic impact of the final rule on small banking entities in accordance with the RFA. The Agencies believe that the final rule will not have a significant economic impact on a substantial number of small banking entities for the reasons described below.

The Agencies previously considered the impact of the proposed rule for purposes of the RFA and concluded that the proposed rule would not appear to have a significant economic impact on a substantial number of small banking entities. In support of this conclusion, the proposed rule, among other things, noted that the thresholds for the metrics reporting requirements under § 75.7 and Appendix A and for the enhanced and core compliance program requirements under § 75.20 and Appendix C of the proposed rule would not capture small banking entities.[2828]

The Agencies received several comments on the impact of the proposed rule on small entities. Commenters argued that the Agencies incorrectly concluded that the proposed rule would not have a significant economic impact on a substantial number of small entities.[2829] Commenters asserted that the proposed rule would have a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services, including covered fund-linked products for investment and hedging purposes and underwriting and market-making related services.[2830]

The Agencies have carefully considered these comments in developing a final rule. To minimize burden on small banking entities, section 75.20(f)(1) of the final rule provides that a banking entity that does not engage in covered trading activities (other than trading in U.S. government or agency obligations, obligations of specified government sponsored entities, and state and municipal obligations) or covered fund activities and investments need only establish a compliance program prior to becoming engaged in such activities or making such investments. In addition, to minimize the burden on small banking entities, a banking entity with total consolidated assets of $10 billion or less that engages in covered trading activities and/or covered fund activities may satisfy the requirements of the final rule by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 and the final rule and adjustments as appropriate given the activities, size, scope and complexity of the banking entity. Only those banking entities with total assets of greater than $10 billion will need to adopt more detailed or enhanced compliance requirements under the final rule. (For purposes of the enhanced compliance program in Appendix B of the final rule, the threshold for banking entities is total consolidated assets of $50 billion or more.) Accordingly, the compliance requirements under the final rule do not have a significant economic impact on a substantial number of small banking entities.

Likewise, the final rule raises the threshold for metrics reporting from the proposed rule to capture only firms that engage in significant trading activities. Specifically, the metrics reporting requirements under § 75.20 and Appendix A of the final rule apply only to banking entities with average trading assets and liabilities on a consolidated, worldwide basis for the preceding year equal to or greater than $10 billion. Accordingly, the metrics reporting requirements under the final rule do not impact small banking entities.

Moreover, the Agencies have revised the definition of covered fund in the final rule to address many of the concerns raised by commenters regarding the unintended consequences of the proposed definition.[2831] The definition of covered fund under the final rule contains a number of exclusions for entities that may rely on exclusions from the Investment Company Act of 1940 contained in section 3(c)(1) or 3(c)(7) of that Act but that are not engaged in investment activities of the type contemplated by section 13 of the BHC Act. These include, for example, exclusions for wholly owned subsidiaries, joint ventures, acquisition vehicles, insurance company separate accounts, registered investments companies, and public welfare investment funds. The Agencies believe that these changes will

[2827] *See* 13 CFR 121.201; *see also* 13 CFR 121.103(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

[2828] *See* Joint Proposal, 76 FR at 68938–68939.

[2829] *See* BoA; SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012); ABA (Keating).

[2830] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

[2831] *See* Part VI.B.1. of this **SUPPLEMENTARY INFORMATION.**

further minimize the burden for small banking entities such as those that may use wholly owned subsidiaries for organizational convenience or make public welfare investments to achieve their financial and Community Reinvestment Act goals.

Finally, in response to commenters' assertion that the proposed rule would have had a significant economic impact on numerous small non-banking entities by restricting their access to a variety of products and services,[2832] the Agencies note that the RFA does not require the Agencies to consider the impact of the final rule, including its indirect economic effects, on small entities that are not subject to the requirements of the final rule.[2833]

For the reasons stated above, the OCC, FDIC, SEC, and CFTC certify, for the banking entities subject to each such Agency's jurisdiction, that the final rule will not result in a significant economic impact on a substantial number of small entities. In light of the foregoing, the Board does not believe, for the banking entities subject to the Board's jurisdiction, that the final rule would have a significant economic impact on a substantial number of small entities.

List of Subjects in 17 CFR Part 75

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

For the reasons discussed in the preamble, the Commodity Futures Trading Commission adds part 75 to 17 CFR Chapter I to read as follows:

[2832] *See* SIFMA *et al.* (Covered Funds) (Feb. 2012); Chamber (Feb. 2012).

[2833] *See e.g.,* In Mid-Tex Electric Cooperative v. FERC, 773 F.2d 327 (D.C. Cir. 1985); *United Distribution Cos.* v. *FERC,* 88 F.3d 1105, 1170 (D.C. Cir. 1996); *Cement Kiln Recycling Coalition* v. *EPA,* 255 F.3d 855 (D.C. Cir. 2001). Commenters relied on Aeronautical Repair Station Association v. Federal Aviation Administration, 494 F.3d 161 (DC Cir 2007) to argue that the Agencies must consider the indirect economic effects of the final rule on small non-banking entities. This case is inapposite, however, because there the agency's own rulemaking release expressly stated that the rule imposed responsibilities directly on certain small business contractors. The court reaffirmed its prior holdings that the RFA limits its application to small entities ''which will be subject to the proposed regulation—that is, those small entities to which the proposed rule will apply.'' *Id.* at 176 (emphasis and internal quotations omitted).

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

Subpart A—Authority and Definitions

Sec.
75.1 Authority, purpose, scope, and relationship to other authorities.
75.2 Definitions.

Subpart B—Proprietary Trading

75.3 Prohibition on proprietary trading.
75.4 Permitted underwriting and market making-related activities.
75.5 Permitted risk-mitigating hedging activities.
75.6 Other permitted proprietary trading activities.
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75.8–75.9 [Reserved]

Subpart C—Covered Fund Activities and Investments

75.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.
75.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.
75.12 Permitted investment in a covered fund.
75.13 Other permitted covered fund activities and investments.
75.14 Limitations on relationships with a covered fund.
75.15 Other limitations on permitted covered fund activities.
75.16–75.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

75.20 Program for compliance; reporting.
75.21 Termination of activities or investments; penalties for violations.
Appendix A to Part 75—Reporting and Recordkeeping Requirements for Covered Trading Activities
Appendix B to Part 75—Enhanced Minimum Standards for Compliance Programs

Authority: 12 U.S.C. 1851.

Subpart A—Authority and Definitions

§ 75.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the Commission under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading by, and investments in or relationships with covered funds by, certain banking entities. This part implements section 13 of the Bank Holding Company Act by defining terms used in the statute and related terms, establishing prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds, and further explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to banking entities for which the CFTC is the primary financial regulatory agency, as defined in section 2(12) of the Dodd-Frank Act.

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the BHC Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of the BHC Act shall apply to the activities of an applicable banking entity, even if such activities are authorized for the applicable banking entity under other applicable provisions of law.

§ 75.2 Definitions.

Unless otherwise specified, for purposes of this part:

(a) *Affiliate* has the same meaning as in section 2(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(k)).

(b) *Bank holding company* has the same meaning as in section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

(c) *Banking entity.* (1) Except as provided in paragraph (c)(2) of this section, *banking entity* means:

(i) Any insured depository institution;

(ii) Any company that controls an insured depository institution;

(iii) Any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and

(iv) Any affiliate or subsidiary of any entity described in paragraphs (c)(1)(i), (ii), or (iii) of this section.

(2) Banking entity does not include:

(i) A covered fund that is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section;

(ii) A portfolio company held under the authority contained in section 4(k)(4)(H) or (I) of the BHC Act (12 U.S.C. 1843(k)(4)(H), (I)), or any portfolio concern, as defined under 13 CFR 107.50, that is controlled by a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), so long as the portfolio company or portfolio concern is not itself a banking entity under paragraphs (c)(1)(i), (ii), or (iii) of this section; or

(iii) The FDIC acting in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(d) *Board* means the Board of Governors of the Federal Reserve System.

(e) *CFTC* or *Commission* means the Commodity Futures Trading Commission.

(f) *Dealer* has the same meaning as in section 3(a)(5) of the Exchange Act (15 U.S.C. 78c(a)(5)).

(g) *Depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

(h) *Derivative.* (1) Except as provided in paragraph (h)(2) of this section, *derivative* means:

(i) Any swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68));

(ii) Any purchase or sale of a commodity, that is not an excluded commodity, for deferred shipment or delivery that is intended to be physically settled;

(iii) Any foreign exchange forward (as that term is defined in section 1a(24) of the Commodity Exchange Act (7 U.S.C. 1a(24)) or foreign exchange swap (as that term is defined in section 1a(25) of the Commodity Exchange Act (7 U.S.C. 1a(25));

(iv) Any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(C)(i));

(v) Any agreement, contract, or transaction in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and

(vi) Any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b));

(2) A derivative does not include:

(i) Any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)), or security-based swap, as that term is defined in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)); or

(ii) Any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)).

(i) *Employee* includes a member of the immediate family of the employee.

(j) *Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(k) *Excluded commodity* has the same meaning as in section 1a(19) of the Commodity Exchange Act (7 U.S.C. 1a(19)).

(l) *FDIC* means the Federal Deposit Insurance Corporation.

(m) *Federal banking agencies* means the Board, the Office of the Comptroller of the Currency, and the FDIC.

(n) *Foreign banking organization* has the same meaning as in section 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)), but does not include a foreign bank, as defined in section 1(b)(7) of the International Banking Act of 1978 (12 U.S.C. 3101(7)), that is organized under the laws of the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, or the Commonwealth of the Northern Mariana Islands.

(o) *Foreign insurance regulator* means the insurance commissioner, or a similar official or agency, of any country other than the United States that is engaged in the supervision of insurance companies under foreign insurance law.

(p) *General account* means all of the assets of an insurance company except those allocated to one or more separate accounts.

(q) *Insurance company* means a company that is organized as an insurance company, primarily and predominantly engaged in writing insurance or reinsuring risks underwritten by insurance companies, subject to supervision as such by a state insurance regulator or a foreign insurance regulator, and not operated for the purpose of evading the provisions of section 13 of the BHC Act (12 U.S.C. 1851).

(r) *Insured depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)), but does not include an insured depository institution that is described in section 2(c)(2)(D) of the BHC Act (12 U.S.C. 1841(c)(2)(D)).

(s) *Loan* means any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.

(t) *Primary financial regulatory agency* has the same meaning as in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)).

(u) *Purchase* includes any contract to buy, purchase, or otherwise acquire. For security futures products, purchase includes any contract, agreement, or transaction for future delivery. With respect to a commodity future, purchase includes any contract, agreement, or transaction for future delivery. With respect to a derivative, purchase includes the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(v) *Qualifying foreign banking organization* means a foreign banking organization that qualifies as such under § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c), or (e)).

(w) *SEC* means the Securities and Exchange Commission.

(x) *Sale* and *sell* each include any contract to sell or otherwise dispose of. For security futures products, such terms include any contract, agreement, or transaction for future delivery. With respect to a commodity future, such terms include any contract, agreement, or transaction for future delivery. With respect to a derivative, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a derivative, as the context may require.

(y) *Security* has the meaning specified in section 3(a)(10) of the Exchange Act (15 U.S.C. 78c(a)(10)).

(z) *Security-based swap dealer* has the same meaning as in section 3(a)(71) of the Exchange Act (15 U.S.C. 78c(a)(71)).

(aa) *Security future* has the meaning specified in section 3(a)(55) of the Exchange Act (15 U.S.C. 78c(a)(55)).

(bb) *Separate account* means an account established and maintained by an insurance company in connection with one or more insurance contracts to hold assets that are legally segregated from the insurance company's other assets, under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(cc) *State* means any State, the District of Columbia, the Commonwealth of Puerto Rico, Guam, American Samoa, the United States Virgin Islands, and the Commonwealth of the Northern Mariana Islands.

(dd) *Subsidiary* has the same meaning as in section 2(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(d)).

(ee) *State insurance regulator* means the insurance commissioner, or a similar official or agency, of a State that is engaged in the supervision of insurance companies under State insurance law.

(ff) *Swap dealer* has the same meaning as in section 1(a)(49) of the Commodity Exchange Act (7 U.S.C. 1a(49)).

Subpart B—Proprietary Trading

§ 75.3 Prohibition on proprietary trading.

(a) *Prohibition.* Except as otherwise provided in this subpart, a banking entity may not engage in proprietary trading. *Proprietary trading* means engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments.

(b) *Definition of trading account.* (1) Trading account means any account that is used by a banking entity to:

(i) Purchase or sell one or more financial instruments principally for the purpose of:

(A) Short-term resale;

(B) Benefitting from actual or expected short-term price movements;

(C) Realizing short-term arbitrage profits; or

(D) Hedging one or more positions resulting from the purchases or sales of financial instruments described in paragraphs (b)(1)(i)(A), (B), or (C) of this section;

(ii) Purchase or sell one or more financial instruments that are both market risk capital rule covered positions and trading positions (or hedges of other market risk capital rule covered positions), if the banking entity, or any affiliate of the banking entity, is an insured depository institution, bank holding company, or savings and loan holding company, and calculates risk-based capital ratios under the market risk capital rule; or

(iii) Purchase or sell one or more financial instruments for any purpose, if the banking entity:

(A) Is licensed or registered, or is required to be licensed or registered, to engage in the business of a dealer, swap dealer, or security-based swap dealer, to the extent the instrument is purchased or sold in connection with the activities that require the banking entity to be licensed or registered as such; or

(B) Is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, to the extent the instrument is purchased or sold in connection with the activities of such business.

(2) *Rebuttable presumption for certain purchases and sales.* The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section.

(c) *Financial instrument*—(1) *Financial instrument* means:

(i) A security, including an option on a security;

(ii) A derivative, including an option on a derivative; or

(iii) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

(2) A financial instrument does not include:

(i) A loan;

(ii) A commodity that is not:

(A) An excluded commodity (other than foreign exchange or currency);

(B) A derivative;

(C) A contract of sale of a commodity for future delivery; or

(D) An option on a contract of sale of a commodity for future delivery; or

(iii) Foreign exchange or currency.

(d) *Proprietary trading does not include:*—(1) Any purchase or sale of one or more financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;

(2) Any purchase or sale of one or more financial instruments by a banking entity that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties;

(3) Any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan of the banking entity that:

(i) Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used;

(ii) Requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

(iii) Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit, and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements;

(iv) Limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan;

(v) Includes written policies and procedures, internal controls, analysis, and independent testing to ensure that the purchase and sale of securities that are not permitted under § 75.6(a) or (b) are for the purpose of liquidity management and in accordance with the liquidity management plan described in paragraph (d)(3) of this section; and

(vi) Is consistent with the Commission's supervisory requirements, guidance, and expectations regarding liquidity management;

(4) Any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency in connection with clearing financial instruments;

(5) Any excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(6) Any purchase or sale of one or more financial instruments by a banking entity, so long as:

(i) The purchase (or sale) satisfies an existing delivery obligation of the banking entity or its customers, including to prevent or close out a failure to deliver, in connection with delivery, clearing, or settlement activity; or

(ii) The purchase (or sale) satisfies an obligation of the banking entity in connection with a judicial,

administrative, self-regulatory organization, or arbitration proceeding;

(7) Any purchase or sale of one or more financial instruments by a banking entity that is acting solely as agent, broker, or custodian;

(8) Any purchase or sale of one or more financial instruments by a banking entity through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity that is established and administered in accordance with the law of the United States or a foreign sovereign, if the purchase or sale is made directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity; or

(9) Any purchase or sale of one or more financial instruments by a banking entity in the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the financial instrument as soon as practicable, and in no event may the banking entity retain such instrument for longer than such period permitted by the Commission.

(e) *Definition of other terms related to proprietary trading.* For purposes of this subpart:

(1) *Anonymous* means that each party to a purchase or sale is unaware of the identity of the other party(ies) to the purchase or sale.

(2) *Clearing agency* has the same meaning as in section 3(a)(23) of the Exchange Act (15 U.S.C. 78c(a)(23)).

(3) *Commodity* has the same meaning as in section 1a(9) of the Commodity Exchange Act (7 U.S.C. 1a(9)), except that a commodity does not include any security;

(4) *Contract of sale of a commodity for future delivery* means a contract of sale (as that term is defined in section 1a(13) of the Commodity Exchange Act (7 U.S.C. 1a(13)) for future delivery (as that term is defined in section 1a(27) of the Commodity Exchange Act (7 U.S.C. 1a(27))).

(5) *Derivatives clearing organization* means:

(i) A derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1);

(ii) A derivatives clearing organization that, pursuant to CFTC regulation, is exempt from the registration requirements under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1); or

(iii) A foreign derivatives clearing organization that, pursuant to CFTC regulation, is permitted to clear for a foreign board of trade that is registered with the CFTC.

(6) *Exchange,* unless the context otherwise requires, means any designated contract market, swap execution facility, or foreign board of trade registered with the CFTC, or, for purposes of securities or security-based swaps, an exchange, as defined under section 3(a)(1) of the Exchange Act (15 U.S.C. 78c(a)(1)), or security-based swap execution facility, as defined under section 3(a)(77) of the Exchange Act (15 U.S.C. 78c(a)(77)).

(7) *Excluded clearing activities* means:

(i) With respect to customer transactions cleared on a derivatives clearing organization, a clearing agency, or a designated financial market utility, any purchase or sale necessary to correct trading errors made by or on behalf of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(ii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a customer provided that such purchase or sale is conducted in accordance with, for transactions cleared on a derivatives clearing organization, the Commodity Exchange Act, CFTC regulations, and the rules or procedures of the derivatives clearing organization, or, for transactions cleared on a clearing agency, the rules or procedures of the clearing agency, or, for transactions cleared on a designated financial market utility that is neither a derivatives clearing organization nor a clearing agency, the rules or procedures of the designated financial market utility;

(iii) Any purchase or sale in connection with and related to the management of a default or threatened imminent default of a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;

(iv) Any purchase or sale in connection with and related to the management of the default or threatened default of a clearing agency, a derivatives clearing organization, or a designated financial market utility; and

(v) Any purchase or sale that is required by the rules or procedures of a clearing agency, a derivatives clearing organization, or a designated financial market utility to mitigate the risk to the clearing agency, derivatives clearing organization, or designated financial market utility that would result from the clearing by a member of security-based swaps that reference the member or an affiliate of the member.

(8) *Designated financial market utility* has the same meaning as in section 803(4) of the Dodd-Frank Act (12 U.S.C. 5462(4)).

(9) *Issuer* has the same meaning as in section 2(a)(4) of the Securities Act of 1933 (15 U.S.C. 77b(a)(4)).

(10) *Market risk capital rule covered position and trading position* means a financial instrument that is both a covered position and a trading position, as those terms are respectively defined:

(i) In the case of a banking entity that is a bank holding company, savings and loan holding company, or insured depository institution, under the market risk capital rule that is applicable to the banking entity; and

(ii) In the case of a banking entity that is affiliated with a bank holding company or savings and loan holding company, other than a banking entity to which a market risk capital rule is applicable, under the market risk capital rule that is applicable to the affiliated bank holding company or savings and loan holding company.

(11) *Market risk capital rule* means the market risk capital rule that is contained in subpart F of 12 CFR part 3, 12 CFR parts 208 and 225, or 12 CFR part 324, as applicable.

(12) *Municipal security* means a security that is a direct obligation of or issued by, or an obligation guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States or political subdivisions thereof.

(13) *Trading desk* means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

§ 75.4 Permitted underwriting and market making-related activities.

(a) *Underwriting activities*—(1) *Permitted underwriting activities.* The prohibition contained in § 75.3(a) does not apply to a banking entity's underwriting activities conducted in accordance with paragraph (a) of this section.

(2) *Requirements.* The underwriting activities of a banking entity are permitted under paragraph (a)(1) of this section only if:

(i) The banking entity is acting as an underwriter for a distribution of securities and the trading desk's underwriting position is related to such distribution;

(ii) The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (a) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The products, instruments or exposures each trading desk may purchase, sell, or manage as part of its underwriting activities;

(B) Limits for each trading desk, based on the nature and amount of the trading desk's underwriting activities, including the reasonably expected near term demands of clients, customers, or counterparties, on the:

(*1*) Amount, types, and risk of its underwriting position;

(*2*) Level of exposures to relevant risk factors arising from its underwriting position; and

(*3*) Period of time a security may be held;

(C) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(D) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis of the basis for any temporary or permanent increase to a trading desk's limit(s), and independent review of such demonstrable analysis and approval;

(iv) The compensation arrangements of persons performing the activities described in paragraph (a) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(v) The banking entity is licensed or registered to engage in the activity described in paragraph (a) of this section in accordance with applicable law.

(3) *Definition of distribution.* For purposes of paragraph (a) of this section, a *distribution* of securities means:

(i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or

(ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933.

(4) *Definition of underwriter.* For purposes of paragraph (a) of this section, *underwriter* means:

(i) A person who has agreed with an issuer or selling security holder to:

(A) Purchase securities from the issuer or selling security holder for distribution;

(B) Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or

(C) Manage a distribution of securities for or on behalf of the issuer or selling security holder; or

(ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.

(5) *Definition of selling security holder.* For purposes of paragraph (a) of this section, *selling security holder* means any person, other than an issuer, on whose behalf a distribution is made.

(6) *Definition of underwriting position.* For purposes of paragraph (a) of this section, *underwriting position* means the long or short positions in one or more securities held by a banking entity or its affiliate, and managed by a particular trading desk, in connection with a particular distribution of securities for which such banking entity or affiliate is acting as an underwriter.

(7) *Definition of client, customer, and counterparty.* For purposes of paragraph (a) of this section, the terms *client, customer,* and *counterparty,* on a collective or individual basis, refer to market participants that may transact with the banking entity in connection with a particular distribution for which the banking entity is acting as underwriter.

(b) *Market making-related activities*—(1) *Permitted market making-related activities.* The prohibition contained in § 75.3(a) does not apply to a banking entity's market making-related activities conducted in accordance with paragraph (b) of this section.

(2) *Requirements.* The market making-related activities of a banking entity are permitted under paragraph (b)(1) of this section only if:

(i) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;

(ii) The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on:

(A) The liquidity, maturity, and depth of the market for the relevant types of financial instrument(s); and

(B) Demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades;

(iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing:

(A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section;

(B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective;

(C) Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by paragraph (b)(2)(ii) of this section, on:

(*1*) The amount, types, and risks of its market-maker inventory;

(*2*) The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes;

(*3*) The level of exposures to relevant risk factors arising from its financial exposure; and

(*4*) The period of time a financial instrument may be held;

(D) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and

(E) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of paragraph (b) of this section, and independent review of such demonstrable analysis and approval;

(iv) To the extent that any limit identified pursuant to paragraph (b)(2)(iii)(C) of this section is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;

(v) The compensation arrangements of persons performing the activities described in paragraph (b) of this section are designed not to reward or incentivize prohibited proprietary trading; and

(vi) The banking entity is licensed or registered to engage in activity described in paragraph (b) of this section in accordance with applicable law.

(3) *Definition of client, customer, and counterparty.* For purposes of paragraph (b) of this section, the terms *client, customer,* and *counterparty,* on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that:

(i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § 75.20(d)(1), unless:

(A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of paragraph (b)(2) of this section; or

(B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.

(ii) [Reserved]

(4) *Definition of financial exposure.* For purposes of paragraph (b) of this section, *financial exposure* means the aggregate risks of one or more financial instruments and any associated loans, commodities, or foreign exchange or currency, held by a banking entity or its affiliate and managed by a particular trading desk as part of the trading desk's market making-related activities.

(5) *Definition of market-maker inventory.* For the purposes of paragraph (b) of this section, *market-maker inventory* means all of the positions in the financial instruments for which the trading desk stands ready to make a market in accordance with paragraph (b)(2)(i) of this section that are managed by the trading desk, including the trading desk's open positions or exposures arising from open transactions.

§ 75.5 Permitted risk-mitigating hedging activities.

(a) *Permitted risk-mitigating hedging activities.* The prohibition contained in § 75.3(a) does not apply to the risk-mitigating hedging activities of a banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity and designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings.

(b) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under paragraph (a) of this section only if:

(1) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(i) Reasonably designed written policies and procedures regarding the positions, techniques and strategies that may be used for hedging, including documentation indicating what positions, contracts or other holdings a particular trading desk may use in its risk-mitigating hedging activities, as well as position and aging limits with respect to such positions, contracts or other holdings;

(ii) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(iii) The conduct of analysis, including correlation analysis, and independent testing designed to ensure that the positions, techniques and strategies that may be used for hedging may reasonably be expected to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risk(s) being hedged, and such correlation analysis demonstrates that the hedging activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged;

(2) The risk-mitigating hedging activity:

(i) Is conducted in accordance with the written policies, procedures, and internal controls required under this section;

(ii) At the inception of the hedging activity, including, without limitation, any adjustments to the hedging activity, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, commodity price risk, basis risk, or similar risks, arising in connection with and related to identified positions, contracts, or other holdings of the banking entity, based upon the facts and circumstances of the identified underlying and hedging positions, contracts or other holdings and the risks and liquidity thereof;

(iii) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section;

(iv) Is subject to continuing review, monitoring and management by the banking entity that:

(A) Is consistent with the written hedging policies and procedures required under paragraph (b)(1) of this section;

(B) Is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates the specific, identifiable risks that develop over time from the risk-mitigating hedging activities undertaken under this section and the underlying positions, contracts, and other holdings of the banking entity, based upon the facts and circumstances of the underlying and hedging positions, contracts and other holdings of the

banking entity and the risks and liquidity thereof; and

(C) Requires ongoing recalibration of the hedging activity by the banking entity to ensure that the hedging activity satisfies the requirements set out in paragraph (b)(2) of this section and is not prohibited proprietary trading; and

(3) The compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.

(c) *Documentation requirement.* (1) A banking entity must comply with the requirements of paragraphs (c)(2) and (c)(3) of this section with respect to any purchase or sale of financial instruments made in reliance on this section for risk-mitigating hedging purposes that is:

(i) Not established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the hedging activity is designed to reduce;

(ii) Established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the purchases or sales are designed to reduce, but that is effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's written policies and procedures established under paragraph (b)(1) of this section or under § 75.4(b)(2)(iii)(B) as a product, instrument, exposure, technique, or strategy such trading desk may use for hedging; or

(iii) Established to hedge aggregated positions across two or more trading desks.

(2) In connection with any purchase or sale identified in paragraph (c)(1) of this section, a banking entity must, at a minimum, and contemporaneously with the purchase or sale, document:

(i) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings of the banking entity that the purchase or sale is designed to reduce;

(ii) The specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and

(iii) The trading desk or other business unit that is establishing and responsible for the hedge.

(3) A banking entity must create and retain records sufficient to demonstrate compliance with the requirements of paragraph (c) of this section for a period that is no less than five years in a form that allows the banking entity to promptly produce such records to the Commission on request, or such longer period as required under other law or this part.

§ 75.6 Other permitted proprietary trading activities.

(a) *Permitted trading in domestic government obligations.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale by a banking entity of a financial instrument that is:

(1) An obligation of, or issued or guaranteed by, the United States;

(2) An obligation, participation, or other instrument of, or issued or guaranteed by, an agency of the United States, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*);

(3) An obligation of any State or any political subdivision thereof, including any municipal security; or

(4) An obligation of the FDIC, or any entity formed by or on behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate capacity or as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(b) *Permitted trading in foreign government obligations*—(1) *Affiliates of foreign banking entities in the United States.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of such foreign sovereign, by a banking entity, so long as:

(i) The banking entity is organized under or is directly or indirectly controlled by a banking entity that is organized under the laws of a foreign sovereign and is not directly or indirectly controlled by a top-tier banking entity that is organized under the laws of the United States;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign banking entity referred to in paragraph (b)(1)(i) of this section is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The purchase or sale as principal is not made by an insured depository institution.

(2) *Foreign affiliates of a U.S. banking entity.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of a financial instrument that is an obligation of, or issued or guaranteed by, a foreign sovereign (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign, by a foreign entity that is owned or controlled by a banking entity organized or established under the laws of the United States or any State, so long as:

(i) The foreign entity is a foreign bank, as defined in § 211.2(j) of the Board's Regulation K (12 CFR 211.2(j)), or is regulated by the foreign sovereign as a securities dealer;

(ii) The financial instrument is an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which the foreign entity is organized (including any multinational central bank of which the foreign sovereign is a member), or any agency or political subdivision of that foreign sovereign; and

(iii) The financial instrument is owned by the foreign entity and is not financed by an affiliate that is located in the United States or organized under the laws of the United States or of any State.

(c) *Permitted trading on behalf of customers*—(1) *Fiduciary transactions.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as trustee or in a similar fiduciary capacity, so long as:

(i) The transaction is conducted for the account of, or on behalf of, a customer; and

(ii) The banking entity does not have or retain beneficial ownership of the financial instruments.

(2) *Riskless principal transactions.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.

(d) *Permitted trading by a regulated insurance company.* The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity that is an insurance company or an affiliate of an insurance company if:

(1) The insurance company or its affiliate purchases or sells the financial instruments solely for:

(i) The general account of the insurance company; or

(ii) A separate account established by the insurance company;

(2) The purchase or sale is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (d)(2) of this section is insufficient to protect the safety and soundness of the covered banking entity, or the financial stability of the United States.

(e) *Permitted trading activities of foreign banking entities.* (1) The prohibition contained in § 75.3(a) does not apply to the purchase or sale of financial instruments by a banking entity if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of any State;

(ii) The purchase or sale by the banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; and

(iii) The purchase or sale meets the requirements of paragraph (e)(3) of this section.

(2) A purchase or sale of financial instruments by a banking entity is made pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (e)(1)(ii) of this section only if:

(i) The purchase or sale is conducted in accordance with the requirements of paragraph (e) of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of any State and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) A purchase or sale by a banking entity is permitted for purposes of paragraph (e) of this section only if:

(i) The banking entity engaging as principal in the purchase or sale (including any personnel of the banking entity or its affiliate that arrange, negotiate or execute such purchase or sale) is not located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to purchase or sell as principal is not located in the United States or organized under the laws of the United States or of any State;

(iii) The purchase or sale, including any transaction arising from risk-mitigating hedging related to the instruments purchased or sold, is not accounted for as principal directly or on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State;

(iv) No financing for the banking entity's purchases or sales is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(v) The purchase or sale is not conducted with or through any U.S. entity, other than:

(A) A purchase or sale with the foreign operations of a U.S. entity if no personnel of such U.S. entity that are located in the United States are involved in the arrangement, negotiation, or execution of such purchase or sale;

(B) A purchase or sale with an unaffiliated market intermediary acting as principal, provided the purchase or sale is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty; or

(C) A purchase or sale through an unaffiliated market intermediary acting as agent, provided the purchase or sale is conducted anonymously on an exchange or similar trading facility and is promptly cleared and settled through a clearing agency or derivatives clearing organization acting as a central counterparty,

(4) For purposes of paragraph (e) of this section, a U.S. entity is any entity that is, or is controlled by, or is acting on behalf of, or at the direction of, any other entity that is, located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of paragraph (e) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is considered to be located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(6) For purposes of paragraph (e) of this section, *unaffiliated market intermediary* means an unaffiliated entity, acting as an intermediary, that is:

(i) A broker or dealer registered with the SEC under section 15 of the Exchange Act or exempt from registration or excluded from regulation as such;

(ii) A swap dealer registered with the CFTC under section 4s of the Commodity Exchange Act or exempt from registration or excluded from regulation as such;

(iii) A security-based swap dealer registered with the SEC under section 15F of the Exchange Act or exempt from registration or excluded from regulation as such; or

(iv) A futures commission merchant registered with the CFTC under section 4f of the Commodity Exchange Act or exempt from registration or excluded from regulation as such.

§ 75.7 Limitations on permitted proprietary trading activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ 75.4 through 75.6 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section, a material conflict of interest between a

banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§§ 75.8–75.9 [Reserved]

Subpart C—Covered Fund Activities and Investments

§ 75.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

(a) *Prohibition.* (1) Except as otherwise provided in this subpart, a banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.

(2) Paragraph (a)(1) of this section does not include acquiring or retaining an ownership interest in a covered fund by a banking entity:

(i) Acting solely as agent, broker, or custodian, so long as;

(A) The activity is conducted for the account of, or on behalf of, a customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest;

(ii) Through a deferred compensation, stock-bonus, profit-sharing, or pension plan of the banking entity (or an affiliate thereof) that is established and administered in accordance with the law of the United States or a foreign sovereign, if the ownership interest is held or controlled directly or indirectly by the banking entity as trustee for the benefit of persons who are or were employees of the banking entity (or an affiliate thereof);

(iii) In the ordinary course of collecting a debt previously contracted in good faith, provided that the banking entity divests the ownership interest as soon as practicable, and in no event may the banking entity retain such ownership interest for longer than such period permitted by the Commission; or

(iv) On behalf of customers as trustee or in a similar fiduciary capacity for a customer that is not a covered fund, so long as:

(A) The activity is conducted for the account of, or on behalf of, the customer; and

(B) The banking entity and its affiliates do not have or retain beneficial ownership of such ownership interest.

(b) *Definition of covered fund.* (1) Except as provided in paragraph (c) of this section, covered fund means:

(i) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), *but for* section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(1) or (7));

(ii) Any commodity pool under section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10)) for which:

(A) The commodity pool operator has claimed an exemption under § 4.7 of this chapter; or

(B) (*1*) A commodity pool operator is registered with the CFTC as a commodity pool operator in connection with the operation of the commodity pool;

(*2*) Substantially all participation units of the commodity pool are owned by qualified eligible persons under § 4.7(a)(2) and (3) of this chapter; and

(*3*) Participation units of the commodity pool have not been publicly offered to persons who are not qualified eligible persons under § 4.7(a)(2) and (3) of this chapter; or

(iii) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, an entity that:

(A) Is organized or established outside the United States and the ownership interests of which are offered and sold solely outside the United States;

(B) Is, or holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities; and

(C) (*1*) Has as its sponsor that banking entity (or an affiliate thereof); or

(*2*) Has issued an ownership interest that is owned directly or indirectly by that banking entity (or an affiliate thereof).

(2) An issuer shall not be deemed to be a covered fund under paragraph (b)(1)(iii) of this section if, were the issuer subject to U.S. securities laws, the issuer could rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act.

(3) For purposes of paragraph (b)(1)(iii) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(c) Notwithstanding paragraph (b) of this section, unless the appropriate Federal banking agencies, the SEC, and

the CFTC jointly determine otherwise, a covered fund does not include:

(1) *Foreign public funds.* (i) Subject to paragraphs (c)(1)(ii) and (iii) of this section, an issuer that:

(A) Is organized or established outside of the United States;

(B) Is authorized to offer and sell ownership interests to retail investors in the issuer's home jurisdiction; and

(C) Sells ownership interests predominantly through one or more public offerings outside of the United States.

(ii) With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer unless ownership interests in the issuer are sold predominantly to persons other than:

(A) Such sponsoring banking entity;

(B) Such issuer;

(C) Affiliates of such sponsoring banking entity or such issuer; and

(D) Directors and employees of such entities.

(iii) For purposes of paragraph (c)(1)(i)(C) of this section, the term *public offering* means a distribution (as defined in § 75.4(a)(3)) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

(A) The distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;

(B) The distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and

(C) The issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.

(2) *Wholly-owned subsidiaries.* An entity, all of the outstanding ownership interests of which are owned directly or indirectly by the banking entity (or an affiliate thereof), except that:

(i) Up to five percent of the entity's outstanding ownership interests, less any amounts outstanding under paragraph (c)(2)(ii) of this section, may be held by employees or directors of the banking entity or such affiliate (including former employees or directors if their ownership interest was acquired while employed by or in the service of the banking entity); and

(ii) Up to 0.5 percent of the entity's outstanding ownership interests may be held by a third party if the ownership interest is acquired or retained by the third party for the purpose of establishing corporate separateness or addressing bankruptcy, insolvency, or similar concerns.

(3) *Joint ventures.* A joint venture between a banking entity or any of its affiliates and one or more unaffiliated persons, *provided that* the joint venture:

(i) Is comprised of no more than 10 unaffiliated co-venturers;

(ii) Is in the business of engaging in activities that are permissible for the banking entity or affiliate, other than investing in securities for resale or other disposition; and

(iii) Is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities.

(4) *Acquisition vehicles.* An issuer:

(i) Formed solely for the purpose of engaging in a *bona fide* merger or acquisition transaction; and

(ii) That exists only for such period as necessary to effectuate the transaction.

(5) *Foreign pension or retirement funds.* A plan, fund, or program providing pension, retirement, or similar benefits that is:

(i) Organized and administered outside the United States;

(ii) A broad-based plan for employees or citizens that is subject to regulation as a pension, retirement, or similar plan under the laws of the jurisdiction in which the plan, fund, or program is organized and administered; and

(iii) Established for the benefit of citizens or residents of one or more foreign sovereigns or any political subdivision thereof.

(6) *Insurance company separate accounts.* A separate account, provided that no banking entity other than the insurance company participates in the account's profits and losses.

(7) *Bank owned life insurance.* A separate account that is used solely for the purpose of allowing one or more banking entities to purchase a life insurance policy for which the banking entity or entities is beneficiary, provided that no banking entity that purchases the policy:

(i) Controls the investment decisions regarding the underlying assets or holdings of the separate account; or

(ii) Participates in the profits and losses of the separate account other than in compliance with applicable supervisory guidance regarding bank owned life insurance.

(8) *Loan securitizations*—(i) *Scope.* An issuing entity for asset-backed securities that satisfies all the conditions of paragraph (c)(8) of this section and the assets or holdings of which are comprised solely of:

(A) Loans as defined in § 75.2(s);

(B) Rights or other assets designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans, provided that each asset meets the requirements of paragraph (c)(8)(iii) of this section;

(C) Interest rate or foreign exchange derivatives that meet the requirements of paragraph (c)(8)(iv) of this section; and

(D) Special units of beneficial interest and collateral certificates that meet the requirements of paragraph (c)(8)(v) of this section.

(ii) *Impermissible assets.* For purposes of paragraph (c)(8) of this section, the assets or holdings of the issuing entity shall not include any of the following:

(A) A security, including an asset-backed security, or an interest in an equity or debt security other than as permitted in paragraph (c)(8)(iii) of this section;

(B) A derivative, other than a derivative that meets the requirements of paragraph (c)(8)(iv) of this section; or

(C) A commodity forward contract.

(iii) *Permitted securities.* Notwithstanding paragraph (c)(8)(ii)(A) of this section, the issuing entity may hold securities if those securities are:

(A) Cash equivalents for purposes of the rights and assets in paragraph (c)(8)(i)(B) of this section; or

(B) Securities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities.

(iv) *Derivatives.* The holdings of derivatives by the issuing entity shall be limited to interest rate or foreign exchange derivatives that satisfy all of the following conditions:

(A) The written terms of the derivative directly relate to the loans, the asset-backed securities, or the contractual rights of other assets described in paragraph (c)(8)(i)(B) of this section; and

(B) The derivatives reduce the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or other assets described in paragraph (c)(8)(i)(B) of this section.

(v) *Special units of beneficial interest and collateral certificates.* The assets or holdings of the issuing entity may include collateral certificates and special units of beneficial interest issued by a special purpose vehicle, provided that:

(A) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate meets the requirements in paragraph (c)(8) of this section;

(B) The special unit of beneficial interest or collateral certificate is used for the sole purpose of transferring to the issuing entity for the loan securitization the economic risks and benefits of the assets that are permissible for loan securitizations under paragraph (c)(8) of this section and does not directly or indirectly transfer any interest in any other economic or financial exposure;

(C) The special unit of beneficial interest or collateral certificate is created solely to satisfy legal requirements or otherwise facilitate the structuring of the loan securitization; and

(D) The special purpose vehicle that issues the special unit of beneficial interest or collateral certificate and the issuing entity are established under the direction of the same entity that initiated the loan securitization.

(9) *Qualifying asset-backed commercial paper conduits.* (i) An issuing entity for asset-backed commercial paper that satisfies all of the following requirements:

(A) The asset-backed commercial paper conduit holds only:

(*1*) Loans and other assets permissible for a loan securitization under paragraph (c)(8)(i) of this section; and

(*2*) Asset-backed securities supported solely by assets that are permissible for loan securitizations under paragraph (c)(8)(i) of this section and acquired by the asset-backed commercial paper conduit as part of an initial issuance either directly from the issuing entity of the asset-backed securities or directly from an underwriter in the distribution of the asset-backed securities;

(B) The asset-backed commercial paper conduit issues only asset-backed securities, comprised of a residual interest and securities with a legal maturity of 397 days or less; and

(C) A regulated liquidity provider has entered into a legally binding commitment to provide full and unconditional liquidity coverage with respect to all of the outstanding asset-backed securities issued by the asset-backed commercial paper conduit (other than any residual interest) in the event that funds are required to redeem maturing asset-backed securities.

(ii) For purposes of this paragraph (c)(9) of this section, a regulated liquidity provider means:

(A) A depository institution, as defined in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c));

(B) A bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)), or a subsidiary thereof;

(C) A savings and loan holding company, as defined in section 10a of the Home Owners' Loan Act (12 U.S.C. 1467a), provided all or substantially all of the holding company's activities are permissible for a financial holding company under section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(k)), or a subsidiary thereof;

(D) A foreign bank whose home country supervisor, as defined in § 211.21(q) of the Board's Regulation K (12 CFR 211.21(q)), has adopted capital standards consistent with the Capital Accord for the Basel Committee on Banking Supervision, as amended, and that is subject to such standards, or a subsidiary thereof; or

(E) The United States or a foreign sovereign.

(10) *Qualifying covered bonds*—(i) *Scope.* An entity owning or holding a dynamic or fixed pool of loans or other assets as provided in paragraph (c)(8) of this section for the benefit of the holders of covered bonds, provided that the assets in the pool are comprised solely of assets that meet the conditions in paragraph (c)(8)(i) of this section.

(ii) *Covered bond.* For purposes of paragraph (c)(10) of this section, a covered bond means:

(A) A debt obligation issued by an entity that meets the definition of foreign banking organization, the payment obligations of which are fully and unconditionally guaranteed by an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section; or

(B) A debt obligation of an entity that meets the conditions set forth in paragraph (c)(10)(i) of this section, provided that the payment obligations are fully and unconditionally guaranteed by an entity that meets the definition of foreign banking organization and the entity is a wholly-owned subsidiary, as defined in paragraph (c)(2) of this section, of such foreign banking organization.

(11) *SBICs and public welfare investment funds.* An issuer:

(i) That is a small business investment company, as defined in section 103(3) of the Small Business Investment Act of 1958 (15 U.S.C. 662), or that has received from the Small Business Administration notice to proceed to qualify for a license as a small business investment company, which notice or license has not been revoked; or

(ii) The business of which is to make investments that are:

(A) Designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or

(B) Qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

(12) *Registered investment companies and excluded entities.* An issuer:

(i) That is registered as an investment company under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8), or that is formed and operated pursuant to a written plan to become a registered investment company as described in § 75.20(e)(3) and that complies with the requirements of section 18 of the Investment Company Act of 1940 (15 U.S.C. 80a–18);

(ii) That may rely on an exclusion or exemption from the definition of ''investment company'' under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) other than the exclusions contained in section 3(c)(1) and 3(c)(7) of that Act; or

(iii) That has elected to be regulated as a business development company pursuant to section 54(a) of that Act (15 U.S.C. 80a–53) and has not withdrawn its election, or that is formed and operated pursuant to a written plan to become a business development company as described in § 75.20(e)(3) and that complies with the requirements of section 61 of the Investment Company Act of 1940 (15 U.S.C. 80a–60).

(13) *Issuers in conjunction with the FDIC's receivership or conservatorship operations.* An issuer that is an entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's capacity as conservator or receiver under the Federal Deposit Insurance Act or Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

(14) *Other excluded issuers.* (i) Any issuer that the appropriate Federal banking agencies, the SEC, and the CFTC jointly determine the exclusion of which is consistent with the purposes of section 13 of the BHC Act.

(ii) A determination made under paragraph (c)(14)(i) of this section will be promptly made public.

(d) *Definition of other terms related to covered funds.* For purposes of this subpart:

(1) *Applicable accounting standards* means U.S. generally accepted accounting principles, or such other accounting standards applicable to a banking entity that the Commission determines are appropriate and that the banking entity uses in the ordinary course of its business in preparing its consolidated financial statements.

(2) *Asset-backed security* has the meaning specified in section 3(a)(79) of the Exchange Act (15 U.S.C. 78c(a)(79)).

(3) *Director* has the same meaning as provided in § 215.2(d)(1) of the Board's Regulation O (12 CFR 215.2(d)(1)).

(4) *Issuer* has the same meaning as in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(22)).

(5) *Issuing entity* means with respect to asset-backed securities the special purpose vehicle that owns or holds the pool assets underlying asset-backed securities and in whose name the asset-backed securities supported or serviced by the pool assets are issued.

(6) *Ownership interest*—(i) *Ownership interest* means any equity, partnership, or other similar interest. An ''other similar interest'' means an interest that:

(A) Has the right to participate in the selection or removal of a general partner, managing member, member of the board of directors or trustees, investment manager, investment adviser, or commodity trading advisor of the covered fund (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(B) Has the right under the terms of the interest to receive a share of the income, gains or profits of the covered fund;

(C) Has the right to receive the underlying assets of the covered fund after all other interests have been redeemed and/or paid in full (excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event);

(D) Has the right to receive all or a portion of excess spread (the positive difference, if any, between the aggregate interest payments received from the underlying assets of the covered fund and the aggregate interest paid to the holders of other outstanding interests);

(E) Provides under the terms of the interest that the amounts payable by the covered fund with respect to the interest could be reduced based on losses arising from the underlying assets of the covered fund, such as allocation of losses, write-downs or charge-offs of the outstanding principal balance, or reductions in the amount of interest due and payable on the interest;

(F) Receives income on a pass-through basis from the covered fund, or has a rate of return that is determined by reference to the performance of the underlying assets of the covered fund; or

(G) Any synthetic right to have, receive, or be allocated any of the rights in paragraphs (d)(6)(i)(A) through (d)(6)(i)(F) of this section.

(ii) *Ownership interest* does not include *restricted profit interest,* which is an interest held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as:

(A) The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received;

(B) All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund;

(C) Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits of § 75.12; and

(D) The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.

(7) *Prime brokerage transaction* means any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.

(8) *Resident of the United States* means a person that is a ''U.S. person'' as defined in rule 902(k) of the SEC's Regulation S (17 CFR 230.902(k)).

(9) *Sponsor* means, with respect to a covered fund:

(i) To serve as a general partner, managing member, or trustee of a covered fund, or to serve as a commodity pool operator with respect to a covered fund as defined in (b)(1)(ii) of this section;

(ii) In any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or

(iii) To share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.

(10) *Trustee.* (i) For purposes of paragraph (d)(9) of this section and § 75.11, a trustee does *not* include:

(A) A trustee that does not exercise investment discretion with respect to a covered fund, including a trustee that is subject to the direction of an unaffiliated named fiduciary who is not a trustee pursuant to section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)); or

(B) A trustee that is subject to fiduciary standards imposed under foreign law that are substantially equivalent to those described in paragraph (d)(10)(i)(A) of this section;

(ii) Any entity that directs a person described in paragraph (d)(10)(i) of this section, or that possesses authority and discretion to manage and control the investment decisions of a covered fund for which such person serves as trustee, shall be considered to be a trustee of such covered fund.

§ 75.11 Permitted organizing and offering, underwriting, and market making with respect to a covered fund.

(a) *Organizing and offering a covered fund in general.* Notwithstanding § 75.10(a), a banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund in connection with, directly or indirectly, organizing and offering a covered fund, including serving as a general partner, managing member, trustee, or

commodity pool operator of the covered fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the covered fund, including any necessary expenses for the foregoing, only if:

(1) The banking entity (or an affiliate thereof) provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(2) The covered fund is organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity (or an affiliate thereof), pursuant to a written plan or similar documentation outlining how the banking entity or such affiliate intends to provide advisory or similar services to its customers through organizing and offering such fund;

(3) The banking entity and its affiliates do not acquire or retain an ownership interest in the covered fund except as permitted under § 75.12;

(4) The banking entity and its affiliates comply with the requirements of § 75.14;

(5) The banking entity and its affiliates do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(6) The covered fund, for corporate, marketing, promotional, or other purposes:

(i) Does not share the same name or a variation of the same name with the banking entity (or an affiliate thereof); and

(ii) Does not use the word ''bank'' in its name;

(7) No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest; and

(8) The banking entity:

(i) Clearly and conspicuously discloses, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

(A) That ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity] or its affiliates; therefore, [the banking entity's] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity] and any affiliate in its capacity as investor in the [covered fund] or as beneficiary of a restricted profit interest held by [the banking entity] or any affiliate'';

(B) That such investor should read the fund offering documents before investing in the covered fund;

(C) That the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and

(D) The role of the banking entity and its affiliates and employees in sponsoring or providing any services to the covered fund; and

(ii) Complies with any additional rules of the appropriate Federal banking agencies, the SEC, or the CFTC, as provided in section 13(b)(2) of the BHC Act, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the covered banking entity and its affiliates.

(b) *Organizing and offering an issuing entity of asset-backed securities.* (1) Notwithstanding § 75.10(a), a banking entity is not prohibited from acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund that is an issuing entity of asset-backed securities in connection with, directly or indirectly, organizing and offering that issuing entity, so long as the banking entity and its affiliates comply with all of the requirements of paragraphs (a)(3) through (a)(8) of this section.

(2) For purposes of paragraph (b) of this section, organizing and offering a covered fund that is an issuing entity of asset-backed securities means acting as the securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78*o*–11(a)(3)) of the issuing entity, or acquiring or retaining an ownership interest in the issuing entity as required by section 15G of that Act (15 U.S.C. 78*o*–11) and the implementing regulations issued thereunder.

(c) *Underwriting and market making in ownership interests of a covered fund.* The prohibition contained in § 75.10(a) does not apply to a banking entity's underwriting activities or market making-related activities involving a covered fund so long as:

(1) Those activities are conducted in accordance with the requirements of § 75.4(a) or (b), respectively;

(2) With respect to any banking entity (or any affiliate thereof) that acts as a sponsor, investment adviser or commodity trading advisor to a particular covered fund or otherwise acquires and retains an ownership interest in such covered fund in reliance on paragraph (a) of this section; acquires and retains an ownership interest in such covered fund and is either a securitizer, as that term is used in section 15G(a)(3) of the Exchange Act (15 U.S.C. 78o–11(a)(3)), or is acquiring and retaining an ownership interest in such covered fund in compliance with section 15G of that Act (15 U.S.C. 78o–11) and the implementing regulations issued thereunder each as permitted by paragraph (b) of this section; or, directly or indirectly, guarantees, assumes, or otherwise insures the obligations or performance of the covered fund or of any covered fund in which such fund invests, then in each such case any ownership interests acquired or retained by the banking entity and its affiliates in connection with underwriting and market making related activities for that particular covered fund are included in the calculation of ownership interests permitted to be held by the banking entity and its affiliates under the limitations of § 75.12(a)(2)(ii) and (d); and

(3) With respect to any banking entity, the aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired and retained under § 75.11, including all covered funds in which the banking entity holds an ownership interest in connection with underwriting and market making related activities permitted under paragraph (c) of this section, are included in the calculation of all ownership interests under § 75.12(a)(2)(iii) and (d).

§ 75.12 Permitted investment in a covered fund.

(a) *Authority and limitations on permitted investments in covered funds.* (1) Notwithstanding the prohibition contained in § 75.10(a), a banking entity may acquire and retain an ownership interest in a covered fund that the banking entity or an affiliate thereof organizes and offers pursuant to § 75.11, for the purposes of:

(i) *Establishment.* Establishing the fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, subject to the limits contained in paragraphs (a)(2)(i) and (a)(2)(iii) of this section; or

(ii) *De minimis investment.* Making and retaining an investment in the covered fund subject to the limits contained in paragraphs (a)(2)(ii) and (a)(2)(iii) of this section.

(2) *Investment limits*—(i) *Seeding period.* With respect to an investment in any covered fund made or held pursuant to paragraph (a)(1)(i) of this section, the banking entity and its affiliates:

(A) Must actively seek unaffiliated investors to reduce, through redemption, sale, dilution, or other methods, the aggregate amount of all ownership interests of the banking entity in the covered fund to the amount permitted in paragraph (a)(2)(i)(B) of this section; and

(B) Must, no later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section), conform its ownership interest in the covered fund to the limits in paragraph (a)(2)(ii) of this section;

(ii) *Per-fund limits.* (A) Except as provided in paragraph (a)(2)(ii)(B) of this section, an investment by a banking entity and its affiliates in any covered fund made or held pursuant to paragraph (a)(1)(ii) of this section may not exceed 3 percent of the total number or value of the outstanding ownership interests of the fund.

(B) An investment by a banking entity and its affiliates in a covered fund that is an issuing entity of asset-backed securities may not exceed 3 percent of the total fair market value of the ownership interests of the fund measured in accordance with paragraph (b)(3) of this section, unless a greater percentage is retained by the banking entity and its affiliates in compliance with the requirements of section 15G of the Exchange Act (15 U.S.C. 78*o*–11) and the implementing regulations issued thereunder, in which case the investment by the banking entity and its affiliates in the covered fund may not exceed the amount, number, or value of ownership interests of the fund required under section 15G of the Exchange Act and the implementing regulations issued thereunder.

(iii) *Aggregate limit.* The aggregate value of all ownership interests of the banking entity and its affiliates in all covered funds acquired or retained under this section may not exceed 3 percent of the tier 1 capital of the banking entity, as provided under paragraph (c) of this section, and shall be calculated as of the last day of each calendar quarter.

(iv) *Date of establishment.* For purposes of this section, the date of establishment of a covered fund shall be:

(A) *In general.* The date on which the investment adviser or similar entity to the covered fund begins making investments pursuant to the written investment strategy for the fund;

(B) *Issuing entities of asset-backed securities.* In the case of an issuing entity of asset-backed securities, the date on which the assets are initially transferred into the issuing entity of asset-backed securities.

(b) *Rules of construction*—(1) *Attribution of ownership interests to a covered banking entity.* (i) For purposes of paragraph (a)(2) of this section, the amount and value of a banking entity's permitted investment in any single covered fund shall include any ownership interest held under § 75.12 directly by the banking entity, including any affiliate of the banking entity.

(ii) *Treatment of registered investment companies, SEC-regulated business development companies and foreign public funds.* For purposes of paragraph (b)(1)(i) of this section, a registered investment company, SEC-regulated business development companies or foreign public fund as described in § 75.10(c)(1) will not be considered to be an affiliate of the banking entity so long as the banking entity:

(A) Does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the company or fund; and

(B) Provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund in compliance with the limitations under applicable regulation, order, or other authority.

(iii) *Covered funds.* For purposes of paragraph (b)(1)(i) of this section, a covered fund will not be considered to be an affiliate of a banking entity so long as the covered fund is held in compliance with the requirements of this subpart.

(iv) *Treatment of employee and director investments financed by the banking entity.* For purposes of paragraph (b)(1)(i) of this section, an investment by a director or employee of a banking entity who acquires an ownership interest in his or her personal capacity in a covered fund sponsored by the banking entity will be attributed to the banking entity if the banking entity, directly or indirectly, extends financing for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the financing is used to acquire such ownership interest in the covered fund.

(2) *Calculation of permitted ownership interests in a single covered fund.* Except as provided in paragraphs (b)(3) or (4) of this section, for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (ii)(A) of this section:

(i) The aggregate number of the outstanding ownership interests held by the banking entity shall be the total number of ownership interests held under this section by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment);

(ii) The aggregate value of the outstanding ownership interests held by the banking entity shall be the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment). If fair market value cannot be determined, then the value shall be the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;

(iii) For purposes of the calculation under paragraph (b)(2)(ii) of this section, once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.

(3) *Issuing entities of asset-backed securities.* In the case of an ownership interest in an issuing entity of asset-backed securities, for purposes of determining whether an investment in a single covered fund complies with the restrictions on ownership interests under paragraphs (a)(2)(i)(B) and (a)(2)(ii)(B) of this section:

(i) For securitizations subject to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11), the calculations shall be made as of the date and according to the valuation methodology applicable pursuant to the requirements of section 15G of the Exchange Act (15 U.S.C. 78o–11) and the implementing regulations issued thereunder; or

(ii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the calculations shall be made as of the date of establishment as defined in paragraph (a)(2)(iv)(B) of this section or such earlier date on which the transferred assets have been valued for purposes of transfer to the covered

fund, and thereafter only upon the date on which additional securities of the issuing entity of asset-backed securities are priced for purposes of the sales of ownership interests to unaffiliated investors.

(iii) For securitization transactions completed prior to the compliance date of such implementing regulations (or as to which such implementing regulations do not apply), the aggregate value of the outstanding ownership interests in the covered fund shall be the fair market value of the assets transferred to the issuing entity of the securitization and any other assets otherwise held by the issuing entity at such time, determined in a manner that is consistent with its determination of the fair market value of those assets for financial statement purposes.

(iv) For purposes of the calculation under paragraph (b)(3)(iii) of this section, the valuation methodology used to calculate the fair market value of the ownership interests must be the same for both the ownership interests held by a banking entity and the ownership interests held by all others in the covered fund in the same manner and according to the same standards.

(4) *Multi-tier fund investments*—(i) *Master-feeder fund investments.* If the principal investment strategy of a covered fund (the ''feeder fund'') is to invest substantially all of its assets in another single covered fund (the ''master fund''), then for purposes of the investment limitations in paragraphs (a)(2)(i)(B) and (a)(2)(ii) of this section, the banking entity's permitted investment in such funds shall be measured only by reference to the value of the master fund. The banking entity's permitted investment in the master fund shall include any investment by the banking entity in the master fund, as well as the banking entity's pro-rata share of any ownership interest of the master fund that is held through the feeder fund; and

(ii) *Fund-of-funds investments.* If a banking entity organizes and offers a covered fund pursuant to § 75.11 for the purpose of investing in other covered funds (a ''fund of funds'') and that fund of funds itself invests in another covered fund that the banking entity is permitted to own, then the banking entity's permitted investment in that other fund shall include any investment by the banking entity in that other fund, as well as the banking entity's pro-rata share of any ownership interest of the fund that is held through the fund of funds. The investment of the banking entity may not represent more than 3 percent of the amount or value of any single covered fund.

(c) *Aggregate permitted investments in all covered funds.* (1) For purposes of paragraph (a)(2)(iii) of this section, the aggregate value of all ownership interests held by a banking entity shall be the sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest in covered funds (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), on a historical cost basis.

(2) *Calculation of tier 1 capital.* For purposes of paragraph (a)(2)(iii) of this section:

(i) *Entities that are required to hold and report tier 1 capital.* If a banking entity is required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be equal to the amount of tier 1 capital of the banking entity as of the last day of the most recent calendar quarter, as reported to its primary financial regulatory agency; and

(ii) If a banking entity is not required to calculate and report tier 1 capital, the banking entity's tier 1 capital shall be determined to be equal to:

(A) In the case of a banking entity that is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, be equal to the amount of tier 1 capital reported by such controlling depository institution in the manner described in paragraph (c)(2)(i) of this section;

(B) In the case of a banking entity that is not controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital:

(*1*) *Bank holding company subsidiaries.* If the banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, be equal to the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital in the manner described in paragraph (c)(2)(i) of this section; and

(*2*) *Other holding companies and any subsidiary or affiliate thereof.* If the banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, be equal to the total amount of shareholders' equity of the top-tier affiliate within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.

(iii) *Treatment of foreign banking entities*—(A) *Foreign banking entities.* Except as provided in paragraph (c)(2)(iii)(B) of this section, with respect to a banking entity that is not itself, and is not controlled directly or indirectly by, a banking entity that is located or organized under the laws of the United States or of any State, the tier 1 capital of the banking entity shall be the consolidated tier 1 capital of the entity as calculated under applicable home country standards.

(B) *U.S. affiliates of foreign banking entities.* With respect to a banking entity that is located or organized under the laws of the United States or of any State and is controlled by a foreign banking entity identified under paragraph (c)(2)(iii)(A) of this section, the banking entity's tier 1 capital shall be as calculated under paragraphs (c)(2)(i) or (ii) of this section.

(d) *Capital treatment for a permitted investment in a covered fund.* For purposes of calculating compliance with the applicable regulatory capital requirements, a banking entity shall deduct from the banking entity's tier 1 capital (as determined under paragraph (c)(2) of this section) the greater of:

(1) The sum of all amounts paid or contributed by the banking entity in connection with acquiring or retaining an ownership interest (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), on a historical cost basis, plus any earnings received; and

(2) The fair market value of the banking entity's ownership interests in the covered fund as determined under paragraph (b)(2)(ii) or (3) of this section (together with any amounts paid by the entity (or employee thereof) in connection with obtaining a restricted profit interest under § 75.10(d)(6)(ii)), if the banking entity accounts for the profits (or losses) of the fund investment in its financial statements.

(e) *Extension of time to divest an ownership interest.* (1) Upon application by a banking entity, the Board may extend the period under paragraph (a)(2)(i) of this section for up to 2 additional years if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must:

(i) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(ii) Provide the reasons for application, including information that addresses the factors in paragraph (e)(2) of this section; and

(iii) Explain the banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2) of this section.

(2) *Factors governing Board determinations.* In reviewing any application under paragraph (e)(1) of this section, the Board may consider all the facts and circumstances related to the permitted investment in a covered fund, including:

(i) Whether the investment would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(ii) The contractual terms governing the banking entity's interest in the covered fund;

(iii) The date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in paragraph (a)(2)(i) of this section;

(iv) The total exposure of the covered banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity and the financial stability of the United States;

(v) The cost to the banking entity of divesting or disposing of the investment within the applicable period;

(vi) Whether the investment or the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated parties, including clients, customers or counterparties to which it owes a duty;

(vii) The banking entity's prior efforts to reduce through redemption, sale, dilution, or other methods its ownership interests in the covered fund, including activities related to the marketing of interests in such covered fund;

(viii) Market conditions; and

(ix) Any other factor that the Board believes appropriate.

(3) *Authority to impose restrictions on activities or investment during any extension period.* The Board may impose such conditions on any extension approved under paragraph (e)(1) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the banking entity or the financial stability of the United States, address material conflicts of interest or other unsound banking practices, or otherwise further the purposes of section 13 of the BHC Act and this part.

(4) *Consultation.* In the case of a banking entity that is primarily regulated by another Federal banking agency, the SEC, or the CFTC, the Board will consult with such agency prior to acting on an application by the banking entity for an extension under paragraph (e)(1) of this section.

§ 75.13 Other permitted covered fund activities and investments.

(a) *Permitted risk-mitigating hedging activities.* (1) The prohibition contained in § 75.10(a) does not apply with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund.

(2) *Requirements.* The risk-mitigating hedging activities of a banking entity are permitted under paragraph (a) of this section only if:

(i) The banking entity has established and implements, maintains and enforces an internal compliance program required by subpart D of this part that is reasonably designed to ensure the banking entity's compliance with the requirements of this section, including:

(A) Reasonably designed written policies and procedures; and

(B) Internal controls and ongoing monitoring, management, and authorization procedures, including relevant escalation procedures; and

(ii) The acquisition or retention of the ownership interest:

(A) Is made in accordance with the written policies, procedures and internal controls required under this section;

(B) At the inception of the hedge, is designed to reduce or otherwise significantly mitigate and demonstrably reduces or otherwise significantly mitigates one or more specific, identifiable risks arising in connection with the compensation arrangement with the employee that directly provides investment advisory, commodity trading advisory, or other services to the covered fund;

(C) Does not give rise, at the inception of the hedge, to any significant new or additional risk that is not itself hedged contemporaneously in accordance with this section; and

(D) Is subject to continuing review, monitoring and management by the banking entity.

(iii) The compensation arrangement relates solely to the covered fund in which the banking entity or any affiliate has acquired an ownership interest pursuant to this paragraph and such compensation arrangement provides that any losses incurred by the banking entity on such ownership interest will be offset by corresponding decreases in amounts payable under such compensation arrangement.

(b) *Certain permitted covered fund activities and investments outside of the United States.* (1) The prohibition contained in § 75.10(a) does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a banking entity only if:

(i) The banking entity is not organized or directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States;

(ii) The activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in the covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity or investment occurs solely outside of the United States.

(2) An activity or investment by the banking entity is pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act for purposes of paragraph (b)(1)(ii) of this section only if:

(i) The activity or investment is conducted in accordance with the requirements of this section; and

(ii)(A) With respect to a banking entity that is a foreign banking organization, the banking entity meets the qualifying foreign banking organization requirements of § 211.23(a), (c) or (e) of the Board's Regulation K (12 CFR 211.23(a), (c) or (e)), as applicable; or

(B) With respect to a banking entity that is not a foreign banking organization, the banking entity is not organized under the laws of the United States or of one or more States and the banking entity, on a fully-consolidated basis, meets at least two of the following requirements:

(*1*) Total assets of the banking entity held outside of the United States exceed total assets of the banking entity held in the United States;

(*2*) Total revenues derived from the business of the banking entity outside of the United States exceed total revenues derived from the business of the banking entity in the United States; or

(*3*) Total net income derived from the business of the banking entity outside of the United States exceeds total net income derived from the business of the banking entity in the United States.

(3) An ownership interest in a covered fund is not offered for sale or sold to a resident of the United States for purposes of paragraph (b)(1)(iii) of this section only if it is sold or has been sold pursuant to an offering that does not target residents of the United States.

(4) An activity or investment occurs solely outside of the United States for purposes of paragraph (b)(1)(iv) of this section only if:

(i) The banking entity acting as sponsor, or engaging as principal in the acquisition or retention of an ownership interest in the covered fund, is not itself, and is not controlled directly or indirectly by, a banking entity that is located in the United States or organized under the laws of the United States or of any State;

(ii) The banking entity (including relevant personnel) that makes the decision to acquire or retain the ownership interest or act as sponsor to the covered fund is not located in the United States or organized under the laws of the United States or of any State;

(iii) The investment or sponsorship, including any transaction arising from risk-mitigating hedging related to an ownership interest, is not accounted for as principal directly or indirectly on a consolidated basis by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State; and

(iv) No financing for the banking entity's ownership or sponsorship is provided, directly or indirectly, by any branch or affiliate that is located in the United States or organized under the laws of the United States or of any State.

(5) For purposes of this section, a U.S. branch, agency, or subsidiary of a foreign bank, or any subsidiary thereof, is located in the United States; however, a foreign bank of which that branch, agency, or subsidiary is a part is not considered to be located in the United States solely by virtue of operation of the U.S. branch, agency, or subsidiary.

(c) *Permitted covered fund interests and activities by a regulated insurance company.* The prohibition contained in § 75.10(a) does not apply to the acquisition or retention by an insurance company, or an affiliate thereof, of any ownership interest in, or the sponsorship of, a covered fund only if:

(1) The insurance company or its affiliate acquires and retains the ownership interest solely for the general account of the insurance company or for one or more separate accounts established by the insurance company;

(2) The acquisition and retention of the ownership interest is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which such insurance company is domiciled; and

(3) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and foreign jurisdictions, as appropriate, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (c)(2) of this section is insufficient to protect the safety and soundness of the banking entity, or the financial stability of the United States.

§ 75.14 Limitations on relationships with a covered fund.

(a) *Relationships with a covered fund.* (1) Except as provided for in paragraph (a)(2) of this section, no banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund pursuant to § 75.11, or that continues to hold an ownership interest in accordance with § 75.11(b), and no affiliate of such entity, may enter into a transaction with the covered fund, or with any other covered fund that is controlled by such covered fund, that would be a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), as if such banking entity and the affiliate thereof were a member bank and the covered fund were an affiliate thereof.

(2) Notwithstanding paragraph (a)(1) of this section, a banking entity may:

(i) Acquire and retain any ownership interest in a covered fund in accordance with the requirements of §§ 75.11, 75.12, or 75.13; and

(ii) Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate thereof) has taken an ownership interest, if:

(A) The banking entity is in compliance with each of the limitations set forth in § 75.11 with respect to a covered fund organized and offered by such banking entity (or an affiliate thereof);

(B) The chief executive officer (or equivalent officer) of the banking entity certifies in writing annually to the Commission (with a duty to update the certification if the information in the certification materially changes) that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; and

(C) The Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

(b) *Restrictions on transactions with covered funds.* A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, or that organizes and offers a covered fund pursuant to § 75.11, or that continues to hold an ownership interest in accordance with § 75.11(b), shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1), as if such banking entity were a member bank and such covered fund were an affiliate thereof.

(c) *Restrictions on prime brokerage transactions.* A prime brokerage transaction permitted under paragraph (a)(2)(ii) of this section shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1) as if the counterparty were an affiliate of the banking entity.

§ 75.15 Other limitations on permitted covered fund activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ 75.11 through 75.13 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the banking entity to a high-risk asset or a high-risk trading strategy; or

(3) Pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* (1) For purposes of this section, a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, and the banking entity has not taken at least one of the actions in paragraph (b)(2) of this section.

(2) Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, the banking entity:

(i) *Timely and effective disclosure.* (A) Has made clear, timely, and effective disclosure of the conflict of interest, together with other necessary information, in reasonable detail and in a manner sufficient to permit a

reasonable client, customer, or counterparty to meaningfully understand the conflict of interest; and

(B) Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(ii) *Information barriers.* Has established, maintained, and enforced information barriers that are memorialized in written policies and procedures, such as physical separation of personnel, or functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer, or counterparty. A banking entity may not rely on such information barriers if, in the case of any specific transaction, class or type of transactions or activity, the banking entity knows or should reasonably know that, notwithstanding the banking entity's establishment of information barriers, the conflict of interest may involve or result in a materially adverse effect on a client, customer, or counterparty.

(c) *Definition of high-risk asset and high-risk trading strategy.* For purposes of this section:

(1) *High-risk asset* means an asset or group of related assets that would, if held by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would pose a threat to the financial stability of the United States.

§§ 75.16–75.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

§ 75.20 Program for compliance; reporting.

(a) *Program requirement.* Each banking entity shall develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part. The terms, scope and detail of the compliance program shall be appropriate for the types, size, scope and complexity of activities and business structure of the banking entity.

(b) *Contents of compliance program.* Except as provided in paragraph (f) of this section, the compliance program required by paragraph (a) of this section, at a minimum, shall include:

(1) Written policies and procedures reasonably designed to document, describe, monitor and limit trading activities subject to subpart B of this part (including those permitted under §§ 75.3 to 75.6), including setting, monitoring and managing required limits set out in §§ 75.4 and 75.5, and activities and investments with respect to a covered fund subject to subpart C of this part (including those permitted under §§ 75.11 through 75.14) conducted by the banking entity to ensure that all activities and investments conducted by the banking entity that are subject to section 13 of the BHC Act and this part comply with section 13 of the BHC Act and this part;

(2) A system of internal controls reasonably designed to monitor compliance with section 13 of the BHC Act and this part and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;

(3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part and includes appropriate management review of trading limits, strategies, hedging activities, investments, incentive compensation and other matters identified in this part or by management as requiring attention;

(4) Independent testing and audit of the effectiveness of the compliance program conducted periodically by qualified personnel of the banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a banking entity must promptly provide to the Commission upon request and retain for a period of no less than 5 years or such longer period as required by the Commission.

(c) *Additional standards.* In addition to the requirements in paragraph (b) of this section, the compliance program of a banking entity must satisfy the requirements and other standards contained in Appendix B of this part, if:

(1) The banking entity engages in proprietary trading permitted under subpart B of this part and is required to comply with the reporting requirements of paragraph (d) of this section;

(2) The banking entity has reported total consolidated assets as of the previous calendar year end of $50 billion or more or, in the case of a foreign banking entity, has total U.S. assets as of the previous calendar year end of $50 billion or more (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States); or

(3) The Commission notifies the banking entity in writing that it must satisfy the requirements and other standards contained in Appendix B of this part.

(d) *Reporting requirements under Appendix A of this Part.* (1) A banking entity engaged in proprietary trading activity permitted under subpart B of this part shall comply with the reporting requirements described in Appendix A of this part, if:

(i) The banking entity (other than a foreign banking entity as provided in paragraph (d)(1)(ii) of this section) has, together with its affiliates and subsidiaries, trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which (on a worldwide consolidated basis) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section;

(ii) In the case of a foreign banking entity, the average gross sum of the trading assets and liabilities of the combined U.S. operations of the foreign banking entity (including all subsidiaries, affiliates, branches and agencies of the foreign banking entity operating, located or organized in the United States and excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) over the previous consecutive four quarters, as measured as of the last day of each of the four prior calendar quarters, equals or exceeds the threshold established in paragraph (d)(2) of this section; or

(iii) The Commission notifies the banking entity in writing that it must satisfy the reporting requirements contained in Appendix A of this part.

(2) The threshold for reporting under paragraph (d)(1) of this section shall be $50 billion beginning on June 30, 2014;

$25 billion beginning on April 30, 2016; and $10 billion beginning on December 31, 2016.

(3) *Frequency of reporting.* Unless the Commission notifies the banking entity in writing that it must report on a different basis, a banking entity with $50 billion or more in trading assets and liabilities (as calculated in accordance with paragraph (d)(1) of this section) shall report the information required by Appendix A of this part for each calendar month within 30 days of the end of the relevant calendar month; beginning with information for the month of January 2015, such information shall be reported within 10 days of the end of each calendar month. Any other banking entity subject to Appendix A of this part shall report the information required by Appendix A of this part for each calendar quarter within 30 days of the end of that calendar quarter unless the Commission notifies the banking entity in writing that it must report on a different basis.

(e) *Additional documentation for covered funds.* Any banking entity that has more than $10 billion in total consolidated assets as reported on December 31 of the previous two calendar years shall maintain records that include:

(1) Documentation of the exclusions or exemptions other than sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 relied on by each fund sponsored by the banking entity (including all subsidiaries and affiliates) in determining that such fund is not a covered fund;

(2) For each fund sponsored by the banking entity (including all subsidiaries and affiliates) for which the banking entity relies on one or more of the exclusions from the definition of covered fund provided by § 75.10(c)(1), (5), (8), (9), or (10), documentation supporting the banking entity's determination that the fund is not a covered fund pursuant to one or more of those exclusions;

(3) For each seeding vehicle described in § 75.10(c)(12)(i) or (iii) that will become a registered investment company or SEC-regulated business development company, a written plan documenting the banking entity's determination that the seeding vehicle will become a registered investment company or SEC-regulated business development company; the period of time during which the vehicle will operate as a seeding vehicle; and the banking entity's plan to market the vehicle to third-party investors and convert it into a registered investment company or SEC-regulated business development company within the time period specified in § 75.12(a)(2)(i)(B);

(4) For any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State, if the aggregate amount of ownership interests in foreign public funds that are described in § 75.10(c)(1) owned by such banking entity (including ownership interests owned by any affiliate that is controlled directly or indirectly by a banking entity that is located in or organized under the laws of the United States or of any State) exceeds $50 million at the end of two or more consecutive calendar quarters, beginning with the next succeeding calendar quarter, documentation of the value of the ownership interests owned by the banking entity (and such affiliates) in each foreign public fund and each jurisdiction in which any such foreign public fund is organized, calculated as of the end of each calendar quarter, which documentation must continue until the banking entity's aggregate amount of ownership interests in foreign public funds is below $50 million for two consecutive calendar quarters; and

(5) For purposes of paragraph (e)(4) of this section, a U.S. branch, agency, or subsidiary of a foreign banking entity is located in the United States; however, the foreign bank that operates or controls that branch, agency, or subsidiary is not considered to be located in the United States solely by virtue of operating or controlling the U.S. branch, agency, or subsidiary.

(f) *Simplified programs for less active banking entities*—(1) *Banking entities with no covered activities.* A banking entity that does not engage in activities or investments pursuant to subpart B or subpart C of this part (other than trading activities permitted pursuant to § 75.6(a)) may satisfy the requirements of this section by establishing the required compliance program prior to becoming engaged in such activities or making such investments (other than trading activities permitted pursuant to § 75.6(a)).

(2) *Banking entities with modest activities.* A banking entity with total consolidated assets of $10 billion or less as reported on December 31 of the previous two calendar years that engages in activities or investments pursuant to subpart B or subpart C of this part (other than trading activities permitted under § 75.6(a)) may satisfy the requirements of this section by including in its existing compliance policies and procedures appropriate references to the requirements of section 13 of the BHC Act and this part and adjustments as appropriate given the activities, size, scope and complexity of the banking entity.

§ 75.21 Termination of activities or investments; penalties for violations.

(a) Any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or this part, or acts in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or this part, including through an abuse of any activity or investment permitted under subparts B or C of this part, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or this part, shall, upon discovery, promptly terminate the activity and, as relevant, dispose of the investment.

(b) Whenever the Commission finds reasonable cause to believe any banking entity has engaged in an activity or made an investment in violation of section 13 of the BHC Act or this part, or engaged in any activity or made any investment that functions as an evasion of the requirements of section 13 of the BHC Act or this part, the Commission may take any action permitted by law to enforce compliance with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.

Appendix A to Part 75—Reporting and Recordkeeping Requirements for Covered Trading Activities

I. Purpose

a. This appendix sets forth reporting and recordkeeping requirements that certain banking entities must satisfy in connection with the restrictions on proprietary trading set forth in subpart B of this part (''proprietary trading restrictions''). Pursuant to § 75.20(d), this appendix generally applies to a banking entity that, together with its affiliates and subsidiaries, has significant trading assets and liabilities. These entities are required to (i) furnish periodic reports to the Commission regarding a variety of quantitative measurements of their covered trading activities, which vary depending on the scope and size of covered trading activities, and (ii) create and maintain records documenting the preparation and content of these reports. The requirements of this appendix must be incorporated into the banking entity's internal compliance program under § 75.20 and Appendix B of this part.

b. The purpose of this appendix is to assist banking entities and the Commission in:

(i) Better understanding and evaluating the scope, type, and profile of the banking entity's covered trading activities;

(ii) Monitoring the banking entity's covered trading activities;

(iii) Identifying covered trading activities that warrant further review or examination

by the banking entity to verify compliance with the proprietary trading restrictions;

(iv) Evaluating whether the covered trading activities of trading desks engaged in market making-related activities subject to § 75.4(b) are consistent with the requirements governing permitted market making-related activities;

(v) Evaluating whether the covered trading activities of trading desks that are engaged in permitted trading activity subject to § 75.4, 75.5, or 75.6(a) and (b) (i.e., underwriting and market making-related related activity, risk-mitigating hedging, or trading in certain government obligations) are consistent with the requirement that such activity not result, directly or indirectly, in a material exposure to high-risk assets or high-risk trading strategies;

(vi) Identifying the profile of particular covered trading activities of the banking entity, and the individual trading desks of the banking entity, to help establish the appropriate frequency and scope of examination by the Commission of such activities; and

(vii) Assessing and addressing the risks associated with the banking entity's covered trading activities.

c. The quantitative measurements that must be furnished pursuant to this appendix are *not* intended to serve as a dispositive tool for the identification of permissible or impermissible activities.

d. In order to allow banking entities and the Agencies to evaluate the effectiveness of these metrics, banking entities must collect and report these metrics for all trading desks beginning on the dates established in § 75.20. The Agencies will review the data collected and revise this collection requirement as appropriate based on a review of the data collected prior to September 30, 2015.

e. In addition to the quantitative measurements required in this appendix, a banking entity may need to develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and this part and to have an effective compliance program, as required by § 75.20 and Appendix B of this part. The effectiveness of particular quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading desk, including types of instruments traded, trading activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure that the activities are within risk tolerances established by the banking entity, and to monitor and examine for compliance with the proprietary trading restrictions in this part.

f. On an ongoing basis, banking entities must carefully monitor, review, and evaluate all furnished quantitative measurements, as well as any others that they choose to utilize in order to maintain compliance with section 13 of the BHC Act and this part. All measurement results that indicate a heightened risk of impermissible proprietary trading, including with respect to otherwise-permitted activities under §§ 75.4 through 75.6(a) and (b), or that result in a material exposure to high-risk assets or high-risk trading strategies, must be escalated within the banking entity for review, further analysis, explanation to the Commission, and remediation, where appropriate. The quantitative measurements discussed in this appendix should be helpful to banking entities in identifying and managing the risks related to their covered trading activities.

II. Definitions

The terms used in this appendix have the same meanings as set forth in §§ 75.2 and 75.3. In addition, for purposes of this appendix, the following definitions apply:

Calculation period means the period of time for which a particular quantitative measurement must be calculated.

Comprehensive profit and loss means the net profit or loss of a trading desk's material sources of trading revenue over a specific period of time, including, for example, any increase or decrease in the market value of a trading desk's holdings, dividend income, and interest income and expense.

Covered trading activity means trading conducted by a trading desk under § 75.4, 75.5, or 75.6(a) or (b). A banking entity may include trading under § 75.3(d) or 75.6(c), (d) or (e).

Measurement frequency means the frequency with which a particular quantitative metric must be calculated and recorded.

Trading desk means the smallest discrete unit of organization of a banking entity that purchases or sells financial instruments for the trading account of the banking entity or an affiliate thereof.

III. Reporting and Recordkeeping of Quantitative Measurements

a. Scope of Required Reporting

General scope. Each banking entity made subject to this part by § 75.20 must furnish the following quantitative measurements for each trading desk of the banking entity, calculated in accordance with this appendix:

- Risk and Position Limits and Usage;
- Risk Factor Sensitivities;
- Value-at-Risk and Stress VaR;
- Comprehensive Profit and Loss Attribution;
- Inventory Turnover;
- Inventory Aging; and
- Customer Facing Trade Ratio

b. Frequency of Required Calculation and Reporting

A banking entity must calculate any applicable quantitative measurement for each trading day. A banking entity must report each applicable quantitative measurement to the Commission on the reporting schedule established in § 75.20 unless otherwise requested by the Commission. All quantitative measurements for any calendar month must be reported within the time period required by § 75.20.

c. Recordkeeping

A banking entity must, for any quantitative measurement furnished to the Commission pursuant to this appendix and § 75.20(d), create and maintain records documenting the preparation and content of these reports, as well as such information as is necessary to permit the Commission to verify the accuracy of such reports, for a period of 5 years from the end of the calendar year for which the measurement was taken.

IV. Quantitative Measurements

a. Risk-Management Measurements

1. Risk and Position Limits and Usage

i. *Description:* For purposes of this appendix, Risk and Position Limits are the constraints that define the amount of risk that a trading desk is permitted to take at a point in time, as defined by the banking entity for a specific trading desk. Usage represents the portion of the trading desk's limits that are accounted for by the current activity of the desk. Risk and position limits and their usage are key risk management tools used to control and monitor risk taking and include, but are not limited, to the limits set out in §§ 75.4 and 75.5. A number of the metrics that are described below, including ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk,'' relate to a trading desk's risk and position limits and are useful in evaluating and setting these limits in the broader context of the trading desk's overall activities, particularly for the market making activities under § 75.4(b) and hedging activity under § 75.5. Accordingly, the limits required under §§ 75.4(b)(2)(iii) and 75.5(b)(1)(i) must meet the applicable requirements under §§ 75.4(b)(2)(iii) and 75.5(b)(1)(i) and also must include appropriate metrics for the trading desk limits including, at a minimum, the ''Risk Factor Sensitivities'' and ''Value-at-Risk and Stress Value-at-Risk'' metrics except to the extent any of the ''Risk Factor Sensitivities'' or ''Value-at-Risk and Stress Value-at-Risk'' metrics are demonstrably ineffective for measuring and monitoring the risks of a trading desk based on the types of positions traded by, and risk exposures of, that desk.

ii. *General Calculation Guidance:* Risk and Position Limits must be reported in the format used by the banking entity for the purposes of risk management of each trading desk. Risk and Position Limits are often expressed in terms of risk measures, such as VaR and Risk Factor Sensitivities, but may also be expressed in terms of other observable criteria, such as net open positions. When criteria other than VaR or Risk Factor Sensitivities are used to define the Risk and Position Limits, both the value of the Risk and Position Limits and the value of the variables used to assess whether these limits have been reached must be reported.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

2. Risk Factor Sensitivities

i. *Description:* For purposes of this appendix, Risk Factor Sensitivities are changes in a trading desk's Comprehensive Profit and Loss that are expected to occur in the event of a change in one or more

underlying variables that are significant sources of the trading desk's profitability and risk.

ii. *General Calculation Guidance:* A banking entity must report the Risk Factor Sensitivities that are monitored and managed as part of the trading desk's overall risk management policy. The underlying data and methods used to compute a trading desk's Risk Factor Sensitivities will depend on the specific function of the trading desk and the internal risk management models employed. The number and type of Risk Factor Sensitivities that are monitored and managed by a trading desk, and furnished to the Commission, will depend on the explicit risks assumed by the trading desk. In general, however, reported Risk Factor Sensitivities must be sufficiently granular to account for a preponderance of the expected price variation in the trading desk's holdings.

A. Trading desks must take into account any relevant factors in calculating Risk Factor Sensitivities, including, for example, the following with respect to particular asset classes:

- *Commodity derivative positions:* risk factors with respect to the related commodities set out in § 20.2 of this chapter, the maturity of the positions, volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Credit positions:* risk factors with respect to credit spreads that are sufficiently granular to account for specific credit sectors and market segments, the maturity profile of the positions, and risk factors with respect to interest rates of all relevant maturities;
- *Credit-related derivative positions:* risk factor sensitivities, for example credit spreads, shifts (parallel and non-parallel) in credit spreads—volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Equity derivative positions:* risk factor sensitivities such as equity positions, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Equity positions:* risk factors for equity prices and risk factors that differentiate between important equity market sectors and segments, such as a small capitalization equities and international equities;
- *Foreign exchange derivative positions:* risk factors with respect to major currency pairs and maturities, exposure to interest rates at relevant maturities, volatility, and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), as well as the maturity profile of the positions; and
- *Interest rate positions, including interest rate derivative positions:* risk factors with respect to major interest rate categories and maturities and volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and shifts (parallel and non-parallel) in the interest rate curve, as well as the maturity profile of the positions.

B. The methods used by a banking entity to calculate sensitivities to a common factor shared by multiple trading desks, such as an equity price factor, must be applied consistently across its trading desks so that the sensitivities can be compared from one trading desk to another.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Value-at-Risk and Stress Value-at-Risk

i. *Description:* For purposes of this appendix, Value-at-Risk (''VaR'') is the commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on current market conditions. For purposes of this appendix, Stress Value-at-Risk (''Stress VaR'') is the percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on market conditions during a period of significant financial stress.

ii. *General Calculation Guidance:* Banking entities must compute and report VaR and Stress VaR by employing generally accepted standards and methods of calculation. VaR should reflect a loss in a trading desk that is expected to be exceeded less than one percent of the time over a one-day period. For those banking entities that are subject to regulatory capital requirements imposed by a Federal banking agency, VaR and Stress VaR must be computed and reported in a manner that is consistent with such regulatory capital requirements. In cases where a trading desk does not have a standalone VaR or Stress VaR calculation but is part of a larger aggregation of positions for which a VaR or Stress VaR calculation is performed, a VaR or Stress VaR calculation that includes only the trading desk's holdings must be performed consistent with the VaR or Stress VaR model and methodology used for the larger aggregation of positions.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

b. Source-of-Revenue Measurements

1. Comprehensive Profit and Loss Attribution

i. *Description:* For purposes of this appendix, Comprehensive Profit and Loss Attribution is an analysis that attributes the daily fluctuation in the value of a trading desk's positions to various sources. First, the daily profit and loss of the aggregated positions is divided into three categories: (i) Profit and loss attributable to a trading desk's existing positions that were also positions held by the trading desk as of the end of the prior day (''existing positions''); (ii) profit and loss attributable to new positions resulting from the current day's trading activity (''new positions''); and (iii) residual profit and loss that cannot be specifically attributed to existing positions or new positions. The sum of (i), (ii), and (iii) must equal the trading desk's comprehensive profit and loss at each point in time. In addition, profit and loss measurements must calculate volatility of comprehensive profit and loss (i.e., the standard deviation of the trading desk's one-day profit and loss, in dollar terms) for the reporting period for at least a 30-, 60- and 90-day lag period, from the end of the reporting period, and any other period that the banking entity deems necessary to meet the requirements of the rule.

A. The comprehensive profit and loss associated with existing positions must reflect changes in the value of these positions on the applicable day. The comprehensive profit and loss from existing positions must be further attributed, as applicable, to changes in (i) the specific Risk Factors and other factors that are monitored and managed as part of the trading desk's overall risk management policies and procedures; and (ii) any other applicable elements, such as cash flows, carry, changes in reserves, and the correction, cancellation, or exercise of a trade.

B. The comprehensive profit and loss attributed to new positions must reflect commissions and fee income or expense and market gains or losses associated with transactions executed on the applicable day. New positions include purchases and sales of financial instruments and other assets/liabilities and negotiated amendments to existing positions. The comprehensive profit and loss from new positions may be reported in the aggregate and does not need to be further attributed to specific sources.

C. The portion of comprehensive profit and loss that cannot be specifically attributed to known sources must be allocated to a residual category identified as an unexplained portion of the comprehensive profit and loss. Significant unexplained profit and loss must be escalated for further investigation and analysis.

ii. *General Calculation Guidance:* The specific categories used by a trading desk in the attribution analysis and amount of detail for the analysis should be tailored to the type and amount of trading activities undertaken by the trading desk. The new position attribution must be computed by calculating the difference between the prices at which instruments were bought and/or sold and the prices at which those instruments are marked to market at the close of business on that day multiplied by the notional or principal amount of each purchase or sale. Any fees, commissions, or other payments received (paid) that are associated with transactions executed on that day must be added (subtracted) from such difference. These factors must be measured consistently over time to facilitate historical comparisons.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

c. Customer-Facing Activity Measurements

1. Inventory Turnover

i. *Description:* For purposes of this appendix, Inventory Turnover is a ratio that measures the turnover of a trading desk's inventory. The numerator of the ratio is the absolute value of all transactions over the reporting period. The denominator of the ratio is the value of the trading desk's inventory at the beginning of the reporting period.

ii. *General Calculation Guidance:* For purposes of this appendix, for derivatives, other than options and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

2. Inventory Aging

i. *Description:* For purposes of this appendix, Inventory Aging generally describes a schedule of the trading desk's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held. Inventory Aging should measure the age profile of the trading desk's assets and liabilities.

ii. *General Calculation Guidance:* In general, Inventory Aging must be computed using a trading desk's trading activity data and must identify the value of a trading desk's aggregate assets and liabilities. Inventory Aging must include two schedules, an asset-aging schedule and a liability-aging schedule. Each schedule must record the value of assets or liabilities held over all holding periods. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value and, for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* One trading day.

iv. *Measurement Frequency:* Daily.

3. Customer-Facing Trade Ratio—Trade Count Based and Value Based

i. *Description:* For purposes of this appendix, the Customer-Facing Trade Ratio is a ratio comparing (i) the transactions involving a counterparty that is a customer of the trading desk to (ii) the transactions involving a counterparty that is not a customer of the trading desk. A trade count based ratio must be computed that records the number of transactions involving a counterparty that is a customer of the trading desk and the number of transactions involving a counterparty that is not a customer of the trading desk. A value based ratio must be computed that records the value of transactions involving a counterparty that is a customer of the trading desk and the value of transactions involving a counterparty that is not a customer of the trading desk.

ii. *General Calculation Guidance:* For purposes of calculating the Customer-Facing Trade Ratio, a counterparty is considered to be a customer of the trading desk if the counterparty is a market participant that makes use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services. However, a trading desk or other organizational unit of another banking entity would not be a client, customer, or counterparty of the trading desk if the other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § 75.20(d)(1) unless the trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk. Transactions conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants would be considered transactions with customers of the trading desk. For derivatives, other than options, and interest rate derivatives, value means gross notional value, for options, value means delta adjusted notional value, and for interest rate derivatives, value means 10-year bond equivalent value.

iii. *Calculation Period:* 30 days, 60 days, and 90 days.

iv. *Measurement Frequency:* Daily.

Appendix B to Part 75—Enhanced Minimum Standards for Compliance Programs

I. Overview

Section 75.20(c) requires certain banking entities to establish, maintain, and enforce an enhanced compliance program that includes the requirements and standards in this Appendix as well as the minimum written policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping provisions outlined in § 75.20. This Appendix sets forth additional minimum standards with respect to the establishment, oversight, maintenance, and enforcement by these banking entities of an enhanced internal compliance program for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and this part.

a. This compliance program must:

1. Be reasonably designed to identify, document, monitor, and report the permitted trading and covered fund activities and investments of the banking entity; identify, monitor and promptly address the risks of these covered activities and investments and potential areas of noncompliance; and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and this part;

2. Establish and enforce appropriate limits on the covered activities and investments of the banking entity, including limits on the size, scope, complexity, and risks of the individual activities or investments consistent with the requirements of section 13 of the BHC Act and this part;

3. Subject the effectiveness of the compliance program to periodic independent review and testing, and ensure that the entity's internal audit, corporate compliance and internal control functions involved in review and testing are effective and independent;

4. Make senior management, and others as appropriate, accountable for the effective implementation of the compliance program, and ensure that the board of directors and chief executive officer (or equivalent) of the banking entity review the effectiveness of the compliance program; and

5. Facilitate supervision and examination by the Agencies of the banking entity's permitted trading and covered fund activities and investments.

II. Enhanced Compliance Program

a. Proprietary Trading Activities

A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, and complexity of, and risks associated with, its permitted trading activities. The compliance program may be tailored to the types of trading activities conducted by the banking entity, and must include a detailed description of controls established by the banking entity to reasonably ensure that its trading activities are conducted in accordance with the requirements and limitations applicable to those trading activities under section 13 of the BHC Act and this part, and provide for appropriate revision of the compliance program before expansion of the trading activities of the banking entity. A banking entity must devote adequate resources and use knowledgeable personnel in conducting, supervising and managing its trading activities, and promote consistency, independence and rigor in implementing its risk controls and compliance efforts. The compliance program must be updated with a frequency sufficient to account for changes in the activities of the banking entity, results of independent testing of the program, identification of weaknesses in the program, and changes in legal, regulatory or other requirements.

1. *Trading Desks:* The banking entity must have written policies and procedures governing each trading desk that include a description of:

i. The process for identifying, authorizing and documenting financial instruments each trading desk may purchase or sell, with separate documentation for market making-related activities conducted in reliance on § 75.4(b) and for hedging activity conducted in reliance on § 75.5;

ii. A mapping for each trading desk to the division, business line, or other organizational structure that is responsible for managing and overseeing the trading desk's activities;

iii. The mission (*i.e.,* the type of trading activity, such as market-making, trading in sovereign debt, etc.) and strategy (*i.e.,* methods for conducting authorized trading activities) of each trading desk;

iv. The activities that the trading desk is authorized to conduct, including (i) authorized instruments and products, and (ii) authorized hedging strategies, techniques and instruments;

v. The types and amount of risks allocated by the banking entity to each trading desk to implement the mission and strategy of the trading desk, including an enumeration of material risks resulting from the activities in which the trading desk is authorized to engage (including but not limited to price risks, such as basis, volatility and correlation risks, as well as counterparty credit risk). Risk assessments must take into account both the risks inherent in the trading activity and the strength and effectiveness of controls designed to mitigate those risks;

vi. How the risks allocated to each trading desk will be measured;

vii. Why the allocated risks levels are appropriate to the activities authorized for the trading desk;

viii. The limits on the holding period of, and the risk associated with, financial instruments under the responsibility of the trading desk;

ix. The process for setting new or revised limits, as well as escalation procedures for

granting exceptions to any limits or to any policies or procedures governing the desk, the analysis that will be required to support revising limits or granting exceptions, and the process for independently reviewing and documenting those exceptions and the underlying analysis;

x. The process for identifying, documenting and approving new products, trading strategies, and hedging strategies;

xi. The types of clients, customers, and counterparties with whom the trading desk may trade; and

xii. The compensation arrangements, including incentive arrangements, for employees associated with the trading desk, which may not be designed to reward or incentivize prohibited proprietary trading or excessive or imprudent risk-taking.

2. *Description of risks and risk management processes:* The compliance program for the banking entity must include a comprehensive description of the risk management program for the trading activity of the banking entity. The compliance program must also include a description of the governance, approval, reporting, escalation, review and other processes the banking entity will use to reasonably ensure that trading activity is conducted in compliance with section 13 of the BHC Act and this part. Trading activity in similar financial instruments should be subject to similar governance, limits, testing, controls, and review, unless the banking entity specifically determines to establish different limits or processes and documents those differences. Descriptions must include, at a minimum, the following elements:

i. A description of the supervisory and risk management structure governing all trading activity, including a description of processes for initial and senior-level review of new products and new strategies;

ii. A description of the process for developing, documenting, testing, approving and reviewing all models used for valuing, identifying and monitoring the risks of trading activity and related positions, including the process for periodic independent testing of the reliability and accuracy of those models;

iii. A description of the process for developing, documenting, testing, approving and reviewing the limits established for each trading desk;

iv. A description of the process by which a security may be purchased or sold pursuant to the liquidity management plan, including the process for authorizing and monitoring such activity to ensure compliance with the banking entity's liquidity management plan and the restrictions on liquidity management activities in this part;

v. A description of the management review process, including escalation procedures, for approving any temporary exceptions or permanent adjustments to limits on the activities, positions, strategies, or risks associated with each trading desk; and

vi. The role of the audit, compliance, risk management and other relevant units for conducting independent testing of trading and hedging activities, techniques and strategies.

3. *Authorized risks, instruments, and products.* The banking entity must implement and enforce limits and internal controls for each trading desk that are reasonably designed to ensure that trading activity is conducted in conformance with section 13 of the BHC Act and this part and with the banking entity's written policies and procedures. The banking entity must establish and enforce risk limits appropriate for the activity of each trading desk. These limits should be based on probabilistic and non-probabilistic measures of potential loss (*e.g.,* Value-at-Risk and notional exposure, respectively), and measured under normal and stress market conditions. At a minimum, these internal controls must monitor, establish and enforce limits on:

i. The financial instruments (including, at a minimum, by type and exposure) that the trading desk may trade;

ii. The types and levels of risks that may be taken by each trading desk; and

iii. The types of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged.

4. *Hedging policies and procedures.* The banking entity must establish, maintain, and enforce written policies and procedures regarding the use of risk-mitigating hedging instruments and strategies that, at a minimum, describe:

i. The positions, techniques and strategies that each trading desk may use to hedge the risk of its positions;

ii. The manner in which the banking entity will identify the risks arising in connection with and related to the individual or aggregated positions, contracts or other holdings of the banking entity that are to be hedged and determine that those risks have been properly and effectively hedged;

iii. The level of the organization at which hedging activity and management will occur;

iv. The manner in which hedging strategies will be monitored and the personnel responsible for such monitoring;

v. The risk management processes used to control unhedged or residual risks; and

vi. The process for developing, documenting, testing, approving and reviewing all hedging positions, techniques and strategies permitted for each trading desk and for the banking entity in reliance on § 75.5.

5. *Analysis and quantitative measurements.* The banking entity must perform robust analysis and quantitative measurement of its trading activities that is reasonably designed to ensure that the trading activity of each trading desk is consistent with the banking entity's compliance program; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. Analysis and models used to determine, measure and limit risk must be rigorously tested and be reviewed by management responsible for trading activity to ensure that trading activities, limits, strategies, and hedging activities do not understate the risk and exposure to the banking entity or allow prohibited proprietary trading. This review should include periodic and independent back-testing and revision of activities, limits, strategies and hedging as appropriate to contain risk and ensure compliance. In addition to the quantitative measurements reported by any banking entity subject to Appendix A of this part, each banking entity must develop and implement, to the extent appropriate to facilitate compliance with this part, additional quantitative measurements specifically tailored to the particular risks, practices, and strategies of its trading desks. The banking entity's analysis and quantitative measurements must incorporate the quantitative measurements reported by the banking entity pursuant to Appendix A of this part (if applicable) and include, at a minimum, the following:

i. Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;

ii. Ongoing, timely monitoring and review of calculated quantitative measurements;

iii. The establishment of numerical thresholds and appropriate trading measures for each trading desk and heightened review of trading activity not consistent with those thresholds to ensure compliance with section 13 of the BHC Act and this part, including analysis of the measurement results or other information, appropriate escalation procedures, and documentation related to the review; and

iv. Immediate review and compliance investigation of the trading desk's activities, escalation to senior management with oversight responsibilities for the applicable trading desk, timely notification to the Commission, appropriate remedial action (*e.g.,* divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when quantitative measurements or other information, considered together with the facts and circumstances, or findings of internal audit, independent testing or other review suggest a reasonable likelihood that the trading desk has violated any part of section 13 of the BHC Act or this part.

6. *Other Compliance Matters.* In addition to the requirements specified above, the banking entity's compliance program must:

i. Identify activities of each trading desk that will be conducted in reliance on exemptions contained in §§ 75.4 through 75.6, including an explanation of:

A. How and where in the organization the activity occurs; and

B. Which exemption is being relied on and how the activity meets the specific requirements for reliance on the applicable exemption;

ii. Include an explanation of the process for documenting, approving and reviewing actions taken pursuant to the liquidity management plan, where in the organization this activity occurs, the securities permissible for liquidity management, the process for ensuring that liquidity management activities are not conducted for the purpose of prohibited proprietary trading, and the process for ensuring that securities purchased as part of the liquidity management plan are highly liquid and conform to the requirements of this part;

iii. Describe how the banking entity monitors for and prohibits potential or actual

material exposure to high-risk assets or high-risk trading strategies presented by each trading desk that relies on the exemptions contained in §§ 75.3(d)(3) and 75.4 through 75.6, which must take into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in value cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;

iv. Establish responsibility for compliance with the reporting and recordkeeping requirements of subpart B of this part and § 75.20; and

v. Establish policies for monitoring and prohibiting potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties.

7. *Remediation of violations.* The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any trading activity that may indicate potential violations of section 13 of the BHC Act and this part and to prevent actual violations of section 13 of the BHC Act and this part. The compliance program must describe procedures for identifying and remedying violations of section 13 of the BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

b. Covered Fund Activities or Investments

A banking entity must establish, maintain and enforce a compliance program that includes written policies and procedures that are appropriate for the types, size, complexity and risks of the covered fund and related activities conducted and investments made, by the banking entity.

1. *Identification of covered funds.* The banking entity's compliance program must provide a process, which must include appropriate management review and independent testing, for identifying and documenting covered funds that each unit within the banking entity's organization sponsors or organizes and offers, and covered funds in which each such unit invests. In addition to the documentation requirements for covered funds, as specified under § 75.20(e), the documentation must include information that identifies all pools that the banking entity sponsors or has an interest in and the type of exemption from the Commodity Exchange Act (whether or not the pool relies on § 4.7 of the regulations under the Commodity Exchange Act (§ 4.7 of this chapter)), and the amount of ownership interest the banking entity has in those pools.

2. *Identification of covered fund activities and investments.* The banking entity's compliance program must identify, document and map each unit within the organization that is permitted to acquire or hold an interest in any covered fund or sponsor any covered fund and map each unit to the division, business line, or other organizational structure that will be responsible for managing and overseeing that unit's activities and investments.

3. *Explanation of compliance.* The banking entity's compliance program must explain how:

i. The banking entity monitors for and prohibits potential or actual material conflicts of interest between the banking entity and its clients, customers, or counterparties related to its covered fund activities and investments;

ii. The banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness of the banking entity related to its covered fund activities and investments; and

iii. The banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by its covered fund activities and investments, taking into account potential or actual exposure to:

A. Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;

B. Assets whose changes in values cannot be adequately mitigated by effective hedging;

C. New products with rapid growth, including those that do not have a market history;

D. Assets or strategies that include significant embedded leverage;

E. Assets or strategies that have demonstrated significant historical volatility;

F. Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and

G. Assets or strategies that expose the banking entity to large and significant concentrations with respect to sectors, risk factors, or counterparties;

4. *Description and documentation of covered fund activities and investments.* For each organizational unit engaged in covered fund activities and investments, the banking entity's compliance program must document:

i. The covered fund activities and investments that the unit is authorized to conduct;

ii. The banking entity's plan for actively seeking unaffiliated investors to ensure that any investment by the banking entity conforms to the limits contained in § 75.12 or registered in compliance with the securities laws and thereby exempt from those limits within the time periods allotted in § 75.12; and

iii. How it complies with the requirements of subpart C of this part.

5. *Internal Controls.* A banking entity must establish, maintain, and enforce internal controls that are reasonably designed to ensure that its covered fund activities or investments comply with the requirements of section 13 of the BHC Act and this part and are appropriate given the limits on risk established by the banking entity. These written internal controls must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part. The internal controls must, at a minimum require:

i. Monitoring and limiting the banking entity's individual and aggregate investments in covered funds;

ii. Monitoring the amount and timing of seed capital investments for compliance with the limitations under subpart C of this part (including but not limited to the redemption, sale or disposition requirements of § 75.12), and the effectiveness of efforts to seek unaffiliated investors to ensure compliance with those limits;

iii. Calculating the individual and aggregate levels of ownership interests in one or more covered fund required by § 75.12;

iv. Attributing the appropriate instruments to the individual and aggregate ownership interest calculations above;

v. Making disclosures to prospective and actual investors in any covered fund organized and offered or sponsored by the banking entity, as provided under § 75.11(a)(8);

vi. Monitoring for and preventing any relationship or transaction between the banking entity and a covered fund that is prohibited under § 75.14, including where the banking entity has been designated as the sponsor, investment manager, investment adviser, or commodity trading advisor to a covered fund by another banking entity; and

vii. Appropriate management review and supervision across legal entities of the banking entity to ensure that services and products provided by all affiliated entities comply with the limitation on services and products contained in § 75.14.

6. *Remediation of violations.* The banking entity's compliance program must be reasonably designed and established to effectively monitor and identify for further analysis any covered fund activity or investment that may indicate potential violations of section 13 of the BHC Act or this part and to prevent actual violations of section 13 of the BHC Act and this part. The banking entity's compliance program must describe procedures for identifying and remedying violations of section 13 of the

BHC Act and this part, and must include, at a minimum, a requirement to promptly document, address and remedy any violation of section 13 of the BHC Act or this part, including § 75.21, and document all proposed and actual remediation efforts. The compliance program must include specific written policies and procedures that are reasonably designed to assess the extent to which any activity or investment indicates that modification to the banking entity's compliance program is warranted and to ensure that appropriate modifications are implemented. The written policies and procedures must provide for prompt notification to appropriate management, including senior management and the board of directors, of any material weakness or significant deficiencies in the design or implementation of the compliance program of the banking entity.

III. Responsibility and Accountability for the Compliance Program

a. A banking entity must establish, maintain, and enforce a governance and management framework to manage its business and employees with a view to preventing violations of section 13 of the BHC Act and this part. A banking entity must have an appropriate management framework reasonably designed to ensure that: Appropriate personnel are responsible and accountable for the effective implementation and enforcement of the compliance program; a clear reporting line with a chain of responsibility is delineated; and the compliance program is reviewed periodically by senior management. The board of directors (or equivalent governance body) and senior management should have the appropriate authority and access to personnel and information within the organizations as well as appropriate resources to conduct their oversight activities effectively.

1. *Corporate governance.* The banking entity must adopt a written compliance program approved by the board of directors, an appropriate committee of the board, or equivalent governance body, and senior management.

2. *Management procedures.* The banking entity must establish, maintain, and enforce a governance framework that is reasonably designed to achieve compliance with section 13 of the BHC Act and this part, which, at a minimum, provides for:

i. The designation of appropriate senior management or committee of senior management with authority to carry out the management responsibilities of the banking entity for each trading desk and for each organizational unit engaged in covered fund activities;

ii. Written procedures addressing the management of the activities of the banking entity that are reasonably designed to achieve compliance with section 13 of the BHC Act and this part, including:

A. A description of the management system, including the titles, qualifications, and locations of managers and the specific responsibilities of each person with respect to the banking entity's activities governed by section 13 of the BHC Act and this part; and

B. Procedures for determining compensation arrangements for traders engaged in underwriting or market making-related activities under § 75.4 or risk-mitigating hedging activities under § 75.5 so that such compensation arrangements are designed not to reward or incentivize prohibited proprietary trading and appropriately balance risk and financial results in a manner that does not encourage employees to expose the banking entity to excessive or imprudent risk.

3. *Business line managers.* Managers with responsibility for one or more trading desks of the banking entity are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading desk(s).

4. *Board of directors, or similar corporate body, and senior management.* The board of directors, or similar corporate body, and senior management are responsible for setting and communicating an appropriate culture of compliance with section 13 of the BHC Act and this part and ensuring that appropriate policies regarding the management of trading activities and covered fund activities or investments are adopted to comply with section 13 of the BHC Act and this part. The board of directors or similar corporate body (such as a designated committee of the board or an equivalent governance body) must ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with this part in light of the organization's business activities and the expectations of the board of directors. The board of directors or similar corporate body must also ensure that senior management has established appropriate incentives and adequate resources to support compliance with this part, including the implementation of a compliance program meeting the requirements of this appendix into management goals and compensation structures across the banking entity.

5. *Senior management.* Senior management is responsible for implementing and enforcing the approved compliance program. Senior management must also ensure that effective corrective action is taken when failures in compliance with section 13 of the BHC Act and this part are identified. Senior management and control personnel charged with overseeing compliance with section 13 of the BHC Act and this part should review the compliance program for the banking entity periodically and report to the board, or an appropriate committee thereof, on the effectiveness of the compliance program and compliance matters with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading activities and covered fund activities or investments, which shall be at least annually.

6. *CEO attestation.* Based on a review by the CEO of the banking entity, the CEO of the banking entity must, annually, attest in writing to the Commission that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established under this appendix and § 75.20 in a manner reasonably designed to achieve compliance with section 13 of the BHC Act and this part. In the case of a U.S. branch or agency of a foreign banking entity, the attestation may be provided for the entire U.S. operations of the foreign banking entity by the senior management officer of the United States operations of the foreign banking entity who is located in the United States.

IV. Independent Testing

a. Independent testing must occur with a frequency appropriate to the size, scope, and risk profile of the banking entity's trading and covered fund activities or investments, which shall be at least annually. This independent testing must include an evaluation of:

1. The overall adequacy and effectiveness of the banking entity's compliance program, including an analysis of the extent to which the program contains all the required elements of this appendix;

2. The effectiveness of the banking entity's internal controls, including an analysis and documentation of instances in which such internal controls have been breached, and how such breaches were addressed and resolved; and

3. The effectiveness of the banking entity's management procedures.

b. A banking entity must ensure that independent testing regarding the effectiveness of the banking entity's compliance program is conducted by a qualified independent party, such as the banking entity's internal audit department, compliance personnel or risk managers independent of the organizational unit being tested, outside auditors, consultants, or other qualified independent parties. A banking entity must promptly take appropriate action to remedy any significant deficiencies or material weaknesses in its compliance program and to terminate any violations of section 13 of the BHC Act or this part.

V. Training

Banking entities must provide adequate training to personnel and managers of the banking entity engaged in activities or investments governed by section 13 of the BHC Act or this part, as well as other appropriate supervisory, risk, independent testing, and audit personnel, in order to effectively implement and enforce the compliance program. This training should occur with a frequency appropriate to the size and the risk profile of the banking entity's trading activities and covered fund activities or investments.

VI. Recordkeeping

Banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A banking entity must retain these records for a period that is no less than 5 years or such longer period as required by the Commission in a form that allows it to promptly produce such records to the Commission on request.

Issued in Washington, DC, on December 30, 2013, by the Commission.

Melissa D. Jurgens,

Secretary of the Commission.

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

Appendices to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds—Commission Voting Summary and Statements of Commissioners

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Chilton and Wetjen voted in the affirmative. Commissioner O'Malia voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the final ''Volcker Rule'' before the Commission today. It achieves the important balance, as directed by Congress, of prohibiting banking entities from proprietary trading while at the same time allowing banking entities to engage in permitted activities, including market making and risk mitigating hedging.

Further, as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the final rule strikes an appropriate balance regarding banking entities investment in hedge funds and private equity funds. As Congress directed—other than for de minimis investments—banking entities are prohibited from sponsoring, owning, and having certain relationships with hedge funds or private equity funds. The final rule focuses the prohibition on entities formed for investing or trading in securities or derivatives and that are typically offered to institutional investors and high-net-worth individuals. The final definition was tailored to exclude entities that are offered more broadly to retail investors or have a more general corporate purpose, such as loan securitizations.

The Commodity Futures Trading Commission (CFTC) consulted and coordinated with the Federal Reserve, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Securities and Exchange Commission in developing this rule. Based on this collaboration, the CFTC's final rule mirrors the language being adopted by the other financial regulators.

The CFTC authority to implement the Volcker Rule is for the banking entities for which we are the primary financial regulatory agency. As of today, the CFTC estimates that our authority primarily applies to approximately 110 registered swap dealers and futures commission merchants (FCMs) that would each individually be banking entities under the Volcker Rule. Grouped by corporate affiliation these represent about 45 different business enterprises.

As a foundation, the final Volcker Rule requires banking entities to have a robust compliance program, including defined limits on market making, underwriting and hedging activities as well as continuous monitoring and management of such activities. It also requires reporting to regulators on specific metrics and trading details. This transparency will enhance the CFTC's ability to oversee swap dealers and FCMs.

Banking entities' customers and counterparties will continue to be provided liquidity through the banking entities' permitted market making. The banking entities are permitted to do so as long as each trading desk's market-maker inventory is designed not to exceed, on an ongoing basis, the reasonably expected near-term demands of clients, customers or counterparties. The banking entities will be required to maintain an ongoing compliance program and follow the rule's limits on market-maker inventory and financial exposure. For instance, banking entities would not be able to stockpile or accumulate positions over time that do not meet expected near-term customer demand.

The final Volcker Rule also permits hedging to reduce identified, specific risks from the banking entity's individual or aggregated positions. Permitted hedging activity will be required to (1) be designed to and (2) demonstrably reduce or otherwise significantly mitigate one or more specific, identifiable risks. The final rule's preamble further states that this activity is not intended to be hedging of generalized risks based on non-position specific modeling or other considerations. Hedging of the general assets and liabilities of the banking entity or a guess as to the direction of the economy will no longer be permitted.

Hedging strategies and positions are subject to analysis, including required correlation analysis, as well as an ongoing recalibration requirement to ensure it is not prohibited proprietary trading.

The Commission also has the legal authority to enforce the Volcker Rule. If the Commission believes there is a violation, Dodd-Frank Section 619 and the final rule state that it can, after providing an opportunity to respond, order the registrant to stop that activity. The Commission also can use existing authority to discipline registrants, including FCMs, swap dealers, and others. The CEA and Commission rules provide that we may restrict, suspend or revoke a registration for good cause. Depending on the facts and circumstances, violation of Dodd-Frank Section 619 may rise to that level.

The talented CFTC staff working along with my fellow Commissioners—Mike Dunn, Jill Sommers, Bart Chilton, Scott O'Malia and Mark Wetjen—really have delivered for the American public.

With this action, the staff of this small but remarkably effective agency will have completed 68 rulemakings, orders and guidances. Though lacking adequate resources, the CFTC staff has diligently sorted through nearly 60,000 public comment letters. They have met with members of the public more than 2,200 times to discuss reform.

These common-sense reforms have been truly transformative.

Bright lights of transparency now are shining on the $380 trillion swaps market. The public can see the price and volume of every transaction, like a modern-day tickertape. Transparent, regulated trading platforms are trading a quarter of a trillion dollars in swaps each day.

A majority of the swaps market is now being centrally cleared—lowering risk and bringing access to anyone wishing to compete.

Ninety-one swap dealers have registered and—for the first time—are being overseen for their swaps activity.

I couldn't be more proud of this dedicated group of public servants.

I am honored to have served along with them during such a remarkable time in the history of this agency.

Appendix 3—Statement of Commissioner Bart Chilton

High Roller's Room

I'm pleased to be voting on a final Volcker Rule. Frankly, two-and-a-half weeks ago, I had grave doubts about getting this done in a meaningful fashion. It had become weaker than the original proposal. But, thankfully, and I thank the Chairman for his tireless efforts, we have a rigorous and robust rule before us.

If you've ever been to a casino, many of them have a high roller's room. There's usually a sign about a $1000 minimum bet. Many have ornate gaming tables and heavy draperies. If you walk around, you can catch a glimpse inside. But other than betting a lot of money, I'm not sure what goes on in there. And, that's fine . . . some high rollers lose and some win.

But, what if what the high rollers did in that room impacted all of us? What if it impacted consumers, our economy and our country? What if what the high rollers did in that room cost us $417 billion dollars (in a big bank bailout) because the games they were playing were tanking the economy?

That's why we need a strong Volcker Rule. We should never again be put in a circumstance where too big to fail high rollers play games of chance with our nation. This rule takes a heavy velvet rope with brass ends across the doorway and closes the high roller's room. (Maybe they'll put in more Blazing 7s or Wheel of Fortunes.)

The dilemma in drafting the final rule has been that there are certain permitted forms of trading that have been difficult to define. Fortunately, the language has been solidified tightly to avoid loopholes.

First, the key parts of the law, and what I have focused on for a very long time, are the words surrounding hedging. Proprietary hedging is allowed under the law, but speculative trading—risky gambles for the house—are exactly what Volcker sought to end. This rule does that by requiring hedges be designed to mitigate and reduce actual risk, and not just by an accidental or collateral effect of the trade. We also have better correlation language in the rule, correlation that shows that the hedging ''activity demonstrably reduces or otherwise significantly mitigates the specific, identifiable risk(s) being hedged.'' This is key—the risk has to be specific and identifiable. You can't just say, ''Ah, oh, that? Hmm, it was a hedge.'' Nope, we aren't going to let ya play that game. The position needs to be correlated with the risk.

Furthermore, there is now an ongoing requirement to recalibrate the position, the

hedge, in order to ensure that the position remains a hedge and does not become speculative. When people say this version of the Volcker Rule will stop circumstances like the London Whale, this ongoing recalibration provision is exactly what will help avoid similar debacles.

Second, the same goes for market making. Yes, market making is allowed, but only for the benefit of the banks' customers—for their customers and not solely in order to collect market maker fees provided by the exchange or for any proprietary speculative reason. Full stop.

Third, on portfolio hedging: One of the changes that has been made is that we have defined what a portfolio is NOT—it can't be some amorphous set of excuses for doing a trade. You can't call deuces and one-eyed jacks wild after the hand has been dealt. You can't do an after-the-fact extract of a set of trades as a rationale for a hedge.

Fourth, I've spoken many times about perverse bonus structures that reward the macho macho men traders. The idea, and it is contained in actual rule text language, is that big bonuses and rewards in banking should not be tied to flyer bets. Our first proposal was fairly poorly drafted on this. It didn't differentiate between prohibited proprietary trading and permitted proprietary trading very well. My view of the language that compensation should be ''designed'' not to reward or incentivize prohibited trading is that this is a sufficiently narrow test. One of the ways we will determine if something is designed in this way is how, in fact, traders are paid. So we will look after-the-fact at the payouts.

Finally, the Volcker Rule won't be implemented until July of 2015. That's ages in these morphing markets where new games seem to be played all the time. I guarantee there will be efforts to find loopholes, figure out ways around what has been written. That's the way of the world. So, my final thought is that this rule must not be static. Regulators need to continue to monitor what is taking place. We need our regulatory eyes in the sky, but also to look around the corner for what's coming next, and be nimble and quick, to ensure that what we do today holds up and that the high roller's room isn't re-opened.

While this may be the end of part of the rulemaking process, it is, and must be, the beginning of a process, that continues.

Thank you.

Appendix 4—Dissenting Statement of Commissioner Scott D. O'Malia

I respectfully dissent from today's Commission vote on the final rule implementing § 619 of the Dodd-Frank Act,[1] commonly known as the ''Volcker Rule.'' I cannot support a rulemaking that undermines the regulatory process, nor clearly delineates the Commission's new jurisdiction and enforcement authority under § 13 of the Bank Holding Company Act of 1956 (''BHC Act'')[2] and fails to include procedures that afford due process to market participants.

Former Supreme Court Justice Louis D. Brandeis, who earlier in his career was instrumental in establishing the Federal Reserve System, stated: ''If we desire respect for the law, we must first make the law respectable.'' But respect—and integrity of process—is what has been most lacking in the Commission's approach to rulemaking.

I believe the Commission must get back to the basics of good government and proper rulemaking. I cannot vote for a final rule that is hardly the product of meaningful consideration by the full Commission, but instead was negotiated exclusively by the Chairman. In addition, I cannot vote for a final rule where the Commission has not devoted enough attention to providing sufficient clarity and due process in the enforcement of new and untested regulatory authority, but still imposes significant obligations upon market participants at an unknown—but surely considerable—cost.

Abuse of Process

Throughout the Commission's rulemakings under the Dodd-Frank Act, I have urged the Commission to act faithfully in accordance with the applicable statutory authorities and the Administrative Procedure Act (''APA'').[3] However, in the implementation of one of the most important mandates issued by Congress in response to the financial crisis, the Commission seems to have forgotten the basics of agency rulemaking. I am deeply troubled by the egregious abuse of process in this rulemaking. Without a doubt, it far surpasses all other previous transgressions to date.

The first opportunity each Commissioner had to review a partial draft of the nearly 1,000-page final rule came only three weeks prior to today's vote. Further, because the Commission was operating in an information vacuum, the fact that the Commissioners were not reviewing the working interagency draft—but instead had the ''CFTC-preferred'' version of the rule—only came to light a few days later.[4] The Commission did not receive a near-final draft of the rule (with language agreed to by all five agencies) until just six days prior to the vote, despite repeated requests by Commissioners for a version of the draft then in circulation amongst the responsible agencies. This six-day draft was not even accompanied by the courtesy of a summary or term sheet in order to aid the Commission in digesting, at the last minute, this incredibly complex and dense final rule.

I am disappointed that today's vote on the final rule is besmirched by the purposeful circumvention of measured review by each Commissioner's office. It is simply not possible to carefully weigh a final rule—particularly one with as much detail and consequence as the Volcker Rule—in the briefest of timeframes. Accordingly, I am concerned that the lack of meaningful participation by the full Commission in the rulemaking process has therefore seriously impaired the ability of the Commission, as a deliberative body, to engage in reasoned decision-making.

Congress established the CFTC as an independent agency led by a Commission—not a director—to act as steward to the futures and swaps markets. In doing so, Congress entrusted each of the Commissioners to independently use his or her experience and expertise to carefully review and deliberate upon all Commission action, including rulemaking. Final rules should reflect the input and collective opinion of the Commission as a whole, but today's vote falls far short of that fundamental standard.

It is imperative that the Commission respect the letter and spirit of the law and adhere faithfully to APA requirements in our implementation of this new statutory authority granted by Congress under the BHC Act. Unfortunately, the Commission's rulemaking over the past three years has been aptly referred to as ''regulation by fiat.''[5] We cannot continue down this path of reflexive, knee-jerk regulation that fails to provide clarity and certainty to market participants. The Commission must get back to the basics and return to a thoughtful, measured approach to regulating our markets in an open and transparent manner.

Jurisdiction and Enforcement Authority

I also believe that the basics of any rulemaking are jurisdiction and enforcement. However, the final rule fails to provide clear and consistent procedures for both (1) the Commission's new enforcement authority under § 13 of the BHC Act and (2) due process for market participants.

As a threshold matter, the Volcker Rule may give us concurrent, and potentially overlapping, jurisdiction as the ''primary financial regulatory agency''[6] of a Commission registrant or registered entity, so long as there is some type of corporate relationship with a banking entity. It is essential that the Commission continue to work with the other responsible agencies on implementation to further outline the scope of each agency's jurisdiction, maximize regulatory efficiency, and provide consistency for market participants, with a minimum of duplicative and costly requirements and wasted resources.[7] The Commission must also be mindful of foreign

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[2] 12 U.S.C. 1851.

[3] 5 U.S.C. 500 *et seq.*

[4] Gina Chon, ''CFTC Goes Its Own Way Over Volcker Rule,'' Fin. Times, November 23, 2013.

[5] *See* SIFMA, *ISDA & IIB* v. *CFTC,* No. 13–CV–1916 (D.D.C.).

[6] Dodd-Frank Act § 2(12).

[7] Senators Carl Levin and Jeff Merkley, co-authors of § 619 of the Dodd-Frank Act, emphasized the importance of enforcement to the success of the Volcker Rule by urging the five responsible agencies to ''provide coordinated and consistent enforcement, including data sharing by regulators'' in their implementation of a final rule. Letter from Hon. Jeff Merkley, Member, United States Senate, and Hon. Carl Levin, Member, United States Senate, to Hon. Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Hon. Thomas Curry, Comptroller of the Currency, Department of the Treasury, Hon. Gary Gensler, Chairman, Commodity Futures Trading Commission, Hon. Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Commission, and Hon. Mary Shapiro, Chairman, Securities and Exchange Commission (Apr. 26, 2012) (on file with the Commission).

regulators and seek harmonization in the extraterritorial application of our jurisdiction, in accordance with principles of international comity.

I am concerned that the Commission has not devoted enough attention to delineating our enforcement authority and procedures under the Volcker Rule, including the implications of not promulgating the final rule under the Commodity Exchange Act (''CEA'').[8] This is important because the final rule is only being promulgated under the BHC Act. Consequently, the Commission is limited to only the enforcement measures provided for by § 13(e)(2) of the BHC Act. By not also promulgating the final rule under the CEA, the Commission cannot use its full suite of enforcement tools under the CEA to ensure compliance with the Volcker Rule.

If the Commission wanted to use its enforcement powers under the CEA, the final rule must be promulgated under the CEA and undergo cost-benefit consideration pursuant to § 15(a) of the CEA.[9] But, by choosing to forgo any cost-benefit analysis and promulgate the Volcker Rule solely under the BHC Act, the Commission has thus limited its enforcement powers.

To illustrate this point, it is critical to emphasize that the Commission's authority under the Volcker Rule is not derived from the CEA, which established the CFTC and its jurisdiction over the futures and swaps market. Section 619 of the Dodd-Frank Act amends the BHC Act, which is administered by the Federal Reserve Board. The Volcker Rule is codified as § 13 of the BHC Act and confers limited enforcement authority to the Commission under § 13(e)(2) to order an affected party to ''terminate the [violative] activity'' and ''dispose of the investment.'' [10]

First, although the statutory text of § 13(e)(2) suggests that the Commission may, essentially, issue a cease and desist order to a banking entity engaging in violative activity, the Commission has not promulgated any provisions in the final rule that would define and delineate such an order.

The issue of enforcement action is not a problem for the banking agencies, who have broad supervisory powers over the safety and soundness of banking entities, and considerable enforcement powers under § 8 of the BHC Act, or §§ 8 or 39 of the Federal Deposit Insurance Act [11] (as described in the preamble to the final rule). Those powers are conferred to the banking agencies as prudential regulators. The Commission, however, is not a prudential regulator of its registrants or registered entities and does not have the same powers as the banking agencies.

Second, I have serious concerns that by not including specific procedures in the final rule for an enforcement action taken by the Commission pursuant to § 13(e)(2), the Commission is not affording due process to any party that might be the subject of a future enforcement action. The statutory text in § 13(e)(2) explicitly states that ''due notice and opportunity for hearing'' must be provided. But, the final rule does not contain any procedures for notice or hearing, and in fact does not even mention that statutory requirement.

Third, I am also concerned that the Commission may nevertheless try to read its enforcement powers under the CEA into its limited enforcement authority under the BHC Act. The final rule, in new § 75.21(b), states that ''the Commission may take any action permitted by law to enforce compliance with section 13 of the BHC Act and this part, including directing the banking entity to restrict, limit, or terminate any or all activities under this part and dispose of any investment.''

That provision, without being promulgated under the CEA and undergoing cost-benefit consideration, cannot permit the use of enforcement powers provided for in the CEA. The enforcement powers the Commission has under the CEA explicitly only apply to violations of ''this Act'' (the CEA), including ''any rule, regulation, or order of the Commission *promulgated in accordance with . . . this Act*'' (emphasis added).[12]

Although it would be possible for the Commission to exercise its power over registration of a Commission registrant or registered entity as a matter of right, it is unclear to me whether the Commission has actually promulgated rules that permit the revocation of registration for a swap dealer.

Section 4s of the CEA [13] governs the registration and regulation of swap dealers and major swap participants, but does not explicitly address revocation of registration. Section 8a of the CEA [14] explicitly applies to the registration of an exclusive list of Commission registrants (intermediaries), but does not include swap dealers. Section 8a of the CEA authorizes the Commission to revoke registration, but only in certain circumstances as described in, for example, §§ 8a(2)(A)–(H), 8a(3), and 8a(4).

Although some of those provisions may permit the revocation of registration of a swap dealer, it is secondary to, for example, either a finding by a court of law or another Federal or State agency that a violation of the CEA occurred,[15] or that the principal of a swap dealer was statutorily disqualified from registration,[16] or that the swap dealer willfully aided or abetted in the violation of the CEA by another person, or failed to supervise a person that violated the CEA.[17] Because these powers over registration only apply where there has been a violation of the CEA, I do not see how they can be applied to a violation of § 13 of the BHC Act.

Commission regulation § 3.60 [18] provides procedures for revocation of registration, but only pursuant to §§ 8a(2), 8a(3), and 8a(4), which do not directly apply to swap dealers as just discussed.

I am concerned that, because there does not appear to be any Commission regulation that permits the revocation of registration for a swap dealer, and because § 75.21 of the final rule does not include any procedures for an enforcement action taken by the Commission pursuant to § 13(e)(2) of the BHC Act, the Commission would not able to effectively enforce the Volcker Rule. Further, the Commission's enforcement powers under the CEA are not available to enforce the Volcker Rule because the final rule was not promulgated under the CEA. I also reiterate that I am deeply troubled by the omission of procedures to afford due process to market participants.

Conclusion

As the Commission moves towards finalizing the last of the rules mandated by the Dodd-Frank Act, I believe it's about time that it got back to the basics of good government and proper rulemaking. The final rule does neither because of the abuse of process in its rulemaking and the lack of due process and clarity in its enforcement procedures. Because of these fundamental flaws in the final rule, I cannot support it.

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[8] 7 U.S.C. 1 *et seq.*

[9] 7 U.S.C. 19(a).

[10] Section 619 of the Dodd-Frank Act, paragraph (e)(2), which is entitled Anti-evasion—Termination of Activities or Investment, provides that ''Notwithstanding any other provision of law, whenever an appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, has reasonable cause to believe that a banking entity or nonbank financial company supervised by the Board under the respective agency's jurisdiction has made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of this section (including through an abuse of any permitted activity) or otherwise violates the restrictions under this section, the appropriate Federal banking agency, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as appropriate, shall order, after due notice and opportunity for hearing, the banking entity or nonbank financial company supervised by the Board to terminate the activity and, as relevant, dispose of the investment. Nothing in this paragraph shall be construed to limit the inherent authority of any Federal agency or State regulatory authority to further restrict any investments or activities under otherwise applicable provisions of law.''

[11] *See, e.g.,* 12 U.S.C. 1818(i).

[12] 7 U.S.C. 9(c)(4)(A).

[13] 7 U.S.C. 6s.

[14] 7 U.S.C. 12a.

[15] 7 U.S.C. 8a(2)(E).

[16] 7 U.S.C. 8a(2)(H).

[17] 7 U.S.C. 8a(3).

[18] 17 CFR 3.60.