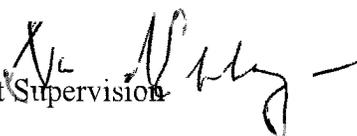


DATE: December 10, 2013

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision 

SUBJECT: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

Recommendation: Staff recommends that the FDIC Board approve the attached final rule to implement section 13 of the Bank Holding Company Act (“BHC Act”), as enacted by section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 13 of the BHC Act, commonly referred to as the “Volcker Rule,” contains certain prohibitions and restrictions on the ability of banking entities to engage in proprietary trading and restricts the ability of banking entities to hold certain investments in, and have certain relationships with, hedge funds and private equity funds. For purposes of section 13, the term “banking entity” includes all insured depository institutions (“IDIs”), irrespective of size, companies controlling IDIs, companies treated as bank holding companies, and any affiliate or subsidiary of the foregoing. However, it is expected that the primary impact will be on a limited number of larger, more complex banking entities that are actively engaged in the trading and fund activities covered by the statutory prohibitions and restrictions as implemented by final rule.

If approved, the final rule will be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System (“Federal Reserve Board”), the Office of the Comptroller of the Currency (“OCC”), the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”) (collectively, the “Agencies”). The final rule will be incorporated into the FDIC’s codified regulations as part 351 and will have an effective date of April 1, 2014. However, banking entities have a conformance period of up to two years from the statutory effective date to fully conform their activities and investments to the requirements of the final rule; this conformance period can be extended by the Federal Reserve Board for at least one additional year based on certain statutory criteria. Staff expects that the additional year will be granted to the conformance period, which would provide banking entities until July 21, 2015, to fully conform to the requirements of this final rule.

I. Introduction

Section 13 of the BHC Act generally prohibits, subject to certain exceptions, 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 permitted activity exemptions.

Section 13(d)(1) of the BHC Act expressly includes exemptions from these prohibitions for certain permitted activities, including:

- Trading in obligations of, or guaranteed by, the U.S. Treasury;
- Trading in obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution;
- Trading in obligations of any State or of any political subdivision thereof (e.g., municipal obligations);
- Underwriting and market making-related activities that are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;
- Risk-mitigating hedging activity;
- Trading on behalf of customers;
- Investments in Small Business Investment Companies (“SBICs”) and public welfare investments;
- Trading for the general account of insurance companies;
- Organizing and offering a covered fund (including limited investments in such funds);
- Foreign trading by non-U.S. banking entities;
- Foreign covered fund activities by non-U.S. banking entities; and
- Other such activity as determined appropriate by the Agencies, provided that such activity would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

The final rule provides certain conditions that would be applied to these permitted activity exemptions and would expand the exempted activities to include, subject to certain limitations:

- Trading by affiliates of foreign banking entities in the United States in financial instruments that are an obligation of, or issued or guaranteed by, the foreign sovereign under whose laws the top-tier banking entity is organized, including any agency or political subdivision of such foreign sovereign; and
- Trading by foreign affiliates of a U.S. banking entity in financial instruments that are an obligation of, or issued or guaranteed by, the foreign sovereign under whose laws the foreign entity is organized, including any agency or political subdivision of such foreign sovereign.

In addition, the final rule excludes certain activities from the definition of “proprietary trading,”

subject to conditions. These excluded activities include:

- Repurchase or reverse repurchase agreements;
- Securities borrowing and lending;
- Liquidity management;
- Certain activities associated with membership in a clearing agency, derivatives clearing organization, or financial market utility;
- Certain activities associated with preventing or closing out a failure to deliver in connection with delivery, clearing, or settlement activities;
- Certain agent, broker, or custodian activities;
- Certain activities as trustee of the banking entity’s deferred compensation, stock-bonus, profit-sharing, or pension plans; and
- Activities in the normal course of collecting a debt previously contracted in good faith.

Section 13 of the BHC Act contains two additional limits on the amount a banking entity may invest in funds organized and offered by the banking entity or an affiliate or a subsidiary.

First, for any particular covered fund, a banking entity may not own directly, and/or indirectly, more than 3 percent of the value or ownership interests of that fund. Second, a banking entity’s aggregate direct and/or indirect ownership in all covered funds may not exceed 3 percent of the banking entity’s Tier 1 capital. Further, any ownership interest in a covered fund that is held by a banking entity must be deducted from the banking entity’s Tier 1 capital, including ownership amounts that fall within the limitations described above.

In addition, section 13 of the BHC Act provides that otherwise allowable trading activity or covered funds activity is not permissible if it would involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties; would result, directly or indirectly, in a material exposure by the banking entity to a high risk position or a high risk trading strategy; or would pose a threat to the safety and soundness of the banking entity or U.S. financial stability.

While the requirements of section 13 of the BHC Act apply to all banking entities regardless of size, the Agencies believe that the prohibited proprietary trading activities and investments in, and relationships with, hedge funds and private equity funds that are covered by section 13 of the BHC Act are generally conducted by larger, more complex banking organizations. As a result, the final rule is designed to place as minimal burden as possible on banks that do not engage in these activities or have only limited exposure. In particular, the final rule provides that:

1. A banking entity is not required to implement a compliance program if it does not engage in activities or investments pursuant to subpart B or subpart C (other than trading activities permitted pursuant to § __.6(a) of subpart B¹). **This eliminates the compliance burden on banking entities that do not engage in covered activities or investments.**²

¹ Trading activities covered by this section (that is, permitted proprietary trading in domestic government obligations) include trading in: obligations of, or guaranteed by, the U.S. Treasury; obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution; obligations of any State or of any political subdivision thereof (e.g., municipal obligations); and obligations of the FDIC, or any entity formed by or on behalf of the FDIC for the purpose of facilitating the disposal of assets acquired in the FDIC's corporate, receiver, or conservator capacity. In addition, it should be noted that § __.3(d) of subpart B provides that, subject to certain requirements, repurchase or reverse repurchase agreements; securities borrowing and lending; and liquidity management activities are exempt from the definition of proprietary trading. Finally, subpart C specifically excludes wholly owned subsidiaries and loan securitizations, among other things and subject to certain conditions, from the definition of covered funds. FDIC staff believes that the combination of these provisions will result in most community banks

2. A banking entity with total consolidated assets of \$10 billion or less can meet the compliance requirements of the final rule simply 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. **This significantly reduces the compliance burden on smaller banking entities that engage in a limited amount of covered activities or investments.**³

The final rule requires all other banking entities to establish a compliance program designed to ensure compliance with the section 13 of the BHC Act and the requirements set forth in the final rule. For some institutions, the compliance program will require the reporting of specified metrics under Appendix A of the final rule. The compliance requirements of the final rule are discussed in more detail below.

II. Background

Section 13 of the BHC Act required the Financial Stability Oversight Council (“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

being exempt from compliance program requirements under the final rule. Nonetheless, the prohibitions of section 13 continue to apply to community banks; as such, community banks should manage their activities with this in mind.

² Banks of all sizes, including community banks, will be required to sell or otherwise dispose of impermissible investments in covered funds during the conformance period. This includes hedge funds, private equity funds, and exposures to securitizations where the underlying assets of the securitization are not loans or other qualifying exposures. For example, all community banks will have to dispose of non-conforming collateralized loan obligations (CLOs), collateralized debt obligations (CDOs) (including CDOs backed by trust preferred securities) and intellectual property securitizations. Non-conforming CLOs would have the conformance period to come into compliance with this rule. Covered funds generally will not include residential mortgage-backed securities (RMBS) (including government sponsored entity (GSE) exposures), commercial mortgage-backed securities (CMBS), auto securitizations, credit card securitizations, and commercial paper backed by conforming asset-backed commercial paper conduits.

³ See footnotes 1 and 2.

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. 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. The Agencies have carefully considered the FSOC study and its recommendations.

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. In October 2011, the FDIC, OCC, Federal Reserve Board, and SEC invited the public to comment on proposed rules implementing that section's requirements. The period for filing public comments on the proposal was extended for an additional 30 days, until February 13, 2012. In January 2012, the CFTC requested comment on a substantially similar proposed rule to implement section 13 and invited public comment on its proposed implementing rule through April 16, 2012.

The Agencies received over 18,000 comments addressing a wide variety of aspects of the proposal, including definitions used by the proposal, exemptions for market making-related activities, risk-mitigating hedging activities, covered fund activities and investments, the use of metrics, and the reporting proposals. The vast majority of these comments were from individuals using a version of a 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; summaries of these meetings are available on the Agencies' public websites. The CFTC staff also hosted a public roundtable on the proposed rule. 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 of the major sections of the proposed rule.

In formulating this final rule, the Agencies carefully reviewed all comments submitted in connection with the rulemaking and considered the suggestions and issues they raised in light of the statutory restrictions and provisions, as well as the FSOC study. 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 many of the comments are described in more detail in the section-by-section description of the final rule. To enhance uniformity in both rules and administration of the requirements of that section, the Agencies have regularly consulted with each other in the development of this final rule.

The final rule builds on the multi-faceted approach in the proposal, which includes development and implementation of a compliance program at each firm engaged in 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, the Agencies have also reduced the compliance burden for banking entities with total consolidated assets of \$10 billion or less. The final rule also eliminates the compliance burden for firms that do not engage in covered activities or investments beyond investing in U.S. government obligations, agency guaranteed obligations, municipal obligations, and other permitted activities that are exempt from the prohibition on proprietary trading.

Moreover, the data that would 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 purposes of section 13 of the BHC Act. Staff recommends that the Agencies continue to revisit and revise the rule as appropriate, in a manner designed to ensure that the final rule faithfully implements the requirements and purposes of the statute in a manner that allows for effective supervision and enforcement.

Under the statute, the restrictions and prohibitions of section 13 of the BHC Act became effective on July 21, 2012. The statute provided banking entities a period of two years to conform their activities and investments to the requirement of the statute. Section 13 also permits the Federal Reserve Board to extend this conformance period, one year at a time, for a total of no more than three additional years, based on certain statutory criteria. FDIC staff expects that the Federal Reserve Board will extend the conformance period for an additional year until July 21, 2015.

III. Overview of the Final Rule

A. General Approach.

The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act, while permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that facilitate liquid markets and are critical to capital generation for businesses of all sizes, households and individuals. 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, giving banking entities appropriate latitude 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.

The final rule includes a framework that describes the key characteristics of both prohibited and permitted activities. The final rule 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 large

firms that are active participants in trading activities to calculate and report 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 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, establishes exclusions from the definition of covered fund and exemptions from the restrictions and limitations on investments in covered funds;
- Subpart D of the final rule generally requires banking entities with more than \$10 billion in total consolidated assets 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 with a significant volume of trading assets and liabilities pursuant to the thresholds in the final rule may be required to compute and report with respect to certain trading activities; and
- Appendix B of the final rule details the enhanced minimum standards for programmatic compliance that certain banking entities with \$50 billion or more of total consolidated assets 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 __.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.

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. 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). 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. Third, the definition includes the purchase or sale of one or more financial instruments by a banking entity that is: (1) 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 (2) 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.

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

Section __.3 of 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.

Section __.4 of 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. 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 as measured by certain trading thresholds in the rule to report data involving 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. These requirements are also intended to work together to ensure that banking entities identify, monitor, and limit the risks associated with these activities.

Section __.5 of the final rule implements the statutory exemption for risk-mitigating hedging. As with the underwriting and market-making exemptions, § __.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. Section __.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. As with the exemptions for underwriting and market making-related activity, these requirements form part of a broader implementation approach that also includes the compliance program requirement and the reporting of quantitative measurements.

Section __.6 of the 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 __.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. This exemption includes banking entities' trading in obligations of the FDIC, or any entity formed by or on

behalf of the FDIC for purpose of facilitating the disposal of assets acquired or held by the FDIC in its corporate, receivership, or conservatorship capacity.

Section __.6(b) of the final rule permits trading in certain foreign government obligations by affiliates of foreign banking entities in the United States and foreign affiliates of a U.S. banking entity abroad. Section __.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. Section __.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.

Section __.6(e) of the final rule describes certain permitted proprietary trading activities of a foreign banking entity. 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. The exemption also requires that the risk as principal, the decision-making, the accounting for this activity, and transaction financing must not occur inside the United States or through any affiliate located in the United States. Under this exemption, such trading activity by a foreign banking entity must not be conducted with or through any U.S. entity other than (1) an unaffiliated U.S. market intermediary acting as principal, (2) an unaffiliated U.S. market intermediary as agent that is conducted anonymously on an exchange, or (3) 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 trading activity.

Section __.7 of 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. This section also describes the terms material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes.

C. Covered Fund Activities and Investments.

Subpart C of the 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 from this prohibition included in the statute. Section __.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.” 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 the types of investment activities typically conducted by hedge funds or private equity funds. These include exclusions for wholly owned subsidiaries, joint ventures, acquisition vehicles, foreign pension or retirement funds, insurance company separate accounts, and public welfare investment funds. In addition, this final rule excludes from the definition of covered fund 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 corporate, conservatorship, or receivership capacity. The final rule also implements the statutory rule of construction in section 13(g)(2) and provides that a loan securitization, qualifying asset-backed

commercial paper conduit, and qualifying covered bonds are not covered by section 13 or the final rule.

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. These interests may take various forms. The definition of ownership interest also explicitly excludes “carried interest” that is solely performance compensation for services provided to the covered fund by the banking entity (or an affiliate, subsidiary, or employee thereof), under certain circumstances. Section __.10 of the final rule also defines a number of other relevant terms, including the terms “prime brokerage transaction,” “sponsor,” and “trustee.”

Section __.11 of 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 __.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. Section __.11 also explains how these requirements apply to issuers of asset-backed securities that are covered funds, implements the statutory exemption for underwriting and market-making ownership interests of a covered fund, and explains the limitations imposed on such activities under the final rule.

Section __.12 of 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 § __.11. 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 __.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, § __.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 __.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 Tier 1 capital) 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.

Section __.13 of 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) in the case of an insurance company for its general or separate accounts, to acquire and retain an ownership interest in, or act as sponsor to, a covered fund.

Section __.14 of 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. Section __.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 __.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, 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.

Section __.15 of 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. 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, and as further described below, 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. In addition, 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 equals or exceeds \$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 \$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, 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 in writing by the primary supervisory Agency for the entity.

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. 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. 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 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.

For banking entities with total assets greater than \$10 billion and less than \$50 billion, the final rule specifies elements that each compliance program established under subpart D of the final rule 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 addressing all covered fund activities and limits; 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 under Appendix B 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 ensure 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.

III. Conclusion

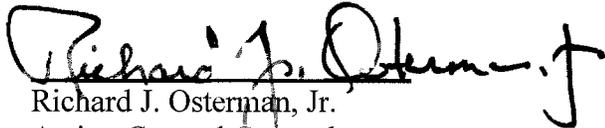
Staff recommends that the FDIC Board approve for publication in the *Federal Register* the attached final rule to implement section 13 of the BHC Act.

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