DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 44

[Docket No. OCC–2011–0014]

RIN 1557–AD44

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

12 CFR Part 248

[Docket No. R–1432]

RIN 7100 AD 82

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 351

RIN 3064–AD85

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 255

[Release No. 34–65545; File No. S7–41–11]

RIN 3235–AL07

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

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

ACTION: Notice of proposed rulemaking.

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

DATES: Comments should be received on or before January 13, 2012.

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

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

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

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

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

- *Viewing Comments Electronically:* Go to *http://www.regulations.gov.* Select ''Document Type'' of ''Public Submissions,'' and in the ''Enter Keyword or ID Box,'' enter Docket ID ''OCC–2011–14,'' and click ''Search.'' Comments will be listed under ''View By Relevance'' tab at the bottom of screen. If comments from more than one agency are listed, the ''Agency'' column will indicate which comments were received by the OCC.
- *Viewing Comments Personally:* You may personally inspect and photocopy comments at the OCC, 250 E Street SW., Washington, DC 20219. For security reasons, the OCC requires that visitors make an appointment to inspect comments. You may do so by calling (202) 874–4700. Upon arrival, visitors will be required to present valid government-issued photo identification and submit to security screening in order to inspect and photocopy comments.

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

Board of Governors of the Federal Reserve System:

You may submit comments, identified by Docket No. R–1432 and RIN 7100 AD 82, by any of the following methods:

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

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

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

- *Agency Web site: http://www.fdic.gov/regulations/laws/federal/propose.html.* Follow instructions for submitting comments on the Agency Web site.
- *Email: Comments@fdic.gov.* Include the RIN 3064–AD85 on the subject line of the message.
- *Mail:* Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.
- *Hand Delivery:* Comments may be hand delivered to the guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

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

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

Electronic Comments

- Use the Commission's Internet comment form (*http://www.sec.gov/rules/proposed.shtml*); or
- Send an email to *rule-comments@sec.gov.* Please include File Number S7–41–11 on the subject line; or
- Use the Federal eRulemaking Portal (*http://www.regulations.gov*). Follow the instructions for submitting comments.

Paper Comments

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

All submissions should refer to File Number S7–41–11. This file number should be included on the subject line if email is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (*http://www.sec.gov/rules/proposed.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10 a.m. and 3 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT:

OCC: Deborah Katz, Assistant Director, or Ursula Pfeil, Counsel, Legislative and Regulatory Activities Division, (202) 874–5090; Roman Goldstein, Senior Attorney, Securities and Corporate Practices Division, (202) 874–5210; Kurt Wilhelm, Director for Financial Markets Group, (202) 874–4660; Stephanie Boccio, Technical Expert for Asset Management Group, or Joel Miller, Group Leader for Asset Management Group, (202) 874–4660, Office of the Comptroller of the Currency, 250 E Street SW., Washington, DC 20219.

Board: Jeremy R. Newell, Counsel, (202) 452–3239, or Christopher M. Paridon, Counsel, Legal Division, (202) 452–3274; Sean D. Campbell, Deputy Associate Director, Division of Research and Statistics, (202) 452–3760; David Lynch, Manager, Division of Bank Supervision and Regulation, (202) 452–2081, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551.

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

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

SUPPLEMENTARY INFORMATION:

I. Background

The Dodd-Frank Act was enacted on July 21, 2010.[1] Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act of 1956 (''BHC Act'') (to be codified at 12 U.S.C. 1851) that generally prohibits any banking entity [2] from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund (''covered fund''), subject to certain exemptions.[3] New section 13 of the BHC Act also provides for nonbank financial companies supervised by the Board that engage in such activities or have such interests or relationships to be subject to additional capital requirements, quantitative limits, or other restrictions.[4]

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

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

[3] The term ''banking entity'' is defined in section 13(h)(1) of the BHC Act, as amended by section 619 of the Dodd-Frank Act. *See* 12 U.S.C. 1851(h)(1). The statutory definition includes any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106), and any affiliate or subsidiary of any of the foregoing. Section 13 of the BHC Act defines the terms ''hedge fund'' and ''private equity fund'' as an issuer that would be an investment company, as defined under the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*), but for section 3(c)(1) or 3(c)(7) of that Act, or any such similar funds as the appropriate Federal banking agencies (i.e., the Board, OCC, and FDIC), the SEC, and the CFTC may, by rule, determine should be treated as a hedge fund or private equity fund. *See* 12 U.S.C. 1851(h)(2).

[4] *See* 12 U.S.C. 1851(a)(2) and (f)(4). A ''nonbank financial company supervised by the Board'' is a nonbank financial company or other company that the Financial Stability Oversight Council (''Council'') has determined, under section 113 of the Dodd-Frank Act, shall be subject to supervision by the Board and prudential standards. The Board is not proposing at this time any additional capital requirements, quantitative limits, or other

Continued

A. Rulemaking Framework

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

Authority for developing and adopting regulations to implement the prohibitions and restrictions of section 13 of the BHC Act is divided between the Agencies in the manner provided in section 13(b)(2) of the BHC Act.[8] The statute also requires the Agencies, in developing and issuing implementing rules, to consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such rules are comparable and provide for consistent application and implementation of the applicable provisions of section 13 of the BHC Act.[9] Such coordination will assist in ensuring that advantages are not unduly provided to, and that disadvantages are not unduly imposed upon, companies affected by section 13 of the BHC Act and that the safety and soundness of banking entities and nonbank financial companies supervised by the Board are protected. The statute requires the Agencies to implement rules under section 13 not later than 9 months after the Council completes its study (i.e., not later than October 18, 2011).[10] The restrictions and prohibitions of section 13 of the BHC Act become effective 12 months after issuance of final rules by the Agencies, or July 21, 2012, whichever is earlier.[11]

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

B. Section 13 of the BHC Act

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

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

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

Additionally, section 13 of the BHC Act permits the Agencies to grant, by rule, other exemptions from the prohibitions on proprietary trading and acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund if the Agencies determine

restrictions on nonbank financial companies pursuant to section 13 of the BHC Act, as it believes doing so would be premature in light of the fact that the Council has not yet finalized the criteria for designation of, nor yet designated, any nonbank financial company.

[5] *See* Financial Stability Oversight Council, 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. See* 12 U.S.C. 1851(b)(1). Prior to publishing its study, the Council requested public comment on a number of issues to assist the Council in conducting its study. *See* 75 FR 61,758 (Oct. 6, 2010). Approximately 8,000 comments were received from the public, including from members of Congress, trade associations, individual banking entities, consumer groups, and individuals. As noted in the issuing release for the Council Study, these comments were carefully considered by the Council when drafting the Council study.

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

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

[8] *See* 12 U.S.C. 1851(b)(2). Under section 13(b)(2)(B) of the BHC Act, rules implementing section 13's prohibitions and restrictions must be issued by: (i) The appropriate Federal banking agencies (i.e., the Board, the OCC, and the FDIC), jointly, with respect to insured depository institutions; (ii) the Board, with respect to any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act, any nonbank financial company supervised by the Board, and any subsidiary of any of the foregoing (other than a subsidiary for which an appropriate Federal banking agency, the SEC, or the CFTC is the primary financial regulatory agency); (iii) the CFTC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act; and (iv) the SEC with respect to any entity for which it is the primary financial regulatory agency, as defined in section 2 of the Dodd-Frank Act. *See id.*

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

[10] *See id.* at 1851(b)(2)(A).

[11] *See id.* at 1851(c)(1).

[12] *See id.* at 1851(c)(6).

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

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

[15] 12 U.S.C. 1851(a)(1)(A) and (B).

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

that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.[17] Furthermore, under the statute, no banking entity may engage in a permitted activity if that activity would (i) involve or result in a material conflict of interest or material exposure of the banking entity to high-risk assets or high-risk trading strategies, or (ii) pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States.[18]

Section 13(f) of the BHC Act separately prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a covered fund, and any affiliate of such a banking entity, from entering into any transaction with the fund, or any other covered fund controlled by such fund, that would be a ''covered transaction'' as defined in section 23A of the Federal Reserve Act (''FR Act''),[19] as if such banking entity or affiliate were a member bank and the covered fund were an affiliate thereof, subject to certain exceptions.[20] Section 13(f) also provides that a banking entity may enter into certain prime brokerage transactions with any covered fund in which a covered fund managed, sponsored, or advised by the banking entity has taken an equity, partnership, or other ownership interest, but any such transaction (and any other permitted transaction with such funds) must be on market terms in accordance with the provisions of section 23B of the FR Act.[21]

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

[17] *Id.* at 1851(d)(1)(J).

[18] *See id.* at 1851(d)(2).

[19] *See* 12 U.S.C. 371c.

[20] 12 U.S.C. 1851(f).

[21] 12 U.S.C. 371c–1.

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

II. Overview of Proposed Rule

A. General Approach

In formulating the proposed rule, the Agencies have attempted to reflect the structure of section 13 of the BHC Act, which is to prohibit a banking entity from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, while permitting such entities to continue to provide client-oriented financial services. However, the delineation of what constitutes a prohibited or permitted activity under section 13 of the BHC Act often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice. The Agencies appreciate that while it is crucial that rules under section 13 of the BHC Act clearly define and implement its requirements, any rule must also preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that section 13 expressly protects and permits. These client-oriented financial services, which include underwriting, market making, and traditional asset management services, are important to the U.S. financial markets and the participants in those markets, and the Agencies have endeavored to develop a proposed rule that does not unduly constrain banking entities in their efforts to safely provide such services. At the same time, providing appropriate latitude to banking entities to provide such client-oriented services need not and should not conflict with clear, robust, and effective implementation of the statute's prohibitions and restrictions. Given these complexities, the Agencies request comment on the potential impacts the proposed approach may have on banking entities and the businesses in which they engage. In particular, and as discussed further in Part VII of this Supplemental Information, the Agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation of section 13 of the BHC Act, and the Agencies request comment on such impacts, including quantitative data, where possible.

In light of these larger challenges and goals, the Agencies' proposal takes a multi-faceted approach to implementing section 13 of the BHC Act. In particular, the proposed rule includes a framework that: (i) Clearly describes the key characteristics of both prohibited and permitted activities; (ii) requires banking entities to establish a comprehensive programmatic compliance regime designed to ensure compliance with the requirements of the statute and rule in a way that takes into account and reflects the unique nature of a banking entity's businesses; and (iii) with respect to proprietary trading, requires certain banking entities to calculate and report meaningful quantitative data that will assist both banking entities and the Agencies in identifying particular activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities. This multi-faceted approach, which is consistent with the implementation and supervisory framework recommended in the Council study, is intended to strike an appropriate balance between accommodating prudent risk management and the continued provision of client-oriented financial services by banking entities while ensuring that such entities do not engage in prohibited proprietary trading or restricted covered fund activities or investments.[23]

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

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

- Subpart A of the proposed rule describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;
- Subpart B of the proposed rule prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from

[23] In recognition of economic impacts that may arise from the proposed rule and its implementation of section 13 of the BHC Act, the Agencies are requesting comment on the relative costs and benefits of the proposal in Part VII of this Supplemental Information.

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

the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;

• Subpart C of the proposed rule prohibits or restricts acquiring or retaining an ownership interest in, and certain relationships with, a covered fund, defines terms relevant to covered fund activities and investments, as well as establishes exemptions from the restrictions on covered fund activities and investments and limitations on those exemptions;

• Subpart D of the proposed rule generally requires banking entities to establish an enhanced compliance program regarding compliance with section 13 of the BHC Act and the proposed rule, including written policies and procedures, internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;

• Appendix A of the proposed rule details the quantitative measurements that certain banking entities may be required to compute and report with respect to their trading activities; [25]

• Appendix B of the proposed rule provides commentary regarding the factors the Agencies propose to use to help distinguish permitted market making-related activities from prohibited proprietary trading; and

• Appendix C of the proposed rule details the minimum requirements and standards that certain banking entities must meet with respect to their compliance program, as required under subpart D.[26]

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

B. Proprietary Trading Restrictions

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

The proposed rule's definition of trading account generally parallels the statutory definition, and provides further guidance regarding the circumstances in which a position will be considered to have been taken principally for the purpose of short-term resale or benefiting from actual or expected short-term price movements, recognizing the importance of providing as much clarity as possible regarding this term, which ultimately defines the scope of accounts subject to the prohibition on proprietary trading.[28] In particular, the proposed definition of trading account identifies three classes of positions that would cause an account to be a trading account. First, the definition includes positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[29] As described in this notice, this language is substantially similar to language for a ''trading position'' used in the Federal banking agencies' current market risk capital rules, as proposed to be revised (''Market Risk Capital Rules''),[30] and the Agencies propose to interpret this language in a similar manner. Second, with respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, the definition includes all positions in financial instruments subject to the prohibition on proprietary trading that are treated as ''covered positions'' under those capital rules, other than certain foreign exchange and commodities positions. Third, the definition includes all positions acquired or taken by certain registered securities and derivatives dealers (or, in the case of financial institutions [31] that are government securities dealers, that have filed notice with an appropriate regulatory agency) in connection with their activities that require such registration or notice.[32] The definition of trading account also contains clarifying exclusions for certain positions that do not appear to involve the requisite short-term trading intent, such as positions arising under certain repurchase and reverse repurchase arrangements or securities lending transactions, positions acquired or taken for *bona fide* liquidity management purposes, and certain positions of derivatives clearing organizations or clearing agencies.[33]

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

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

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

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

[27] *See* proposed rule § __.3(b)(1).

[28] *See* proposed rule § __.3(b)(2).

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

[30] *See* 76 FR 1890 (Jan. 11, 2011).

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

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

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

[34] *See* proposed rule § __.3(b)(3).

[35] *See* proposed rule § __.4(a), (b).

requirement and the reporting of quantitative measurements, in order to assist banking entities and the Agencies in identifying prohibited trading activities that may be conducted in the context of, or mischaracterized as, permitted underwriting or market making-related activities.

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

Section __.6 of the proposed rule implements statutory exemptions for trading in certain government obligations, trading on behalf of customers, trading by a regulated insurance company, and trading by certain foreign banking entities outside the United States. Section __.6(a) of the proposed rule describes the government obligations in which a banking entity may trade notwithstanding the prohibition on proprietary trading, which include U.S. government and agency obligations, obligations and other instruments of certain government sponsored entities, and State and municipal obligations.[38] Section __.6(b) of the proposed rule describes permitted trading on behalf of customers and identifies three categories of transactions that would qualify for the exemption.[39] These categories include: (i) Transactions conducted by a banking entity as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for the account of a customer where the customer, and not the banking entity, has beneficial ownership of the related positions; (ii) riskless principal transactions; and (iii) transactions conducted by a banking entity that is a regulated insurance company for the separate account of insurance policyholders, subject to certain conditions. Section __.6(c) of the proposed rule describes permitted trading by a regulated insurance company for its general account, and generally parallels the statutory language governing this exemption.[40] Finally, § __.6(d) of the proposed rule describes permitted trading outside of the United States by a foreign banking entity.[41] The proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity not currently subject to section 4 of the BHC Act. The exemption also clarifies when trading will be considered to have occurred solely outside of the United States, as required by the statute, and provides a number of specific criteria for determining whether that standard is met.

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

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

As described in Part II.B.5 of the Supplementary Information below, the Agencies expect to utilize the conformance period provided in section 13(c)(2) of the BHC Act to further refine and finalize the reporting requirements, reflecting the substantial public comment, practical experience, and revision that will likely be required to ensure appropriate, effective use of reported quantitative data in practice.

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

C. Covered Fund Activities and Investments

Subpart C of the proposed rule implements the statutory prohibition on, as principal, directly or indirectly, acquiring and retaining an ownership

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

[37] *See* proposed rule § __.5(b)(3).

[38] *See* proposed rule § __.6(a).

[39] *See* proposed rule § __.6(b).

[40] *See* proposed rule § __.6(c).

[41] *See* proposed rule § __.6(d).

[42] *See* proposed rule § __.7.

[43] *See* proposed rule § __.8.

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

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

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

Section __.11 of the proposed rule implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. Section __.11(a) of the proposed rule outlines the conditions that must be met in order for a banking entity to organize and offer a covered fund under this authority. These requirements are contained in the statute and are intended to allow a banking entity to engage in certain traditional asset management and advisory businesses in compliance with section 13 of the BHC Act.[47] The requirements are discussed in detail in Part III.C.2 of this Supplementary Information.

Section __.12 of the proposed rule permits a banking entity to acquire and retain, as an investment in a covered fund, an ownership interest in a covered fund that the banking entity organizes and offers under § __.11.[48] This section implements section 13(d)(4) of the BHC Act and related provisions. Section 13(d)(4) of the BHC Act permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers pursuant to section 13(d)(1)(G), or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section __.12 of the proposed rule implements this authority and related limitations, including limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments.[49] Proposed § __.12 also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from applicable capital, as relevant), as well as sets forth how a banking entity may request an extension of the period of time within which it must conform an investment in a single covered fund.[50]

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

Section __.13(b) of the proposed rule permits a banking entity to use an ownership interest in a covered fund to hedge, but only with respect to individual or aggregated obligations or liabilities of a banking entity that arise from: (i) The banking entity acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the customer's exposure to the profits and losses of the covered fund (similar to acting as a ''riskless principal''); or (ii) a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund.[53] Additionally, § __.13(b) of the proposed rule requires that the hedge represent a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in the covered fund arising out of the transaction that the acquisition or retention of an ownership interest in the covered fund is intended to hedge or otherwise mitigate.[54] Proposed § __.13(b) also requires a banking entity to document, at the time the transaction is executed, the hedging rationale for all hedging transactions involving an ownership interest in a covered fund.[55]

Section __.13(c) of the proposed rule implements section 13(d)(1)(I) of the BHC Act and permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) or 4(c)(13) of the BHC Act. This statutory exemption limits the extraterritorial application of the statutory restrictions on covered fund activities and investments to foreign firms that, in the course of operating outside of the United States, engage in activities permitted under relevant foreign law outside of the United States, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States.[56] The proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which covered fund activities or investments by such an entity will be considered to have occurred solely outside of the United States (including clarifying when an ownership interest will be considered to have been offered for sale or sold to a resident of the United States). Section __.13(d) of the proposed rule also implements in part the rule of construction contained in section 13(g)(2) of the BHC Act, which permits the sale and securitization of loans.[57] Proposed § __.13(d) clarifies that a

[44] *See* proposed rule § __.10(b)(1).

[45] *See* proposed rule § __.10(b)(3).

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

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

[48] *See* proposed rule § __.12.

[49] *See* proposed rule § __.12(a)(2).

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

[51] *See* proposed rule § __.13(a)—(c).

[52] *See* proposed rule § __.13(a).

[53] *See* proposed rule § __.13(b)(1).

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

[55] *See* proposed rule § __.13(b)(3).

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

[57] *See* 12 U.S.C. 1851(g)(2).

banking entity may acquire and retain an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) Loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) a limited amount of interest rate or foreign exchange derivatives that materially relate to such loans and that are used for hedging purposes with respect to the securitization structure.[58] The authority contained in this section of the proposed rule would therefore allow a banking entity to acquire and retain an ownership interest in a loan securitization vehicle (which would be a covered fund for purposes of section 13(h)(2) of the BHC Act and the proposed rule) that the banking entity organizes and offers, or acts as sponsor to, in excess of the three percent limits specified in section 13(d)(4) of the BHC Act and § __.12 of the proposed rule.

Section __.14 of the proposed rule implements section 13(d)(1)(J) of the BHC Act[59] and permits a banking entity to engage in any covered fund activity or investment that the Agencies determine promotes and protects the safety and soundness of banking entities and the financial stability of the United States.[60] The Agencies have proposed to permit three activities at this time under this authority. These activities involve acquiring and retaining an ownership interest in, or acting as sponsor to, certain bank owned life insurance (''BOLI'') separate accounts, investments in and sponsoring of certain asset-backed securitizations, and investments in and sponsoring of certain entities that rely on the exclusion from the definition of investment company in section 3(c)(1) and/or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a–1 *et seq.*) (''Investment Company Act'') but that are, in fact, common corporate organizational vehicles.[61] Additionally, the Agencies have proposed to permit a banking entity to acquire and retain an ownership interest in, or act as sponsor to, a covered fund, if such acquisition or retention is done (i) in the ordinary course of collecting a debt previously contracted, or (ii) pursuant to and in compliance with the conformance or extended transition periods implemented under section 13(c)(6) of the BHC Act.[62]

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

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

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

D. Compliance Program Requirement

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

- Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading activities and covered fund activities and investments of the banking entity to ensure that such activities comply with section 13 of the BHC Act and the proposed rule;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and the proposed rule in the banking entity's covered trading and covered fund activities and to prevent the occurrence of activities that are prohibited by section 13 of the BHC Act and the proposed rule;
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the proposed rule;
- Independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and the proposed rule, which a banking entity must promptly provide to the relevant Agency upon request and retain for a period of no less than 5 years.

[58] *See* proposed rule § __.13(d).

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

[60] *See* 12 U.S.C. 1851(d)(1)(J).

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

[62] *See* proposed rule at § __.14(b).

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

[64] *See* proposed rule § __.15.

[65] *See* proposed rule § __.16.

[66] 12 U.S.C. 371c–1.

[67] *See* proposed rule § __.17.

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

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

E. Conformance Provisions

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

F. Treatment of Smaller, Less-Complex Banking Entities

In formulating the proposed rule, the Agencies have carefully considered and taken into account the potential impact of the proposed rule on small banking entities and banking entities that engage in little or no covered trading activities or covered fund activities and investments, including the burden and cost that might be associated with such banking entities' compliance with the proposed rule. In particular, the Agencies have proposed to reduce the effect of the proposed rule on such banking entities by limiting the application of certain requirements, such as the reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule and the compliance program requirements contained in subpart D and Appendix C of the proposed rule, to those banking entities that engage in little or no covered trading activities or covered fund activities and investments. The Agencies have also requested comment (i) throughout this Supplementary Information on a number of questions related to the costs and burdens associated with particular aspects of the proposal, as well as (ii) in Part VII.B of this Supplementary Information on any significant alternatives that would minimize the impact of the proposal on small banking entities.

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

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

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

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

[70] *See* 76 FR 8265 (Feb. 14, 2011).

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

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

[73] The definitions of ''affiliate'' and ''subsidiary'' are discussed in detail in Part III.A.2 of this Supplemental Information.

III. Section by Section Summary of Proposed Rule

A. Subpart A—Authority and Definitions

1. Section __.1: Authority, Purpose, Scope, and Relationship to Other Authorities

a. Authority and Scope

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

b. Effective Date

Section 13(c)(1) of the BHC Act provides that section 13 shall take effect on the earlier of (i) 12 months after the date of issuance of final rules implementing that section, or (ii) 2 years after the date of enactment of section 13, which is July 21, 2012.[75] Because the Agencies did not issue final rules implementing section 13 of the BHC Act by July 21, 2011, § __.1 of the proposed rule specifies that the effective date for its provisions will be July 21, 2012.

The Agencies note that the proposed effective date will impact not only the date on which the proposed rule's prohibitions and restrictions on proprietary trading and covered fund activities and investments go into effect (subject to the conformance period or extended transition period provided by section 13(c) of the BHC Act),[76] but also the date on which a banking entity must comply with (i) the reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule and (ii) the compliance program mandate of § __.20 and Appendix C of the proposed rule. As proposed, § __.1 would require a banking entity subject to either the reporting and recordkeeping or compliance program requirements to begin complying with these requirements as of July 21, 2012.[77] With respect to the compliance program requirement of the proposed rule, § __.1 would require a banking entity to have developed and implemented the required program by the proposed effective date, though the Agencies note that prohibited activities and investments may not be fully conformed by that date. The Agencies expect a banking entity to fully conform all investments and activities to the requirements of the proposed rule as soon as practicable within the conformance periods provided in section 13 of the BHC Act and the Board's rules thereunder, which define the conformance periods. With respect to the reporting and recordkeeping requirements of the proposed rule, § __.1 of the proposed rule would require a banking entity to begin furnishing these reports for all trading units or asset management units as of the effective date, though the quantitative measurements furnished for proprietary trading activities that are conducted in reliance on the authority provided by the conformance period would not be used to identify prohibited proprietary trading until such time as the relevant trading activities must be conformed.

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

Question 1. Does the proposed effective date provide banking entities with sufficient time to prepare to comply with the prohibitions and restrictions on proprietary trading and covered fund activities and investments? If not, what other period of time is needed and why?

Question 2. Does the proposed effective date provide banking entities with sufficient time to implement the proposal's compliance program requirement? If not, what are the impediments to implementing specific elements of the compliance program and what would be a more effective time period for implementing each element and why?

Question 3. Does the proposed effective date provide banking entities sufficient time to implement the proposal's reporting and recordkeeping requirements? If not, what are the impediments to implementing specific elements of the proposed reporting and recordkeeping requirements and what would be a more effective time period for implementing each element and why?

Question 4. Should the Agencies use a gradual, phased in approach to implement the statute rather than having the implementing rules become effective at one time? If so, what prohibitions and restrictions should be implemented first? Please explain.

2. Section __.2: Definitions

Section __.2 of the proposed rule defines a variety of terms used throughout the proposed rule, including ''banking entity,'' which defines the scope of entities to which the proposed rule applies. Consistent with the statutory definition of that term, § __.2(e) of the proposed rule provides that a ''banking entity'' includes: (i) Any insured depository institution; (ii) any company that controls an insured depository institution; (iii) any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (12 U.S.C. 3106); and (iv) any affiliate or subsidiary of any of the foregoing.[78] In addition, in order to avoid application of section 13 of the BHC Act in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme, the proposed rule also clarifies that the term ''banking entity'' does not include any affiliate or subsidiary of a banking entity, if that affiliate or subsidiary is (i) a covered fund, or (ii) any entity controlled by such a covered fund.[79] This clarification is proposed because the definition of ''affiliate'' and ''subsidiary'' under the BHC Act is broad, and could include a covered fund that a banking entity has permissibly sponsored or made an investment in because, for example, the banking entity acts as general partner or managing member of the covered fund as part of its permitted sponsorship activities.[80] If

[74] *See* proposed rule § __.1(d).

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

[76] *See id.* at 1851(c)(2)–(6).

[77] *See* proposed rule § __.1.

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

[79] The Agencies note that since the proposed rule implements section 13 of the BHC Act, it incorporates that Act's definition of ''affiliate'' and ''subsidiary.'' *See* proposed rule §§ __.2(a) and (bb). The terms affiliate and subsidiary are generally defined in section 2 of the BHC Act according to whether such entity controls or is controlled by another relevant entity. *See* 12 U.S.C. 1841(d), (k). The concept of control under the proposed rule, in turn, is as defined in section 2 of the BHC Act and as implemented by the Board. *See* 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

[80] Under section 2 of the BHC Act and the Board's Regulation Y (12 CFR part 225), a banking entity acting as general partner or managing member of another company would be deemed to control that company and, as such, the company would be both

Continued

such a covered fund were considered a ''banking entity'' for purposes of the proposed rule, the fund itself would become subject to all of the restrictions and limitations of section 13 of the BHC Act and the proposed rule, which would be inconsistent with the purpose and intent of the statute. For example, such a covered fund would then generally be prohibited from investing in other covered funds, notwithstanding the fact that section 13(f)(3) of the BHC Act specifically contemplates such investments. Accordingly, the proposed rule would exclude from the definition of banking entity any fund that a banking entity may invest in or sponsor as permitted by the proposed rule.

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

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

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

Request for Comment

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

Question 5. Is the proposed rule's definition of banking entity effective? What alternative definitions might be more effective in light of the language and purpose of the statute?

Question 6. Are there any entities that should not be included within the definition of banking entity since their inclusion would not be consistent with the language or purpose of the statute or could otherwise produce unintended results? Should a registered investment company be expressly excluded from the definition of banking entity? Why or why not?

Question 7. Is the proposed rule's exclusion of a covered fund that is organized, offered and held by a banking entity from the definition of banking entity effective? Should the definition of banking entity be modified to exclude any covered fund? Why or why not?

Question 8. Banking entities commonly structure their registered investment company relationships and investments such that the registered investment company is not considered an affiliate or subsidiary of the banking entity. Should a registered investment company be expressly excluded from the definition of banking entity? Why or why not? Are there circumstances in which such companies should be treated as banking entities subject to section 13 of the BHC Act? How many such companies would be covered by the proposed definition?

Question 9. Under the proposed rule, would issuers of asset-backed securities be captured by the proposed definition of ''banking entity''? If so, are issuers of asset-backed securities within certain asset classes particularly impacted? Are particular types of securitization vehicles (trusts, LLCs, etc.) more likely than others to be included in the definition of banking entity? Should issuers of asset-backed securities be excluded from the proposed definition of ''banking entity,'' and if so, why? How would such an exclusion be consistent with the language and purpose of the statute?

Question 10. What would be the potential impact of including existing issuers of asset-backed securities[83] in the proposed definition of ''banking entity'' on existing issuers of asset-backed securities and the securitization market generally? How many existing issuers of asset-backed securities might be included in the proposed definition of ''banking entity''? Are there ways in which the proposed rule could be amended to mitigate or eliminate potential impact, if any, on existing asset-backed securities[84] without compromising the intent of the statute?

Question 11. What would be the legal and economic impact to an issuer of asset-backed securities of being considered a ''banking entity''? What additional costs would be incurred in the establishment and implementation of a compliance program related to the provisions of the proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? Who would pay those additional costs?

Question 12. If the ownership requirement under the proposed rule for credit risk retention (section 15G of the Exchange Act) combined with the control inherent in the position of servicer or investment manager means that more securitization vehicles would be considered affiliates of banking entities, would fewer banking entities be willing to (i) serve as the servicer or investment manager of securitization transactions and/or (ii) serve as the originator or securitizer (as defined in section 15G of the Exchange Act) of securitization transactions? What other impact might the potential interplay between these rules have on future securitization transactions? Could there be other potential unintended consequences?

Question 13. Are the proposed rule's definitions of buy and purchase and sale and sell appropriate? If not, what alternative definitions would be more appropriate? Should any other terms be defined? If so, are there existing definitions in other rules or regulations that could be used in this context? Why would the use of such other definitions be appropriate?

B. Subpart B—Proprietary Trading Restrictions

1. Section __.3: Prohibition on Proprietary Trading

Section __.3 of the proposed rule describes the scope of the prohibition on proprietary trading and defines a

an ''affiliate'' and ''subsidiary'' of the banking entity for purposes of the BHC Act. *See* 12 U.S.C. 1841(d), (k).

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

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

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

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

number of terms related to proprietary trading. The Agencies note that the definition of ''proprietary trading'' in the statute and under the proposed rule is broad. This definition must be viewed in light of the exemptions described later in the proposed rule, which reflect statutory provisions permitting a number of activities.

a. Prohibition on Proprietary Trading

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

b. ''Trading Account''

i. Definition of ''Trading Account''

Section 13(h)(6) of the BHC Act defines the term ''trading account'' as ''any account used for acquiring or taking positions in securities [or other enumerated instruments] principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements),'' as well as any such other accounts that the Agencies by rule determine.[87] As an initial matter, the Agencies note that it is often difficult to clearly identify the purpose for which a position is acquired or taken and whether that purpose is short-term in nature, particularly since identification of that purpose generally depends on the intent with which the position is acquired or taken. Moreover, the statute does not define the terms ''near-term'' or ''short-term'' for these purposes.

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

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

ii. Positions Acquired or Taken for Short-Term Trading Purposes

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

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

This prong reflects the statutory definition's reference to positions acquired or taken ''principally for the purpose of selling in the near-term (or otherwise with the intent to resell in order to profit from short-term price movements).'' [92]

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

Section __.3(b)(2)(i)(A)(*2*) of the proposed rule includes covered financial positions acquired or taken principally for the purpose of benefitting from actual or expected short-term price movements.[94] This part of the trading account definition does not require the *resale* of the position; rather, it requires only an intent to engage in any form of transaction on a short-term basis (including a transaction

[85] *See* proposed rule § __.3(b)(1).

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

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

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

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

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

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

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

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

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

separate from, but related to, the initial acquisition of the position) for the purpose of benefitting from a short-term movement in the price of the underlying position. This part of the proposed definition would, for example, include a derivative or other position where the banking entity enters into (or intends to enter into) a subsequent transaction in the near-term to simply offset or ''close out,'' rather than sell, all or a portion of the risks of the initial position, in order to benefit from a price movement occurring between the acquisition of the underlying position and the subsequent offsetting transaction. Similarly, it would also include a derivative, commodity future, or other position that, regardless of the term of that position, is subject to the exchange of short-term variation margin through which the banking entity intends to benefit from short-term price movements. The proposed definition would also capture the acquisition of a debt instrument where the banking entity intends to enter into a short-term transaction to simply offset, rather than sell, the credit, interest rate and/or other material risk elements of the initial position so as to benefit from a price movement occurring between acquisition of the underlying position and the subsequent offsetting transaction.

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

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

iii. Overview of Current Market Risk Capital Rules Approach to Short-Term Trading Positions

The first prong of the proposed trading account definition, which references positions acquired principally for short-term trading purposes, is, like the statutory definition it implements, substantially similar to a key portion of the definition of a ''covered position'' under the Market Risk Capital Rules.[97] For the reasons discussed below, the Agencies have taken this similarity into account and propose to construe the first prong of the definition of trading account under the proposed rule—and in particular its reference to ''short-term''—in a manner that is consistent with the Market Risk Capital Rules' approach to identifying positions taken with short-term trading intent.

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

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

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

[97] The Federal banking agencies' current Market Risk Capital Rules are located at 12 CFR Part 3, Appendix B (OCC), 12 CFR Part 208, Appendix E and 12 CFR Part 225, Appendix E (Board), and 12 CFR Part 325, Appendix C (FDIC), and apply on a consolidated basis to banks and bank holding companies with trading activity (on a worldwide consolidated basis) that equals 10 percent or more of the institution's total assets, or $1 billion or more. On January 11, 2011, the Federal banking agencies proposed revisions to the Market Risk Capital Rules that include, *inter alia,* changes to the definition of covered position. Proposed revisions to the Market Risk Capital Rules include (i) changes to portions of the covered position definition not relevant to the statutory definition of trading account in section 13 of the BHC Act and (ii) the addition of a requirement that any position in a trading account also be a ''trading position'' in order to be considered a covered position. *See* 76 FR 1890 (Jan. 11, 2011). The revised definition of ''trading position'' that has been proposed for those purposes is generally identical to this proposed rule's definition of trading account (i.e., a position acquired or taken: (i) For the purpose of short-term resale; (ii) with the intent of benefitting from actual or expected short-term price movements; (iii) to lock in short-term arbitrage profits; or (iv) to hedge another trading position). The Agencies also note that the first prong of the proposed rule's trading account definition is also substantially similar to the Basel Committee's definition of ''trading book.'' *See* Basel Committee on Banking Supervision, *Amendment to the Capital Accord to Incorporate Market Risks, available at http://bis.org/publ/bcbs119.pdf.*

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

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

definition of trading account in section 13 of the BHC Act in that it refers to acquiring or taking positions (i) principally for the purpose of selling in the near-term or (ii) otherwise with the intent to resell in order to profit from short-term price movements.

In providing guidance regarding the application of ''trading account,'' the Call Report also states that trading account positions include any position that is classified as ''trading securities'' under relevant U.S. Generally Accepted Accounting Principles (''GAAP'') standards for accounting.[100] Under the referenced accounting standards, trading securities are defined as those ''that are bought and held principally for the purpose of selling them in the near-term'' and ''generally used with the objective of generating profits on short-term differences in price.''[101] The Agencies note that the definition of a trading security under the relevant U.S. GAAP accounting standards is similar to both (i) the financial positions described in the second prong of the Call Report's definition of trading account and (ii) the financial positions described in the statutory definition of trading account under section 13 of the BHC Act.

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

In order to better reinforce the general consistency between the proposal's approach to defining a trading account and the ''trading account'' concept embedded in the Market Risk Capital Rules, the second prong of the proposed definition of trading account, contained in § __.3(b)(2)(i)(B) of the proposed rule, provides that a trading account includes any account used to acquire or take one or more covered financial positions, other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery (unless the position is otherwise held with short-term intent), that are also market risk capital rule covered positions, if the banking entity, or any affiliate of the banking entity that is a bank holding company, calculates risk-based capital ratios under the Market Risk Capital Rules.[103] For these purposes, a ''market risk capital rule covered position'' is defined as any covered position as that term is defined for purposes of (i) in the case of a banking entity that is a bank holding company or insured depository institution, the market risk capital rule that is applicable to the banking entity, and (ii) in the case of a banking entity that is affiliated with a bank holding company, other than a banking entity to which a market risk capital rule is applicable, the market risk capital rule that is applicable to the affiliated bank holding company.[104] In particular, for banking entities already subject to the Market Risk Capital Rules, it appears that positions subject to trading account treatment under those rules because they involve short-term trading intent are generally the type of positions to which the proprietary trading restrictions of section 13 of the BHC Act were intended to apply. In addition, including all covered financial positions that receive trading account treatment under the Market Risk Capital Rules because they meet a nearly identical standard regarding short-term trading intent would also eliminate the potential for inconsistency or regulatory arbitrage in which a banking entity might characterize a position as ''trading'' for capital purposes but not for purposes of the proposed rule.

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

iv. Positions Acquired or Taken by Securities Dealers, Swap Dealers, and Security-Based Swap Dealers

The third prong of the proposed definition of trading account is contained in § __.3(b)(2)(i)(C) of the

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

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

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

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

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

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

proposed rule and provides that a trading account includes *any account* used to acquire or take one or more covered financial positions by a banking entity that is: (i) A SEC-registered securities or municipal securities dealer; (ii) a government securities dealer that registered, or that has filed notice, with an appropriate regulatory agency; [106] (iii) a CFTC-registered swap dealer; or (iv) a SEC-registered security-based swap dealer, in each case to the extent that the covered financial position is acquired or taken in connection with the activities that require the banking entity to be registered, or to file notice, as such.[107] Similarly included is any covered financial position acquired or taken by a banking entity that is engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, if such position is acquired or taken in connection with the activities of such business.[108] As a result of this third prong, all covered financial positions acquired or taken by a registered dealer, swap dealer or security-based swap dealer, a government securities dealer that has filed notice with an appropriate regulatory agency, or a banking entity engaged in the same type of dealing activities outside the United States, are automatically included within the scope of positions described in the trading account definition, if they are acquired or taken in connection with the activities that require the banking entity to be registered, or file notice, as such (or, in the case of a banking entity engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States, in connection with the activities of such business). As discussed below, the proposed rule contains exemptions that permit a variety of covered trading activity in which these types of entities typically engage, notwithstanding the inclusion of all covered financial positions of such entities within the definition of trading account.

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

v. Rebuttable Presumption for Certain Positions

In order to provide greater clarity and guidance on the application of the trading account definition, and in particular for those banking entities with no experience in evaluating short-term trading intent or that are not subject to the Market Risk Capital Rules, the proposed rule also includes a rebuttable presumption regarding certain positions that, by reason of their holding period, are presumed to be trading account positions. In particular, § __.3(b)(2)(ii) of the proposed rule provides that an account would be presumed to be a trading account if it is used to acquire or take a covered financial position, other than dealing positions or certain Market Risk Capital Rules covered positions that are automatically considered part of the trading account, that the banking entity holds for a period of sixty days or less. However, the presumption does not apply if the banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.[109] Because it appears likely that most positions held for sixty days or less would have been acquired with short-term trading intent, the proposal presumes such positions are trading account positions unless the banking entity can demonstrate otherwise. The purpose of the proposed rebuttable presumption is to simplify the process of evaluating whether individual positions are included in the definition of trading account. The proposal does not apply this rebuttable presumption to positions described in § __.3(b)(2)(i)(B) or (C) of the proposed rule (i.e., certain Market Risk Capital Rules positions and dealing positions), because these positions are automatically part of the trading account, and cannot be rebutted.

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

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

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

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

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

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

transactions that clearly do not involve short-term trading, notwithstanding the typical holding period of the related positions.

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

vi. Request for Comment

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

Question 14. Is the proposed rule's definition of trading account effective? Is it over- or under-inclusive in this context? What alternative definition might be more effective in light of the language and purpose of the statute? How would such definition better identify the accounts that are intended to be covered by section 13 of the BHC Act?

Question 15. Is the proposed rule's approach for determining when a position falls within the definition of ''trading account'' for purposes of the proposed rule from when it must be reported in the ''trading account'' for purpose of filing the Call Report effective? What additional guidance could the Agencies provide on this distinction? Are there alternative approaches that would be more effective in light of the language and purpose of the statute? Is this approach workable for affiliates of bank holding companies that are not subject to the Federal banking agencies' market Risk Capital Rules (e.g., affiliated investment advisers)? If not, why not? Are affiliates of bank holding companies familiar with the concepts from the Market Risk Capital Rules that are being incorporated into the proposed rule? If not, what steps would an affiliate of a bank holding company have to take to become familiar with these concepts and what would be the costs and/or benefits of such actions? Is application of the trading account concept from the Federal banking agencies' Market Risk Capital Rules to affiliates of bank holding companies necessary to promote consistency and prevent regulatory arbitrage? Please explain.

Question 16. Is the manner in which the Agencies intend to take into account, and substantially adopt, the approach used in the Market Risk Capital Rules and related concepts for determining whether a position is acquired with short-term trading intent effective?

Question 17. Should the proposed rule's definition of trading account, or its use of the term ''short-term,'' be clarified? Are there particular transactions or positions to which its application would be unclear? Should the proposed rule define ''short-term'' for these purposes? What alternative approaches to construing the term ''short-term'' should the Agencies consider and/or adopt?

Question 18. Are there particular transactions or positions to which the application of the proposed definition of trading account is unclear? Is additional regulatory language, guidance, or clarity necessary?

Question 19. Is the exchange of variation margin as a potential indicator of short-term trading in derivative or commodity future transactions appropriate for the definition of trading account? How would this impact such transactions or the manner by which banking entities conduct such transactions? For instance, would banking entities seek to avoid the use of variation margin to avoid this rule? What are the costs and benefits of referring to the exchange of variation margin to determine if positions should be included in a banking entity's trading account? Please explain.

Question 20. Are there particular transactions or positions that are included in the definition of trading account that should not be? If so, what transactions or positions and why?

Question 21. Are there particular transactions or positions that are not included in the definition of trading account that should be? If so, what transactions or positions and why?

Question 22. Is the proposed rule of construction for positions acquired or taken by dealers, swap dealers and security-based swap dealers appropriate and consistent with the purpose and language of section 13 of the BHC Act? Is its application to any particular type of entity, such as an insured depository institution engaged in derivatives dealing activities, sufficiently clear and effective? If not, what alternative would be clearer and/or more effective?

Question 23. Is the rebuttable presumption included in the proposed rule appropriate and effective? Are there more effective ways in which to provide clarity regarding the determination of whether or not a position is included within the definition of trading account? If so, what are they?

Question 24. Are records currently created and retained that could be used to demonstrate investment or other non-trading purposes in connection with rebutting the presumption in the proposed rule? If yes, please identify such records and explain when they are created and whether they would be useful in connection with a single transaction or a category of similar transactions. If no, we seek commenter input regarding the manner in which banking entities might demonstrate investment or other non-trading intent. Should the Agencies require banking entities to make and keep records to demonstrate investment or non-trading intent with respect to their covered financial positions?

Question 25. How should the proposed trading account definition address arbitrage positions? Should all arbitrage positions be included in the definition of trading account, unless the timing of such profits is long-term and established at the time the arbitrage position is acquired or taken? Please explain in detail, including a discussion of different arbitrage trading strategies and whether subjecting such strategies to the proposed rule would be consistent with the language and purpose of section 13 of the BHC Act.

Question 26. Is the holding period referenced in the rebuttable presumption appropriate? If not, what holding period would be more appropriate, and why?

Question 27. Should the proposed rule include a rebuttable presumption regarding positions that are presumed *not* to be within the definition of trading account? If so, why, and what would the presumption be?

Question 28. Should any additional accounts be included in the proposed rule pursuant to the authority granted under section 13(h)(6) of the BHC Act? If so, what accounts and why? For example, should accounts used to acquire or take certain long-term positions be included in the definition? If so, how would subjecting such accounts to the proposed rule's prohibitions and restrictions be consistent with the language and purpose of section 13 of the BHC Act?

Question 29. Do any of the activities currently engaged in by issuers of asset-backed securities that would be considered a banking entity constitute proprietary trading as defined by § __.3(b) of this rule proposal? Would any activities relating to investment of funds in accounts held by issuers of asset-backed securities (e.g., reserve accounts, prefunding accounts, reinvestment accounts, etc.) or the purchase and sale of securities as part of the management of a collateralized debt obligation portfolio be considered proprietary trading under the proposed rule? What would be the potential impact of the prohibition on proprietary trading on the use of such accounts in (i) existing securitization transactions and (ii) future securitization transactions? Would any of the securities typically acquired and retained using these accounts be considered an ownership interest in a covered fund under the proposed rule? Does the exclusion of trading in certain government obligations in § __.6(a) of the proposed rule mitigate the impact of the proposed rule on such issuers of asset-backed securities and their activities? Why or why not?

c. Excluded Positions

i. Excluded Positions Under Certain Repurchase and Reverse Repurchase Arrangements

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

ii. Excluded Positions Under Securities Lending Transactions

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

iii. Excluded Positions Acquired or Taken for Liquidity Management Purposes

Section ____.3(b)(2)(iii)(C) of the proposed definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take a position for the purpose of *bona fide* liquidity management, so long as important criteria are met.[113]

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

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

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

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

[113] *See* proposed rule § ____.3(b)(2)(iii)(C).

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

iv. Excluded Positions of Derivatives Clearing Organizations and Clearing Agencies

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

v. Request for Comment

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

Question 30. Are the proposed clarifying exclusions for positions under certain repurchase and reverse repurchase arrangements and securities lending transactions over- or under-inclusive and could they have unintended consequences? Is there an alternative approach to these clarifying exclusions that would be more effective? Are the proposed clarifying exclusions broad enough to include *bona fide* arrangements that operate in economic substance as secured loans and are not based on expected or anticipated movements in asset prices? Are there other types of arrangements, such as open dated repurchase arrangements, that should be excluded for clarity and, if so, how should the proposed rule be revised? Alternatively, are the proposed clarifying exclusions narrow enough to not inadvertently exclude from coverage any similar arrangements or transactions that do not have these characteristics?

Question 31. Are repurchase and reverse repurchase arrangements and securities lending transactions sufficiently similar that they should be treated in the same way for purposes of the proposed rule? Are there aspects of repurchase and reverse repurchase arrangements or securities lending transactions that should be highlighted in considering the application of the proposed rule? Do repurchase and reverse repurchase arrangements or securities lending transactions raise any additional or heightened concerns regarding risk? Please identify and explain how these concerns should be reflected in the proposed rule.

Question 32. Are the proposed exclusions for repurchase and reverse repurchase arrangements and securities lending transactions appropriate or are there conditions that commenters believe would be appropriate as a pre-requisite to relying on these exclusions? Please identify such conditions and explain. Alternatively, we seek commenter input regarding why repurchase and reverse repurchase arrangements and securities lending transactions do not present the potential for abuse, namely, that a banking entity might attempt to improperly mischaracterize prohibited proprietary trading as activity that qualifies for the proposed exclusions.

Question 33. Is the proposed clarifying exclusion for liquidity management transactions effective and appropriate? If not, what alternative would be more effective and appropriate, and why? Is the proposed exclusion under- or over-inclusive? Does the proposed clarifying exclusion place sufficient limitations on liquidity management transactions to prevent abuse of the clarifying exclusion? If not, what additional limitations should be specified? Are any of the limitations contained in the proposed rule inappropriate or unnecessary? If so, how could such limitations be eliminated or altered in way that does not permit abuse of the clarifying exclusion?

Question 34: Is the proposed exclusion for liquidity management positions necessary? If not excluded, would such activity otherwise qualify for an exemption contained in the proposed rule (e.g., the exemptions contains in §§ ____.5 and ____.6(a) of the proposed rule)? What types of banking entities are likely to engage in the liquidity management activities described in the proposed exclusion?

Question 35: What types of instruments do particular types of banking entities currently use in connection with liquidity management activities (e.g., Treasuries)? Why are such instruments chosen for liquidity management purposes? Would such instruments meet the proposed requirement that the position be highly liquid and limited to financial instruments the market, credit and other risk of which are not expected to give rise to appreciable profits or losses as a result of short-term price movements? Why or why not?

Question 36: What methodologies do banking entities currently use for estimating deviations from normal operations in connection with liquidity management programs?

Question 37: Which unit or units within a banking entity are typically responsible for liquidity management? What is the typical reporting line structure used to control and supervise that unit or units? Are the responsibilities of personnel in the unit limited to liquidity management or do they perform other functions in addition to liquidity management? How is compensation determined for personnel in the unit of the banking entity responsible for liquidity management?

Question 38: Would current liquidity management programs meet the five proposed criteria for liquidity management programs? If not which criteria would not be met, and why? What effect would the proposed liquidity management exclusions have on current liquidity management programs and banking entities in general?

Question 39: Are liquidity management programs used for purposes other than ensuring the banking entity has sufficient assets available to it that are readily marketable to meet expected short-term liquidity needs? If so, for what purposes, and why?

Question 40: What costs or other burdens would arise if the proposal did not contain an exclusion for positions acquired or taken for liquidity management purpose? Please explain and quantify these costs or other burdens in detail.

Question 41: Is the proposed liquidity management exclusion sufficiently clear? If not, why is the exclusion unclear and how should the Agencies clarify the terms of this exclusion?

Question 42. Is the proposed clarifying exclusion for certain positions taken by derivatives clearing organizations and clearing agencies effective and appropriate? If not, what alternative would be more effective and appropriate, and why?

Question 43. Are any additional clarifying exclusions warranted? If so, what clarifying exclusion, and why?

[115] *See* proposed rule § ____.3(b)(2)(iii)(D).

Question 44. Should the proposed definition exclude any position the market risk of which cannot be hedged by the banking entity in a two-way market?[116] If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account?

Question 45. Should the proposed definition include a clarifying exclusion for any position in illiquid assets? If so, what would be the basis for concluding that such positions are clearly not within the statutory definition of trading account? How should ''illiquid assets'' be defined for these purposes? Should the definition be consistent with the definition given that term in the Board's Conformance Rule under section 13 of the BHC Act (12 CFR 225.180 et seq.)? [117]

d. Covered Financial Position

i. Definition of ''Covered Financial Position''

Section __.3(b)(3)(i) of the proposed rule defines a covered financial position as any long, short, synthetic or other position[118] in: (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. The types of financial instruments described in the proposed definition are consistent with those referenced in section 13(h)(4) of the BHC Act as part of the statutory definition of proprietary trading.[119]

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

Question 46. Is the proposed rule's definition of covered financial position effective? Is the definition over- or under-inclusive? What alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act, and why?

Question 47. Are there definitions in other rules or regulations that might inform the proposed definition of covered financial position? If so, what rule or regulation? How should that approach be incorporated into the proposed definition? Why would that approach be more appropriate?

Question 48. Are there particular transactions or positions to which the application of the proposed definition of covered financial position is unclear? Is additional regulatory language, guidance, or clarity necessary?

Question 49. The proposal would apply to long, short, synthetic, or other positions in one of the listed categories of financial instruments. Does this language adequately describe the type of positions that are intended to fall within the proposed definition of covered financial position? If not, why not? Are there different or additional concepts that should be specified in this context? Please explain.

Question 50. Should the Agencies expand the scope of covered financial positions to include other transactions, such as spot commodities or foreign exchange or currency, or certain subsets of transaction (e.g., spot commodities or foreign exchange or currency traded on a high-frequency basis)? If so, which instruments and why?

Question 51. What factors should the Agencies consider in deciding whether to extend the scope of the proprietary trading restriction to other financial instruments under the authority granted in section 13(h)(4) of the BHC Act? Please explain.

Question 52. Is the proposed exclusion of any position that is a loan, a commodity, or foreign exchange or currency effective? If not, what alternative approaches might be more effective in light of the language and purpose of section 13 of the BHC Act? Should additional positions be excluded? If so, why and under what authority?

ii. Other Terms Used in the Definition of Covered Financial Position

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

The proposed rule also defines the term ''derivative.'' [124] In particular, the

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

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

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

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

[120] *See* proposed rule § ____.3(b)(ii).

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

[122] *See* proposed rule § ____.2(w).

[123] *See* proposed rule §§ ____.3(c)(1), (2).

[124] *See* proposed rule § ____.2(l).

definition of ''derivative'' under the proposed rule includes any ''swap'' (as that term is defined in the Commodity Exchange Act) and any ''security-based swap'' (as that term is defined in the Exchange Act), in each case as further defined by the CFTC and SEC by joint regulation, interpretation, guidance, or other action, in consultation with the Board pursuant to section 712(d) of the Dodd-Frank Act. The Agencies have proposed to incorporate these definitions of ''swap'' and ''security-based swap'' under the Federal securities and commodities laws because those definitions: (i) Govern the primary Federal regulatory scheme applicable to exchange-traded and over-the-counter derivatives; (ii) will be frequently evaluated and applied by banking entities in the course of their trading activities; and (iii) capture agreements and contracts that are or function as derivatives.[125] The proposed rule also includes within the definition of derivative certain other transactions that, although not included within the definition of ''swap'' or ''security-based swap,'' also appear to be, or operate in economic substance as, derivatives, and which if not included could permit banking entities to engage in proprietary trading that is inconsistent with the spirit of section 13 of the BHC Act. Specifically, the proposed definition of derivative also includes: (i) Any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled; (ii) any foreign exchange forward or foreign exchange swap (as those terms are defined in the Commodity Exchange Act); [126] (iii) any agreement, contract, or transaction in foreign currency described in section 2(c)(2)(C)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(C)(i)); [127] (iv) any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and (v) any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b)). The Agencies are requesting comment on whether including these five types of transactions within the proposed definition of derivative is appropriate.

To provide additional clarity, the proposed definition of derivative also clarifies two types of transactions that are outside the scope of the definition. First, the proposed definition of derivative would not include any consumer, commercial, or other agreement, contract, or transaction that the CFTC and SEC have further defined by joint regulation, interpretation, guidance, or other action as not within the definition of swap, as that term is defined in the Commodity Exchange Act, or security-based swap, as that term is defined in the Exchange Act. The SEC and CFTC have, in proposing rules further defining the terms ''swap'' and ''security-based swap,'' proposed to not include a variety of agreements, contracts, and transactions within those definitions by joint regulation or interpretation, and the Agencies have proposed to expressly reflect such exclusions in the proposed rule's definition in order to avoid the potential application of its restrictions to transactions that are not commonly thought to be derivatives.[128] Second, the proposed definition of derivative also does not include any identified banking product, as defined in section 402(b) of the Legal Certainty for Bank Products Act of 2000 (7 U.S.C. 27(b)), that is subject to section 403(a) of that Act (7 U.S.C. 27a(a)). This provision is proposed to clearly exclude identified banking products that are expressly excluded (i) from the definition of ''security-based swap'' and (ii) from Commodity Exchange Act and CFTC jurisdiction pursuant to section 403(a) of the Legal Certainty for Bank Products Act of 2000.[129]

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

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

Question 53. Are the proposed rule's definitions of commodity and contract of sale of a commodity for future delivery appropriate? If not, what

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

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

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

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

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

[130] *See* proposed rule § ____.2(q).

alternative definitions would be more appropriate?

Question 54. Is the proposed definition of derivative effective? If not, what alternative definition would be more effective? Should the proposed rule expressly incorporate the definition of ''swap'' and security-based swap'' under the Federal commodities and securities laws? If not, what alternative approach should be taken? Are there transactions included in those incorporated definitions that should not be included in the proposed rule's definition? If so, what transactions and why? Are there transactions excluded from those incorporated definitions that should be included within the proposed rule's definition? If so, what transactions and why?

Question 55. Is the proposed inclusion of foreign exchange forwards and swaps in the definition of derivative effective? If not, why not? On what basis would the Agencies conclude that such transactions are not derivatives? Are these transactions economically or functionally more similar to secured loans or repurchase arrangements than to commodity forwards and swaps? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative? What effect is including foreign exchange swaps and forwards in the definition of derivative likely to have on banking entities, participants in the foreign exchange markets, and the liquidity and efficiency of foreign exchange markets generally? If included within the definition of derivative, should transactions in foreign exchange swaps and forwards be permitted under section 13(d)(1)(J) of the BHC Act? If so, why and on what basis? Please quantify your responses, to the extent feasible.

Question 56. Is the proposed inclusion of any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question 57. Is the proposed inclusion of foreign currency transactions described in section 2(c)(2)(C)(i) of the Commodity Exchange Act in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question 58. Is the proposed inclusion of commodity transactions described in section 2(c)(2)(D)(i) of the Commodity Exchange Act in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question 59. Is the proposed inclusion of any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b)) in the definition of derivative effective? If not, why not? Would there be any unintended consequences to banking entities if such transactions are included in the proposal's definition of derivative?

Question 60. Is the manner in which the proposed definition of derivative excludes any transaction that the CFTC or SEC exclude by joint regulation, interpretation, guidance, or other action from the definition of ''swap'' or ''security-based swap'' effective? If not, what alternative approach would be more appropriate? Should such exclusions be restated in the proposed rule's definition? If so, why?

Question 61. Is the proposed rule's definition of loan appropriate? If not, what alternative definition would be more appropriate? Should the definition of ''loan'' exclude a security? Should other types of traditional banking products be included in the definition of ''loan''? If so, why?

iii. Definition of Other Terms Related to Proprietary Trading

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

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

Question 62. Are the proposed rule's definitions of other terms in § __.3(d) appropriate? If not, what alternative definitions would be more appropriate?

Question 63. Is the definition of additional terms for purposes of subpart B of the proposed rule necessary? If so, what terms should be defined? How should those terms be defined?

2. Section __.4: Permitted Underwriting and Market Making-Related Activities

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

a. Permitted Underwriting Activities

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

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

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

Third, the transaction must be effected solely in connection with a distribution of securities for which the banking entity is acting as an underwriter. This prong is intended to give effect to the essential element of the underwriting exemption—i.e., that the transaction be in connection with underwriting activity. For these purposes, the proposed rule defines both (i) a distribution of securities and (ii) an underwriter. The definitions of these terms are generally identical to the

[131] *See* 12 U.S.C. 1851(d)(1)(B).

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

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

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

The definition of ''underwriter'' in the proposed rule is generally similar to that under the SEC's Regulation M, except that the proposed rule's definition would also include, within that definition, a person who has an agreement with another underwriter to engage in a distribution of securities for or on behalf of an issuer or selling security holder.[138] Consistent with current practices and the Council study, the Agencies propose to take into consideration the extent to which the banking entity is engaged in the following activities when determining whether a banking entity is acting as an underwriter as part of a distribution of securities:

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

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

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

Fourth, to the extent that the transaction involves a security for which a person must generally be a registered securities dealer, municipal securities dealer or government securities dealer in order to underwrite the security, the banking entity must have the appropriate dealer registration (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act) or otherwise be exempt from registration or excluded from regulation as a dealer.[140] Similarly, if the banking entity is engaged in the business of a dealer outside the United States in a manner for which no U.S. registration is required, the banking entity must be subject to substantive regulation of its dealing business in the jurisdiction in which the business is located. This requirement is intended to ensure that (i) any underwriting activity conducted in reliance on the exemption is subject to appropriate regulation and (ii) banking entities are not simultaneously characterizing the transaction as underwriting for purposes of the exemption while characterizing it in a different manner for purposes of applicable securities laws.

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

Sixth, the underwriting activities of the banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, and not from appreciation in the value of covered financial positions it holds related to such activities or the hedging of such covered financial position.[142] This requirement

[133] 17 CFR 242.100 *et seq.*

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

[135] 17 CFR 242.100.

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

[137] *See* Regulation M Concept Release, 59 FR at 21684–85.

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

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

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

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

[142] For these purposes, underwriting spreads would include any ''gross spread'' (i.e., the

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is intended to ensure that activities conducted in reliance on the underwriting exemption demonstrate patterns of revenue generation and profitability consistent with, and related to, the services an underwriter provides to its customers in bringing securities to market, rather than changes in the market value of the securities underwritten.

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

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

Question 64. Is the proposed rule's implementation of the underwriting exemption effective? If not, what alternative approach would be more effective? For example, should the exemption include other transactions that do not involve a distribution of securities for which the banking entity is acting as underwriter?

Question 65. Are the seven requirements included in the underwriting exemption effective? Is the application of each requirement to potential transactions sufficiently clear? Should any of the requirements be changed or eliminated? Should other requirements be added in order to better provide an exemption that is not susceptible to abuse through the taking of speculative, proprietary positions in the context of, or mischaracterized as, underwriting? Alternatively, are any of the proposed requirements inappropriately restrictive in that they would be inconsistent with the statutory exemption for certain underwriting activities? If so, how?

Question 66. Do underwriters currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, underwriting? If so, what are those processes?

Question 67. Would any of the proposed requirements cause unintended consequences? Would the proposed requirements alter current underwriting practices in any way? Would any of the proposed requirements trigger an unwillingness to engage in underwriting? What impact, if any, would the proposed exemption have on capital raising? Please explain.

Question 68. What increased costs, if any, would underwriters incur to satisfy the seven proposed requirements of the underwriting exemption? Would underwriters pass the increased costs onto issuers, selling security holders, or their customers in connection with qualifying for the proposed exemption?

Question 69. In addition to the specific activities highlighted above for purposes of evaluating whether a banking entity is acting as an underwriter as part of distribution of securities (e.g., assisting an issuer in capital raising, performing due diligence, etc), are there other or alternative activities that should be considered? Please explain.

Question 70. Should the requirement that a covered financial position be a security be expanded to include other financial instruments? If so, why? How are such other instruments underwritten within the meaning of section 13(d)(1)(B) of the BHC Act?

Question 71. Is the proposed definition of a ''distribution'' of securities appropriate, or over- or under-inclusive in this context? Is there any category of underwriting activity that would not be captured by the proposed definition? If so, what are the mechanics of that underwriting activity? Should it be permitted under the proposed rule, and, if so, why? Would an alternative definition better identify offerings intended to be covered by the proposed definition? If so, what alternative definition, and why?

Question 72. Is the proposed definition of ''underwriter'' appropriate, or over- or under-inclusive in this context? Would an alternative definition, such as the statutory definition of ''underwriter'' under the Securities Act, better identify persons intended to be covered by the proposed definition? If so, why?

Question 73. How accurately can a banking entity engaging in underwriting predict the near-term demands of clients, customers, and counterparties with respect to an offering? How can principal risk that is retained in connection with underwriting activities to support near-term client demand be distinguished from positions taken for speculative purposes?

Question 74. Is the requirement that the underwriting activities of a banking entity relying on the underwriting exemption be designed to generate revenues primarily from fees, commissions, underwriting spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by underwriting activities? Is any further clarification or additional guidance necessary?

Question 75. Is the requirement that the compensation arrangements of persons performing underwriting activities at a banking entity be designed not to reward proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted underwriting activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question 76. Are there other types of underwriting activities that should also be included within the scope of the underwriting exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and purpose of section 13 of the BHC Act? What criteria, requirements, or restrictions would be appropriate to include with respect to such additional activities to prevent misuse or evasion of the prohibition on proprietary trading?

Question 77. Does the proposed underwriting exemption appropriately accommodate private placements? If not, what changes are necessary to do so?

Question 78. The creation, offer and sale of certain structured securities such as trust preferred securities or tender option bonds, among others, may involve the purchase of another security and repackaging of that security through an intermediate entity. Should the sale of the security by a banking entity to an intermediate entity as part of the creation of the structured security be

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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.

permitted under one of the exemptions to the prohibition on proprietary trading currently included in the proposed rule (e.g., underwriting or market making)? Why or why not? For purposes of determining whether an exemption is available under these circumstances, should gain on sale resulting from the sale of the purchased security to the intermediate entity as part of the creation of the structured security be considered a relevant factor? Why or why not? What other factors should be considered in connection with the creation of the structured securities and why? Would the analysis be different if the banking entity acquired and retained the security to be sold to the intermediate entity as part of the creation of the structured securities as part of its underwriting of the underlying security? Why or why not?

Question 79. We seek comment on the application of the proposed exemption to a banking entity retaining a portion of an underwriting. Please discuss whether or not firms frequently retain securities in connection with a distribution in which the firm is acting as underwriter. Please identify the types of offerings in which this may be done (e.g., fixed income offerings, securitized products, etc.). Please identify and discuss any circumstances which can contribute to the decision regarding whether or not to retain a portion of an offering. Please describe the treatment of retained securities (e.g., the time period of retention, the type of account in which securities are retained, the potential disposition of the securities). Please discuss whether or not the retention is documented and, if so, how. Should the Agencies require disclosure of securities retained in connection with underwritings? Should the Agencies require specific documentation to demonstrate that the retained portion is connected to an underwriting pursuant to the proposed rule? If so, what kind of documentation should be required? Please discuss how you believe retention should be addressed under the proposal.

b. Permitted Market Making-Related Activities

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

i. Approach to Implementing the Exemption for Market Making-Related Activities.

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

In order to address these complexities, the Agencies have proposed a multi-faceted approach that draws on several key elements. First, similar to the underwriting exemption, the proposed rule includes a number of criteria that a banking entity's activities must meet in order to rely on the exemption for market making-related activities. These criteria are intended to ensure that the banking entity is engaged in *bona fide* market making. As described in greater detail in Part III.D of the Supplementary Information, among these criteria is the requirement that the banking entity have in place a programmatic compliance regime to guide its compliance with section 13 of the BHC Act and the proposed rule. This compliance regime includes requirements that a banking entity have effective policies, procedures, and internal controls that are designed to ensure that prohibited proprietary trading positions are not taken under the guise of permitted market making-related activity. Second, as described in greater detail in Part III.B.5 of this Supplementary Information, Appendix B of the proposed rule contains a detailed commentary regarding how the Agencies propose to identify permitted market making-related activities. This commentary includes six principles the Agencies propose to use as a guide to help distinguish market-making related activities from prohibited proprietary trading. Third, also as described in greater detail in Part III.B.5 of this Supplementary Information, § __.7 and Appendix A of the proposed rule require a banking entity with significant covered trading activities to report certain quantitative measurements for each of its trading units.[145] These quantitative measurements are intended to assist both banking entities and the Agencies in assessing whether the quantitative profile of a trading unit (e.g., the types of revenues it generates and the risks it retains) is consistent with permitted market making-related activities under the proposed rule.

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

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

Question 80. Is the proposed rule's approach to implementing the exemption for permitted market making-related activities (i) appropriate and (ii) likely to be effective? If not, what

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

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

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

alternative approach would be more appropriate or effective?

Question 81. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted market making-related activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 82. Does the proposed multi-faceted approach provide banking entities and market participants with sufficient clarity regarding what constitutes permitted market making-related activities? If not, how could greater clarity be provided?

Question 83. What impact will the proposed multi-faceted approach have on the market making-related services that a banking entity provides to its customers? How will the proposed approach impact market participants who use the services of market makers? How will the approach impact the capital markets at large, and in particular the liquidity, efficiency and price transparency of capital markets? If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated? Would the proposed rule's prohibition on proprietary trading and exemption for market making-related activity reduce incentives or opportunities for banking entities to trade against customers, as opposed to trading on behalf of customers? If so, please discuss the benefits arising from such reduced incentives or opportunities.

Question 84. What burden will the proposed multi-faceted approach have on banking entities, their customers, and other market participants? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question 85. Are there particular asset classes that raise special concerns in the context of market making-related activity that should be considered in connection with the proposed market-making exemption? If so, what asset class(es) and concern(s), and how should the concerns be addressed in the proposed exemption?

Question 86. Are there other market making-related activities that the rule text should more clearly permit? Why or why not?

ii. Required Criteria for Permitted Market Making-Related Activities

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

First Criterion—Establishment of Internal Compliance Program

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

Second Criterion—Bona Fide Market Making

Section __.4(b)(2)(ii) of the proposed rule articulates the core element of the statutory exemption, which is that the activity must be market making-related. In order to give effect to this requirement, § ____.4(b)(2)(ii) of the proposed rule requires the trading desk or other organizational unit that purchases or sells a particular covered financial position to hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the covered financial position for its own account on a regular or continuous basis. Notably, this criterion requires that a banking entity relying on the exemption with respect to a particular transaction must actually make a market in the covered financial position involved; simply because a banking entity makes a market in one type of covered financial position does not permit it to rely on the market-making exemption for another type of covered financial position.[146] Similarly, the particular trading desk or other organizational unit of the banking entity that is relying on the exemption for a particular type of covered financial position must also be the trading desk or other organizational unit that is actually making the market in that covered financial position; market making in a particular covered financial position by one trading desk of a banking entity does not permit another trading desk of the banking entity to rely on the market-making exemption for that type of covered financial position.

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

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

- Making continuous, two sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- A pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;

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

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

• Making continuous quotations that are at or near the market on both sides; and

• Providing widely accessible and broadly disseminated quotes.[148]

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

• Holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis;[149]

• With respect to securities, regularly purchasing covered financial positions from, or selling the positions to, clients, customers, or counterparties in the secondary market; and

• Transaction volumes and risk proportionate to historical customer liquidity and investments needs.[150]

The Agencies would apply these indicia when evaluating when a banking entity is eligible for the market making-related activities exemption, but also recognize that these indicia cannot be applied at all times and under all circumstances because some may be inapplicable to the specific asset class or market in which the market making activity is conducted.

The *bona fide* market making-related activity described in § __.4(b)(2)(ii) of the proposed rule would include block positioning if undertaken by a trading desk or other organizational unit of a banking entity for the purpose of intermediating customer trading.[151] In addition, *bona fide* market making-related activity may include taking positions in securities in anticipation of customer demand, so long as any anticipatory buying or selling activity is reasonable and related to clear, demonstrable trading interest of clients, customers, or counterparties.

Third Criterion—Reasonably Expected Near-Term Demands of Clients, Customers, and Counterparties

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

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

[148] The Agencies note that these indicia are generally consistent with the indicia of *bona fide* market making in equity markets articulated by the SEC for purposes of describing the exception to the locate requirement of the SEC's Regulation SHO for market makers engaged in *bona fide* market-making activities. *See* Exchange Act Release No. 58775 (October 14, 2008), 73 FR 61690, 61698–61699 (Oct. 17, 2008); *see also* 17 CFR 242.203(b)(2)(iii).

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

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

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

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

Fourth Criterion—Registration Under Securities or Commodities Laws

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

Fifth Criterion—Revenues From Fees, Commissions, Bid/Ask Spreads or Other Similar Income

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

Sixth Criterion—Compensation Incentives

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

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

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

[154] *See* proposed rule §§ __.4(b)(2)(iv)(B), (C). 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. *See* 15 U.S.C. 78c(a)(5) (the definition of "dealer" in section 3(a)(5) of the Exchange Act, 15 U.S.C. 78c(a)(5), 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.").

Seventh Criterion—Consistency With Appendix B Commentary

Under § __.4(b)(2)(vi) of the proposed rule, the market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are required to be consistent with the commentary provided in Appendix B, which provides guidance that the Agencies propose to apply to help distinguish permitted market making-related activities from prohibited proprietary trading. Appendix B's proposed commentary, which is described in detail below in Part III.B.5 of this Supplementary Information, discusses various factors by which the Agencies propose to distinguish prohibited proprietary trading from permitted market making-related activities (e.g., how and to what extent a market maker hedges the risk of its market-making transactions, including (i) further detail related directly to other criteria in § __.4(b)(2) (e.g., the types of revenues generated by market makers), and (ii) expectations regarding other factors not expressly included in § __.4(b)(2)).

B. Market Making-Related Hedging

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

iii. Request for Comment

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

Question 87. Are the seven criteria included in the market-making exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other criteria be added?

Question 88. Is incorporation of concepts from the definition of ''market maker'' under the Exchange Act useful for purposes of section 13 of the BHC Act and consistent with its purposes? If not, what alternative definition would be more useful or more consistent?

Question 89. Is the proposed exemption overly broad or narrow? For example, would it encompass activity that should be considered prohibited proprietary trading under the proposed rule? Alternatively, would it prohibit forms of market making or market making-related activities that are permitted under other rules or regulations?

Question 90. We seek commenter input on the types of banking entities and forms of activities that would not qualify for the proposed market-making exemption but that commenters consider to otherwise be market making. Please discuss the impact of not permitting such activities under the proposed exemption (e.g., the impact on liquidity).

Question 91. Is the requirement that a trading desk or other organizational unit relying on the market-making exemption hold itself out as being willing to buy and sell, or otherwise enter into long and short positions in, the relevant covered financial position for its own account on a regular or continuous basis effective? If not, what alternative would be more effective? Does the proposed requirement appropriately differentiate between market making-related activities in different markets and asset classes? If not, how could such differences be better reflected? Should the requirement be modified to include certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency, but do not serve customer, client or counterparty demands, within the scope of market making-related activity? If so why? How could such liquidity- or price transparency-promoting activities be meaningfully identified and distinguished from prohibited proprietary trading practices that also may incidentally promote liquidity or price transparency? Do particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed in the proposal? If so, how could the proposal better address those instruments, markets or market features?

Question 92. Do the proposed indicia of market making in liquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included? Is reliance on the SEC's indicia of *bona fide* market making for purposes of Regulation SHO under the Exchange Act and the equity securities market appropriate in the context of section 13 of the BHC Act and the proposed rule with respect to liquid markets? If not, why not?

Question 93. Do the proposed indicia of market making in illiquid markets accurately reflect the factors that should generally be used to analyze whether a banking entity is engaged in market making-related activities for purposes of section 13 of the BHC Act and the proposed rule? If not, why not? Should any of the proposed factors be eliminated or modified? Should any additional factors be included?

Question 94. How accurately can a banking entity predict the near-term demands of clients, customers, and counterparties? Are there measures that can distinguish the amount of principal risk that should be retained to support such near-term client, customer, or counterparty demand from positions taken for speculative purposes? How is client, customer, or counterparty demand anticipated in connection with market making-related activities, and how does such approach vary by asset class?

Question 95. Is the requirement that a banking entity relying on the market-making exemption be registered as a dealer (or in the case of a financial institution that is a government securities dealer, has filed notice of that status as required by section 15C(a)(1)(B) of the Exchange Act), or exempt from registration or excluded from regulation as a dealer under relevant securities or commodities laws effective? If not, how should the requirement be changed? Does the requirement appropriately take into account the particular registration requirements applicable to dealing in different types of financial instruments? If not, how could it better do so? Does the requirement appropriately take into account the various registration exemptions and exclusions available to certain entities, such as banks, under the securities and commodities laws? If not, how could it better do so?

Question 96. Is the requirement that a trading desk or other organizational unit of a banking entity relying on the market-making exemption be designed to generate revenues primarily from fees, commissions, bid/ask spreads or similar income effective? If not, how should the requirement be changed? Does the requirement appropriately capture the type and nature of revenues typically generated by market making-related activities? Is any further clarification or additional guidance necessary? Can revenues primarily from fees, commissions, bid/ask spreads or similar income be meaningfully separated from other types of revenues?

Question 97. Is the requirement that the compensation arrangements of persons performing market making-related activities at a banking entity not be designed to encourage proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted market making-related activity? Are their specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question 98. Is the inclusion of market making-related hedging transactions within the market-making exemption effective and appropriate? Are the proposed requirements that certain hedging transactions must meet in order to be considered to have been made in connection with market making-related activity effective and sufficiently clear? If not, what alternative requirements would be more effective and/or clearer? Should any of the proposed requirements be eliminated? If so, which ones, and why?

Question 99. 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?

Question 100. Are there other types of market making-related activities that should also be included within the scope of the market-making exemption? If so, what additional activities and why? How would an exemption for such additional activities be consistent with the language and intent of section 13 of the BHC Act? What criteria, requirements, or restrictions would be appropriate to include with respect to such additional activities? How would such criteria, requirements, or restrictions prevent circumvention or evasion of the prohibition on proprietary trading?

Question 101. Do banking entities currently have processes in place that would prevent or reduce the likelihood of taking speculative, proprietary positions in the context of, or mischaracterized as, market making-related activities? If so, what processes?

3. Section __.5: Permitted Risk-Mitigating Hedging Activities

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

a. Approach to Implementing the Hedging Exemption

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

In light of these complexities, the Agencies have again proposed a multi-faceted approach to implementation. As with the underwriting and market-making exemptions, the Agencies have proposed a set of criteria that must be met in order for a banking entity to rely on the hedging exemption. The proposed criteria are intended to define the scope of permitted risk-mitigating hedging activities and to foreclose reliance on the exemption for prohibited proprietary trading that is conducted in the context of, or mischaracterized as, permitted hedging activity. This includes implementation of the programmatic compliance regime required under subpart D of the proposed rule and, in particular, requires that a banking entity with significant trading activities implement robust, detailed hedging policies and procedures and related internal controls that are designed to prevent prohibited proprietary trading in the context of permitted hedging activity.[155] In particular, a banking entity's compliance regime must include written hedging policies at the trading unit level and clearly articulated trader mandates for each trader to ensure that the decision of when and how to put on a hedge is consistent with such policies and mandates, and not fully left to a trader's discretion.[156] In addition, to address potential supervisory concerns raised by certain types of hedging transactions, § __.5 of the proposed rule also requires a banking entity to document certain hedging transactions at the time the hedge is established. This multi-faceted approach is intended to articulate the Agencies' expectations regarding the scope of permitted risk-

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

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

mitigating hedging activities in a manner that limits potential abuse of the hedging exemption while not unduly constraining the important risk management function that is served by a banking entity's hedging activities.

b. Required Criteria for Permitted Risk-Mitigating Hedging Activitiesm

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

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

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

In addition, this criterion would include a series of hedging transactions designed to hedge movements in the price of a portfolio of positions. For example, a banking entity may need to engage in dynamic hedging, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other holdings. The Agencies recognize that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions.[157]

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

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

Fifth, § __.5(b)(2)(iv) of the proposed rule requires that the hedging transaction not give rise, at the

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

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

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

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

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

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

c. Documentation Requirement

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

d. Request for Comment

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

Question 102. Is the proposed rule's approach to implementing the hedging exemption effective? If not, what alternative approach would be more effective?

Question 103. Does the proposed multi-faceted approach appropriately take into account and address the challenges associated with differentiating prohibited proprietary trading from permitted hedging activities? Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 104. Does the proposed approach to implementing the hedging exemption provide banking entities and market participants with sufficient clarity regarding what constitutes permitted hedging activities? If not, how could greater clarity be provided?

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

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

Question 105. What impact will the proposed approach to implementing the hedging exemption have on the hedging and risk management activities of a banking entity and the services it provide to its clients? If any of these impacts are positive, how can they be amplified? If any of these impacts are negative, how can they be mitigated?

Question 106. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question 107. Are the criteria included in the hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?

Question 108. Is the requirement that a transaction hedge or otherwise mitigate one or more specific risks, including market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity effective? If not, what requirement would be more effective? Does the proposed approach sufficiently articulate the types of risks that a banking entity typically hedges? Does the proposal sufficiently address application of the hedging exemption to portfolio hedging strategies? If not, how should the proposal be changed?

Question 109. Does the manner in which section __.5 of the proposal would implement the risk-mitigating hedging exemption effectively address transactions that hedge or otherwise mitigate specific risks arising in connection with and related to *aggregated* positions, contracts, or other holdings of a banking entity? Do certain hedging strategies or techniques that involve hedging the risks of aggregated positions (e.g., portfolio hedging) (i) create the potential for abuse of the hedging exemption or (ii) give rise to challenges in determining whether a banking entity is engaged in exempt, risk-mitigating hedging activity or prohibited proprietary trading? If so, what hedging strategies and techniques, and how? Should additional restrictions, conditions, or requirements be placed on the use of the hedging exemption with respect to aggregated positions so as to limit potential abuse of the exemption, assist banking entities and the Agencies in determining compliance with the exemption, or otherwise improve the effectiveness of the rule? If so, what additional restrictions, conditions, or requirements, and why?

Question 110. Is the requirement that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge or otherwise mitigate effective? If not, how should the requirement be changed? Should some specific level of correlation and/or hedge effectiveness be required? Should the proposal specify in greater detail how correlation should be measured? Should the proposal require hedges to be effective in periods of financial stress? Does the proposal sufficiently reflect differences in levels of correlation among asset classes? If not, how could it better do so?

Question 111. Is the requirement that the transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction effective? Does the requirement establish an appropriate range for legitimate hedging while constraining impermissible proprietary trading? Is this requirement sufficiently clear? If not, what alternative would be more effective and/or clearer? Are there types of risk-mitigating hedging activities that may give rise to new and significant exposures that should be permitted under the hedging exemption? If so, what activities? Should the requirement that no significant exposure be introduced be extended for the duration of the hedging position? If so, why?

Question 112. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?

Question 113. Is the requirement that the compensation arrangements of persons performing risk-mitigating hedging activities at a banking entity be designed not to reward proprietary risk-taking effective? If not, how should the requirement be changed? Are there other types of compensation incentives that should be clearly referenced as consistent, or inconsistent, with permitted risk-mitigating hedging activity? Are there specific and identifiable characteristics of compensation arrangements that clearly incentivize prohibited proprietary trading?

Question 114. Is the proposed documentation requirement effective? If not, what alternative would be more effective? Are there certain additional types of hedging transactions that should be subject to the documentation requirement? If so, what transactions and why? Should all types of hedging transactions be subject to the documentation requirement? If so, why? Should banking entities be required to document more aspects of a particular transactions (e.g., all of the criteria applicable to § __.5(b) of the proposed rule)? If so, what aspects and why? What burden would the proposed documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

Question 115. Aside from the required documentation, do the substantive requirements of the proposed risk-mitigating hedging exemption suggest that additional documentation would be required to achieve compliance with the proposed rule? If so, what burden would this additional documentation requirement place on banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

4. Section __.6: Other Permitted Trading Activities

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

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

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

request comment on the following questions:

Question 116. Is the proposed rule's approach of identifying which of the statutory exemptions contained in section 13(d)(1) of the BHC Act apply to the proposed rule's proprietary trading provisions effective and/or consistent with the language and purpose of the statute? If not, what alternative would be more effective and/or consistent with the language and purpose of the statute?

Question 117. Are there statutory exemptions that should apply to the proposed rule's proprietary trading provisions that were not included? If so, what exemptions and why?

Question 118. Are there statutory exemptions that were included in the proposed rule's proprietary trading provisions that should not have been included? If so, what exemptions and why?

a. Permitted Trading in Government Obligations

Section __.6(a) of the proposed rule, which implements section 13(d)(1)(A) of the BHC Act,[163] permits the purchase or sale of a covered financial position that is: (i) An obligation of the United States or any agency thereof; [164] (ii) an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*); or (iii) an obligation issued by any State or any political subdivision thereof.[165] The proposed rule also clarifies that these obligations include limited as well as general obligations of the relevant government entity. The Agencies note that, consistent with the statutory language, the types of instruments described with respect to the enumerated government-sponsored entities include not only obligations of such entities, but also participations and other instruments of or issued by such entity. This would include, for example, pass-through or participation certificates that are issued and guaranteed by one of these government-sponsored entities (e.g., the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with their securitization activities.

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

Question 119. Is the proposed rule's application to trading in government obligations sufficiently clear? Should such obligations expressly include, for example, instruments issued by third parties but insured or guaranteed by an enumerated government entity or otherwise backed by its full faith and credit?

Question 120. Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question 121. Should the Agencies adopt an additional exemption for proprietary trading in options or other derivatives referencing an enumerated government obligation under section 13(d)(1)(J) of the BHC Act? For example, should the Agencies provide an exemption for options or other derivatives with respect to U.S. government debt obligations? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question 122. Should the Agencies adopt an additional exemption for proprietary trading in the obligations of foreign governments and/or international and multinational development banks under section 13(d)(1)(J) of the BHC Act? If so, what types of obligations should be exempt? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question 123. Should the Agencies adopt an additional exemption for proprietary trading in any other type of government obligations under section 13(d)(1)(J) of the BHC Act? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

Question 124. Are the definitions of ''government security'' and ''municipal security'' in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of this exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the BHC Act.

b. Permitted Trading on Behalf of Customers

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

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

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

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

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

[166] For example, in the case of a banking entity acting as investment adviser to a registered mutual fund, any trading by the banking entity in its capacity of investment adviser and on behalf of that

structured so as to involve a listed form of relationship but nonetheless allows gains or losses from trading activity to inure to the benefit or detriment of the banking entity would fall outside the scope of this category.

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

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

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

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

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

Question 125. Is the proposed rule's articulation of three categories of transactions on behalf of customers effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any of the categories be eliminated? Should any additional categories be added? Please explain.

Question 126. Is the proposed rule's exemption of certain investment adviser, commodity trading advisor, trustee or similar fiduciary transactions effective? What other types of relationships are or should be captured by the proposed rule's reference to ''similar fiduciary relationships,'' and why? Is application of this part of the exemption to particular transactions sufficiently clear? Should any other specific types of fiduciary or other relationships be specified in the rule? If so, what types and why? What impact will the proposed rule's implementation of the exemption have on the investment adviser, commodity trading advisor, trustee or similar fiduciary activities of banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

Question 127. Is the proposed rule's exemption of riskless principal transactions effective? If not, what alternative would be more appropriate? Is the description of qualifying riskless principal activity sufficiently clear? If not, how should it be clarified? Should the riskless principal transaction exemption include a requirement that the banking entity must purchase (or sell) the covered financial position as principal at the same price to satisfy the customer buy (or sell) order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee? Why or why not? Should the riskless principal exemption include a requirement with respect to the timeframe in which the principal transaction must be allocated to a riskless principal or customer account? Why or why not?

Question 128. Is the proposed rule's exemption of trading for separate accounts by insurance companies effective? If not, what alternative would be more appropriate? Does the proposed exemption sufficiently address the variety of customer-driven separate account structures typically used? If not, how should it address such structures? Does the proposed exemption sufficiently address the variety of regulatory or supervisory regimes to which insurance companies may be subject?

Question 129. What impact will the proposed rule's implementation of the exemption have on the insurance activities of insurance companies affiliated with banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

Question 130. Should the term ''customer'' be defined for purposes of the exemption for transactions on behalf of customers? If so, how should it be defined? For example, would an appropriate definition be (i) a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction, (ii) a direct and substantive relationship between the banking entity and a prospective customer prior to the transaction, or (iii) a relationship initiated by the banking entity to a prospective customer for purposes of the transaction?

fund would be permitted pursuant to § __.6(b)(i) of the proposed rule, so long as the relevant criteria were met.

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

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

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

[170] *See* proposed rule § __.2(z).

Question 131. Is the exemption for trading on behalf of customers in the proposed rule over- or under-inclusive? If it is under-inclusive, please discuss any additional activities that should qualify as trading on behalf of customers under the rule. What are the mechanics of the particular trading activity and how does it qualify as being on behalf of customers? Are there certain requirements or restrictions that should be placed on the activity, if permitted by the rule, to prevent evasion of the prohibition on proprietary trading? How would permitting the activity be consistent with the purpose and language of section 13 of the BHC Act? If the proposed exemption is over-inclusive, please explain what aspect of the proposed exemption does not involve trading on behalf of customers within the language and purpose of the statute.

c. Permitted Trading by a Regulated Insurance Company

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

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

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

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

Question 132. Should any of the statutory requirements for the exemption be further clarified in the proposed rule? If so, how? Should any additional requirements be added? If so, what requirements and why?

Question 133. Does the proposed rule appropriately and clearly define a general account for these purposes? If not, what alternative definition would be more appropriate?

Question 134. For purposes of the exemption, are the insurance company investment laws, regulations, and written guidance of any particular State or jurisdiction insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States? If so, why?

Question 135. What impact will the proposed rule's implementation of the exemption have on the insurance activities of insurance companies affiliated with banking entities? If such impacts are negative, how could they be mitigated or eliminated in a manner consistent with the purpose and language of the statute?

d. Permitted Trading Outside of the United States

Section __.6(d) of the proposed rule implements section 13(d)(1)(H) of the BHC Act,[174] which permits certain foreign banking entities to engage in proprietary trading that occurs solely outside of the United States.[175] This statutory exemption limits the extraterritorial application of the prohibition on proprietary trading to the foreign activities of foreign firms, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States. Consistent with the statute, the proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which proprietary trading by such an entity will be considered to have occurred solely outside of the United States.

i. Foreign Banking Entities Eligible for the Exemption

Section __.6(d)(1)(i) of the proposed rule provides that, in order to be eligible for the foreign trading exemption, the banking entity must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. This requirement limits the scope of the exemption to banking entities that are organized under foreign law and controlled only by entities organized under foreign law. Consistent with the statutory language, a banking entity organized under the laws of the United States or any State and the subsidiaries and branches of such banking entity (wherever organized or licensed) may not rely on the exemption.[176] Similarly, a U.S. subsidiary or branch of a foreign banking entity would not qualify for the exemption.

Section __.6(d)(1)(ii) of the proposed rule incorporates the statutory requirement that the banking entity must also conduct the transaction pursuant to sections 4(c)(9) or 4(c)(13) of the BHC Act. Section __.6(d)(2) clarifies when a banking entity would meet that requirement, the criteria for which vary depending on whether or not the banking entity is a foreign banking organization.[177]

[171] *See* 12 U.S.C. 1851(d)(1)(F).

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

[173] *See* proposed rule § __.3(c)(6).

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

[175] This section's discussion of the concept ''solely outside of the United States'' is provided solely for purposes of the proposed 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.

[176] Under the proposal, a ''State'' means any State, territory or possession of the United States, and the District of Columbia. *See* proposed rule § __.2(aa).

[177] Section __.6(d)(2) only addresses when a transaction will be considered to have been conducted pursuant to section 4(c)(9) of the BHC

Section 4(c)(9) of the BHC Act provides that the restrictions on interests in nonbanking organizations contained in that statute do not apply to the ownership of shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of the BHC Act and would be in the public interest.[178] The Board has implemented section 4(c)(9) as part of subpart B of the Board's Regulation K,[179] which specifies a number of conditions and requirements that a foreign banking organization must meet in order to use such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States. The proposed rule makes clear that if a banking entity is a foreign banking organization, it will qualify for the foreign trading exemption if the entity is a qualifying foreign banking organization that conducts the transaction in compliance with subpart B of the Board's Regulation K, and the transaction occurs solely outside of the United States.

Section 13 of the BHC Act also applies to foreign companies that control a U.S. insured depository institution but are not currently subject to the BHC Act generally or to the Board's Regulation K—for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company. Accordingly, the proposed rule also clarifies when this type of foreign banking entity would be considered to have conducted a transaction ''pursuant to section 4(c)(9)'' for purposes of the foreign trading exemption.[180] In particular, the draft rule proposes that to qualify for the foreign trading exemption, such firms must meet at least two of three requirements that evaluate the extent to which the foreign entity's business is conducted outside the United States, as measured by assets, revenues, and income. This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) of the BHC Act and § 211.23(a) of the Board's Regulation K, except that the test does not also require such a foreign entity to demonstrate that more than half of its banking business is outside the United States.[181]

ii. Trading Solely Outside of the United States

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

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

- The transaction is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;
- No party to the transaction is a resident of the United States;
- No personnel of the banking entity that is directly involved in the transaction is physically located in the United States;[182] and
- The transaction is executed wholly outside the United States.

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

A resident of the United States is defined in § __.2(t) of the proposed rule, and includes: (i) Any natural person resident in the United States; (ii) any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State; (iii) any estate of which any executor or administrator is a resident of the United States; (iv) any trust of which any trustee, beneficiary or, if the trust is revocable, settlor is a resident of the United States; (v) any agency or branch of a foreign entity located in the United States; (vi) any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the United States; (vii) any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a resident of the United States; or (viii) any partnership or corporation organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States principally for the purpose of engaging in one or more transactions described in § __.6(d)(1) or § __.13(c)(1) of the proposed rule.[183] The proposed definition is designed to capture the scope of U.S. counterparties, decision-makers and personnel that, if involved in the transaction, would preclude that transaction from being considered to have occurred solely outside the United States. The Agencies note that the proposed definition is similar but not identical to the definition of ''U.S. person'' for purposes of the SEC's Regulation S, which governs securities offerings and sales outside of the United

Act. Although the statute also references section 4(c)(13) of the BHC Act, the Board has applied the authority contained in that section solely to the foreign activities of U.S. banking organizations which, by the express terms of section 13(d)(1)(H) of the BHC Act, are unable to rely on the foreign trading exemption.

[178] *See* 12 U.S.C. 1843(c)(9).

[179] *See* 12 CFR 211.20 *et seq.*

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

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

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

[183] *See* proposed rule § __.2(t).

States that are not registered under the Securities Act.[184]

iii. Request for Comment

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

Question 136. Is the proposed rule's implementation of the foreign trading exemption effectively delineated? If not, what alternative would be more effective and/or clearer?

Question 137. Are the proposed rule's provisions regarding when an activity will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Do those provisions effectively address the application of the foreign trading exemption to foreign banking entities not subject to the BHC Act generally? If not, how should the proposed rule apply the exemption?

Question 138. Are the proposed rule's provisions regarding when an activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should any requirements be modified or removed? If so, which requirements and why? Should additional requirements be added? If so, what requirements and why?

Question 139. Is the proposed rule's definition of ''resident of the United States'' effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Is the definition over- or under-inclusive? If so, why? Should the definition more closely track, or incorporate by reference, the definition of ''U.S. person'' under the SEC's Regulation S under the Securities Act? If so, why?

Question 140. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered?

Question 141. Should the Agencies use the authority provided in section 13(d)(1)(J) of the BHC Act to allow U.S.-controlled banking entities to engage in proprietary trading pursuant to section 4(c)(13) of the BHC Act outside of the United States under certain circumstances? If so, under what circumstances should this be permitted and how would such activity promote and protect the safety and soundness of banking entities and the financial stability of the United States?

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

Section 13(d)(1)(J) of the BHC Act permits the Agencies to grant, by rule, other exemptions from the prohibition on proprietary trading if the Agencies determine that the exemption would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.[185] The Agencies have not, at this time, proposed any such discretionary exemptions with respect to the prohibition on proprietary trading. The Agencies request comment as follows:

Question 142. Should the Agencies adopt any exemption from the prohibition on proprietary trading under section 13(d)(1)(J) of the BHC Act? If so, what exemption and why? How would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?

5. Section __.7: Reporting and Recordkeeping Requirements Applicable to Trading Activities

Section __.7 of the proposed rule, which implements in part section 13(e)(1) of the BHC Act,[186] requires certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. In addition, § __.7 requires banking entities to comply with the recordkeeping requirements in § __.20 of the proposed rule, related to the banking entity's compliance program,[187] 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.[188] Proposed Appendix A requires a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The measurements vary depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contains a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of a banking entity's market-making operations, would constitute prohibited proprietary trading.

A banking entity must comply with proposed Appendix A's reporting and recordkeeping requirements only if it has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.[189] The Agencies have not proposed to extend the reporting and recordkeeping requirements to banking entities with smaller amounts of trading activity, as it appears that the more limited benefits of applying these requirements to such banking entities, whose trading activities are typically small, less complex, and easier to supervise, would not justify the burden associated with complying with the reporting and recordkeeping requirements.

a. General Approach to Reporting and Recordkeeping Requirements

The reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule are an important part of the proposed rule's multi-faceted approach to implementing the prohibition on proprietary trading. These requirements are intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies. To do so, the proposed rule requires certain

[184] *See* 17 CFR 230.902(k).

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

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

[187] *See* Supplementary Information, Part III.D.

[188] *See* proposed rule § __.7.

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

banking entities to calculate and report detailed quantitative measurements of their trading activity, by trading unit. These measurements will help banking entities and the Agencies in assessing whether such trading activity is consistent with permitted trading activities in scope, type and profile. The quantitative measurements that must be reported under the proposed rule are generally designed to reflect, and to provide meaningful information regarding, certain characteristics of trading activities that appear to be particularly useful in differentiating permitted market making-related activities from prohibited proprietary trading. For example, the proposed quantitative measurements measure the size and type of revenues generated, and the types of risks taken, by a trading unit. Each of these measurements appears to be useful in assessing whether a trading unit is (i) engaged in permitted market making-related activity or (ii) materially exposed to high-risk assets or high-risk trading strategies. Similarly, the proposed quantitative measurements also measure how much revenue is generated per such unit of risk, the volatility of a trading unit's profitability, and the extent to which a trading unit trades with customers. Each of those characteristics appears to be useful in assessing whether a trading unit is engaged in permitted market making-related activity.

However, the Agencies recognize that no single quantitative measurement or combination of measurements can accurately identify prohibited proprietary trading without further analysis of the context, facts, and circumstances of the trading activity. In addition, certain quantitative measurements may be useful for assessing one type of trading activity, but not helpful in assessing another type of trading activity. As a result, the Agencies propose to use a variety of quantitative measurements to help identify transactions or activities that warrant more in-depth analysis or review.

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

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

In addition to the proposed quantitative measurements, a banking entity may itself develop and implement other quantitative measurements in order to effectively monitor its covered trading activities for compliance with section 13 of the BHC Act and the proposed rule and to establish, maintain, and enforce an effective compliance program, as required by § __.20 of the proposed rule and Appendix C. The Agencies note that the proposed quantitative measurements in Appendix A are intended to assist banking entities and Agencies in monitoring compliance with the proprietary trading restrictions and, thus, are related to the compliance program requirements in § __.20 of the proposed rule and proposed Appendix C. Nevertheless, implementation of the proposed quantitative measurements under Appendix A would not necessarily provide all the data necessary for the banking entity to establish an effective compliance program, and a banking entity may need to develop and implement additional quantitative measurements. The Agencies recognize that appropriate and effective quantitative measurements may differ based on the profile of the banking entity's businesses in general and, more specifically, of the particular trading unit, including types of instruments traded, trading activities and strategies, and history and experience (e.g., whether the trading desk is an established, successful market maker or a new entrant to a competitive market). In all cases, banking entities must ensure that they have robust measures in place to identify and monitor the risks taken in their trading activities, to ensure the activities are within risk tolerances established by the banking entity, and to monitor for compliance with the proprietary trading restrictions in the proposed rule.

To the extent that data regarding measurements, as set forth in the proposed rule, are collected, the Agencies propose to utilize the automatic two-year conformance period provided in section 13 of the BHC Act to carefully review that data, further study the design and utility of these measurements, and if necessary, propose changes to the reporting requirements as the Agencies believe are needed to ensure that these measurements are as effective as possible.[190] This heuristic, gradual approach to implementing reporting requirements for quantitative measurements would be intended to ensure that the requirements are formulated in a manner that maximizes their utility for identifying trading activity that warrants additional scrutiny in assessing compliance with the prohibition on proprietary trading, while limiting the risk that the use of quantitative measurements could inadvertently curtail permissible market making-related activities that provide an important service to market participants and the capital markets at large.

In addition, the Agencies request comment on the use of numerical thresholds for certain quantitative

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

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

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

Question 143. Is the use of the proposed reporting requirements as part of the multi-faceted approach to implementing the prohibition on proprietary trading appropriate? Why or why not?

Question 144. Is the proposed gradual approach to implementing reporting requirements effective? If not, what approach would be more effective? For example, should the Agencies defer reporting of quantitative measurements until banking entities have developed and refined their compliance programs through the supervision and examination process? What would be the costs and benefits of such an approach?

Question 145. What role, if any, could or should the Office of Financial Research (''OFR'') play in receiving and analyzing banking entities' reported quantitative measurements? Should reporting to the OFR be required instead of reporting to the relevant Agency, and would such reporting be consistent with the composition and purpose of OFR? In the alternative, should reporting to either (i) only the relevant Agency (or Agencies) or (ii) both the relevant Agency (or Agencies) and OFR be required? If so, why? What are the potential costs and benefits of reporting quantitative measurements to the OFR? Please explain.

Question 146. Is there an alternative manner in which the Agencies should develop and propose the reporting requirements for quantitative measurements? If so, how should they do so?

Question 147. Does the proposed approach provide sufficient time for the development and implementation of effective reporting requirements? If not, what alternative approach would be preferable?

Question 148. Should a trading unit be permitted not to furnish a quantitative measurement otherwise required under Appendix A if it can demonstrate that the measurement is not, as applied to that unit, calculable or useful in achieving the purposes of the Appendix with respect to the trading unit's covered trading activities? How might a banking entity make such a demonstration?

Question 149. Is the manner in which the Agencies propose to utilize the conformance period for review of collected data and refinement of the reporting requirements effective? If not, what process would be more effective?

Question 150. Is the proposed $1 billion trading asset and liability threshold, which is also currently used in the Market Risk Capital Rules for purposes of identifying which banks and bank holdings companies must comply with those rules, an appropriate standard for triggering the reporting and recordkeeping requirements of the proposed rule? Why or why not? If not, what alternative standard would be a better benchmark for triggering the reporting and recordkeeping requirements?

Question 151. What are the typical trading activities (e.g., market making-related activities) of a banking entity with less than $1 billion in gross trading assets and liabilities? How complex are those trading activities?

Question 152. Should the proposed $1 billion trading and asset liability threshold used for triggering the reporting and recordkeeping requirements adjust each time the thresholds for complying with the Market Risk Capital Rules adjust, or otherwise be adjusted over time? If not, how and when should the numerical threshold be adjusted?

Question 153. Should all banking entities be required to comply with the reporting and recordkeeping requirements set forth in Appendix A in order to better protect against prohibited proprietary trading, rather than only those banking entities that meet the proposed $1 billion trading asset and liability threshold? Why or why not?

Question 154. Should banking entities that fall under the proposed $1 billion trading asset and liability threshold be required to comply with the reporting and recordkeeping provisions for a pilot period in order to help inform judgment regarding the levels of quantitative measurements at such entities and the appropriate frequency and scope of examination by the relevant Agency for such banking entities? Why or why not?

b. Proposed Appendix A—Purpose and Definitions

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

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

The types of trading and market making-related activities in which banking entities engage is often highly complex, and any quantitative measurement is capable of producing both ''false negatives'' and ''false positives'' that suggest that prohibited proprietary trading is occurring when it is not, or vice versa. Recognizing this, section I of proposed Appendix A makes clear that the quantitative measurements that may be required to be reported would *not* be intended to serve as a dispositive tool for identifying permissible or impermissible activities.

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

- Each discrete unit engaged in the coordinated implementation of a revenue generation strategy that participates in the execution of any covered trading activity; [191]
- Each organizational unit used to structure and control the aggregate risk-taking activities and employees of one or more trading units described above;
- All trading operations, collectively; and
- Any other unit of organization specified by the relevant Agency with respect to a particular banking entity.[192]

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

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

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

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

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

Question 155. Are the ways in which the proposed rule would make use of reported quantitative measurements effective? If not, what uses would be more effective? Should the proposed rule instead use quantitative measurements as a dispositive tool for identifying prohibited proprietary trading? If so, what types of quantitative measurements should be employed, what numerical amount would indicate impermissible proprietary trading activity, and why? Should the quantitative measurements play a less prominent role than proposed in identifying prohibited proprietary trading and why?

Question 156. Are the proposed definitions of terms provided in Appendix A effective? If not, how should the definitions be amended?

Question 157. Is the proposed definition of ''trading unit'' effective? Is it sufficiently clear? If not, what alternative definition would be more effective and/or clearer? Should the definition include more or less granular levels of activity? If so, what specific criteria should be used to determine the appropriate level of granularity?

Question 158. If you are a banking entity, how would your trading activity be categorized, in terms of quantity and type, under the proposed definition of trading unit in Appendix A? For each trading unit type, what categories of quantitative measurements (e.g., risk-management measurements) or specific quantitative measurements (e.g., Stressed Value-at-Risk (''Stress VaR'')) are best suited to assist in distinguishing prohibited proprietary trading from permitted trading activity?

Question 159. Is the proposed rule's requirement that quantitative measurements be reported at multiple levels of organization, including for quantitative measurements historically reported on an aggregate basis (e.g., Value-at-Risk (''VaR'') or Stress VaR) appropriate? If not, what alternative would be more effective? What burdens are associated with such a requirement? How might those burdens be reduced or limited? Please quantify your answers, to the extent feasible.

c. Proposed Appendix A—Scope of Required Reporting

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

Banking Entities With Gross Trading Assets and Liabilities of $5 Billion or More

For any banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $5 billion, the proposal would require the banking entity to furnish quantitative measurements for all trading units of the banking entity engaged in trading activity subject to §§ __.4, __.5, or __.6(a) of the proposed rule (i.e., permitted underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations). The scope of data to be furnished depends on the activity in which the trading unit is engaged. First, for the trading units of such a banking entity that are engaged in market making-related activity pursuant to § __.4(b) of the proposed rule, proposed Appendix A requires that a banking entity furnish seventeen quantitative measurements.[193] Second, all trading units of such a banking entity engaged in trading activity subject to §§ __.4(a), __.5, or __.6(a) of the proposed rule would be required to report five quantitative measurements designed to measure the general risk and profitability of the trading unit.[194] The Agencies expect that each of these general types of measurements will be useful in assessing the extent to which any permitted trading activity involves exposure to high-risk assets or high-risk trading strategies. These requirements would apply to all type of trading units engaged in underwriting and market making-related activity, risk-mitigated hedging, and trading in certain government obligations. These additional measurements are designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.

Banking Entities With Gross Trading Assets and Liabilities Between $1 Billion and $5 Billion

For any banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, equals or exceeds $1 billion but is less than $5 billion, the proposal would require quantitative measurements to be furnished for trading units that are engaged in market making-related activity subject to § __.4(b) of the proposed rule. Trading units of such banking entities that are engaged in market making-related activities must report eight quantitative measurements that are designed to help evaluate the extent to which the quantitative profile of a trading unit's activities is consistent with permissible market making-related activities.[195] The proposal applies a smaller number of measurements to a smaller universe of trading units for this class of banking entities because they are likely to pose lesser compliance risk and fewer supervisory and examination challenges. A less burdensome reporting regime, coupled with other elements of the proposal (e.g., the compliance program requirement), is likely to be equally as effective in ensuring compliance with section 13 of the BHC Act and the proposed rule for banking entities with smaller trading operations.

Frequency of Calculation and Reporting

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

Question 160. Is the proposed tiered approach to identifying which banking entities and trading units must comply with the reporting requirements effective? If not, what alternative would be more effective? Does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved? Should the relevant gross trading assets and liabilities threshold for any category be increased or reduced? If so, why?

Question 161. Should the $1 billion and $5 billion gross trading assets and liabilities thresholds used to identify the extent to which a banking entity is required to furnish quantitative measurements be increased or reduced? If so, why? Should the thresholds be indexed in some way to account for fluctuations in capital markets activity over time? If so, what would be an appropriate method of indexation?

Question 162. Is the proposed $5 billion trading asset and liability threshold an appropriate standard for triggering enhanced reporting requirements under the proposed rule? Why or why not? If not, what alternative standard would be a better benchmark for triggering enhanced reporting requirements?

Question 163. Should the proposed $5 billion trading and asset liability threshold used for triggering enhanced reporting requirements under the proposed rule be subject to adjustment over time? If so, how and when should the numerical threshold be adjusted?

Question 164. Is there a different criterion other than gross trading assets and liabilities that would be more appropriate for identifying banking entities that must furnish quantitative measurements? If so, what is the alternative criterion, and why would it be more appropriate? Are worldwide gross trading assets and liabilities the appropriate criterion for foreign-based banking entities? If not, what alternative criterion would be more appropriate, and why?

Question 165. Are the quantitative measurements specified for the various types of banking entities and trading

[193] *See* proposed rule Appendix A.III.A. These seventeen quantitative measurements are discussed further below.

[194] *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.

[195] *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.

units effective? If not, what alternative set of measurements would be more effective? For each type of trading unit, does the proposal strike the appropriate balance between the potential benefits of the reporting requirements for monitoring and assuring compliance and the potential costs of those reporting requirements? If not, how could that balance be improved?

Question 166. Should banking entities with gross trading assets and liabilities between $1 billion and $5 billion also be required to calculate and report some of the quantitative measurements proposed for banking entities meeting the $5 billion threshold for purposes of assessing whether the banking entity's underwriting, market making, risk-mitigating hedging, and trading in certain government obligations activities involve a material exposure to high-risk assets or high-risk trading strategies? If so, which quantitative measurements and why? If not, why not?

Question 167. Is the proposed frequency of reporting effective? If not, what frequency would be more effective? Should the quantitative measurements be required to be reported quarterly, annually, or upon the request of the applicable Agency and why?

d. Proposed Appendix A—Quantitative Measurements

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

- *Risk-management measurements*—VaR, Stress VaR, VaR Exceedance, Risk Factor Sensitivities, and Risk and Position Limits;
- *Source-of-revenue measurements*—Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, Spread Profit and Loss, and Comprehensive Profit and Loss Attribution;
- *Revenues-relative-to-risk measurements*—Volatility of Comprehensive Profit and Loss, Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio, Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss, Unprofitable Trading Days based on Portfolio Profit and Loss, Skewness of Portfolio Profit and Loss, and Kurtosis of Portfolio Profit and Loss;
- *Customer-facing activity measurements*—Inventory Turnover, Inventory Aging, and Customer-facing Trade Ratio; and
- *Payment of fees, commissions, and spreads measurements*—Pay-to-Receive Spread Ratio.

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

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

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

The third set of measurements relates to realized risks and revenue relative to realized risks, and includes Volatility of Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, Unprofitable Trading Days based on Comprehensive Profit and Loss and Unprofitable Trading Days based on

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

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

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

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

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

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

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

Question 168. Are the proposed quantitative measurements appropriate in general? If not, what alternative(s) would be more appropriate, and why? Should certain quantitative measurements be eliminated, and if so, why? Should additional quantitative measurements be added? If so, which measurements and why? How would those additional measurements be described and calculated?

Question 169. How many of the proposed quantitative measurements do banking entities currently utilize? What are the current benefits and costs associated with calculating such quantitative measurements? Would the reporting and recordkeeping requirements proposed in Appendix A for such quantitative measurements impose any significant, additional benefits or costs?

Question 170. Which of the proposed quantitative measurements do banking entities currently not utilize? What are the potential benefits and costs to calculating these quantitative measurements and complying with the proposed reporting and recordkeeping requirements? Please quantify your answers, to the extent feasible.

Question 171. Is the scope and frequency of required reporting appropriate? If not, what alternatives would be more appropriate? What burdens would be associated with reporting quantitative measurements on that basis, and how could those burdens be reduced or eliminated in a manner consistent with the purpose and language of the statute? Please quantify your answers, to the extent feasible.

Question 172. For each of the categories of quantitative measurements (e.g., quantitative measurements relating to risk management), what factors should be considered in order to further refine the proposed category of quantitative measurements to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of the end of the day)? Please quantify your answers, to the extent feasible.

Question 173. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to calculate the required quantitative measurements (e.g., collect data and make computations)? Do commenters anticipate the need to develop additional infrastructure to obtain and retain data necessary to compute the proposed quantitative measurements? Please explain and quantify your answers, to the extent feasible.

Question 174. For each individual quantitative measurement that is proposed:

- Is the use of the quantitative measurement to help distinguish between permitted and prohibited trading activities effective? If not, what alternative would be more effective? Does the quantitative measurement provide any additional information of value relative to other quantitative measurements proposed?
- Is the use of the quantitative measurement to help determine whether an otherwise-permitted trading activity is consistent with the requirement that such activity must not result, directly or indirectly, in a material exposure by the banking entity to high-risk assets and high-risk trading strategies effective? If not, what alternative would be more effective?
- What factors should be considered in order to further refine the proposed quantitative measurement to better distinguish prohibited proprietary trading from permitted trading activity? For example, should the timing of a calculation be considered significant in certain contexts (e.g., should specific quantitative measurements be calculated during the middle of a trading day instead of at the end of the day)?
- If the quantitative measurement is proposed to be applied to a trading unit that is engaged in activity pursuant to §§ __.4(a), __.5, or __.6(a) of the proposed rule, is the quantitative measurement calculable in relation to such activity? Is the quantitative measurement useful for determining whether underwriting, risk-mitigating hedging, or trading in certain government obligations is resulting, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies?
- Is the description of the quantitative measurement sufficiently clear? What alternative would be more appropriate or clearer? Is the description of the quantitative measurement appropriate, or is it overly broad or narrow? If it is overly broad, what additional clarification is needed? Should the Agencies provide this additional clarification in the appendix's description of the quantitative measurement? If the description is overly narrow, how should it be modified to appropriately describe the quantitative measurement, and why?
- Is the general calculation guidance effective and sufficiently clear? If not, what alternative would be more effective or clearer? Is more or less specific calculation guidance necessary? If so, what level of specificity is needed to calculate the quantitative measurement? What are the different calculation options and methodologies that could be used to reach the desired level of specificity? What are the costs and benefits of these different options? If the proposed calculation guidance is not sufficiently specific, how should the calculation guidance be modified to reach the appropriate level of specificity? For example, rather than provide this level of specificity in proposed Appendix A, should the Agencies instead make each banking entity responsible for determining the best method of calculating the quantitative measurement at this level of specificity, based on the banking entity's business and profile, which would then be subject to supervision, review, or examination by the relevant Agency? If the proposed calculation guidance is overly specific, why is it too specific and how should the guidance be modified to reach the appropriate level of specificity?
- Is the general calculation guidance for the measurement consistent with how banking entities currently calculate the quantitative measurement, if they do so? If not, how does the proposed guidance differ from methodology currently used by banking entities? What is the purpose of the current calculation methodology used by banking entities?
- What operational or logistical challenges might be associated with performing the calculation of the quantitative measurement and obtaining any necessary informational inputs?
- Is the quantitative measurement not calculable for any specific type of trading unit? If so, what type of trading unit, and why is the quantitative measurement not calculable for that type of trading unit? Is there an alternative quantitative measurement that would reflect the same trading activity but not pose the same calculation difficulty? Are there particular challenges to documenting that a specific quantitative measurement is not calculable?
- Is the quantitative measurement substantially likely to frequently produce false negatives or false positives that suggest that prohibited proprietary trading is occurring when it is not, or vice versa? If so, why? If so, what alternative quantitative measurement would better help identify prohibited proprietary trading?
- Should the quantitative measurement better account for distinctions among trading activities, trading strategies, and asset classes? If so, how? For example, should the quantitative measurements better account for distinctions between trading activities in cash and derivatives markets? If so, how? Are there any other distinctions for which the quantitative measurements may need to account? If so, what distinctions, and why?
- Does the quantitative measurement provide useful information as applied to all types of trading activities, or only a certain subset of trading activities? If it only provides useful information for a subset of trading activities, how should this issue be addressed? How beneficial is the information that the quantitative measurement provides for this subset of trading activities? Do any of the other quantitative measurements provide the

same level of beneficial information for this subset of trading activities? Should the quantitative measurement be required to be reported for all trading activities, only a relevant subset of trading activities, or not at all?

• Does the quantitative measurement provide useful information as applied to all asset classes, or only a certain subset of asset classes? If it only provides useful information for a subset of asset classes, how should this issue be addressed? How beneficial is the information the quantitative measurement provides for this subset of asset classes? Do any of the other quantitative measurements provide the same level of beneficial information for this subset of asset classes? Should the quantitative measurement be required to be reported for all asset classes, only a relevant subset of asset classes, or not at all?

• Is the calculation period effective and sufficiently clear? If not, what alternative would be more effective or clearer?

• How burdensome and costly would it be to calculate the measurement at the specified calculation frequency and calculation period? Are there any difficulties or costs associated with calculating the measurement for particular trading units? How significant are those potential costs relative to the potential benefits of the measurement in monitoring for impermissible proprietary trading? Are there potential modifications that could be made to the measurement that would reduce the burden or cost? If so, what are those modifications? Please quantify your answers, to the extent feasible.

Question 175. In light of the size, scope, complexity, and risk of covered trading activities, are there certain types of quantitative measurements that will not be appropriate for some types of banking entities, desks, or levels? If so, would it be appropriate to require only certain quantitative measurements for such banking entities, desks, or levels?

Question 176. How might the number of quantitative measurements impact behavior of banking entities? Is there a cost of requiring more quantitative measurements, such as the cost of increased uncertainty regarding the combined results of such quantitative measurements? To what extent and in what ways might uncertainty as to how the quantitative measurements are applied and evaluated impact behavior?

Proposed Appendix B—Commentary Regarding Identification of Permitted Market Making-Related Activities

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

The commentary regarding identification of permitted market making-related activities, which is contained in Part III of proposed Appendix B, includes three principal components. The first component provides an overview of market making-related activities and describes, in detail, typical practices in which market makers engage and typical characteristics of market making-related activities, articulating the general framework within which the Agencies view market making-related activities.[196] For example, the commentary provides that market making-related activities, in the context of a banking entity acting as principal, generally involve either (i) in the case of market making in a security that is executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker, where such exchange or organized trading facility provides the ability to register as a market maker, or (ii) in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy. The second component of the commentary provides an overview of prohibited proprietary trading activities, which describes the general framework within which the Agencies view prohibited proprietary trading and contrasts that activity to the practices and characteristics of market making-related activities.[197] The third component describes certain challenges that arise in distinguishing permitted market making-related activities and prohibited proprietary trading, particularly in cases in which both of these activities occur within the context of a market making operation,[198] and proposes guidance that the Agencies would apply in distinguishing permitted market making-related activities from prohibited proprietary trading. This guidance includes six factors that would cause a banking entity to be considered, absent explanatory circumstances, to be engaged in prohibited proprietary trading, and not permitted market making-related activity. The six factors are:

• Trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers;[199]

• Trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues;

• Trading activity in which a trading unit: (i) Generates only very small or very large amounts of revenue per unit of risk taken; (ii) does not demonstrate consistent profitability; or (iii) demonstrates high earnings volatility;

• Trading activity in which a trading unit either (i) does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, or (ii) holds principal positions in excess of reasonably expected near term customer demands;

• Trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads; and

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

[197] *See* proposed rule Appendix B, § III.B.

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

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

• The use of compensation incentives for employees of a particular trading activity that primarily reward proprietary risk-taking.[200]

The proposed commentary makes clear that the enumerated factors are subject to certain facts and circumstances that may explain why a trading activity may meet one or more factors but does not involve prohibited proprietary trading, and provides a range of examples of such explanatory facts and circumstances.[201] The Agencies emphasize that these examples are not meant to be exhaustive, as a variety of other circumstances may exist to explain why a particular trading activity, even if meeting one of the factors, may nonetheless be a permitted market making-related activity.[202]

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

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

Question 177. Is the overview of permitted market making-related activities and prohibited proprietary trading proposed in Appendix B accurate? If not, what alternative overview would be more accurate? Does the overview appropriately account for differences in market making-related activities across different asset classes? If not, which type of market making-related activity does the overview not sufficiently describe or account for?

Question 178. Is the requirement that a market maker engaged in market making that is executed on an exchange or an organized trading facility must be a registered market maker, provided the relevant exchange or organized trading facility provides the ability to register, appropriate, or is it over- or under-inclusive? Please discuss and provide detailed examples of any such markets where registering as a market maker is not feasible or should not be required for purposes of this rule, and unregistered market makers provide similar services or perform similar functions.

Question 179. With respect to market making that is executed on an exchange or an organized trading facility, what potential impact or unintended consequences might result from limiting the market making exemption to registered market makers when the relevant exchange or organized trading facility registers market makers? Would such a requirement result in any potential decrease in the passive provision of liquidity by the submission of resting orders? Do you anticipate that any such decrease would be exacerbated in times of market stress? If yes, please describe the impact on liquidity and the marketplace in general. Please discuss whether and how any potential decrease in liquidity could be mitigated. In addition, would such a requirement result in additional costs that would be borne by market participants purchasing and selling on an exchange or organized trading facility? Please identify and discuss any other additional costs. Please discuss whether and how any such consequences can be mitigated.

Question 180. In addition to benefits discussed in the Supplementary Information, are there other benefits that would be achieved by requiring that a market maker be registered with respect to market making on an exchange or an organized trading facility? Is there a way to amplify these benefits? Could these benefits be realized through alternative means? If so, how?

Question 181. In addition to registered market makers on exchanges or organized trading facilities, what other classes of liquidity providers exist? Are their obligations and activities similar to, or different than those of registered market makers? If so, how? Are the compensated in a different manner?

Question 182. How much liquidity is provided by registered market makers versus other liquidity providers by asset class (e.g., equities, etc.) with respect to trading on an exchange or an organized trading facility? The Agencies encourage commenters to provide data in support of comments.

Question 183. Is there any specific element of market making-related activity that the overview does not take into account in its description of market making? If so, how should the overview account for this element? Are there any descriptions of market making-related activity in the overview that should not be considered to be market making-related activity? If so, why? Is there any specific element of prohibited proprietary trading activity that the overview does not take into account in its description of prohibited proprietary trading? If so, how should the overview account for this element? Are there any descriptions of prohibited proprietary trading activity in the overview that should not be considered to be prohibited proprietary trading? If so, why?

Question 184. Are each of the six factors specified for helping to distinguish permitted market making-related activity from prohibited proprietary trading appropriate? If not, how should they be changed, and why? Should any factors be eliminated or added? If so, which ones and why? Could any of the proposed factors occur as a result of the banking entity engaging in one of the other permitted activities (e.g., underwriting, trading on behalf of customers)? If so, would the facts and circumstances that the Agencies propose to consider be sufficient to determine and verify that the banking entity is not engaged in prohibited proprietary trading? If not, how should this issue be addressed?

Question 185. Are the facts and circumstances that would be used to determine whether a banking entity's activities satisfy a certain factor appropriate? If not, how should they be changed, and why? Should any be eliminated or added? If so, which ones, and why?

Question 186. Are the identified quantitative measurements that the Agencies would use to help assess a particular factor appropriate? If not, how should they be changed, and why? Should any be eliminated or added? If so, which ones, and why?

f. Incorporation of Numerical Thresholds in the Commentary Regarding Identification of Permitted Market Making-Related Activities

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

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

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

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

activities for compliance and summarize that review to the relevant Agency.

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

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

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

Question 187. What are the potential benefits and costs of incorporating into the proposed rule one or more numerical thresholds for certain quantitative measurements that, if reported by a banking entity, would require the banking entity to review its trading activities for compliance and summarize that review to the relevant Agency? Would such thresholds provide useful clarity to banking entities and/or market participants regarding the types of trading activities that merit additional scrutiny? Should numerical thresholds be used for any purposes other than highlighting trading activities that should be reviewed, the results of which would be reported to the relevant Agency? If so, for what purpose, and how and why?

Question 188. For which of the relevant quantitative measurements might it be appropriate and effective to include a numerical threshold that would trigger banking entity review and explanation? How should a numerical threshold be formulated, and why? Should a numerical threshold for a single quantitative measurement be applied individually, or should the threshold instead be triggered by exceeding some combination of numerical thresholds for different measurements? For any particular threshold, what numerical amount should be used, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the amount vary by asset class or other characteristic? If so, how?

Question 189. For each of the following illustrative examples of potential thresholds, is the threshold formulated effectively? If not, what alternative formulation would be more effective? Should the threshold formulation vary by asset class or other characteristic? If so, how and why? If the threshold was utilized, what actual numerical amount should be specified, and why? How would such numerical amount be consistent with a level at which further review and explanation is warranted? Should the numerical amount vary by asset class or other characteristic? If so, how and why?

- ''If a trading unit reports an increase in VaR, Stress VaR, or Risk Factor Sensitivities greater than [__] over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit's activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.''
- ''If a trading unit reports an average Comprehensive Profit and Loss that is less than [__] times greater than the Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for [__] consecutive months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit's activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.''
- ''If a trading unit reports a Comprehensive Profit and Loss to Volatility Ratio that is less than [__] times greater than that trading desk's Portfolio Profit and Loss to Volatility Ratio over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit's activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.''
- ''If a trading unit reports a number of Unprofitable Trading Days Based on Portfolio Profit and Loss that is less than [__] greater than the number of Unprofitable Trading Days Based on Comprehensive Profit and Loss for [__] consecutive months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit's activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.''
- ''If a trading unit reports a Pay-to-Receive Spread Ratio that is less than [__] over a period of [__] months, or such other threshold as [Agency] may require, the banking entity must (i) promptly review and investigate the trading unit's activities to verify whether the trading unit is operating in compliance with the proprietary trading restrictions and (ii) report to [Agency] a summary of such review, including any explanatory circumstances.''

6. Section __.8: Limitations on Permitted Trading Activities

Section __.8 of the proposed rule implements section 13(d)(2) of the BHC Act, which places certain limitations on the permitted trading activities (*e.g.*, permitted market making-related activities, risk-mitigating hedging, etc.) in which a banking entity may engage.[203] Consistent with the statute, § __.8(a) of the proposed rule provides that no transaction, class of transactions, or activity is permissible under §§ __.4 through __.6 of the proposed rule if the transaction, class of transactions, or activity would:

- 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.

[203] *See* 12 U.S.C. 1851(d)(2).

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

a. Scope of ''Material Conflict of Interest''

Section __.8(b) of the proposed rule defines the scope of material conflicts of interest which, if arising in connection with a permitted trading activity, are prohibited under the proposal.[204] 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.[205] In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances.

To address these types of material conflicts of interest, § __.8(b) of the proposed rule specifies that a material conflict of interest between a banking entity and its clients, customers, or counterparties exists if the banking entity engages in any transaction, class of transactions, or activity that would involve or result in the banking entity's interests being materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity, unless the banking entity has appropriately addressed and mitigated the conflict of interest, where possible, and subject to specific requirements provided in the proposal, through either (i) timely and effective disclosure, or (ii) informational barriers.[206] 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 §§ __.4 through __.6 of the proposed rule.[207]

However, 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 and banking laws and regulations.

Section __.8(b)(1) of the proposed rule describes the two requirements that must be met in cases where a banking entity addresses and mitigates a material conflict of interest through timely and effective disclosure. First, § __.8(b)(1)(i) of the proposed rule requires that the banking entity, *prior* to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict may arise, make clear, timely, and effective disclosure of the conflict or potential conflict of interest, together with any other necessary information.[208] 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.[209] Disclosure that is only general or generic, rather than specific to the individual, class, or type of transaction or activity, or that omits details or other information that would be necessary to a reasonable client's, customer's, or counterparty's understanding of the conflict of interest, would not meet this standard. Second, § __.8(b)(1)(ii) of the proposed rule requires that the disclosure be made explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty that was created or would be created by the conflict or potential conflict.[210]

The Agencies note that, in order to provide the requisite opportunity for the client, customer or counterparty to negate or substantially mitigate the disadvantage created by the conflict, the disclosure would need to be provided sufficiently close in time to the client's, customer's, or counterparty's decision to engage in the transaction or activity to give the client, customer, or counterparty an opportunity to meaningfully evaluate and, if necessary, take steps that would negate or substantially mitigate the conflict. Disclosure provided far in advance of the individual, class, or type of transaction, such that the client, customer, or counterparty is unlikely to take that disclosure into account when evaluating a transaction, would not suffice. Conversely, disclosure provided without a sufficient period of time for the client, customer, or counterparty to evaluate and act on the information it receives, or disclosure provided after the fact, would also not suffice under the proposal. The Agencies note that the proposed definition would not prevent or require disclosure with respect to transactions or activities that align the interests of the banking entity with its clients, customers, or counterparties or that otherwise do not involve ''material'' conflicts of interest as discussed above.

The proposed disclosure standard reflects the fact that some types of conflicts may be appropriately resolved through the disclosure of clear and meaningful information to the client, customer, or counterparty that provides such party with an informed opportunity to consider and negate or substantially mitigate the conflict.

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

[205] *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.*

[206] *See* proposed rule § __.8(b)(1).

[207] The Agencies note that a banking entity subject to Appendix C must implement a compliance program that includes, among other things, policies and procedures that explain how the banking entity monitors and prohibits conflicts of interest with clients, customers, and counterparties. Further, as noted in the discussion of the definition of ''material conflict of interest'' in Part III.B.6 of this Supplemental Information, the discussion of that definition is provided solely for purposes of the proposed 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).

[208] *See* proposed rule § __.8(b)(1)(A).

[209] *See id.*

[210] *See* proposed rule § __.8(b)(1)(B).

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

Section __.8(b)(2) of the proposed rule describes the requirements that must be met in cases where a banking entity uses information barriers that are reasonably designed to prevent a material conflict of interest from having a materially adverse effect on a client, customer or counterparty. Information barriers can be used to restrict the dissemination of information within a complex organization and to prevent material conflicts by limiting knowledge and coordination of specific business activities among units of the entity. Examples of information barriers include, but are not limited to, restrictions on information sharing, limits on types of trading, and greater separation between various functions of the firm. Information barriers may also require that banking entity units or affiliates have no common officers or employees. Such information barriers have been recognized in Federal securities laws and rules as a means to address or mitigate potential conflicts of interest or other inappropriate activities.[211]

In order to address and mitigate a conflict of interest through the use of the information barriers pursuant to § __.8(b)(2) of the proposed rule, a banking entity would be required to establish, maintain, and enforce information barriers that are memorialized in written policies and procedures, including physical separation of personnel, functions, or limitations on types of activity, that are reasonably designed, taking into consideration the nature of the banking entity's business, to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty.[212] Importantly, the proposed rule also provides that, notwithstanding a banking entity's establishment of such information barriers, if the banking entity knows or should reasonably know that a material conflict of interest arising out of a specific transaction, class or type of transactions, or activity may involve or result in a materially adverse effect on a client, customer, or counterparty, the banking entity may not rely on those information barriers to address and mitigate any conflict of interest. In such cases, the transaction or activity would be prohibited, unless the banking entity otherwise complies with the requirements of § __.8(b)(1).[213] This aspect of the proposal is intended to make clear that, in specific cases in which a banking entity has established an information barrier but knows or should reasonably know that it has failed or will fail to prevent a conflict of interest arising from a specific transactions or activity that disadvantages a client, customer, or counterparty, the information barrier is insufficient to address that conflict and the transaction would be prohibited, unless the banking entity is otherwise able to address and mitigate the conflict through timely and effective disclosure under the proposal.[214]

The Agencies note that the proposed definition of material conflict of interest does not address instances in which a banking entity has made a material misrepresentation to its client, customer, or counterparty in connection with a transaction, class of transactions, or activity, as such transactions or activity appears to involve fraud rather than a conflict of interest. However, the Agencies note that such misrepresentations are generally illegal under a variety of Federal and State regulatory schemes (e.g., the Federal securities laws). In addition, the Agencies note that any activity involving a material misrepresentation to, or other fraudulent conduct with respect to, a client, customer, or counterparty would not be permitted under the proposed rule in the first instance. For example, a trading activity involving a material misrepresentation to a client, customer, or counterparty would fail, on its face, to satisfy the proposed terms of the underwriting or market-making exemption.

b. Definition of ''High-Risk Asset'' and ''High-Risk Trading Strategy''

Section __.8(c) of the proposed rule defines ''high-risk asset'' and ''high-risk trading strategy'' for proposes of § __.8's proposed limitations on permitted trading activities. Section __.8(c)(1) defines a ''high-risk asset'' as an asset or group of assets that would, if held by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail. Section __.8(c)(2) defines a ''high-risk trading strategy'' as a trading strategy that would, if engaged in by the banking entity, significantly increase the likelihood that the banking entity would incur a substantial financial loss or would fail.[215]

c. Request for Comment

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

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

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

[213] *See* proposed rule § __.8(b)(2).

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

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

Agencies request comment on the following questions:

Question 190. Is the manner in which the proposed rule implements the limitations of section 13(d)(2) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question 191. Is the proposed rule's definition of material conflict of interest effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question 192. Is the proposed definition of material conflict of interest over-or under-inclusive? If so, how should the definition be broader or narrower? Is there an alternative definition that would be appropriate? If so, what definition? Why would that alternative definition better define material conflict of interest for purposes of implementing section 13 of the BHC Act?

Question 193. Would the proposed definition of material conflict of interest have any unintended chilling effect on underwriting, market making, risk-mitigating hedging or other permitted activities? If so, what alternatives might limit such an effect?

Question 194. Would the proposed definition of material conflict of interest lead to unintended consequences? If so, what unintended consequences and why? Please suggest modifications to the proposed definition that would mitigate those consequences.

Question 195. Is it likely that the proposed definition of material conflict of interest would anticipate all future material conflicts of interest, particularly as the financial markets evolve and change? If not, what alternative definition would better anticipate future material conflicts of interest?

Question 196. Does the proposed rule provide sufficient guidance for determining when a material conflict of interest exists? If not, what additional detail should be provided? Should the Agencies adopt an approach similar to that under the securities laws, in which a material conflict of interest is not specifically defined?

Question 197. Are there transactions, classes or types of transactions, or activities inherent in underwriting, market-making, risk-mitigating hedging or other permitted activities that should not be prohibited but may be captured by the proposed definition of material conflict of interest? If so, what transactions and activities? Should they be permitted under the proposed rule? If so, why and under what conditions, if any? Conversely, are there transactions or activities that would be permitted under the proposed rule that should be prohibited? If so, what transactions and activities? Why should they be prohibited under the proposed rule?

Question 198. Please discuss the inherent conflicts of interest that arise from *bona fide* underwriting, market making-related activity, risk-mitigating hedging, or any other permitted activity, and provide specific examples of such inherent conflicts. Do you believe that such conflicts ever result in a materially adverse interest between a banking entity and a client, customer, or counterparty? How should the proposal address inherent conflicts that result from otherwise-permitted activities?

Question 199. Is the manner in which the proposed rule permits the use of disclosure in certain cases to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of disclosure to address and mitigate conflicts? If so, what additional and alternative requirements, and why? Is the level of detail and specificity required by the proposed rule with respect to disclosure appropriate? If not, what alternative level of detail and specificity would be more appropriate?

Question 200. Should the proposed rule require written disclosure to a client, customer, or counterparty regarding a material conflict of interest? If so, please explain why written disclosure should be required. Are there certain circumstances where written disclosure should be required, but others where oral disclosure should be sufficient? For example, should oral disclosure be permitted for transactions in certain fast-moving markets or transactions with sophisticated clients, customers, or counterparties? If oral disclosure is permitted under certain circumstances, should subsequent written disclosure be required? Please explain.

Question 201. Should the proposed rule provide further detail regarding the types of conflicts of interest that cannot be addressed and mitigated through disclosure? If so, what type of additional detail would be helpful, and why? Should the proposed rule enumerate an exhaustive or non-exhaustive list of conflicts that cannot be addressed and mitigated through disclosure? If so, what conflicts should that list include, and why?

Question 202. Should the proposed rule provide further detail regarding the frequency at which disclosure must be made? Should general disclosure be permitted for certain types of transactions, classes of transactions, or activities? For example, should a banking entity be permitted to make a one-time, written disclosure to a client, customer, or counterparty prior to engaging in a certain type of transaction or activity? Should general disclosure be permitted for certain types of clients, customers, or counterparties (e.g., highly sophisticated parties)? Please explain why specific disclosure (i.e., prior to each transaction, class of transaction, or activity) would not be necessary under the identified circumstances. Are there any clients, customers, or counterparties that should be able to waive a material conflict of interest under certain circumstances? If so, under what circumstances would a waiver approach be appropriate and consistent with the statute? Please explain.

Question 203. Should the proposed definition of material conflict of interest deem certain potential conflicts of interest to not be material conflicts of interest if a banking entity establishes, maintains, and enforces policies and procedures (other than information barriers) reasonably designed to prevent transactions, classes of transactions, or activities that would involve or result in a material conflict of interest? If so, for what types of potential conflicts? What policies and procedures would be appropriate? How would this approach be consistent with the purpose and language of the statute? Should such policies and procedures only be considered effective if they prevent the banking entity from receiving an advantage to the disadvantage of the client, customer, or counterparty?

Question 204. Are there any particular types of clients, customers, or counterparties for whom disclosure of a material conflict of interest should not be required under the proposal, consistent with the statute? Please identify the types of clients, customers, or counterparties for whom disclosure might not be necessary and explain. Why might disclosures be useful for some clients, customers, or counterparties, but not others? Please explain. What characteristics should a firm use in determining whether or not a client, customer, or counterparty needs a particular disclosure?

Question 205. Are there additional steps that a banking entity that seeks to manage conflicts of interest through the use of disclosure should be required to take with regard to disclosure? If so, what steps?

Question 206. Are there circumstances in which disclosure might be impracticable or ineffective? If so, what circumstances, and why?

Question 207. Is the manner in which the proposed rule permits the use of information barriers to address and mitigate conflicts of interest appropriate? Why or why not? Should additional or alternative requirements be placed on the use of information barriers to address and mitigate conflicts? If so, what additional and alternative requirements, and why?

Question 208. Should the proposed rule mandate the use of other means of managing potential conflicts of interest? If so, what specific means should be considered? How effective are any such methods as currently used? Can such methods be circumvented? If so, in what ways?

Question 209. What burdens or costs might be associated with the disclosure-related or information barrier-related requirements contained in the proposed definition of material conflict of interest? How might these burdens or costs be eliminated or reduced in a manner consistent with the purpose and language of section 13 of the BHC Act?

Question 210. Are there specific transactions, classes of transactions or activities that should be managed through consent? If so, what transactions or activities, and why? What form of consent should be required? What level of detail should any such consent include? Should consent only apply to certain conflicts and not others? If so, which conflicts? Are there circumstances in which obtaining consent might be impracticable or ineffective? Should consent be limited to certain types of clients, customers, or counterparties? If so, which clients, customers, or counterparties? Are there certain types of clients, customers, or counterparties for whom consent would never be sufficient? Are there additional steps that a banking entity that seeks to manage conflicts of interest through the use of consent should be required to take? Please specify such steps.

Question 211. What is the potential relationship between, and interplay of, the proposed rule and Section 621 of the Dodd-Frank Act regarding conflicts of interest relating to certain securitizations which contains a prohibition on material conflicts of interest?

Question 212. Should the proposed rule provide for specific types of procedures that would be more effective in managing and mitigating conflicts of interest than others? Do banking entities currently use certain procedures that effectively manage and mitigate material conflicts of interest? If so, please describe such procedures and explain why such procedures are effective. Is the proposed rule consistent with such procedures? Why or why not? What are the costs and benefits of modifying your current procedures in response to the proposed rule?

Question 213. Is the proposed rule's definition of a high-risk asset effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular assets that are deemed high-risk *per se*? If so, what assets and why?

Question 214. Is the proposed rule's definition of a high-risk trading strategy effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should the proposed rule specify particular trading strategies that are deemed high-risk *per se*? If so, what trading strategies and why?

C. Subpart C—Covered Fund Activities and Investments

As noted above, except as otherwise permitted, section 13(a)(1)(B) of the BHC Act prohibits a banking entity from acquiring or retaining any ownership in, or acting as sponsor to, a covered fund.[216] Subpart C of the proposed rule applies those portions of section 13 of the BHC Act that operate as a prohibition or restriction on a banking entity's ability, as principal, directly or indirectly, to acquire or retain an ownership interest in, act as sponsor to, or have certain relationships with, a covered fund. Subpart C also implements the permitted activity and investment authorities provided for under section 13(d)(1) of the BHC Act related to covered fund activities and investments, as well as the rule of construction related to the sale and securitization of loans under section 13(g)(2) of that Act. Additionally, subpart C contains a discussion of the internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments, and incorporates by reference the minimum compliance standards for banking entities contained in subpart D of the proposed rule, as well as Appendix C, to the extent applicable.

1. Section __.10: Prohibition of Acquisition or Retention of Ownership Interests in, and Certain Relationships With, a Covered Fund

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

a. Prohibition Regarding Covered Fund Activities and Investments

Section __.10(a) of the proposed rule implements section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, as principal, directly or indirectly, acquiring or retaining an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless otherwise permitted under subpart C of the proposed rule.[217] This prohibition reflects the statute's purpose and effect of limiting a banking entity's ability to invest in or have exposure to a covered fund.

The Agencies note that the general prohibition in § __.10(a) of the proposed rule applies solely to a banking entity's acquisition or retention of an ownership interest in or acting as sponsor to a covered fund ''as principal, directly or indirectly.'' [218] As such, the proposed rule would not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund: (i) By a banking entity in good faith in a fiduciary capacity, except where such ownership interest is held under a trust that constitutes a company as defined in section (2)(b) of the BHC Act; (ii) by a banking entity in good faith in its capacity as a custodian, broker, or agent for an unaffiliated third party; (iii) by a ''qualified plan,'' as that term is defined in section 401 of the Internal Revenue Code of 1956 (26 U.S.C. 401), if the ownership interest would be attributed to a banking entity solely by operation of section 2(g)(2) of the BHC Act; or (iv) by a director or employee of a banking entity who acquires the interest in his or her personal capacity and who is directly engaged in providing advisory or other services to the covered fund, unless the banking entity, directly or indirectly, extended credit for the purpose of enabling the director or employee to acquire the ownership interest in the fund and the credit was used to acquire such ownership interest in the fund.

Among other things, § __.10(b) of the proposed rule defines the term ''covered fund.'' [219] This definition explains the universe of entities to which the

[216] *See* 12 U.S.C. 1851(a)(1)(B).

[217] *See* proposed rule § __.10(a).

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

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

prohibition contained in § __.10(a) applies unless the activity is specifically permitted under an available exemption contained in subpart C of the proposed rule. Other related terms, including ''ownership interest,'' ''prime brokerage transaction,'' ''sponsor,'' and ''trustee,'' are in turn defined in §§ __.10(b)(2) through __.10(b)(6) of the proposed rule.

b. ''Covered Fund'' and Related Definitions

i. Definition of ''Covered Fund''

Section 13(h)(2) of the BHC Act defines the terms ''hedge fund'' and ''private equity fund'' to mean ''any issuer that would be an investment company, as defined in the [Investment Company Act], but for section 3(c)(1) or 3(c)(7) of that Act,'' or such similar funds as the Agencies may by rule determine.[220] Given that the statute defines a ''hedge fund'' and ''private equity fund'' synonymously, the proposed rule implements this statutory definition by combining the terms into the definition of a ''covered fund.'' [221]

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

[220] 12 U.S.C. 1851(h)(2). Sections 3(c)(1) and 3(c)(7) of the Investment Company Act, in relevant part, provide two exclusions from the definition of ''investment company'' for, as appropriate, (1) any issuer whose outstanding securities are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities (other than short-term paper), or (2) any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time proposes to make a public offering of such securities. *See* 15 U.S.C. 80a–3(c)(1) and (c)(7).

[221] *See* proposed rule § __.10(b)(1).

The proposed rule follows the scope of the statutory definition by covering an issuer only if it would be an investment company, as defined in the Investment Company Act, *but for* section 3(c)(1) or 3(c)(7) of that Act.[222] Additionally, the proposed rule incorporates the statutory application of the rule to ''such similar funds as the Agencies may determine by rule as provided in section 13(b)(2) of the BHC Act.'' [223] The Agencies have proposed to include as ''similar funds'' a commodity pool,[224] as well as the foreign equivalent of any entity identified as a ''covered fund.'' [225] These entities have been included in the proposed rule as ''similar funds'' given that they are generally managed and structured similar to a covered fund, except that they are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States.

ii. Definition of ''Ownership Interest''

The proposed rule defines ''ownership interest'' in order to make clear the scope of section 13(a)(1)(B) of the BHC Act and § __.10(a)'s prohibition on a banking entity acquiring or retaining any equity, partnership, or other ownership interest in a covered fund. The definition of ownership interest includes a description of what interests constitute an ownership interest, as well as an exclusion from the definition of ownership interest for carried interest.[226] The proposed rule defines ownership interest to mean, with respect to a covered fund, any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar interest) in a covered fund, whether voting or nonvoting, as well as any derivative of such interest. This definition focuses on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form. To the extent that a debt security or other interest of a covered fund exhibits substantially the same characteristics as an equity or other ownership interest (e.g., provides the holder with voting rights, the right or ability to share in the covered fund's profits or losses, or the ability, directly or pursuant to a contract or synthetic interest, to earn a return based on the performance of the fund's underlying holdings or investments), the Agencies could consider such instrument an ownership interest as an ''other similar instrument.''

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

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

[223] 12 U.S.C. 1851(b)(2).

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

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

[226] *See* proposed rule § __.10(b)(3).

employee thereof) promptly after being earned or, if not so distributed, the reinvested profit of the banking entity (or the affiliate, subsidiary or employee thereof) does not share in the subsequent profits and losses of the covered fund; (iii) the banking entity (or the affiliate, subsidiary or employee thereof) does not provide funds to the covered fund in connection with acquiring or retaining this carried interest; and (iv) the interest is not transferable by the banking entity (or the affiliate, subsidiary or employee thereof) except to an affiliate or subsidiary.[227] The proposed rule therefore permits a banking entity to receive an interest as performance compensation for services provided by it or one of its affiliates, subsidiaries, or employees to a covered fund, but only if the enumerated conditions are met.

iii. Definition of ''Prime Brokerage Transaction''

Section 13(f)(3) of the BHC Act permits a banking entity to enter into a prime brokerage transaction with a covered fund in which a covered fund managed, organized, or sponsored by such banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest.[228] However, section 13 of the BHC Act does not define what qualifies as a prime brokerage transaction. In order to provide clarity regarding the types of services and relationships that are permitted as a prime brokerage transaction, the proposed rule defines a ''prime brokerage transaction'' to mean one or more products or services provided by a banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.[229]

iv. Definition of ''Sponsor'' and ''Trustee''

The proposed rule defines ''sponsor'' in the same manner as section 13(h)(5) of the BHC Act.[230] Section __.10(b)(5) of the proposed rule defines the term ''sponsor'' as an entity that: (i) Serves as a general partner, managing member, trustee, or commodity pool operator of a covered fund; (ii) in any manner selects or controls (or has employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) shares with a covered fund, for the corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[231]

The definition of ''sponsor'' contained in section 13(h)(5) of the BHC Act focuses on the ability to control the decision-making and operational functions of the fund. In keeping with this focus, the proposed rule defines the term ''trustee'' (which is a part of the definition of ''sponsor'') to exclude trustee that does not exercise investment discretion with respect to a covered fund, including a directed trustee, as that term is used in section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)). The proposed rule provides that a ''trustee'' includes any banking entity that directs a directed trustee, or any person who possesses authority and discretion to manage and control the assets of the covered fund.[232]

v. Request for Comment

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

Question 215. Is the proposed rule's approach to applying section 13 of the BHC Act's restrictions related to covered fund activities and investments to those instances where a banking entity acts ''as principal or beneficial owner'' effective? If not, why? What alternative approach might be more effective in light of the language and purpose of the statute?

Question 216. Does the proposed rule effectively address the circumstances under which an investment by a director or employee of a banking entity in a covered fund would be attributed to a banking entity? If not, why? What alternative might be more effective?

Question 217. Does the proposed rule's definition of ''covered fund'' effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute?

Question 218. Is specific inclusion of commodity pools within the definition of ''covered fund'' effective and consistent with the language and purpose of the statute? Why or why not?

Question 219. The proposed definition of ''sponsor'' focuses on ''the ability to control the decision-making and operational functions of the fund.'' In the securitization context, is this an appropriate manner to determine the identity of the sponsor? If not, what factors should be used to determine the identity of the sponsor in the securitization context for purposes of the proposed rule and why? Is the definition of ''sponsor'' set forth in the SEC's Regulation AB[233] an appropriate party to treat as sponsor for purposes of the proposed rule? Is additional guidance necessary with respect to how the proposed definition of ''sponsor'' should be applied to a securitization transaction?

Question 220. Should the application of the proposed definition of ''sponsor'' mean that the servicer or investment manager in a securitization transaction would be considered the sponsor for purposes of the proposed rule? What impact would this interpretation of the proposed definition have on existing securitizations?

Question 221. Should the definition of ''covered fund'' focus on the characteristics of an entity rather than whether it would be an investment company but for section 3(c)(1) or 3(c)(7) of the Investment Company Act? If so, what characteristics should be considered and why? Would a definition focusing on an entity's characteristics rather than its form be consistent with the language and purpose of the statute?

Question 222. Instead of adopting a unified definition of ''covered fund'' for those entities included under section 13(h)(2) of the BHC Act, should the Agencies consider having separate definitions for ''hedge fund'' and ''private equity fund''? If so, which definitions and why?

Question 223. Should the Agencies consider using the authority provided under section 13(d)(1)(J) of the BHC Act to exempt the acquisition or retention of an ownership interest in a covered fund with certain attributes or characteristics, including, for example: (i) A performance fee or allocation to an investment manager's equity account calculated by taking into account income and realized and unrealized gains; (ii) borrowing an amount in excess of one-half of its total capital commitments or has gross notional exposure in excess of twice its total capital commitments; (iii) sells securities or other assets short; (iv) has restricted or limited investor redemption rights; (v) invests in public and non-public companies through privately negotiated transactions resulting in private ownership of the business; (vi) acquires the unregistered equity or equity-like securities of such companies that are illiquid as there is

[227] *See* proposed rule § __.10(b)(3)(ii).

[228] *See* 12 U.S.C. 1851(f)(3).

[229] *See* proposed rule § __.10(b)(4).

[230] *See* 12 U.S.C. 1851(h)(5).

[231] *See* proposed rule § __.10(b)(5).

[232] *See* proposed rule § __.10(b)(6)(ii).

[233] *See* 17 CFR 229.1101(*l*).

no public market and third party valuations are not readily available; (vii) requires holding those investments long-term; (viii) has a limited duration of ten years or less; or (ix) returns on such investments are realized and the proceeds of the investments are distributed to investors before the anticipated expiration of the fund's duration? Which, if any, of these characteristics are appropriate to describe a hedge fund or private equity fund that should be considered a covered fund for purposes of this rule? Are there any other characteristics that would be more appropriate to describe a covered fund? If so, which characteristics and why?

Question 224. Is specific inclusion of certain non-U.S. entities as a ''covered fund'' under § __.10(b)(1)(iii) of the proposed rule necessary, or would such entities already be considered to be a ''covered fund'' under § __.10(b)(1)(i) of the proposed rule? If so, why? Does the proposed rule's language on non-U.S. entities correctly describe those non-U.S. entities, if any, that should be included in the definition of ''covered fund''? Why or why not? What alternative language would be more effective? Should we define non-U.S. funds by reference to the following structural characteristics: whether they are limited in the number or type of investors; whether they operate without regard to statutory or regulatory requirements relating to the types of instruments in which they may invest or the degree of leverage they may incur? Why or why not?

Question 225. Are there any entities that are captured by the proposed rule's definition of ''covered fund,'' the inclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?

Question 226. Are there any entities that are not captured by the proposed rule's definition of ''covered fund,'' the exclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?

Question 227. Do the proposed rule's definitions of ''covered fund'' and/or ''ownership interest'' pose unique concerns or challenges to issuers of asset-backed securities and/or securitization vehicles? If so, why? Do certain types of securitization vehicles (trusts, LLCs, etc.) typically issue asset-backed securities which would be included in the proposed definition of ownership interest? What would be the impact of the application of the proposed rules to these securitization vehicles? Are certain asset classes (collateralized debt obligations, future flows, corporate debt repackages, etc.) more likely to be impacted by the proposed definition of ''covered fund'' because the issuer cannot rely on an exemption other than 3(c)(1) or 3(c)(7) of the Investment Company Act?

Question 228. How many existing issuers of asset-backed securities would be included in the proposed definition of ''covered fund?'' What would be the legal and economic impact of the proposed rule on holders of asset-backed securities issued by existing securitization vehicles that would be included in the proposed definition of covered fund?

Question 229. Are there entities that issue asset-backed securities (as defined in Section 3(a) of the Exchange Act) that should be exempted from the requirements of the proposed rule? How would such an exemption promote and protect the safety and soundness of the banking entity and the financial stability of the United States as required by section 13(d)(1)(J) of the BHC Act?

Question 230. Since certain existing asset-backed securities may have a term that exceeds the conformance or extended transition periods provided for under section 13(c) of the BHC Act, should the Agencies consider using the authority contained in section 13(d)(1)(J) of that Act to exclude those existing asset-backed securities from the proposed definition of ''ownership interest'' and/or should the rule permit a banking entity to acquire or retain an ownership interest in existing asset-backed issuers? If so, how would either approach be consistent with the language and purpose of the statute?

Question 231. Many issuers of asset-backed securities have features and structures that resemble some of the features of hedge funds and private equity funds (e.g., CDOs are managed by an investment adviser that has the discretion to choose investments, including investments in securities). If the proposed definition of ''covered fund'' were to exempt any entity issuing asset-backed securities, would this allow for interests in hedge funds or private equity funds to be structured as asset-backed securities and circumvent the proposed rule? If this approach is taken, how should the proposal address this concern?

Question 232. Are the structural similarities between an entity that issues asset-backed securities and hedge funds and private equity funds of sufficient concern that the Agencies should not exclude any entity that issues asset-backed securities from the definition of covered fund?

Question 233. Should entities that rely on a separate exclusion from the definition of investment company other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act be included in the definition of ''covered fund''? Why or why not?

Question 234. Do the proposed rule's definitions of ''ownership interest'' and ''carried interest'' effectively implement the statute? What alternative definitions might be more appropriate in light of the language and purpose of the statute? Are there other types of instruments that should be included or excluded from the definition of ''ownership interest''? Does the proposed definition of ownership interest capture most interests that are typically viewed as ownership interests? Is the proposed rule's exemption of carried interest from the definition of ownership interest with respect to a covered fund appropriate? Does the exemption adequately address existing compensation arrangements and the way in which a banking entity becomes entitled to carried interest? Is it consistent with the current tax treatment of these arrangements?

Question 235. In the context of asset-backed securities, the distinction between debt and equity may be complicated (e.g., trust certificates issued in a residential mortgage backed security transaction) and the legal, accounting and tax treatment may differ for the same instrument. Is guidance necessary with respect to the application of the definition of ownership interest for asset-backed securitization transactions?

Question 236. In many securitization transactions, the residual interest represents the ''equity'' in the transaction. As this often constitutes the portion of the securitization transaction with the most risk, because it may absorb any losses experienced by the underlying assets before any other interests issued by the securitization vehicle, should the Agencies instead use their authority under section 13(d)(1)(J) of the BHC Act to exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?

Question 237. For purposes of limiting either an exclusion for issuers of asset-backed securities from the proposed definition of ''covered fund'' and/or an exclusion of asset-backed securities from the proposed definition of ''ownership interest,'' what definition of asset-backed security most effectively implements the language of section 13 of the BHC Act? Section 3(a)(77) of the Exchange Act and the SEC's Regulation

AB [234] provide two possible definitions. Is either of these definitions sufficient, and if so why? If one of the definitions is too narrow, what additional entities/securities should be included and why? If one of the definitions is too broad, what entities/securities should be excluded and why? Would some other definition of asset-backed security be more consistent with the language and purpose of section 13 of the BHC Act?

Question 238. Are there special concerns raised by not including as an ownership interest the residual interests in a securitization vehicle? Should the Agencies instead exempt the buying and selling of any ownership interest in a securitization vehicle that is a covered fund other than the residual interest?

Question 239. Should the legal form of a beneficial interest be a determining factor for deciding whether a beneficial interest is an ''ownership interest''? For example, should pass-through trust certificates issued as part of a securitization transaction be excluded from the definition of ''ownership interest''? Should the definition of ownership interest explicitly include debt instruments with equity features (e.g., voting rights, profit participations, etc.)?

Question 240. How should the proposed rule address those instances in which both debt and equity interests are issued, and the debt interests receive all of the economic benefits and all of the control rights? Should the debt interests (other than the residual interest) be counted as ownership interests even though they are not legally ownership and do not receive any profit participation? Should the equity interests be counted as ownership interests even though the holder does not receive economic benefits or have any control rights? Should the residual interest be considered the only ''ownership interest'' for purposes of the proposed rule? Should mezzanine interests that lack both control rights and profit participation be considered an ownership interest? If the mezzanine interests obtain control rights (because more senior classes have been repaid), should they become ''ownership interests'' at that time for purposes of the proposed rule? If both debt and equity interests are counted as ownership interests, how should percentages of ownership interests be calculated when the units of measurement do not match (e.g., a single trust certificate, a single residual certificate with no face value and multiple classes of currency-denominated notes)?

Question 241. Does the proposed rule's definition of ''prime brokerage transaction'' effectively implement the statute? What other types of transactions or services, if any, should be included in the definition? Should any types of transactions or services be excluded from the definition? Would an alternative definition be more effective, and if so, why?

Question 242. Do the proposed rule's definitions of ''sponsor'' and ''trustee'' effectively implement the statute? Is the exclusion of ''directed trustee'' from the definition of ''trustee'' appropriate?

Question 243. Do the proposed rule's other definitions in § __.10(b) effectively implement the statute? What alternative definitions might be more effective in light of the language and purpose of the statute? Are additional definitions needed, and if so, what definition(s)?

2. Section __.11: Permitted Organizing and Offering of a Covered Fund

Section __.11 of the proposed rule implements section 13(d)(1)(G) of the BHC Act and permits a banking entity to organize and offer a covered fund, including acting as sponsor of the fund, if certain criteria are met.[235] This exemption is designed to permit a banking entity to be able to engage in certain traditional asset management and advisory businesses in compliance with section 13 of the BHC Act.[236]

a. Required Criteria for Permitted Organizing and Offering of Covered Funds

Section __.11 of the proposed rule provides for and describes the conditions that must be met in order to enable a banking entity to qualify for the exemption to organize and offer a covered fund.[237] These conditions include: (i) The banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;[238] (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 as permitted under subpart C of the proposed rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under § __.16 of the proposed rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, (A) may not share the same name or a variation of the same name with the banking entity(or an affiliate or subsidiary thereof), and (B) may not use the word ''bank'' in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and (viii) the banking entity must (A) clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in § __.11(h) of the proposed rule, and (B) comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[239] These requirements are explained in detail below.

i. Bona Fide Services

Section __.11(a) of the proposed rule requires that, in order to qualify for the exemption related to organizing and offering a covered fund, a banking entity provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services.[240] 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.[241] Additionally, depending on the type of banking entity that conducts the activity or provides the service, variations in the

[234] *See* 17 CFR 229.1101(c).

[235] *See* proposed rule § __.11.

[236] 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan).

[237] *See* proposed rule §§ __.11(a)–(h).

[238] While section 13(d)(1)(G) of the BHC Act does not explicitly mention ''commodity trading advisory services,'' the Agencies have proposed to include commodity pools within the definition of ''covered fund'' and commodity trading advisory services in the same way as investment advisory services because commodity trading advisory services are the functional equivalent of investment advisory services to commodity pools.

[239] *See id.* at § __.11(a)–(h). The Agencies are not proposing any such additional rules at this time, although they may do so in the future.

[240] *See* 12 U.S.C. 1851(d)(1)(G)(i); proposed rule § __.11(a).

[241] *See, e.g.,* 12 U.S.C. 1843(c)(4), (c)(8), (k),12 CFR 225.28(b)(5) and (6), 12 CFR 225.86, 12 CFR 225.125 (with respect to a bank holding company); 12 U.S.C. 24 (Seventh), 92a, 12 CFR Part 9 (with respect to a national bank); 12 U.S.C. 1831a, 12 CFR Part 362 (with respect to a state nonmember bank).

precise services involved may occur. For example, a national bank and an SEC-registered investment adviser may provide substantially similar investment advisory services to clients, but be subject to different statutory and regulatory requirements. In recognition of potential variations in services and functional regulation, the proposed rule does not specify what services would qualify as ''*bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services'' under § __.11(a) of the proposed rule. Instead, the proposed rule largely mirrors the statutory language of section 13(d)(1)(G)(i) of the BHC Act and reflects the intention that so long as a banking entity provides trust, fiduciary, investment advisory, or commodity trading advisory services in compliance with relevant statutory and regulatory requirements, the requirement contained in § __.11(a) of the proposed rule would generally be deemed to be satisfied.

ii. ''Customers of Such Services'' Requirement

Section 13(d)(1)(G)(ii) of the BHC Act requires that a banking entity organize and offer a covered fund ''only in connection with'' the provision of qualified services to persons that are customers of such services of the banking entity.[242] Section __.11(b) of the proposed rule implements the statute and reflects the statutory requirement that there are two independent conditions contained in section 13(d)(1)(G)(ii) of the BHC Act: (i) A covered fund must be organized and offered in connection with *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services, and (ii) the banking entity providing those services may offer the covered fund only to persons that are customers of those services of the banking entity.[243] 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.[244]

Section 13(d)(1)(G)(ii) of the BHC Act does not explicitly require that the customer relationship be pre-existing. Accordingly, the proposed rule provides that it may be established through or in connection with the banking entity's organization and offering of a covered fund, so long as that fund is a manifestation of the provision by the banking entity of *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services to the customer. This application of the customer requirements is consistent with the manner in which trust, fiduciary, investment advisory, and commodity trading advisory services are provided by banking entities. Historically, banking entities have raised capital commitments for covered funds from existing customers as well as individuals or entities that have no pre-existing relationship with the banking entity.

Banking entities commonly organize and offer funds to customers of the banking entity's trust, fiduciary, and investment advisory or commodity trading advisory services as a way of ensuring the efficient and consistent provision of these services. For example, a person often obtains the investment advisory services of the banking entity by acquiring an interest in a fund organized and offered by the banking entity. This is distinguished from a fund organized and offered by a banking entity for the purpose of itself investing as principal, indirectly through its investment in the fund, in assets held by the fund. Under the proposed rule, a banking entity could, consistent with past practice, provide a covered fund to persons that are customers of such services for purposes of the exemption so long as the fund is organized and offered as a means of providing *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services to customers. The banking entity may not organize and offer a covered fund as a means of itself investing in the fund or assets held in the fund.[245]

The Agencies note that a banking entity could, through organizing and offering a covered fund pursuant to the authority contained in § __.11 of the proposed rule that itself makes investments or engages in trading activity, seek to evade the restrictions contained in section 13 of the BHC Act and the proposed rule. In order to address these concerns, the proposed rule provides that a banking entity relying on the authority contained in § __.11 must organize and offer a covered fund pursuant to a credible plan or similar documentation outlining how the banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund.

iii. Compliance With Investment Limitations

Section 13(d)(1)(G)(iii) of the BHC Act limits the ability of a banking entity that organizes and offers a covered fund to acquire or retain an ownership interest in that covered fund.[246] Separately, other provisions of section 13 of the BHC Act provide independent exemptions which permit a banking entity to acquire or retain an ownership interest in a covered fund.[247] Section __.11(c) of the proposed rule incorporates these statutory provisions by prohibiting a banking entity from acquiring or retaining an ownership interest in a covered fund that it organizes and offers except as permitted under subpart C of the proposed rule.[248] The limits on a banking entity's ability to invest in a covered fund that it organizes and offers are described in § __.12 of the proposal.

iv. Compliance With Section 13(f) of the BHC Act

Section __.11(d) of the proposed rule requires that the banking entity comply with the limitations on certain relationships with covered funds.[249] These limitations apply in several contexts, and are contained in § __.16 of the proposed rule, discussed in detail below. In general, § __.16 of the proposed rule prohibits certain transactions or relationships that would be covered by section 23A of the FR Act, and provides that any permitted transaction is subject to section 23B of the FR Act, in each instance as if such banking entity were a member bank and such covered fund were an affiliate thereof.[250]

v. No Guarantees or Insurance of Fund Performance

Section __.11(e) of the proposed rule prohibits the banking entity from, directly or indirectly, guaranteeing, assuming or otherwise insuring the obligations or performance of the covered fund or any covered fund in which such covered fund invests.[251]

[242] *See* 12 U.S.C. 1851(d)(1)(G)(ii).

[243] *See* proposed rule § __.11(b).

[244] *See* 156 Cong. Rec. at S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[245] The proposed rule does not change any requirement imposed by separate statute, regulation, or other law, if applicable. For instance, a banking entity that conducts a private placement of a covered fund pursuant to the SEC's Regulation D pertaining to private offerings would still be expected to comply with the relevant requirements related to such offering, including the limitations related to the manner in which and types of persons to whom it may offer or sell interests in such fund. *See* 12 CFR 230.501 *et seq.*

[246] *See* 12 U.S.C. 1851(d)(1)(G)(iii).

[247] *See, e.g., id.* at 1851(d)(1)(C).

[248] *See* proposed rule § __.11(c).

[249] 12 U.S.C. 1851(d)(1)(G)(iv); proposed rule § __.11(d).

[250] *See* Supplementary Information, Part III.C.7.

[251] 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § __.11(e).

This prong implements section 13(d)(1)(G)(iv) of the BHC Act and is intended to prevent a banking entity from engaging in bailouts of a covered fund in which it has an interest.[252]

vi. Limitation on Name Sharing With a Covered Fund

Section __.11(f) of the proposed rule prohibits the covered fund from sharing the same name or a variation of the same name with the banking entity, for corporate, marketing, promotional, or other purposes.[253] This section implements section 13(d)(1)(G)(v) of the BHC Act and addresses the concern that name-sharing could undermine market discipline and encourage a banking entity to bail out a covered fund it organizes and offers in order to preserve the entity's reputation.[254] Thus, under § __.11(f) of the proposed rule, a covered fund would be prohibited from sharing the same name or variation of the same name with a banking entity that organizes and offers or serves as sponsor to that fund (or an affiliate or subsidiary of such banking entity). A covered fund would also be prohibited under the proposed rule from using the word ''bank'' in its name.[255]

vii. Limitation on Ownership by Directors and Employees

Section __.11(g) of the proposed rule implements section 13(d)(1)(G)(vii) of the BHC Act. The provision prohibits any director or employee of the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[256] This allows an individual acting as fund manager or adviser and employed by a banking entity to acquire or retain an ownership interest in a covered fund that aligns the manager or adviser's incentives with those of its customers by allowing the individual to have ''skin in the game'' with respect to a covered fund for which that individual provides management or advisory services (which customers or clients often request).[257]

The Agencies recognize that director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in section 13(d)(4) of the BHC Act and § __.12 of the proposed rule. In order to address this concern, the proposed rule would generally attribute an ownership interest in a covered fund acquired or retained by a director or employee to such person's employing banking entity, if the banking entity either extends credit for the purpose of allowing the director or employee to acquire such ownership interest, guarantees the director or employee's purchase, or guarantees the director or employee against loss on the investment.

viii. Disclosure Requirements

Section __.11(h) of the proposed rule requires that, in connection with organizing and offering a covered fund, the banking entity (i) clearly and conspicuously disclose, in writing, to prospective and actual investors in the covered fund (such as through disclosure in the covered fund's offering documents) that ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the banking entity and its affiliates or subsidiaries]; therefore, [the banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by [the banking entity and its affiliates or subsidiaries] in their capacity as investors in [the covered fund],'' and (ii) comply with any additional rules of the appropriate Agency as provided in section 13(b)(2) of the BHC Act designed to ensure that losses in any such covered fund are borne solely by the investors in the covered fund and not by the banking entity.[258] The proposed rule also provides, as an additional disclosure requirement related to organizing and offering a covered fund, that a banking entity clearly and conspicuously disclose, in writing, to any prospective and actual investor (such as through disclosure in the covered fund's offering documents): (i) That such investor should read the fund offering documents before investing in the covered fund; (ii) that the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and (iii) the role of the banking entity and its affiliates, subsidiaries, and employees in sponsoring or providing any services to the covered fund. As noted above, the proposed rule clarifies that a banking entity may satisfy the requirements of this prong with respect to a covered fund by making the required disclosures, in writing, in the covered fund's offering documents.[259]

ix. Request for Comment

The Agencies request comment on the proposed rule's approach with respect to implementing the exemption permitting banking entities to organize and offer a covered fund. In particular, the Agencies request comment on the following questions:

Question 244. Is the proposed rule's approach to implementing the exemption for organizing and offering a covered fund effective? If not, what alternative approach would be more effective and why?

Question 245. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 246. Is the proposed rule's approach to implementing the scope of *bona fide* trust, fiduciary, investment advisory and commodity trading advisory services consistent with the statute? If not, what alternative approach would be more effective? Should the scope of such services be broader or, in the alternative, more limited? Are there specific services which should be included but which are not currently under the proposed rule?

Question 247. Does the proposed rule effectively implement the ''customers of such services'' requirement? If not, what alternative approach would be more effective and why? Is the proposed rule's approach consistent with the statute? Why or why not? How do banking entities currently sell or provide interests in covered funds? Do banking entities rely on a concept of ''customer'' by reference to other laws or

[252] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[253] 12 U.S.C. 1851(d)(1)(G)(vi); proposed rule § __.11(f).

[254] 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[255] 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).

[256] *See* 12 U.S.C. 1851(d)(1)(G)(vii); proposed rule § __.11(g).

[257] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[258] 12 U.S.C. 1851(d)(1)(G)(viii); proposed rule § __.11(h).

[259] As contemplated in § __.11(a)(8)(ii) of the proposed rule, to the extent that any additional rules are issued to ensure that losses in a covered fund are borne solely by the investors in the covered fund and not by the banking entity, a banking entity would be required to comply with those as well in order to satisfy the requirements of section 13(d)(1)(G)(viii) of the BHC Act.

regulations, and if so, what laws or regulations?

Question 248. Does the proposed rule effectively and clearly recognize the manner in which banking entities provide trust, fiduciary, investment advisory, or commodity trading advisory services to customers? If not, how should the proposed rule be modified to be more effective or clearer?

Question 249. Should the Agencies consider adopting a definition of ''customer of such services'' for purposes of implementing the exemption related to organizing and offering a covered fund? If so, what criteria should be included in such definition? For example, should the customer requirement specify that the relationship be pre-existing? Should the Agencies consider adopting an existing definition related to ''customer'' and if so, what definitions (for instance, the SEC's ''pre-existing, substantive relationship'' concept applicable to private offerings under its Regulation D) would provide for effective implementation of the customer requirement in section 13(d)(1)(G) of the BHC Act? If so, why and how? How should the customer requirement be applied in the context of non-U.S. covered funds? Is there an equivalent concept used for such non-U.S. covered fund offerings?

Question 250. Should the Agencies distinguish between direct and indirect customer relationships for purposes of implementing section 13(d)(1)(G) of the BHC Act? Should the rule differentiate between a customer relationship established by a customer as opposed to a banking entity? If so, why?

Question 251. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective, and why?

Question 252. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitation on certain relationships with a covered fund contained in § __.16 of the proposed rule? If not, what alternative approach would be more effective, and why?

Question 253. Does the proposed rule effectively implement the prohibition on a covered fund sharing the same name or variation of the same name with a banking entity? If not, what alternative approach would be more effective and why? Should the prohibition on a covered fund sharing the same name be limited to specific types of banking entities (e.g., insured depository institutions and bank holding companies) or only to the banking entity that organizes and offers the fund, and if so why?

Question 254. Does the proposed rule effectively implement the limitation on director or employee investments in a covered fund organized and offered by a banking entity? If not, what alternative approach would be more effective and why? Should the agencies provide additional guidance on what ''other services'' should be included for purposes of satisfying § __.11(g)? Why or why not?

Question 255. Are the disclosure requirements related to organizing and offering a covered fund appropriate? If not, what alternative disclosure requirement(s) should the proposed rule include? Should the Agencies consider adoption of a model disclosure form related to this requirement? Does the timing of the proposed disclosure requirement adequately address disclosure to secondary market purchasers?

3. Section __.12: Permitted Investment in a Covered Fund

Section __.12 of the proposed rule describes the limited circumstances under which a banking entity may acquire or retain, as an investment, an ownership interest in a covered fund that the banking entity or one of its subsidiaries or affiliates organizes and offers. This section implements section 13(d)(4) of the BHC Act and related provisions, and describes the statutory limits on both (i) the amount and value of an investment by a banking entity in a covered fund, and (ii) the aggregate value of all investments in all covered funds made by the banking entity.

As described below, a banking entity that makes or retains an investment in a covered fund under § __.12 of the proposed rule is generally subject to three principal limitations related to such investment. First, the banking entity's investment in a covered fund may not represent more than 3 percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule). Second, the banking entity's investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment. Third, a banking entity may invest no more than 3 percent of its tier 1 capital in covered funds.[260]

a. Authority and Limitations on Permitted Investments

Section 13(d)(4) of the BHC Act permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers pursuant to section 13(d)(1)(G), for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements.[261] Section __.12 of the proposed rule implements this authority and related limitations.

Consistent with this statutory provision, the proposed rule requires a banking entity to (i) actively seek unaffiliated investors to ensure that the banking entity's investment conforms with the limits of § __.12, and (ii) reduce through redemption, sale, dilution, or other methods the aggregate amount and value of all ownership interests of the banking entity in a single fund held under § __.12 to an amount that does not exceed 3 percent of the total outstanding ownership interests of the fund not later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to § __.12(e) of the proposed rule) (the ''per-fund limitation''). Additionally, § __.12 of the proposed rule implements the statutory requirement that the aggregate value of all ownership interests of the banking entity in all covered funds held as an investment not exceed 3 percent of the tier 1 capital of the banking entity (the ''aggregate funds limitation'').[262]

b. Permitted Investment in a Single Covered Fund

Section __.12(b) of the proposed rule describes the limitations and restrictions on a banking entity's ability to make or retain an investment in a single covered fund. This section implements the requirements of section 13(d)(4) of the BHC Act.[263]

Section __.12 of the proposed rule describes the manner in which the limitations on the amount and value of ownership interests in a covered fund must be calculated, in recognition of the fact that a covered fund may have multiple classes of ownership interests which possess different characteristics

[260] *See, e.g.,* proposed rule §§ __.12(b)(2), (c).

[261] *See* 12 U.S.C. 1851(d)(4).

[262] *See* proposed rule at § __.12(a)(2)(ii). The process and manner in which a banking entity's 3 percent tier 1 capital limit is determined for purposes of the proposed rule is discussed in detail below in Part III.C.3 of this Supplementary Information.

[263] *See* 12 U.S.C. 1851(d)(4)(B).

or values that impact a person's ownership in that fund. A banking entity must apply the limits to both the total value and amount of its investment in a covered fund. For purposes of applying these limits, the banking entity must calculate (without regard to committed funds not yet called for investment): (i) The value of all investments or capital contributions made with respect to any ownership interest by the banking entity in a covered fund, divided by the value of all investments or capital contributions made by all persons in that covered fund, and (ii) the total number of ownership interests held as an investment by the banking entity in a covered fund divided by the total number of ownership interests held by all persons in that covered fund.[264] Therefore, under the proposed rule, such calculation would include as the numerator the amount or value of a banking entity's investment in a covered fund, and as the denominator the amount or value (matched to the unit of measurement in the numerator) of all classes of ownership interests held by all persons in that covered fund. As noted above, the banking entity's investment in a covered fund also may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment.[265]

In order to ensure that a banking entity calculates its investment in a covered fund accurately and does not evade the per-fund investment limitation, the proposed rule requires that the banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests in the covered fund.[266]

Under the proposed rule, the amount and value of a banking entity's investment in any single covered fund is (i) the total amount or value held by the banking entity directly and through any entity that is controlled, directly or indirectly, by the banking entity,[267] plus (ii) the *pro rata* amount or value of any covered fund held by any entity (other than certain operating entities noted below) that is not controlled, directly or indirectly, by the banking entity but in which the banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares.[268]

Additionally, the proposed rule provides that, to the extent that a banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the banking entity (whether or not pursuant to an express agreement), such investment shall be included in the calculation of a banking entity's per-fund limitation.[269] In this way, the proposed rule prevents a banking entity from evading the limitations under § __.12 of the proposed rule through committed co-investments.

Section __.12(b)(3) of the proposed rule provides that the amount and value of a banking entity's investment in a covered fund may at no time exceed the 3 percent limits contained in § __.12(b) of the proposed rule after the conclusion of any conformance period, if applicable.[270] In cases where a fund calculates its value or stands ready to issue or redeem interests frequently (e.g., daily), a banking entity must calculate its per-fund limitation no less frequently than the fund performs such calculation or issues or redeems interests. In recognition of the fact that not every covered fund may calculate or determine its valuation daily (for instance, if it does not allow redemptions except infrequently or invests principally in illiquid assets for which no market price is readily available), the proposed rule would not require a daily calculation of value for such fund (unless a daily calculation is determined by the fund).[271] In such cases, the calculation of the amount and value of a banking entity's per-fund limitation must be made no less frequently than at the end of every quarter.[272] Additionally, since a banking entity must organize and offer any covered fund in which it invests, the Agencies expect that such banking entity would closely and regularly monitor not only the value of such fund's interests, but also any changes in the fund's investors' relative ownership percentages.[273]

c. Aggregate Permitted Investments in All Covered Funds and Calculation of a Banking Entity's Tier 1 Capital

In addition to a limit on investments in a single covered fund, section 13(d)(4) of the BHC Act requires the banking entity to comply with the aggregate funds limitation on investments in all covered funds.[274] As required under section 13(d)(4)(B)(ii)(II) of the BHC Act, the proposed rule provides that the aggregate of a banking entity's ownership interests in all covered funds that are held under § __.12 of the proposed rule may not exceed 3 percent of the tier 1 capital of a banking entity.[275] In order to maintain equality in application of the aggregate funds limitation, the proposed rule provides that, for purposes of determining compliance with § __.12 of the proposed rule, the aggregate of all of a banking entity's investments in all covered funds under § __.12 of the proposed rule must be valued pursuant to applicable accounting standards.[276] This value calculation is separate and in addition to the required calculation of the value of a banking entity's investment in a covered fund as part of determining compliance with the per-fund limitation.

Tier 1 capital is a banking law concept that, in the United States, is

[264] *See* proposed rule § __.12(b)(2).

[265] Under the proposed rule, a banking entity's investment in a covered fund may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment since the banking entity's permitted investment in a covered fund may be no more than 3 percent of the value and amount of such fund's total ownership interests, and the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund. *See* 12 U.S.C. 1851(d)(1)(G)(v); proposed rule § __.11(e).

[266] *See* proposed rule § __.12(b)(4).

[267] *See* proposed rule § __.12(b)(1)(A).

[268] *See* proposed rule § __.12(b)(1)(B). As noted above, whether or not an investment is controlled or noncontrolled will be determined consistent with the BHC Act, as implemented by the Board. *See* 12 U.S.C. 1841(a)(2); 12 CFR 225.2(e).

[269] *See* proposed rule § __.12(b)(2)(B).

[270] *See* proposed rule § __.12(b)(3).

[271] With respect to an issuer of asset-backed securities, depending on the transaction structure, such calculation may need to be made each time a payment is made to any holder of the issuer's asset-backed securities.

[272] The Agencies note that while calculation of a banking entity's ownership interest in a covered fund must be determined no less frequently than at the end of every quarter, it is possible that no change in a banking entity's ownership interest (e.g., no redemptions or other changes in investor composition) may occur during every quarter.

[273] For instance, where a banking entity acts as sponsor to a covered fund, in connection with the organizing and offering of that fund it may include a requirement (such as a ''tag-along'' redemption right) in the fund's organizational documents in order to assist the banking entity in complying with the per-fund investment limitation.

[274] As noted in the discussion regarding the per-fund limitation, the proposed rule provides that, for purposes of determining compliance with § __.12, the banking entity's permitted investment in a covered fund shall be calculated in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests. However, the value of a banking entity's aggregate permitted investments in all covered funds shall be determined in accordance with applicable accounting standards. *See* proposed rule § __.12(c)(1).

[275] *See* 12 U.S.C. 1851(d)(4)(B)(ii)(II); proposed rule § __.12(a)(2)(ii).

[276] *See* proposed rule § __.12(c)(1).

calculated and reported by certain depository institutions and bank holding companies in order to determine their compliance with regulatory capital standards. Accordingly, the proposed rule clarifies that for purposes of the aggregate funds limitation in § __.12, a banking entity that is a bank, a bank holding company, a company that controls an insured depository institution that reports tier 1 capital, or uninsured trust company that reports tier 1 capital (each a ''reporting banking entity'') must apply the reporting banking entity's tier 1 capital as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.[277]

However, not all entities subject to section 13 of the BHC Act calculate and report tier 1 capital. In order to provide a measure of equality related to the aggregate funds limitation contained in section 13(d)(4)(B)(ii)(II) of the BHC Act and § __.12(c) of the proposed rule, the proposed rule clarifies how the aggregate funds limitation shall be calculated for entities that are not required to calculate and report tier 1 capital in order to determine compliance with regulatory capital standards. Under the proposed rule, with respect to any banking entity that is not affiliated with a reporting banking entity and not itself required to report capital in accordance with the risk-based capital rules of a Federal banking agency, the banking entity's tier 1 capital for purposes of the aggregate funds limitation shall be the total amount of shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as determined under applicable accounting standards.[278] For a banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is a depository institution (e.g., a subsidiary of a national bank), the aggregate funds limitation shall be the amount of tier 1 capital reported by such depository institution.[279] For a banking entity that is not itself required to report tier 1 capital but is a subsidiary of a reporting banking entity that is not a depository institution (e.g., a nonbank subsidiary of a bank holding company), the aggregate funds limitation shall be the amount of tier 1 capital reported by the top-tier affiliate of such banking entity that holds and reports tier 1 capital.[280] Thus, for purposes of calculating the aggregate funds limitation under § __.12(c)(2) of the proposed rule, the tier 1 capital for the different types of banking entities would be as follows:

Type of banking entity	*Tier 1 capital for purposes of § __.12*
Depository institution that is a reporting banking entity (or a subsidiary thereof).	Tier 1 capital of the depository institution as of the last day of the most recent calendar quarter that has ended, as reported to the relevant Federal banking agency.
Bank holding company or a subsidiary thereof (other than a reporting banking entity).	Tier 1 capital of the bank holding company as of the last day of the most recent calendar quarter that has ended, as reported to the Board.
Company that controls an insured depository institution and that is a reporting banking entity (or a subsidiary thereof other than a reporting banking entity).	Tier 1 capital of the top tier entity within such organization as of the last day of the most recent calendar quarter that has ended, as reported to the Board.
Other banking entity (including an industrial loan company holding company, thrift holding company, or a subsidiary thereof).	Shareholders' equity of the top-tier entity within such organization as of the last day of the most recent calendar quarter that has ended, under applicable accounting standards.

Additionally, in the case of a depository institution that is itself a reporting banking entity and is also a subsidiary or affiliate of a reporting banking entity, the aggregate of all investments in all covered funds held by the depository institution (including investments by its subsidiaries) may not exceed 3 percent of either the tier 1 capital of the depository institution or of the top-tier reporting banking entity that controls such depository institution.[281]

d. Deduction of an Investment in a Covered Fund From Tier 1 Capital

Section 12(d) of the proposed rule also implements the provision contained in section 13(d)(4)(b)(iii) of the BHC Act regarding the deduction of a banking entity's aggregate investment in a covered fund held under section 13(d)(4) of that Act from the assets and tangible equity of the banking entity. The statute also provides that the amount of the deduction must increase commensurate with the leverage of the underlying fund.[282]

Section __.12(d) of the proposal requires a banking entity to deduct the aggregate value of its investments in covered funds from tier 1 capital. Since § __.12 of the proposed rule implements the authorities contained in section 13(d)(4) of the BHC Act related to an investment in a fund organized and offered by the banking entity (or an affiliate or subsidiary thereof), the deduction contained in § __.12(d) applies only to those ownership interests held as an investment by a banking entity pursuant to § __.12 of the proposed rule.[283] For instance, a banking entity that acquires or retains an ownership interest in a covered fund as a permitted risk-mitigating hedge under § __.13(b) of the proposed rule, or that acquires or retains an ownership interest in the course of collecting a debt previously contracted in good faith, would not be required to deduct the value of such ownership interest from its tier 1 capital.[284] The deduction required under § __.12(d) of the proposed rule must be calculated consistent with other like deductions under the applicable risk-based capital rules.[285]

[277] *See* proposed rule § __.12(c)(1)(A).

[278] *See* proposed rule § __.12(c)(2)(ii)(B)(2).

[279] *See* proposed rule § __.12(c)(2)(ii)(A).

[280] *See* proposed rule § __.12(c)(1)(B).

[281] If the aggregate value of all investments in all covered funds attributable to such a depository institution is less than 3 percent of its tier 1 capital, then that amount of capital which is greater than the amount supporting the depository institution's investments (or those held by its subsidiaries) in a covered fund, but less than 3 percent of the depository institution's tier 1 capital, may be used to support an investment in a covered fund by an affiliated banking entity that is not itself a depository institution that holds and reports tier 1 capital or controlled, directly or indirectly, by such a depository institution.

[282] *See* 12 U.S.C. 1851(d)(4)(B)(iii).

[283] *See* proposed rule § __.12(d).

[284] The Agencies note that since this deduction from capital implements Section 13(d)(4)(B)(iii) of the BHC Act, it is being included in this proposed rule which deals with Section 13 of the BHC Act. However, the Agencies may relocate this deduction as part of any later revised capital rules if, in the future, it is determined that inclusion in such rules is more appropriate.

[285] *See* 12 CFR part 208, Appendices A, E, and F (for a state member bank); 12 CFR part 225, Appendices A, E, and G (for a bank holding

Continued

e. Extension of Time To Divest an Ownership Interest in a Single Covered Fund

Section 13(d)(4)(C) of the BHC Act permits the Board, upon application by a banking entity, to extend for up to 2 additional years the period of time within which a banking entity must reduce its attributable ownership interests in a covered fund to no more than 3 percent of such fund's total ownership interests.[286] The statute provides the possibility of an extension only with respect to the per-fund limitation, and not to the aggregate funds limitation.[287] Section __.12(e) of the proposed rule implements this provision of the statute. In order to grant any extension, the Board must determine that the extension would be consistent with safety and soundness and would not be detrimental to the public interest.[288]

Section __.12(e) of the proposed rule requires any banking entity that seeks an extension of this conformance period to submit a written request to the Board. Under the proposal, any such request must: (i) Be submitted in writing to the Board at least 90 days prior to the expiration of the applicable time period; (ii) provide the reasons why the banking entity believes the extension should be granted; and (iii) provide a detailed explanation of the banking entity's plan for reducing or conforming its investment(s).

In addition, the proposed rule provides that any extension request by a banking entity must address each of the following matters (to the extent they are relevant): (i) Whether the investment would—(A) involve or result in material conflicts of interest between the banking entity and its clients, customers or counterparties; (B) result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies; (C) pose a threat to the safety and soundness of the banking entity; or (D) pose a threat to the financial stability of the United States; (ii) market conditions; (iii) the contractual terms governing the banking entity's interest in the covered fund; (iv) the date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the banking entity to enable the banking entity to comply with the limitations in section 12(a)(2)(i)(B) of the proposed rule; (v) the total exposure of the banking entity to the investment and the risks that disposing of, or maintaining, the investment in the covered fund may pose to the banking entity or the financial stability of the United States; (vi) the cost to the banking entity of divesting or disposing of the investment within the applicable period; (vii) whether the divestiture or conformance of the investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty; (viii) the banking entity's prior efforts to divest or sell interests in the covered fund, including activities related to the marketing of interests in such covered fund; and (ix) any other factor that the Board believes appropriate.[289] Under the proposed rule, the Board would consider requests for an extension in light of all relevant facts and circumstances, including the factors described above.

Section __.12(e) of the proposed rule also would allow the Board to impose conditions on any extension granted under the proposed rule if the Board determines conditions are necessary or appropriate to protect the safety and soundness of banking entities or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the BHC Act and the proposed rule.[290] In cases where the banking entity is primarily supervised by another Agency, the Board would consult with such Agency both in connection with its review of the application and, if applicable, prior to imposing conditions in connection with the approval of any request by the banking entity for an extension of the conformance period under the proposed rule.[291]

f. Request for Comment

The Agencies request comment on the proposed rule's approach to implementing the exemption which allows a banking entity to make or retain a permitted investment in a covered fund that it organizes and offers. In particular, the Agencies request comment on the following questions:

Question 256. Is the proposed rule's approach to implementing the exemption that allows a banking entity to make or retain a permitted investment in a covered fund effective? If not, what alternative approach would be more effective and why?

Question 257. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 258. Should the proposed rule specify at what point a covered fund will be considered to have been ''established'' for purposes of commencing the period in which a banking entity may own more than 3 percent of the total outstanding ownership interests in such fund? If so, why and how?

Question 259. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitations on an investment in a single covered fund? If not, what alternative approach would be more effective and why?

Question 260. Does the proposed rule effectively implement the requirement that a banking entity comply with the limitations on the aggregate of all investments in all covered funds? If not, what alternative approach would be more effective and why?

Question 261. Is the proposed rule's approach to calculating a banking entity's investment in a covered fund effective? Should the per-fund calculation be based on committed capital, rather than invested capital? Why or why not? Is the timing of the calculation of a banking entity's ownership interest in a single covered fund appropriate? If not, why not, and what alternative approach would be more effective and why? For example, should the per-fund calculation be required on a less-frequent basis (e.g., monthly) for funds that compute their value and allow purchases and redemptions on a daily basis (e.g., daily)? Why or why not?

company); 12 CFR part 3, Appendices A, B, and C (for a national bank); 12 CFR part 325, Appendices A, C, and D (for a state nonmember bank); and 12 CFR part 167, Appendix C (for a federal thrift).

[286] 12 U.S.C. 1851(d)(4)(C).

[287] *See id.*

[288] As noted in Part III.C.2.a.ii of this Supplementary Information, the Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through organizing and offering a covered fund pursuant to the authority contained in § __.11 of the proposed rule. Therefore, in addition to taking action against a banking entity that does not actively seek unaffiliated investors to reduce or dilute the investment of the banking entity as provided under § __.12(a)(2) of the proposed rule, the Agencies expect that if a banking entity is habitually or routinely seeking an extension of the one-year period provided under § __.12(a)(2)(i)(B), this could be evidence of seeking to evade the restrictions contained in the proposed rule and, as appropriate, the Agencies may take action against such banking entity.

[289] *See* proposed rule § __.12(e)(1)(ii).

[290] Nothing in section 13 of the BHC Act or the proposed rule limits or otherwise affects the authority that the Board, the other Federal banking agencies, the SEC, or the CFTC may have under other provisions of law. In the case of the Board, these authorities include, but are not limited to, section 8 of the Federal Deposit Insurance Act and section 8 of the BHC Act. *See* 12 U.S.C. 1818, 1847.

[291] *See* proposed rule §§ __.12(e)(iii) and (iv).

Question 262. Is the proposed rule's approach to parallel investments effective? Why or why not? Should this provision require a contractual obligation and/or knowing participation? Why or why not? How else could the proposed rule define parallel investments? What characteristics would more closely achieve the scope and intended purposes of section 13 of the BHC Act?

Question 263. Is the proposed rule's treatment of investments in a covered fund by employees and directors of a banking entity effective? If not, what alternative approach would be more effective and why?

Question 264. Is the proposed rule's approach to differentiating between controlled and noncontrolled investments in a covered fund unduly complex or burdensome? If so, what alternative approach, if any, would be more effective and why?

Question 265. Is the proposed rule's approach to valuing an investment in a covered fund according to the same standards utilized by the covered fund for determining the aggregate value of its assets and ownership interests effective? If not, what alternative valuation approach would be more effective and why? Should the rule specify one methodology for valuing an investment in a covered fund?

Question 266. Is the proposed rule's approach regarding when to require the calculation of a banking entity's aggregate investments in all covered funds effective? What is the potential impact of calculating a banking entity's aggregate investment limit under the proposed rule on a quarterly basis as opposed to solely at the time an investment in a covered fund is made? Would calculation of the aggregate investment limit solely at the time an investment in a covered fund is made be consistent with the language and purpose of the statute? Does the proposed rule provide sufficient guidance for an issuer of asset-backed securities about how and when to make such calculation? Why or why not?

Question 267. Is the proposed rule's approach to determining and calculating a banking entity's relevant tier 1 capital limit effective? If not, what alternative approach would be more effective and why? With respect to applying the aggregate funds limitation to a banking entity that is not affiliated with an entity that is required to hold and report tier 1 capital, is total shareholder equity on a consolidated basis as of the last day of the most recent calendar quarter that has ended an effective proxy for tier 1 capital? If not, what alternative approach would be more effective and why?

Question *268.* Should the proposed rule be modified to permit a banking entity to bring its investments in covered funds into compliance with the proposed rule within a reasonable period of time if, for example, the banking entity's aggregate permitted investments in covered funds exceeds 3 percent of its tier 1 capital for reasons unrelated to additional investments (e.g., a banking entity's tier 1 capital decreases)? Why or why not?

Question 269. Does the proposed rule effectively and appropriately implement the deduction from capital for an investment in a covered fund contained in section 13(d)(4)(B)(iii) of the BHC Act? If not, what alternative approach would be more effective or appropriate, given the statutory language of the BHC Act and overall structure of section 13(d)(4), and why? What effect, if any, should the Agencies give to the cross-reference in section 13(d)(4) to section 13(d)(3) of the BHC Act, which provides Agencies with discretion to require additional capital, if appropriate, to protect the safety and soundness of banking entities engaged in activities permitted under section 13 of the BHC Act? How, if at all, should a banking entity's deduction of its investment in a covered fund be increased commensurate with the leverage of the covered fund? Should the amount of the deduction be proportionate to the leverage of the covered fund? For example, instead of a dollar-for-dollar deduction, should the deduction be set equal to the banking entity's investment in the covered fund times the difference between 1 and the covered fund's equity-to-assets ratio?

Question 270. Does the proposed rule effectively implement the Board's statutory authority to grant an extension of the period of time a banking entity may retain in excess of 3 percent of the ownership interests in a single covered fund? Are the enumerated factors that the Board may consider in connection with reviewing such an extension appropriate (including factors related to the effect of an extension of the covered fund), and if not, why not? Are there additional factors that the Board should consider in reviewing such a request? Are there specific additional conditions or limitations that the Board should, by rule, impose in connection with granting such an extension? If so, what conditions or limitations would be more effective?

Question 271. Given that the statute does not provide for an extension of time for a banking entity to comply with the aggregate funds limitation, within what period of time should a banking entity be required to bring its investments into conformance with the aggregate funds limit? Should the proposed rule expressly contain a grace period for complying with these limits? Why or why not? If yes, what grace period would be most effective and why?

Question 272. Does the proposed rule effectively implement the prohibition on a banking entity guaranteeing or insuring the obligations or performance of certain covered funds? If not, what alternative approach would be more effective and why?

Question 273. In the context of securitization transactions, control and ownership are often completely separated. Is additional guidance necessary with respect to how control should be determined with respect to issuers of asset-backed securities for purposes of determining the calculation of the per-fund and aggregate ownership limitations?

Question 274. In many securitization transactions, the voting rights of investors are extremely limited and management may be contractually delegated to a third party (because issuers of asset-backed securities rarely have a board with any authority or any employees). The servicer or manager has the ''ability to control the decision-making and operational functions of the fund.'' When calculating the per-fund and aggregate ownership limitations, to whom should the proposed rule allocate ''control'' in this type of situation? Which participants in a securitization transaction would need to include the activities of an issuer of asset-backed securities in their calculations of per-fund and aggregate ownership, and what is the potential impact of such inclusion?

Question 275. For purposes of calculating the per-fund and aggregate ownership limitations, how should the proposed rule address those instances in which equity is issued, but the equity holder does not receive economic benefits or have any control rights? For instance, in order to enhance or achieve bankruptcy remoteness, a single purpose trust without an owner (i.e, an orphan trust) may hold all of the equity interests in a securitization vehicle. Such interests often do not have any meaningful economic or control rights.

4. Section __.13: Other Permitted Covered Fund Activities and Investments

Section 13 of the proposed rule implements the statutory exemptions described in sections 13(d)(1)(C), (E), and (I) of the BHC Act that permit a banking entity: (i) To acquire an ownership interest in, or act as sponsor to, one or more SBICs, a public welfare investment, or a certain qualified rehabilitation expenditure;[292] (ii) to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedging position; and (iii) in the case of a non-U.S. banking entity, to acquire or retain an ownership interest in or sponsor a foreign covered fund. Additionally, § __.13 of the proposed rule implements in part the rule of construction related to the sale and securitization of loans contained in section 13(g)(2) of the BHC Act. Similar to § __.6 of the proposed rule (which implements certain permitted proprietary trading activities), § __.13 contains only the statutory exemptions contained in section 13(d)(1) of the BHC Act that the Agencies have determined apply, either by plain language or by implication, to investments in or relationships with a covered fund.[293]

a. Permitted Investments in SBICs and Related Funds

Section __.13(a) of the proposed rule implements sections 13(d)(1)(E) and (J) of the BHC Act[294] and permits a banking entity to acquire or retain any ownership interest in, or act as sponsor to: (i) One or more SBICs, as defined in section 102 of the Small Business Investment Act of 1958 (12 U.S.C. § 662); (ii) an investment that is designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. § 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); and (iii) an investment that is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.[295] Since section 13(d)(1)(E) of the BHC Act does not limit a banking entity's investment to a limited partnership or other non-controlling investment, § __.13(a) of the proposed rule would permit a banking entity to be a shareholder, general partner, managing member, or trustee of an SBIC without regard to whether the interest is a controlling or non-controlling interest.[296]

In addition to the acquisition or retention of an ownership interest, permitting a banking entity to act as sponsor to these types of public interest investments will provide valuable expertise and services to these types of entities, as well as help enable banking entities to provide valuable funding and assistance to small business and low- and moderate-income communities. Therefore, the Agencies believe this exemption would be consistent with the safe and sound operation of banking entities, and would also promote the financial stability of the United States.

The Agencies request comment on the proposed rule's approach to implementing the exemption for permitted investments in and relationships with SBICs and certain related funds. In particular, the Agencies request comment on the following questions:

Question 276. Is the proposed rule's approach to implementing the SBIC, public welfare and qualified rehabilitation investment exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?

Question 277. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 278. Should the proposed rule permit a banking entity to sponsor an SBIC and other identified public interest investments? Why or why not? Does the Agencies' determination under section 13(d)(1)(J) of the BHC Act regarding sponsoring of an SBIC, public welfare or qualified rehabilitation investment effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?

Question 279. What would the effect of the proposed rule be on a banking entity's ability to sponsor and syndicate funds supported by public welfare investments or low income housing tax credits which are utilized to assist banks and other insured depository institutions with meeting their Community Reinvestment Act (''CRA'') obligations?

Question 280. Does the proposed rule unduly constrain a banking entity's ability to meet the convenience and needs of the community through CRA or other public welfare investments or services? If so, why and how could the proposed rule be revised to address this concern?

b. Permitted Risk-Mitigating Hedging Activities

Section __.13(b) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund if the transaction is made in connection with, and related to, certain individual or aggregated positions, contracts, or other holdings of the banking entity and is designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. This section of the proposed rule implements, in relevant part, section 13(d)(1)(C) of the BHC Act, which provides an exemption from the prohibition on acquiring or retaining an ownership interest in a covered fund for certain risk-mitigating hedging activities.[297]

Interests by a banking entity in a covered fund may not typically be used as hedges for specific positions, contracts, or other holdings of a banking entity. However, two situations where a banking entity may potentially acquire or retain an ownership interest in a covered fund as a hedge are (i) when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund (similar to acting as a ''riskless principal''),[298] and (ii) to cover

[292] Section __.13(a) of the proposed rule also implements a proposed determination by the Agencies under section 13(d)(1)(J) of the BHC Act that a banking entity may not only invest in such entities as provided under section 13(d)(1)(E) of the BHC Act, but also may sponsor an entity described in that paragraph and that such activity, since it generally would facilitate investment in small businesses and support the public welfare, would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

[293] In particular, § __.13 of the proposed rule does not include: (i) The exemption in section 13(d)(1)(A) of the BHC Act for trading in certain permitted government obligations; (ii) the exemption in section 13(d)(1)(H) of the BHC Act for certain foreign proprietary trading activities; and (iii) the exemption contained in section 13(d)(1)(B) of the BHC Act related to underwriting and market-making related activities. Each of these exemptions appear relevant only to covered trading activities and not to covered fund activities.

[294] Section 13(d)(1)(E) of the BHC Act permits a banking entity to make investments in one or more SBICs, investments designed primarily to promote the public welfare, investments of the type permitted under 12 U.S.C. 24(eleventh), and investments that are qualified rehabilitation expenditures with respect to a qualified rehabilitated building or certified historic structure. *See* 12 U.S.C. 1851(d)(1)(E).

[295] *See* proposed rule § __.13(a).

[296] Pursuant to the exemption contained in § __.13(a) of the proposed rule, a banking entity may acquire an ownership interest in, or act as sponsor to, a low income housing credit fund, if such fund qualifies as an SBIC, public welfare investment or qualified rehabilitation expenditure.

[297] *See* 12 U.S.C. 1851(d)(1)(C).

[298] In order to prevent evasion of the general limitation that a banking entity may not acquire or retain more than 3 percent of the ownership interests in any single covered fund that such banking entity organizes and offers, the proposed rule limits a banking entity's ability to acquire or retain an ownership interest in a covered fund as

a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund. Section __.13(b) of the proposed rule provides an exemption for banking entity to acquire or retain an ownership interest in a covered fund in these limited situations.[299]

i. Approach for Hedges Using an Ownership Interest in a Covered Fund

As noted above in the discussion of § __.5 of the proposed rule, risk-mitigating hedging activities present certain implementation challenges because of the potential that prohibited activities or investments could be conducted in the context of, or mischaracterized as, hedging transactions. In light of these complexities, the Agencies have proposed a multi-faceted approach to implementation, which is discussed in detail above in reference to § __.5 of the proposed rule.[300] As with the hedging exemption provided under § __.5, this multi-faceted approach is intended to clearly articulate the Agencies' expectations regarding the scope of permitted hedging activities under § __.13(b) in a manner that limits potential abuse of the hedging exemption while not unduly constraining the important risk management function that is served by a banking entity's hedging activities. However, because of the possibility that using an ownership interest in a covered fund as a hedging instrument may mask an intent to evade the limitations on the amount and value of ownership interests in a covered fund or funds under § __.12, the proposed rule contains several additional requirements related to a banking entity's ability to use an ownership interest in a covered fund as a hedging instrument.

ii. Required Criteria for Permitted Risk-Mitigating Hedging Activities Involving a Covered Fund

Section __.13(b) of the proposed rule describes the criteria that a banking entity must meet in order to rely on the hedging exemption with respect to ownership interests of a covered fund. The majority of these requirements are substantially similar to those discussed in detail above in connection with the risk-mitigating hedging exemption contained in § __.5 of the proposed rule, and include the requirements that: (i) The hedge is made in connection with and related to individual or aggregated obligations or liabilities of the banking entity that are: (A) taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (B) directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund; (ii) the banking entity has established the internal compliance program required by subpart D designed to ensure the banking entity's compliance with the requirements of this paragraph, including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing; (iii) the transaction is designed to reduce the specific risks to the banking entity in connection with and related to such obligations or liabilities; (iv) the acquisition or retention of an ownership interest in a covered fund: (A) Is made in accordance with the written policies, procedures and internal controls established by the banking entity pursuant to subpart D; (B) hedges or otherwise mitigates an exposure to a covered fund through a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that arises out of a transaction conducted solely to accommodate a specific customer request with respect to, or directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund; (C) does not give rise, at the inception of the hedge, to significant exposures that were not already present in individual or aggregated positions, contracts, or other holdings of a banking entity and are not hedged contemporaneously; and (D) is subject to continuing review, monitoring and management by the banking entity that: (1) Is consistent with its written hedging policies and procedures; (2) maintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and (3) mitigates any significant exposure arising out of the hedge after inception; and (v) the compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.[301]

These requirements, while substantially similar to those contained in § __.5 above, are different in several material aspects. First, § __.13(b)(1)(i) of the proposed rule provides that any banking entity relying on this exemption may only hedge or otherwise mitigate one or more specific risks arising in connection with and related to the two situations enumerated in that section. These are risks taken by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund.[302] Second, § __.13(b)(2)(ii)(B) of the proposed rule requires that the acquisition or retention of an ownership interest in a covered fund hedge or otherwise mitigate a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund, which requires greater equivalency between the reference asset and hedging instrument than the correlation required under § __.5. Third, § __.13(b)(3) of the proposed rule imposes a documentation requirement on all types of hedging transactions where the banking entity uses ownership interests in a covered fund as the hedging instrument. This requirement is broader than that contained in § __.5 and is reflective of the limited scope of positions or exposures for which a banking entity may acquire or retain an ownership interest in a covered fund as a hedge. Specifically, for *any* transaction that a banking entity acquires or retains an ownership interest in a covered fund in reliance of the hedging exemption, the banking entity must document the risk-mitigating purposes of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holding of the banking entity that the transaction is designed to reduce. Such documentation must be established at the time the hedging transaction is effected, not after the fact. This documentation requirement establishes a contemporaneous record that will assist the Agencies in assessing

a permitted risk-mitigating hedge to those situations where the customer of the banking entity is not itself a banking entity. *See* proposed rule § __.13(b)(1)(i)(A).

[299] *See* proposed rule § __.13(b).

[300] *See* Supplementary Information, Part III.B.3.

[301] *See* proposed rule § __.13(b).

[302] *See* proposed rule § __.13(b)(1)(i).

the actual reasons for which the position was established.

iv. Request for Comment

In addition to those questions raised in connection with the proposed implementation of the risk-mitigating hedging exemption under § __.5 of the proposed rule, the Agencies request comment on the proposed implementation of that same exemption with respect to covered fund activities. In particular, the Agencies request comment on the following questions:

Question 281. Is the proposed rule's approach to implementing the hedging exemption for acquiring or retaining an ownership interest in a covered fund effective? If not, what alternative approach would be more effective?

Question 282. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 283. What burden will the proposed approach to implementing the hedging exemption have on banking entities? How can any burden be minimized or eliminated in a manner consistent with the language and purpose of the statute?

Question 284. Are the criteria included in § __.13(b)'s hedging exemption effective? Is the application of each criterion to potential transactions sufficiently clear? Should any of the criteria be changed or eliminated? Should other requirements be added?

Question 285. Is the requirement that an ownership interest in a covered fund may only be used as a hedge (i) by the banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or (ii) to cover compensation arrangements with an employee of the banking entity that directly provides investment advisory or other services to that fund effective? If not, what other requirements would be more effective?

Question 286. Does the proposed rule sufficiently articulate the types of risks and positions that a banking entity typically would utilize an ownership interest in a covered fund to hedge? If not, how should the proposal be changed?

Question 287. Is the requirement that that the hedging transaction involve a substantially similar offsetting exposure to the same covered fund and in the same amount of ownership interest to the risk or risks the transaction is intended to hedge or otherwise mitigate effective? If not, how should the requirement be changed? Should some other level of correlation be required? Should the proposal specify in greater detail how correlation should be measured? If not, how could it better do so?

Question 288. Is the requirement that the transaction not give rise, at the inception of the hedge, to material risks that are not themselves hedged in a contemporaneous transaction effective? Is the proposed materiality qualifier appropriate and sufficiently clear? If not, what alternative would be effective and/or clearer?

Question 289. Is the requirement that any transaction conducted in reliance on the hedging exemption be subject to continuing review, monitoring and management after the transaction is established effective? If not, what alternative would be more effective?

Question 290. Is the proposed documentation requirement effective? If not, what alternative would be more effective? What burden would the proposed documentation requirement place on covered banking entities? How might such burden be reduced or eliminated in a manner consistent with the language and purpose of the statute?

c. Permitted Covered Fund Activities and Investments Outside of the United States

Section __.13(c) of the proposed rule, which implements section 13(d)(1)(I) of the BHC Act,[303] permits certain foreign banking entities to acquire or retain an ownership interest in, or to act as sponsor to, a covered fund so long as such activity occurs solely outside of the United States and the entity meets the requirements of sections 4(c)(9) or 4(c)(13) of the BHC Act. The purpose of this statutory exemption appears to be to limit the extraterritorial application of the statutory restrictions on covered fund activities to foreign firms that, in the course of operating outside of the United States, engage outside the United States in activities permitted under relevant foreign law, while preserving national treatment and competitive equality among U.S. and foreign firms within the United States.[304] Consistent with this purpose, the proposed rule defines both the type of foreign banking entities that are eligible for the exemption and the circumstances in which covered fund activities or investments by such an entity will be considered to have occurred solely outside of the United States (including clarifying when an ownership interest will be deemed to have been offered for sale or sold to a resident of the United States).

i. Foreign Banking Entities Eligible for the Exemption

Section __.13(c)(1)(i) of the proposed rule incorporates the statutory requirement that the banking entity not be, directly or indirectly, controlled by a banking entity that is organized under the laws of the United States or of one or more States. Consistent with the statutory language, banking entities organized under the laws of the United States or of one or more States, or the subsidiaries or branches thereof (wherever organized or licensed), may not rely on the exemption. Similarly, the U.S. subsidiaries or U.S. branches of foreign banking entities would not qualify for the exemption.

Section __.13(c)(2) clarifies when a banking entity would be considered to have met the statutory requirement that the banking entity conduct the activity pursuant to paragraphs 4(c)(9) or 4(c)(13) of the BHC Act[305] Section 4(c)(9) of the BHC Act generally provides that the restrictions on nonbanking activities contained in section 4(a) of that statute do not apply to the ownership of shares held or activities conducted by any company organized under the laws of a foreign country the greater part of whose business is conducted outside the United States, if the Board by regulation or order determines that, under the circumstances and subject to the conditions set forth in the regulation or order, the exemption would not be substantially at variance with the purposes of this Act and would be in

[303] Section 13(d)(1)(I) of the BHC Act permits a banking entity to acquire or retain an ownership interest in, or have certain relationships with, a covered fund notwithstanding the prohibition on proprietary trading and restrictions on investments in, and relationships with, a covered fund, if: (i) such activity or investment is conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; (ii) the activity occurs solely outside of the United States; (iii) no ownership interest in such fund is offered for sale or sold to a resident of the United States; and (iv) the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States. *See* 12 U.S.C. 1851(d)(1)(I).

[304] *See* 156 Cong. Rec. S5897 (daily ed. July 15, 2010) (statement of Sen. Merkley).

[305] Section __.13(c)(2) of the proposed rule only addresses when a transaction or activity will be considered to have been conducted pursuant to section 4(c)(9) of the BHC Act; although the statute also references section 4(c)(13) of the BHC Act, the Board has applied the authority contained in that section only to include certain foreign activities of U.S. banking organizations. The express language of section 13(d)(1)(I) of the BHC Act limits its availability to foreign banking entities that are not controlled by a banking entity organized under the laws of the United States or of one or more states. A foreign banking entity may not rely on the exemptive authority of section 4(c)(13) and, so, that section is not addressed in the proposed rule.

the public interest.[306] The Board has, in part, implemented section 4(c)(9) through subpart B of the Board's Regulation K, which specifies a number of conditions and requirements that a foreign banking organization must meet in order to use such authority. Such conditions and requirements include, for example, a qualifying foreign banking organization test that requires the foreign banking organization to demonstrate that more than half of its worldwide business is banking and that more than half of its banking business is outside the United States.

The proposed rule makes clear that a banking entity will qualify for the foreign fund exemption if the entity is a foreign banking organization subject to subpart B of the Board's Regulation K and the transaction occurs solely outside the United States. Section 13 of the BHC Act also applies to foreign companies that are banking entities covered by Section 13 but are not currently subject either to the BHC Act generally or the Board's Regulation K, for example, because the foreign company controls a savings association or an FDIC-insured industrial loan company but not a bank or branch in the United States. Accordingly, the proposed rule clarifies when such a foreign banking entity would be considered to have conducted a transaction or activity "pursuant to section 4(c)(9)" for purposes of the exemption at § __.13(c) of the proposed rule.[307] In particular, the proposed rule proposes that to qualify for the foreign banking entity exemption, such firms must meet at least two of three requirements that evaluate the extent to which the foreign entity's business is conducted outside the United States, as measured by assets, revenues, and income. This test largely mirrors the qualifying foreign banking organization test that is made applicable under section 4(c)(9) and § 211.23(a) of the Board's Regulation K, except that the relevant test under § __.13(c)(2)(ii) of the proposed rule does not require such a foreign entity to demonstrate that more than half of its business is banking conducted outside the United States.[308]

ii. Transactions and Activities Solely Outside of the United States

Section __.13(c) of the proposed rule also clarifies when a transaction or activity will be considered to have occurred solely outside of the Unites States for purposes of the exemption. In interpreting this aspect of the statutory language, the proposal focuses on the extent to which material elements of the transaction occur within, or are effected by personnel within, the United States. This aspect of the proposal reflects the apparent intent of the foreign funds exemption to avoid extraterritorial application of the restrictions on covered funds activities and investments outside the United States while preserving competitive parity within U.S. market. The proposed rule does not evaluate solely whether the risk of the transaction or activity, or management or decision-making with respect to such transaction or activity, rests outside the United States. Rather, the proposal also provides that foreign banking entities may not structure a transaction or activity so as to be "outside of the United States" for risk and booking purposes while simultaneously engaging in transactions within U.S. markets that are prohibited for U.S. banking entities.

In particular, § __.13(c)(3) of the proposed rule provides that a transaction or activity will be considered to have occurred solely outside of the United States only if all of the following three conditions are satisfied:

- The transaction or activity is conducted by a banking entity that is not organized under the laws of the United States or of one or more States;
- No subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund is incorporated or physically located in the United States; and
- No ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

These three criteria reflect statutory constraints and are intended to ensure that a transaction or activity conducted in reliance on the exemption does not involve either investors that are residents of the United States or a relevant U.S. employee of the banking entity, as such involvement would appear to constitute a sufficient locus of activity in the U.S. marketplace so as to preclude the availability of the exemption.

A resident of the United States is defined in § __.2(t) of the proposed rule, and is described in detail in Part III.B.4.d of this Supplementary Information. The proposed rule applies this definition in the context of the foreign covered funds exemption because it would appear to appropriately capture the scope of counterparties (including investors that are residents of the United States) or relevant U.S. personnel of the banking entity, that, if involved in the transaction or activity, would preclude such transaction or activity from being considered to have occurred solely outside the United States. Under the proposed rule, an employee or entity engaged in the offer or sale of an ownership interest (or booking such transaction) must be outside of the United States; however, an employee or entity with no customer relationship and involved solely in providing administrative services or so-called "back office" functions to the fund as incident to the activity permitted under § __.13(c) of the proposed rule (such as clearing and settlement or maintaining and preserving records of the fund with respect to a transaction where no ownership interest is offered for sale or sold to a resident of the United States) would not be subject to this requirement.

iii. Request for Comment

The Agencies request comment on the proposed rule's approach to implementing the foreign covered funds activity and investment exemption. In particular, the Agencies request comment on the following questions:

Question 291. Is the proposed rule's implementation of the "foreign funds" exemption effective? If not, what alternative would be more effective and/or clearer?

Question 292. Are the proposed rule's provisions regarding when an activity will be considered to be conducted pursuant to section 4(c)(9) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Does it effectively address application of the foreign funds exemption to foreign banking entities not subject to the BHC Act generally? If not, how could it better address application of the exemption?

Question 293. Are the proposed rule's provisions regarding when a transaction or activity will be considered to have occurred solely outside the United States effective and sufficiently clear? If not, what alternative would be more

[306] *See* 12 U.S.C. 1843(c)(9).

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

[308] *See* 12 U.S.C. 1843(c)(9); 12 CFR 211.23(a); proposed rule § __.13(c)(2). This difference reflects the fact that foreign entities subject to section 13 of the BHC Act but not the BHC Act are, in many cases, predominantly commercial firms. A requirement that a firm also demonstrate that more than half of its banking business is outside the United States would likely make the exemption unavailable to many such firms and subject their global activities to the prohibition on acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund, a result that the statute does not appear to have intended.

effective and/or clearer? Should additional requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?

Question 294. Is the proposed exemption consistent with the purpose of the statute? Is the proposed exemption consistent with respect to national treatment for foreign banking organizations? Is the proposed exemption consistent with the concept of competitive equity?

Question 295. Does the proposed rule effectively define a resident of the United States for these purposes? If not, how should the definition be altered? What definitions of resident of the United States are currently used by banking entities? Would using any one of these definitions reduce the burden of complying with section 13 of the BHC Act? Why or why not?

d. Sale and Securitization of Loans

Section __.13(d) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) Loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure.[309] The authority contained in this section of the proposed rule would therefore allow a banking entity to engage in the sale and securitization of loans by acquiring and retaining an ownership interest in certain securitization vehicles (which could qualify as a covered fund for purposes of section 13(h)(2) of the BHC Act and the proposed rule) that the banking entity organizes and offers, or acts as sponsor to, in excess of and without being subject to the limitations contained in § __.12 of the proposed rule. Proposed § __.13(d) is designed to assist in implementing section 13(g)(2) of the BHC Act, which provides that nothing in section 13 of the BHC Act shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law.[310]

The Agencies note that the phrase ''materially relate to terms of such loans'' is intended to quantitatively limit the derivatives permitted in a ''securitization of loans'' under § __.13(d) of the proposed rule to include only those derivatives where the notional amount of the derivative is tied to the outstanding principal balance of the loans supporting the asset-backed securities of such issuer, either individually or in the aggregate. Additionally, such derivatives must be used solely to hedge risks that result from a mismatch between the loans and the related asset-backed securities (e.g., fixed rate loans with floating rate asset-backed securities, loans tied to the Prime Rate with LIBOR asset-backed securities, or Euro-denominated loans with Dollar-denominated asset-backed securities). Therefore, § __.13(d)(3) of the proposed rule would not allow the use of a credit default swap by an issuer of asset-backed securities.

The Agencies request comment on the proposed rule's approach to implementing the rule of construction related to the sale and securitization of loans. In particular, the Agencies request comment on the following questions:

Question 296. Is the proposed rule's implementation of the statute's ''sale and securitization of loans'' rule of construction effective? If not, what alternative would be more effective and/or clearer?

Question 297. Are there other entities or activities that should be included in the proposed rule's implementation of the rule of construction related to the sale and securitization of loans? If so, what entity or activity and why?

Question 298. Is the proposed rule's application of the rule of construction contained in section 13(g)(2) of the BHC Act appropriate?

Question 299. Are the proposed rule and this Supplementary Information sufficiently clear regarding which derivatives would be allowed in a ''securitization of loans'' under § __.13(d)(3) of the proposed rule? Is additional guidance necessary with respect to the types of derivatives that would be included in or excluded from a securitization of loans for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? If so, what topics should the additional guidance discuss and why?

Question 300. Should derivatives other than interest rate or foreign exchange derivatives be allowed in a ''securitization of loans'' for purposes of interpreting the rule of construction contained in section 13(g)(2) of the BHC Act? Why or why not? What would be the legal and economic impact of not allowing the use of derivatives other than interest rate or foreign exchange derivatives in a ''securitization of loans'' under § __.13(d)(3) of the proposed rule for existing issuers of asset-backed securities and for future issuers of asset-backed securities?

Question 301. Should the Agencies consider providing additional guidance for when a transaction with intermediate steps constitutes one or more securitization transactions that each would be subject to the rule? For example, both auto lease securitizations and asset-backed commercial paper conduits typically involve intermediate securitizations. The asset-backed securities issued to investors in such covered funds are technically supported by the intermediate asset-backed securities. Should these kinds of securitizations be viewed as a single transaction and included within a securitization of loans for purposes of the proposed rule? Should each step be viewed as a separate securitization?

5. Section __.14: Covered Fund Activities and Investments Determined To Be Permissible

Section __.14 of the proposed rule, which implements section 13(d)(1)(J) of the BHC Act,[311] permits a banking entity to engage in any covered funds activity that the Agencies determine promotes and protects the safety and soundness of a banking entity and the financial stability of the United States.[312] Any activity authorized under § __.14 of the proposed rule must still comply with the prohibition and limitations governing relationships with covered funds contained in section 13(f) of the BHC Act, as implemented by § __.16 of this proposal.[313] Additionally,

[309] *See* proposed rule § __.13(d). The types of derivatives permitted under § __.13(d)(3) of the proposed rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities.

[310] *See* 12 U.S.C. 1851(g)(2).

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

[312] *See* 12 U.S.C. 1851(d)(1)(J).

[313] Section 13(d)(1)(J) of the BHC Act only provides the Agencies with the ability to provide additional exemptions from the prohibitions contained in section 13(a)(1) of the BHC Act. Section 13(f) of the BHC Act, which deals with relationships and transactions with a fund that is, directly or indirectly, organized and offered or sponsored by a banking entity, operates as an independent prohibition and set of limitations on

like other activities permissible under section 13(d)(1) of the BHC Act and as implemented by subpart C of the proposed rule, activities found permissible under § __.14 of the proposed rule and section 13(d)(1)(J) remain subject to other provisions of section 13 of the BHC Act, including the sections limiting conflicts of interest and high-risk assets or trading strategies, as well as the section designed to prevent evasion of section 13 of the BHC Act.[314]

The Agencies have proposed to permit three activities at this time under this authority. These activities involve acquiring or retaining an ownership interest in and sponsoring of (i) certain BOLI separate accounts; (ii) certain entities that, although within the definition of covered fund are, in fact, common corporate organizational vehicles; and (iii) a covered fund in the ordinary course of collecting a debt previously contracted in good faith or pursuant to and in compliance with the conformance or extended transition period provided for under the Board's rules issued under section 13(c)(6) of the BHC Act.

a. Investments in Certain Bank Owned Life Insurance Separate Accounts

Banking entities have for many years invested in life insurance policies that cover key employees, in accordance with supervisory policies established by the Federal banking agencies.[315] These BOLI investments are typically structured as investments in separate accounts that are excluded from the definition of ''investment company'' under the Investment Company Act by virtue of section 3(c)(1) or 3(c)(7) of that Act. By virtue of reliance on these exclusions, these BOLI accounts would be covered by the definition of ''hedge fund'' or ''private equity fund'' in section 13 of the BHC Act.[316]

However, when made in the normal course, these investments do not involve the speculative risks intended to be addressed by section 13 of the BHC Act. Moreover, applying the prohibitions in section 13 to these investments would eliminate an investment that helps banking entities to reduce their costs of providing employee benefits as well as other costs.

Section __.14(a)(1) of the proposed rule permits a banking entity to acquire and retain these BOLI investments, as well as act as sponsor to a BOLI separate account.[317] The proposal includes a number of conditions designed to ensure that BOLI investments are not conducted in a manner that raises the concerns that section 13 of the BHC Act is intended to address. In particular, in order for a banking entity to invest in or sponsor a BOLI separate account, the banking entity that purchases the insurance policy: (i) May not control the investment decisions regarding the underlying assets or holdings of the separate account; and (ii) must hold its ownership interests in the separate account in compliance with applicable supervisory guidance provided by the appropriate Federal regulatory agency regarding BOLI.[318]

The Agencies have structured this exemption in the proposed rule so as to allow a banking entity to continue to manage and structure its risks and obligations related to its employee compensation or benefit plan obligations in a manner that promotes and protects the safety and soundness of banking entities, which on an industry-wide level has the concomitant effect of promoting and protecting the financial stability of the United States.

b. Investments in Certain Other Covered Funds

As noted above, the definition of ''covered fund'' as contained in § __.10(b)(1) of the proposed rule potentially includes within its scope many entities and corporate structures that would not usually be thought of as a ''hedge fund'' or ''private equity fund.'' Additionally, the Dodd-Frank Act contains other provisions that permit or require a banking entity to acquire or retain an ownership interest in or act as sponsor to a covered fund in a manner not specifically described under section 13 of the BHC Act.

Section __.14(a)(2) of the proposed rule permits a banking entity to own certain specified entities that are often part of corporate structures and that, by themselves and without other extenuating circumstances or factors, do not raise the type of concerns which section 13 of the BHC Act was intended to address but which nevertheless may be captured by the definition of ''hedge fund'' or ''private equity fund'' in section 13(h)(2) of the BHC Act. Specifically, § __.14(a)(2) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to (i) a joint venture between the banking entity and any other person, provided that the joint venture is an operating company and does not engage in any activity or any investment not permitted under the proposed rule; (ii) an acquisition vehicle, provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or one of its affiliates; and (iii) a wholly-owned subsidiary of the banking entity that is (A) engaged principally in providing *bona fide* liquidity management services described under § __.3(b)(2)(iii)(C) of the proposed rule, and (B) carried on the balance sheet of the banking entity.[319]

The Agencies note that these types of entities may meet the definition of covered fund contained in § __.10(b)(1) of the proposed rule (and as contained in section 13(h)(2) of the BHC Act), to the extent these entities rely solely on section 3(c)(1) or 3(c)(7) of the Investment Company Act. However, these types of entities do not engage in the type and scope of activities to which Congress intended section 13 of the BHC Act to apply.[320] Additionally, without this exemption, many entities would be forced to alter their corporate structure without achieving any reduction in risk. Permitting such investments in these entities would thus appear to promote and protect the safety and soundness of banking entities and promote and protect the financial stability of the United States.

the activities of banking entities. As such, § __.14 of the proposed rule cannot and does not provide any exemptions from the prohibition on relationships or transaction with a covered fund contained in section 13(f) of the BHC Act or § __.16 of the proposed rule.

[314] *See* 12 U.S.C. 1851(d)(2), (e)(1).

[315] *See, e.g.,* Bank Owned Life Insurance, Interagency Statement on the Purchase and Risk Management of Life Insurance (''Interagency BOLI Guidance'') (Dec. 7, 2004).

[316] *See* 12 U.S.C. 1851(h)(2).

[317] The proposed rule defines ''separate account'' as ''an account established and maintained by an insurance company subject to regulation by a State insurance regulatory or a foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.'' *See* proposed rule § __.2(z).

[318] *See* proposed rule § __.14(a)(1)(i)–(ii). While other guidance or requirements may be imposed by the Agencies or an individual Agency for a specific banking entity for which it serves as the primary financial regulator, the Agencies note that, at a minimum, investments under authority of this section must comply with the Interagency BOLI Guidance. This guidance requires, among other things, that a banking entity generally: (i) Not control the investment decisions regarding the underlying assets or holdings of the separate account; (ii) demonstrate to the satisfaction of the relevant Agency that the potential returns from the investments in such separate account are appropriately matched to the banking entity's employee compensation or benefit plan obligations; and (iii) not use such separate account to take speculative positions or to support the general operations of the banking entity.

[319] *See* proposed rule § __.14(a)(2).

[320] *See* 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Reps. Himes and Frank).

Section __.14(a)(2) of the proposed rule also permits a banking entity to comply with section 15G of the Exchange Act (15 U.S.C. 78o–11), added by section 941 of the Dodd-Frank Act, which requires a banking entity to maintain a certain minimum interest in certain sponsored or originated asset-backed securities.[321] In order to give effect to this separate requirement under the Dodd-Frank Act, § __.14(a)(2)(iii) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to an issuer of asset-backed securities, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a banking entity that is a ''securitizer'' or ''originator'' in compliance with the minimum requirements of section 15G of the Exchange Act (15 U.S.C. 78*o*–11) and any implementing regulations issued thereunder.[322] The Agencies have structured this exemption to recognize that Congress imposed other requirements on firms that are banking entities under section 13 of the BHC Act. Additionally, permitting a banking entity to retain the minimum level of economic interest will incent banking entities to engage in more careful and prudent underwriting and evaluation of the risks and obligations that may accompany asset-backed securitizations, which would promote and protect the safety and soundness of banking entities and the financial stability of the United States.

Section 14(a)(2) of the proposed rule permits a banking entity to acquire and retain an ownership interest in a covered fund that is an issuer of asset-backed securities described in § 13(d) of the proposed rule, the assets or holdings of which are solely comprised of: (i) Loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) interest rate or foreign exchange derivatives that (A) materially relate to the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure. This exemption augments the authority regarding the sale and securitization of loans available under § __.13(d) of the proposed rule (which partially implements the rule of construction under section 13(g)(2) of the BHC Act) and permits a banking entity to engage in the purchase, and not only the sale and securitization, of loans through authorizing the acquisition or retention of an ownership interest in such securitization vehicles that the banking entity does not organize and offer, or for which it does not act as sponsor, provided that the assets or holdings of such vehicles are solely comprised of the instruments or obligations referenced above.[323]

Permitting banking entities to acquire or retain an ownership interest in these loan securitizations will provide a deeper and richer pool of potential participants and a more liquid market for the sale of such securitizations, which in turn should result in increased availability of funds to individuals and small businesses, as well as provide greater efficiency and diversification of risk. The Agencies believe this exemption would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States.[324]

c. Acquiring or Retaining an Ownership Interest in or Acting a Sponsor to a Covered Fund Under Certain Specified Authorities

Section __.14(b) of the proposed rule permits a banking entity to acquire or retain an ownership interest in or act as sponsor to a covered fund in those instances where the ownership interest is acquired or retained by a banking entity (i) in the ordinary course of collecting a debt previously contracted in good faith, if the banking entity divests the ownership interest within applicable time periods provided for by the applicable Agency, or (ii) pursuant to and in compliance with the Conformance or Extended Transition Period authorities provided for under the proposed rule.[325]

Allowing banking entities to rely on these authorities for acquiring or retaining an ownership interest in or acting as sponsor to a covered fund will enable banking entities to manage their risks and structure their business in a manner consistent with their chosen corporate form and in a manner that otherwise complies with applicable laws. Thus, permitting such activities would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States.

d. Request for Comment

The Agencies request comment on the proposed rule's approach to implementing the exemption related to activities specifically determined to be permissible under section 13(d)(1)(J) of the BHC Act. In particular, the Agencies request comment on the following questions:

Question 302. Is the proposed rule's implementation of exemptions for covered fund activities and investments pursuant to section 13(d)(1)(J) of the BHC Act effective? If not, what alternative would be more effective and/or clearer?

Question 303. Is the proposed rule's approach to utilizing section 13(d)(1)(J) of the BHC Act to permit a banking entity to acquire or retain an ownership interest in, or act as sponsor to, certain entities that would fall into the definition of covered fund effective? Why or why not? If not, what alternative would be more effective and why? What legal authority under the statute would permit such an alternative?

Question 304. Are the proposed rule's provisions regarding when a covered fund activity will be deemed to be permitted under authority of section 13(d)(1)(J) of the BHC Act effective and sufficiently clear? If not, what alternative would be more effective and/or clearer?

Question 305. Do the exemptions provided for in § __.14 of the proposed rule effectively promote and protect the safety and soundness of banking entities and the financial stability of the United States? If not, why not?

Question 306. Are the proposed rule's provisions regarding what qualifications must be satisfied in order to qualify for an exemption under § __.14 of the proposed rule effective and sufficiently clear? If not, what alternative would be more effective and/or clearer? Should additional requirements be added? If so, what requirements and why? Should additional requirements be modified or removed? If so, what requirements and why or how?

Question 307. Does the proposed rule effectively cover the scope of covered funds activities which the Agencies should specifically determine to be permissible under section 13(d)(1)(J) of the BHC Act? If not, what activity or activities should be permitted? For additional activities that should be permitted, on what grounds would these activities promote and protect the safety and soundness of banking entities and the financial stability of the United States?

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[321] 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).

[322] *See* proposed rule § __.14(a)(2)(iii).

[323] *See id.* at § __.14(a)(2)(v).

[324] The Agencies note that proposed exemption applies only to the covered fund-related provisions of the proposed rule, and not to its prohibition on proprietary trading.

[325] *See* proposed rule § __.14(b). The Conformance or Extended Transition period authorities are substantially similar to those proposed by the Board in its February 2011 final rule governing such conformance periods under section 13 of the BHC Act.

Question 308. Does the proposed rule effectively address the interplay between the restrictions on covered fund activities and investments in section 13 of the BHC Act and the requirements imposed on certain banking entities under section 15G of the Exchange Act? Why or why not?

Question 309. Rather than permitting the acquisition or retentions of an ownership interest in, or acting as sponsor to, specific covered funds under section 13(d)(1)(J) of the BHC Act, should the Agencies use the authority provided under section 13(d)(1)(J) to permit investments in a covered fund that display certain characteristics? If so, what characteristics should the Agencies consider? How would investments with such characteristics promote and protect the safety and soundness of the banking entity and promote the financial stability of the United States?

Question 310. Should venture capital funds be excluded from the definition of ''covered fund''? Why or why not? If so, should the definition contained in rule 203(*l*)–1 under the Advisers Act be used? Should any modification to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question 311. Should non-U.S. funds or entities be included in the definition of ''covered fund''? Should any non-U.S. funds or entities be excluded from this definition? Why or why not? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question 312. Should so-called ''loan funds'' that invest principally in loans and not equity be excluded from the definition of ''covered fund''? Why or why not? What characteristics would be most effective in determining whether a fund invests principally in loans and not equity? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the BHC Act?

Question 313. Are the proposed rule's proposed determinations that the specified covered funds activities or investments promote and protect the safety and soundness of banking entities and the financial stability of the United States appropriate? If not, how should the determinations be amended or altered?

6. Section __.15: Internal Controls, Reporting and Recordkeeping Requirements Applicable to Covered Fund Activities and Investments

Section __.15 of the proposed rule, which implements section 13(e)(1) of the BHC Act,[326] requires a banking entity engaged in covered fund activities and investments to comply with (i) the internal controls, reporting, and recordkeeping requirements required under § __.20 and Appendix C of the proposed rule, as applicable and (ii) such other reporting and recordkeeping requirements as the relevant supervisory Agency may deem necessary to appropriately evaluate the banking entity's compliance with this subpart C.[327] These requirements are discussed in detail in Part III.D of this Supplementary information.

7. Section __.16: Limitations on Relationships With a Covered Fund

Section 13(f) of the BHC Act generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the FR Act.[328] Section __.16 of the proposed rule implements this provision. Section __.16(a)(2) of the proposed rule clarifies that, for reasons explained in detail below, certain transactions between a banking entity and a covered fund remain permissible. Section __.16(b) of the proposed rule implements the statute's requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and covered fund is subject to section 23B of the FR Act,[329] which, in general, requires that the transaction be on market terms or on terms at least as favorable to the banking entity as a comparable transaction by the banking entity with an unaffiliated third party.

a. General Prohibition on Certain Transactions and Relationships

Section 13(f)(1) of the BHC Act generally prohibits a banking entity that, directly or indirectly, serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund (or that organizes and offers a covered fund pursuant to section 13(d)(1)(G) of the BHC Act) from engaging in any transaction with the covered fund, or with any covered fund that is controlled by such fund, if the transaction would be a ''covered transaction'' as defined in section 23A of the FR Act, as if the banking entity and any affiliate thereof were a member bank and the covered fund were an affiliate thereof.[330] Section __.16(a)(1) of the proposed rule includes this prohibition.

Consistent with the requirements of section 13(f)(1) of the BHC Act, § __.16(a)(1) of the proposed rule is more restrictive than section 23A of the FR Act because § __.16(a)(1) generally prohibits a banking entity and any of its affiliates from entering into any such transaction, while section 23A permits covered transactions with affiliates so long as the transactions meet specified quantitative and qualitative requirements.[331]

b. Transactions That Would Be a ''Covered Transaction''

Section 13(f) of the BHC Act applies to covered transactions as defined in section 23A of the FR Act without incorporating any of the provisions in section 23A that provide exemptions from the prohibitions in that section for certain types of covered transactions.[332]

[326] 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).

[327] *See* proposed rule § __.15.

[328] 12 U.S.C. 371c.

[329] 12 U.S.C. 371c–1.

[330] As noted above, the proposed rule implements the definition of ''banking entity'' in a manner that does not include covered funds for which a banking entity acts as sponsor or organizes and offers pursuant to section 13(d)(1)(G) of the BHC Act, or any covered fund in which such related covered fund invests. Accordingly, these covered funds (and any covered fund in which such covered fund acquired or retains a controlling investment) are not generally subject to the prohibitions contained in § __.16 of the proposed rule.

[331] Section 23A of the FR Act limits the aggregate amount of covered transactions by a member bank to no more than (i) 10 per centum of the capital stock and surplus of the member bank in the case of any affiliate, and (ii) 20 per centum of the capital stock and surplus of the member bank in the case of all affiliates. *See* 12 U.S.C. 371c(a). Conversely, section 13(f) of the BHC Act operates as a general prohibition on such transactions without providing any similar amount of permitted transactions.

[332] 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

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Section __.16 of the proposed rule adopts the same language as the statute. The definition of ''covered transaction'' contained in section 23A of the FR Act itself includes an explicit exemption from the definition of ''covered transaction'' for ''such purchase of real and personal property as may be specifically exempted by the Board by order or regulation.'' [333] Since these transactions are, by definition, excluded from the definition of ''covered transaction,'' any transaction that is specifically exempted by the Board pursuant to this specific authority would not be deemed to be a covered transaction as defined in section 23A of the FR Act.

c. Certain Transactions and Relationships Permitted

While section 13(f)(1) of the BHC Act operates as a general prohibition on a banking entity's ability to enter into a transaction with a related covered fund that would be a covered transaction as defined under section 23A of the FR Act, other specific portions of the statute expressly provide for, or make reference to, a banking entity's ability to engage in certain transactions or relationships with such funds.[334] Section __.16(a)(2) of the proposed rule implements and clarifies these authorities.

i. Permitted Investments and Ownerships Interests

Section__.16(a)(2) of the proposed rule clarifies that a banking entity may acquire or retain an ownership interest in a covered fund in accordance with the requirements of subpart C of the proposed rule.[335] This clarification is proposed in order to remove any ambiguity regarding whether the section prohibits a banking entity from acquiring or retaining an interest in securities issued by a related covered fund in accordance with the other provisions of the rule, since the purchase of securities of a related covered fund would be a covered transaction as defined by section 23A of the FR Act. There is no evidence that Congress intended section 13(f)(1) of the BHC Act to override the other provisions of section 13 with regard to the acquisition or retention of ownership interests specifically permitted by the section. Moreover, a contrary reading would make these more specific sections that permit covered transactions between a banking entity and a covered fund mere surplusage.

ii. Prime Brokerage Transactions Also Permitted

Section __.16(a)(2)(ii) of the proposed rule implements section 13(f)(3)(A) of the BHC Act, which provides that a banking entity may enter into any prime brokerage transaction with a covered fund in which a covered fund managed, sponsored, or advised by such banking entity has taken an ownership interest, so long as certain enumerated conditions are satisfied.[336] The proposed rule defines ''prime brokerage transaction'' to mean one or more products or services provided by the banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, and data, operational, and portfolio management support.[337] To engage in a prime brokerage transaction with a covered fund pursuant to § __.16(a)(2)(ii) of the proposed rule, a banking entity must be in compliance with the limitations set forth in § __.11 of the proposed rule with respect to a covered fund organized and offered by such banking entity. In addition, as required by statute, the chief executive officer (or equivalent officer) of the banking entity must certify in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. Finally, the Board must not have determined that such transaction is inconsistent with the safe and sound operation and condition of the banking entity.

d. Restrictions on Transactions With Any Permitted Covered Fund

Section __.16(b) of the proposed rule implements sections 13(f)(2) and 13(f)(3)(B) of the BHC Act and applies section 23B of the FR Act [338] 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.[339] Section 23B provides that transactions between a member bank and an affiliate must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to such banking entity as those prevailing at the time for comparable transactions with or involving other unaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.[340]

Section __.16(b) applies this requirement to transactions between a banking entity that serves as investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund and that fund and any other fund controlled by that fund. It also applies this condition to a permissible prime brokerage transaction in which a banking entity may engage pursuant to § __.16(a)(2)(ii) of the proposed rule.[341]

e. Request for Comment

The Agencies request comment on the proposed rule's approach to implementing the limitations on certain relationships with covered funds and, in particular, the manner in which the Agencies have proposed to apply a banking entity's ability to make explicitly permitted investments for these purposes, as described above. In particular, the Agencies request comment on the following questions:

Question 314. Is the proposed rule's approach to implementing the limitations on certain transactions with a covered fund effective? If not, what alternative approach would be more effective and why?

Question 315. Should the approach include other elements? If so, what elements and why? Should any of the proposed elements be revised or eliminated? If so, why and how?

Question 316. What types of transactions or relationships that currently exist between banking entities and a covered fund (or another covered fund in which such covered fund makes a controlling investment) would be prohibited under the proposed rule? What would be the effect of the proposed rule on banking entities' ability to continue to meet the needs and demands of their clients? Are there other transactions between a banking entity and such covered funds that are not already covered but that should be prohibited or limited under the proposed rule?

Question 317. Should the Agencies provide a different definition of ''prime

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.

[333] *Id.* at 371c(b)(7)(C).

[334] *See, e.g.,* 12 U.S.C. 1851(d)(1)(G), (d)(4), and (f)(3).

[335] *See* proposed rule § __.16(a)(2)(i).

[336] *See* proposed rule § __.16(a)(2)(ii).

[337] *See* proposed rule § __.10(b)(4).

[338] 12 U.S.C. 371c–1.

[339] *See* proposed rule § __.16(b).

[340] 12 U.S.C. 371c–1(a); 12 CFR 223.51.

[341] *See* 12 U.S.C. 1851(f)(2), (f)(3)(B); proposed rule § __.16(b).

brokerage transaction'' under the proposed rule? If so, what definition would be appropriate? Are there any transactions that should be included in the definition of ''prime brokerage transaction''? Are there transactions or practices provided by banking entities that should be excluded in order to mitigate the burdens of complying with section 13 of the BHC Act?

Question 318. With respect to the CEO (or equivalent officer) certification required under section 13(f)(3)(A)(ii) of the BHC Act and § __.16(a)(2)(ii)(B) of the proposed rule, what would be the most useful, efficient method of certification (e.g., a new stand-alone certification, a certification incorporated into an existing form or filing, Web site certification, or certification filed directly with the relevant Agency)?

8. Section __.17: Other Limitations on Permitted Covered Funds Activities

Section __.17 of the proposed rule implements section 13(d)(2) of the BHC Act, which places certain limitations on the permitted covered fund activities and investments in which a banking entity may engage. Consistent with the statute and § __.8 of the proposed rule, § __.17 provides that no transaction, class of transactions, or activity is permissible under §§ __.11 through __.16 of the proposed rule if the transaction, class of transactions, or activity would:

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

Section __.17 of the proposed rule further defines ''material conflict of interest,'' ''high-risk assets,'' and ''high-risk trading strategies'' for these purposes, which are identical to the definitions of the same terms for purposes of § __.8 of the proposed rule related to proprietary trading, and are described in detail in Part III.B.6 of this Supplementary Information.[342]

The Agencies request comment on the proposed limitations on permitted covered fund activities and investments, including with respect to the questions in Part III.B.6 of the Supplemental Information as they pertain to covered fund activities and investments in particular.

D. Subpart D (Compliance Program Requirement) and Appendix C (Minimum Standards for Programmatic Compliance)

Subpart D of the proposed rule, which implements section 13(e)(1) of the BHC Act,[343] requires certain banking entities to develop and provide for the continued administration of a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on covered trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the proposed rule.[344] This compliance program requirement forms a key part of the proposal's multi-faceted approach to implementing section 13 of the BHC Act, and is intended to ensure that banking entities establish, maintain and enforce compliance procedures and controls to prevent violation or evasion of the prohibitions and restrictions on covered trading activities and covered fund activities and investments.

1. Section __.20: Compliance Program Mandate

The proposed rule adopts a tiered approach to implementing the compliance program mandate, requiring a banking entity engaged in covered trading activities or covered fund activities and investments to establish a compliance program that contains specific elements and, if the banking entity's activities are significant, meet a number of minimum standards. If a banking entity does not engage in covered trading activities and covered fund activities and investments, it must ensure that its existing compliance policies and procedures include measures that are designed to prevent the banking entity from becoming engaged in such activities and making such investments and must develop and provide for the required compliance program under proposed § __.20(a) of the proposed rule prior to engaging in such activities or making such investments, but is not otherwise required to meet the requirements of subpart D of the proposed rule.[345]

Section __.20(a) of the proposed rule contains the core requirement that each banking entity engaged in covered trading activities or covered fund activities and investments must establish, maintain and enforce a program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading activities and covered fund activities and investments set forth in section 13 of the BHC Act and the proposed rule and that such program must be suitable for the size, scope, and complexity of activities and business structure of the banking entity. Section __.20(b) of the proposed rule specifies the following six elements that each compliance program established under subpart D must provide for, at a minimum:

- Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading activities and covered fund activities and investments of the banking entity to ensure that such activities and investments comply with section 13 of the BHC Act and the proposed rule;
- A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and the proposed rule in the banking entity's covered trading activities and covered fund activities and investments and to prevent the occurrence of activities that are prohibited by section 13 of the BHC Act and the proposed rule;
- A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and the proposed rule;
- Independent testing for the effectiveness of the compliance program, conducted by qualified banking entity personnel or a qualified outside party;
- Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and
- Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and the proposed rule, which a banking entity must promptly provide to the relevant supervisory Agency upon request and retain for a period of no less than 5 years.

[342] As noted in the discussion of the definition of ''material conflict of interest in Part III.B.6 of this Supplementary Information, the proposed disclosure provisions of that definition are provided solely for purposes of the proposed rule's definition of material conflict of interest, and do not affect a banking entity's obligation to comply with additional or different disclosure or other requirements with respect to a conflict under applicable securities, banking, or other laws (e.g., section 27B of the Securities Act, which governs conflicts of interest relating to certain securitizations; section 206 of the Investment Advisers Act of 1940, which applies to conflicts of interest between investment advisers and their clients; or 12 CFR 9.12, which applies to conflicts of interest in the context of a national bank's fiduciary activities).

[343] *See* 12 U.S.C. 1851(e)(1).

[344] *See* proposed rule § __.20.

[345] *See* proposed rule § __.20(d).

In addition, for a banking entity with significant covered trading activities or covered fund activities and investments, § __.20(c) requires the compliance program established under subpart D to meet a number of minimum standards, which are specified in Appendix C of the proposed rule. In particular, a banking entity must comply with the minimum standards specified in Appendix C of the proposed rule if:

• With respect to its covered trading activities, it engages in any covered trading activities and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters, (i) is equal to or greater than $1 billion or (ii) equals 10 percent or more of its total assets; and

• With respect to its covered fund activities and investments, it engages in any covered fund activities and investments and either (i) has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion or (ii) sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

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

If a banking entity does not meet the thresholds specified in § __.20(c)(2), it need not comply with each of the minimum standards specified in Appendix C. However, the proposed rule would require such a banking entity to establish a compliance program that effectively implements the six elements specified in § __.20(b). Banking entities engaged in a relatively small amount of covered fund activities are encouraged to look to the minimum standards of Appendix C for guidance. Generally, the Agencies would expect that the closer a banking entity is to the thresholds specified in § __.20(c)(2), the more its compliance program should generally include the specific requirements described in Appendix C. Within the bounds of subpart D and Appendix C, a banking entity has discretion to structure and manage its program for compliance with section 13 of the BHC Act and the proposed rule in a manner that best reflects the unique organization and operation of the banking entity and its affiliates and subsidiaries, and is suitable taking account of the size, scope, and complexity of activities in which the banking entity and its affiliates and subsidiaries engage.

As described above, § __.20(d) of the proposed rule clarifies that, if a banking entity does not engage in covered trading activities and/or covered fund activities or investments, it will have satisfied the requirements of this section if its existing compliance policies and procedures include measures that are designed to prevent the banking entity from becoming engaged in such activities or making such investments and which require the banking entity to develop and provide for the compliance program required under paragraph (a) of this section prior to engaging in such activities or making such investments.

2. Appendix C—Minimum Standards for Programmatic Compliance

Appendix C of the proposed rule specifies a variety of minimum standards applicable to the compliance program of a banking entity with significant covered trading activities or covered fund activities and investments.[346] Section I.A of proposed Appendix C sets forth the purpose of the required compliance program, which is to ensure that each banking entity establishes, maintains, and enforces an effective compliance program, consisting of written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping, that:

• Is designed to clearly document, describe, and monitor the covered trading activities and covered fund activities or investments and the risks of the banking entity related to such activities or investments, identify potential areas of noncompliance, and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and the proposed rule;

• Specifically addresses the varying nature of activities or investments conducted by different units of the banking entity's organization, including the size, scope, complexity, and risks of the individual activity or investment;

• Subjects the effectiveness of the compliance program to independent review and testing;

• Makes senior management and intermediate managers accountable for the effective implementation of the compliance program, and ensures that the board of directors or chief executive officer (''CEO'') review the effectiveness of the compliance program; and

• Facilitate supervision of the banking entity's covered trading activities and covered fund activities or investments by the Agencies.

A banking entity's compliance program should not be developed through a generic, one-size-fits-all approach, but rather should carefully take into account and reflect the unique manner in which a banking entity operates, as well as the particular compliance risks and challenges that its businesses present. In light of the complexities presented in differentiating prohibited proprietary trading from permitted market making-related activities in particular, the Agencies expect that such a dynamic, carefully-tailored approach to internal compliance will play an important role in ensuring that banking entities comply with section 13's prohibitions and restrictions. In addition, although this statement of purpose appears within the text of proposed Appendix C, the Agencies note the statement equally describes the general purpose of any compliance program required under subpart D of the proposed rule, regardless of whether proposed Appendix C specifically applies.

Section I.B of proposed Appendix C provides for several definitions used throughout the appendix, including the definition of ''trading unit'' and ''asset management unit'' to which the minimum standards apply. The term ''trading unit'' is defined in the same way as in Appendix A, as described in Part II.B.5 of the Supplementary Information, and is intended to identify multiple layers of a banking entity's organizational structure because any effective compliance program will need to manage, limit and monitor covered trading activity at each such level of organization in order to effectively support compliance with the prohibition on proprietary trading. The term ''asset management unit'' is defined as any unit of organization of a banking entity that makes an investment in, acts as sponsor to, or has relationships with, a covered fund that the banking entity sponsors, organizes and offers, or in which a covered fund

[346] The Agencies have proposed to include these minimum standards as part of the regulation itself, rather than as accompanying guidance, reflecting the compliance program's importance within the general implementation framework.

sponsored or advised by a banking entity invests.

Section I.C of proposed Appendix C incorporates by reference the six elements that must be included in the compliance program under § __.20 of the proposed rule, and section I.D describes the structure of a compliance program meeting the minimum standards. In particular, section I.D permits a banking entity to establish a compliance program on an enterprise-wide basis to satisfy the requirements of § __.20 of the proposed rule and the appendix, which program could cover the banking entity and all of its affiliates and subsidiaries collectively. In order to do so, the program must (i) be clearly applicable, both by its terms and in operation, to all such affiliates and subsidiaries, (ii) specifically address the requirements set forth in proposed Appendix C, (iii) take into account and address the consolidated organization's business structure, size, and complexity, as well as the particular activities, risks, and applicable legal requirements of each subsidiary and affiliate, and (iv) be determined through periodic independent testing to be effective for the banking entity and its affiliates and subsidiaries. In addition, the enterprise-wide program would be subject to supervisory review and examination by any Agency vested with rulewriting authority under section 13 of the BHC Act with respect to the compliance program and the activities of any banking entity for which the Agency has such authority. Further, such Agency would have access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rulewriting authority.

a. Internal Policies and Procedures

Section II of proposed Appendix C articulates minimum standards for the first element of the compliance program, internal policies and procedures, for both covered trading activities and covered fund activities and investments. With respect to covered trading activities, the proposal would require that internal policies and procedures: (i) Specify how the banking entity identifies its trading accounts; (ii) identify the trading activity in which the banking entity is engaged and how that activity is organized; (iii) thoroughly articulate the mission, strategy, risks, and compliance controls for each trading unit; (iv) include for each trader a mandate that describes the scope of his or her trading activity; (v) clearly articulate and document a comprehensive description of the risks associated with the trading unit's activities; (vi) document a comprehensive explanation of how the mission and strategy of the trading unit, and its related risk levels, comply with the proposed rule; and (vii) require the banking entity to promptly address and remedy any violation of section 13 of the BHC Act and the proposed rule. These internal policies and procedures would require banking entities to have the data and standards to prevent prohibited proprietary trading and to identify abnormalities and discrepancies that may be indicative of prohibited proprietary trading. The internal policies and procedures should also provide the Agencies with a clear, comprehensive picture of a banking entity's covered trading activities that can be effectively reviewed. With respect to covered fund activities and investments, the proposal would require that internal policies and procedures describe all covered fund activities in which the banking entity engages and the procedures used by the banking entity to ensure that it complies with the restrictions of section 13 of the BHC Act and the proposed rule.

The Agencies expect that these internal policies and procedures will be regularly reviewed and updated to reflect changes in business practices, strategies, or laws and regulations, though frequent, unexplained changes to policies and procedures or other aspects of the compliance program—particularly changes to reduce their stringency—would warrant additional scrutiny from banking entity management, independent testing personnel, and Agency supervisors or examiners.

b. Internal Controls

Section III of proposed Appendix C articulates minimum standards for the second element of the compliance program, internal controls. With respect to covered trading activities, the proposal would require internal controls that: (i) Are reasonably designed to ensure that the covered trading activity is conducted in conformance with a trading unit's authorized risks, instruments and products, as documented in the banking entity's written policies and procedures; (ii) establish and enforce risk limits for each trading unit; and (iii) perform robust analysis and quantitative measurement of covered trading activity for conformance with section 13 of the BHC Act and the proposed rule. In particular, the banking entity must perform analysis and quantitative measurement that is reasonably designed to: (i) Ensure that the activity of each trading unit is appropriate to the mission, strategy, and risk of each trading unit, as documented in the banking entity's internal written policies and procedures; (ii) monitor and assist in the identification of potential and actual prohibited trading activity; and (iii) prevent the occurrence of prohibited proprietary trading. This analysis and measurement should incorporate the quantitative measurements calculated and reported under Appendix A of the proposed rule, but should also include other analysis and measurements developed by the banking entity that are specifically tailored to the business, risks, practices, and strategies of its trading units. The Agencies expect that the thoughtful use of these types of quantitative tools to monitor the extent to which the activities of a trading unit are consistent with its stated mission, strategy, and risk profile may help identify, for both banking entities and Agencies, abnormalities or discrepancies in permitted trading activity that may be indicative of prohibited proprietary trading. In addition, these internal controls must provide for regular monitoring of the effectiveness of the banking entity's compliance program and require the banking entity to take prompt action to address and remedy any deficiencies identified and to provide timely notification to the relevant Agency of any investigation and remedial action taken.

With respect to covered fund activities and investments, the internal controls required under section III of proposed Appendix C generally focus on ensuring that a banking entity has effective controls in place to monitor its investments in, and relationships with, covered funds to ensure its compliance with the covered fund activity and investments restrictions, including controls that relate to implementing remedies in the event of a violation of the requirements of section 13 of the BHC Act and the proposed rule.

c. Responsibility and Accountability

Section IV of proposed Appendix C articulates minimum standards for the third element of the compliance program, responsibility and accountability. These standards focus on four key constituencies—the board of directors, the CEO, senior management, and managers at each trading unit and asset management unit level. Section IV makes clear that the board of directors, or similar corporate body, and the CEO are responsible for creating an appropriate ''tone at the top'' by setting an appropriate culture of compliance and establishing clear policies regarding the management of covered trading activities and covered fund activities and investments. Senior management must be made responsible for communicating and reinforcing the culture of compliance established by the board of directors and the CEO, for the actual implementation and enforcement of the approved compliance program, and for taking effective corrective action, where appropriate. Managers with responsibility for one or more trading units or asset management units of the banking entity that are engaged in covered trading activity or covered fund activity and investments are accountable for effective implementation and enforcement of the compliance program for the applicable trading unit or asset management unit.

d. Independent Testing

Section V of proposed Appendix C articulates minimum standards for the fourth element of the compliance program, independent testing. A banking entity subject to the appendix must ensure that its independent testing is conducted by a qualified independent party, such as the banking entity's internal audit department, outside auditors, consultants or other qualified independent parties. The independent testing must examine both the banking entity's compliance program and its actual compliance with the proposed rule. Such testing must include not only the general adequacy and effectiveness of the compliance program and compliance efforts, but also the effectiveness of each element of the compliance program and the banking entity's compliance with each provision of the proposed rule. This requirement is intended to ensure that a banking entity continually reviews and assesses, in an objective manner, the strength of its compliance efforts and promptly identifies and remedies any weaknesses or matters requiring attention within the compliance framework.

e. Training

Section VI of proposed Appendix C articulates minimum standards for the fifth element of the compliance program, training. It proposes to require that a banking entity provide adequate training to its trading personnel and managers, as well as other appropriate personnel, in order to effectively implement and enforce the compliance program. In particular, personnel engaged in covered trading activities or covered fund activities and investments should be educated with respect to applicable prohibitions and restrictions, exemptions, and compliance program elements to an extent sufficient to permit them to make informed, day-to-day decisions that support the banking entity's compliance with the proposed rule and section 13 of the BHC Act. In particular, any personnel with discretionary authority to trade, in any amount, should be appropriately trained regarding the differentiation of prohibited proprietary trading and permitted trading activities and given detailed guidance regarding what types of trading activities are prohibited. Similarly, personnel providing investment management or advisory services, or acting as general partner, managing member, or trustee of a covered fund, should be appropriately trained regarding what covered fund activities and investments are permitted and prohibited.

f. Recordkeeping

Section VII of proposed Appendix C articulates minimum standards for the sixth element of the compliance program, recordkeeping. Generally, a banking entity must create records sufficient to demonstrate compliance and support the operation and effectiveness of its compliance program (i.e., records demonstrating the banking entity's compliance with the requirements of section 13 of the BHC Act and the proposed rule, any scrutiny or investigation by compliance personnel or risk managers, and any remedies taken in the event of a violation or non-compliance), and retain these records for no less than five years in a form that allows the banking entity to promptly produce these records to any relevant Agency upon request. Records created and retained under the compliance program shall include trading records of the trading units, including trades and positions of each such unit.

g. Request for Comment

The Agencies request comment on the compliance program requirement contained in § __.20 of the proposed rule and the minimum standards specified in proposed Appendix C. In particular, the Agencies request comment on the following questions:

Question 319. Is the proposed rule's inclusion of a compliance program requirement effective in light of the purpose and language of the statute? If not, what alternative would be more effective?

Question 320. Is the proposed application of § __.20's compliance program requirement to all banking entities engaged in covered trading activity or covered trading investments and activities and the minimum standards of proposed Appendix C to only banking entities with significant covered trading or covered fund activities, effective? If not, what alternative would be more effective? Should proposed Appendix C apply to all banking entities? If so, why? Are the thresholds proposed for determining whether a banking entity must comply with proposed Appendix C appropriate? If not, what alternative would be more effective?

Question 321. What implementation, operational, or other burdens or expenses might be associated with the compliance program requirement? How could those burdens or expenses be reduced or eliminated in a manner consistent with the purpose and language of the statute?

Question 322. Do the proposed compliance program requirement and minimum standards provide sufficient guidance and clarity regarding how compliance programs should be structured? If not, what additional guidance or clarity is needed? Do the proposed compliance program requirement and minimum standards provide sufficient discretion to banking entities to structure a compliance program that appropriately reflects the unique nature of their businesses? If not, how could additional discretion be provided in a manner consistent with the purpose and language of the statute?

Question 323. Are the six proposed elements of a required compliance program effective? If not, what alternative would be more effective? Should elements be added or removed? If so, which ones and why?

Question 324. For each of the six proposed elements of a required compliance program for which minimum standards are provided in proposed Appendix C, are the proposed minimum standards effective? If not, what alternative would be more effective? Should minimum standards be added or removed? If so, which ones and why?

Question 325. Does the requirement that a banking entity provide timely notification to the relevant Agency provide sufficient guidance as to what activities must be reported and how and when such reporting should be made? Should more specific standards be provided (e.g., regarding the timing of reporting and the types of activities that must be reported)? If so, what additional criteria should be implemented? Should the notification requirement be applied explicitly to banking entities that are not required to comply with the minimum standards specified in Appendix C because they are below the thresholds specified in § __.20(c)(2)? Why or why not?

Question 326. Are there specific records that banking entities should be required to make and keep to document compliance with section 13 of the BHC Act and the proposed rule? Please explain.

Question 327. What process should the Agencies use in determining whether to require a banking entity that, based on its size, would not be subject to Appendix C to comply with all or portions of the appendix under section I.E of the proposed appendix? What considerations should the Agencies take into account in making such a determination? Should this requirement be implemented by an Agency order, by authority delegated to Agency staff, or a different method? Please explain.

Question 328. Should the proposed rule permit banking entities to comply with Appendix C of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program? Should the proposed appendix provide additional clarity or discretion regarding how such an enterprise-wide program should be structured? If so, how? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context.

Question 329. Should the proposed rule permit banking entities to comply with § __.20(b) of the proposed rule on an enterprise-wide basis? If so, why? What are the advantages and disadvantages of an enterprise-wide compliance program for smaller banking entities that are not subject to Appendix C? Please include a discussion relating to the infrastructure of an enterprise-wide compliance program and its management in the context of smaller banking entities. If enterprise-wide compliance or similar programs are used in other contexts, please describe your experience with such programs and how those experiences influence your judgment concerning whether or not you would choose an enterprise-wide compliance program in this context. Are there particular reasons why a enterprise-wide compliance program should be permitted for larger banking entities subject to the requirements of Appendix C, but not those that are subject to § __.20(b) of the proposed rule?

Question 330. What are the particular challenges that should be considered in connection with establishing a compliance program on an enterprise-wide basis? How will such challenges be addressed? Can an enterprise-wide compliance program be appropriately tailored to each of the subsidiaries and affiliates of a banking entity?

Question 331. Are there efficiencies that can be gained through an enterprise-wide compliance program? If so, how and what efficiencies?

Question 332. Would the complexities of various types of covered trading activity be adequately reflected in an enterprise-wide compliance program?

Question 333. Should only outside parties be permitted to conduct independent testing for the effectiveness of the proposed compliance program to satisfy certain minimum standards? If so, why? Under the proposal, the independent testing requirement may be satisfied by testing conducted by an internal audit department or a third party. Should the rule specify the minimum standards for ‘‘independence’’ as applied to internal and/or external parties testing the effectiveness of the compliance program? For example, would an internal audit be deemed to be independent if none of the persons involved in the testing are involved with, or report to persons that are involved with, activities implicated by section 13 of the BHC Act? Why or why not?

Question 334. Do you anticipate that banking entities that do not meet the thresholds specified in § __.20(c) would voluntarily comply with the proposed minimum standards in Appendix C in order to effectively implement the six elements specified in § __.20(b)? Are there specific minimum standards that would not be practical or would be unattainable for a banking entity that does not meet the § __.20(c) thresholds? Please identify the minimum standard(s) and explain.

Question 335. In light of the size, scope, complexity, and risk of covered trading activities, do commenters anticipate the need to hire new staff with particular expertise in order to establish, maintain, and enforce the proposed compliance program requirement concerning covered trading activities or any subset of covered trading activities?

Question 336. With respect to the proposed requirement that training should occur with a frequency appropriate to the size and risk profile of the banking entity's covered trading activities and covered fund activities, should there be a minimum requirement that such training shall be conducted no less than once every twelve (12) months? If so, why?

Question 337. Should proposed rule's Appendix C be revised to require a banking entity's CEO to annually certify that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established pursuant to Appendix C in a manner that is reasonably designed to achieve compliance with section 13 of the BHC Act and this proposal? If so, why? If so, what would be the most useful, efficient method of certification (e.g., a new stand-alone certification, a certification incorporated into an existing form or filing, Web site certification, or certification filed directly with the relevant Agency)? Would a central data repository with a CEO attestation to the Agencies be a preferable approach?

Question 338. Do the proposed rule requirements relating to establishment and implementation of a compliance program pose unique concerns or challenges to issuers of asset-backed securities that are banking entities, and if so, why? Are certain asset classes particularly impacted by the proposed rule requirements, and if so, how?

Question 339. How would existing issuers of asset-backed securities that are banking entities pay for establishing and implementing a compliance program? Should existing issuers of asset-backed securities that cannot comply with the compliance program requirements be excluded from the proposed definition of ‘‘banking entity’’? Should such exclusion be limited, and if so, based on what factors? Are the proposed thresholds specified in § ____.20(c) of the proposed rule and/or the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question 340. With respect to future securitizations, what would be the impact of the establishment and implementation of the compliance program related to the provisions of the proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? Are the proposed thresholds specified in § __.20(c) of the proposed rule and/or the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question 341. Would existing issuers of asset-backed securities that are banking entities be able to establish and implement a compliance program related to the provisions of the proposed rule as required by § __.20 of the proposed rule (including Appendix C, where applicable)? If amendments to transactional documents are necessary, are there any obstacles that would make such amendments difficult to execute? If existing issuers of asset-backed securities cannot establish and implement a compliance program, what would be the impact on such existing issuers of asset-backed securities and the holders of securities issued by a non-compliant issuer of asset-backed securities? Is the allowance of an enterprise-wide compliance program as set forth in Appendix C of the proposed rule sufficient to minimize these concerns for issuers of asset-backed securities?

Question 342. To rely on the exemptions for permitted underwriting, market making-related, and risk-mitigating hedging activities, the proposed rule requires banking entities to establish the internal compliance program under § __.20 and, where applicable, Appendix C, designed to ensure compliance with the requirements of the applicable exemption (e.g., policies and procedures, internal controls and monitoring procedures, etc.). Do these requirements in the proposed rule impose undue cumulative burdens, such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? If so, why does the proposed rule impose cumulative burdens and what are the costs of those burdens? Please explain the circumstances under which these burdens may arise. Is there a way to reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed rule imposes that are particularly effective, and if so, how can the Agencies make better use of these requirements?

Question 343. Are the six elements of the proposed compliance program requirement mutually reinforcing and cost effective, or are there redundancies in the six elements? Please explain any redundant requirements in the policies and procedures, internal controls, management framework, independent testing, training, and recordkeeping requirements in § __.20(b) of the proposed rule or proposed Appendix C. Why are such requirements redundant, and how should the redundancy be addressed and remedied in the rule?

Question 344. A banking entity that meets the $1 billion or greater trading assets and liabilities threshold would be required under the proposed rule to comply with both the reporting and recordkeeping requirements in Appendix A with respect to quantitative measurements and the compliance program requirement in Appendix C. Are the requirements in these appendices mutually reinforcing and cost effective, or do the appendices impose redundant requirements on banking entities that meet the $1 billion threshold? Please explain any redundant requirements in the appendices and how such redundancy should be addressed and remedied in the rule.

Question 345. Proposed Appendix C incorporates the quantitative measurements provided in proposed Appendix A in the internal controls requirement for banking entities that are engaged in covered trading activity and meet the $1 billion or greater trading assets and liabilities threshold. Do the requirements in proposed Appendix A and Appendix C impose undue cumulative burdens with respect to any elements (e.g., quantitative measurements), such that the marginal benefit of a given requirement is not justified by the cost that the requirement imposes? Please explain why the proposed appendices impose cumulative burdens, the costs of those burdens, and the circumstances under which these burdens may arise. Is there a way to reduce or eliminate such burdens or requirements in a manner consistent with the language and purpose of the statute? For any requirements in the appendices that impose undue burdens, are there other requirements that could be substituted that would more efficiently ensure compliance with the statute? Are there any requirements that the proposed appendices impose that are particularly effective, and if so, how can the Agencies make better use of these requirements?

Question 346. Should the relevant Agency prescribe any specific method by which the board of directors or similar corporate body reviews and approves the compliance program? For example, should the relevant Agency require that: (i) A chief compliance officer or similar officer present an annual compliance report including, as appropriate, recommended actions to be taken by the banking entity to improve compliance or correct any compliance deficiencies; (ii) the board review any such recommendations and determine whether to approve them; and (iii) the banking entity notify the relevant Agency if the board declines to approve such recommendations, or approves different actions than those recommended in the compliance report? What are the advantages and disadvantages of such an approach?

3. *Section __.21: Termination of Activities or Investments; Penalties for Violations*

Section __.21 of the proposed rule implements section 13(e)(2) of the BHC Act, which requires the termination of activities or investments that violate or function as an evasion of section 13 of the Act.[347] In particular, § __.21(a) of the proposed rule requires any banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or the proposed rule or in a manner that functions as an evasion of the requirements of section 13 of the BHC Act or the proposed rule, including through an abuse of any activity or investment permitted under subparts B or C, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or the proposed rule, to terminate the activity and, as relevant, dispose of the investment.[348] Section __.21(b) of the proposed rule provides that if a relevant Agency finds reasonable cause to believe any banking entity has engaged in an activity or made an investment described in paragraph (a), the relevant Agency may, after due notice and an opportunity for hearing, by order, direct the banking entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.[349]

E. Subpart E—Conformance Provisions

Section 13(c)(6) of the BHC Act required the Board, acting alone, to adopt rules implementing those provisions of section 13 of the BHC Act that provide a banking entity or a nonbank financial company supervised by the Board a period of time *after* the effective date of section 13 of the BHC Act to bring the activities, investments, and relationships of the banking entity or company that were commenced, acquired, or entered into before the effective date of section 13 of the BHC Act into compliance with that section and the agencies' implementing regulations.[350] The Board's Conformance Rule, which was required

[347] *See* 12 U.S.C. 1851(e)(2).

[348] *See* proposed rule § __,21(a). The Agencies have proposed to include § __.21(a), in addition to the provisions of § __.21(b) of the proposed rule, to make clear that the requirement to terminate an activity or, as relevant, dispose of an investment would be triggered where a banking entity discovers a violation or evasion, regardless of whether an Agency order has been issued.

[349] *See* proposed rule § __,21(b).

[350] *See* 12 U.S.C. 1851(c)(6).

under section 13(c)(6) of the BHC Act, was issued on February 8, 2011.[351] As noted in its issuing release, this period is intended to give markets and firms an opportunity to adjust to section 13 of the BHC Act.[352]

As part of the current proposal, the Board is proposing to relocate the Board's Conformance Rule, which was added as §§ 225.180–182 of the Board's Regulation Y, to subpart E of the Board's proposed rule.[353] The Board is also proposing to make certain conforming and technical changes to the language and defined terms of the Board's Conformance Rule in connection with its proposed relocation to subpart E of the Board's current proposal. The Board is not, however, proposing any substantive changes to the Board's Conformance Rule as part of this proposed rule. In particular, the Board's Conformance Rule defined certain terms related to section 13 of the BHC Act, including ''banking entity,'' ''hedge fund and private equity fund,'' ''insured depository institution,'' and ''Board.''[354] For the sake of consistency, the Board is proposing to eliminate these definitions as they are now defined elsewhere, and in more comprehensive a manner, in the proposed rule.[355] These alternative or replacement definitions are substantially similar to those contained in the Board's Conformance Rule and are discussed in further detail in Part III.A.2 of this Supplementary Information.

In connection with incorporating provisions of the existing Board's Conformance Rule into the current proposal, the Board notes that the conformance period and extended transition period provided by section 13(c) of the BHC Act and the Board's Conformance Rule do *not* permit a banking entity to engage in any new activity or make any new investment in a covered fund without complying with the restrictions and prohibitions of section 13 of the BHC Act and implementing rules thereunder. The conformance period and extended transition period provided by the Board's Conformance Rule permit a banking entity to bring those of its *existing* activities and investments that do not conform to the requirements of section 13 of the BHC Act and the proposed rule into conformance. The Board's Conformance Rule does *not* authorize a banking entity to engage in *new* or *additional* prohibited activities or investments, and this restriction would continue to apply under the current proposed rule.

With respect to proprietary trading, the Board expects that each banking entity will identify those trading units of the banking entity that are engaged in prohibited proprietary trading as of or after the effective date of section 13 of the BHC Act and the type of proprietary trading in which they are engaged. A banking entity is expected to bring the prohibited proprietary trading activity of a trading unit into compliance with the requirements of the proposed rule as soon as practicable within the conformance period. A trading unit may not expand its activity to include prohibited proprietary trading after the effective date of the proposed rule. Similarly, a trading unit that is not identified as engaging in proprietary trading as of the effective date may not begin engaging in such activity after the effective date.

With respect to a covered fund activity or investment, the conformance period (or, in the case of an illiquid fund for which a banking entity has received Board approval, the extended transition period) generally permits a banking entity to retain an existing investment in a covered fund, make additional capital contributions to a covered fund if contractually obligated to do so, or continue certain existing relationships with a covered fund.[356] However, pursuant to the conformance period or extended transition period, a banking entity may not make a new investment or capital contribution that it is not contractually obligated to make in, or establish a new relationship with, a covered fund after the effective date of the proposed rule.[357]

Request for Comment

In light of the interplay between the Board's Conformance Rule and the current proposed rule, the Board is requesting comment on whether any of the conformance provisions should be revised. In particular, the Board requests comment on the following question:

Question 347. Should any portion of the Board's Conformance Rule be revised in light of other elements of the current proposed rule? If so, why and how?

IV. Request for Comments

The Agencies are interested in receiving comments on all aspects of the proposed rule.

V. Solicitation of Comments on Use of Plain Language

Section 722 of the Gramm-Leach-Bliley Act, Public Law 106–102, sec. 722, 113 Stat. 1338, 1471 (Nov. 12, 1999), requires the OCC, Board and FDIC to use plain language in all proposed and final rules published after January 1, 2000. The OCC, Board and FDIC invite public comments on how to make this proposal easier to understand. For example:

• Have we organized the material to suit your needs? If not, how could this material be better organized?

• Are the requirements in the proposed regulation clearly stated? If not, how could the regulation be more clearly stated?

• Does the proposed regulation contain language or jargon that is not clear? If so, which language requires clarification?

• Would a different format (grouping and order of sections, use of headings, paragraphing) make the regulation easier to understand? If so, what changes to the format would make the regulation easier to understand?

• What else could we do to make the regulation easier to understand?

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

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

[353] *See* Board proposed rule §§ __.30 to __.32.

[354] *See* Board's Conformance Rule §§ 225.180(a)–(c), (e).

[355] *See* proposed rule §§ __.2(e), (f), (p); __.10(b)(1).

[356] For instance, under the Board's Conformance Rule and the current proposed rule, a banking entity may retain an existing ownership interest in a covered fund under authority of the conformance period or extended transition period without regard to the per-fund or aggregate fund limitations contained in § __.12 of the proposed rule. Additionally, a banking entity may continue to serve as sponsor to a covered fund under authority of the conformance period, but only if the banking entity acted as sponsor to such fund as of the effective date of section 13 of the BHC Act and the nature of the relationship was continuous. A banking entity may also serve as sponsor of an illiquid fund pursuant to the extended transition period, but only to the extent such service is related to the banking entity's retention of its permitted ownership interest in such fund.

[357] In the case of a covered fund that a banking entity organizes and offers, or begins to act as sponsor to, after the effective date of section 13 of the BHC Act, the banking entity must comply with the requirements of the proposed rule with respect to its relationships with, and acquisition and retention of an ownership interest in, such covered fund. For instance, after the effective date of section 13 of the BHC Act, a banking entity may only acquire and retain an ownership interest in that covered fund as a permitted investment only (i) if the banking entity organizes and offers or acts as sponsor to that fund, and (ii) in compliance with the per-fund limitation and aggregate fund limitation of the proposed rule. Similarly, a banking entity's relationship with such covered fund would be subject to the limitations contained in the proposed rule.

VI. The Economic Impact of the Proposed Rule Under Section 13 of the BHC Act—Request for Comment

Section 13 of the BHC Act imposes on all banking entities prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, a covered fund,[358] which apply to banking entities whether or not the Agencies adopt implementing rules. In formulating the proposed rule to implement these provisions, which is required by statute, the Agencies have chosen a multi-faceted approach to establish a regulatory framework that provides for clear, robust, and effective implementation of the statute's provisions in a consistent manner, while also not unduly constraining the ability of banking entities to engage in permitted activities and investments.[359] The Agencies have proposed this approach after considering the Council's findings and recommendations regarding how to implement section 13 of the BHC Act and a variety of alternatives described throughout this Supplemental Information.[360] The Agencies seek comment, in particular, on the potential costs and benefits of those aspects of the proposed rule that involve choices made, or the exercise of discretion, by the Agencies in implementing section 13 of the BHC Act.

The Agencies recognize that there are economic impacts that may arise from the proposed rule and its implementation of section 13 of the BHC Act and invite comment on the manner in which the proposed rule implements section 13 of the BHC Act, including commenters' views on the potential economic impacts discussed in this Part of the Supplemental Information. In addition, the Agencies seek comment on whether the proposed rule represents a balanced and effective approach to implementing section 13 of the BHC Act or whether alternative approaches to implementing section 13 of the BHC Act exist that would provide greater benefits or involve fewer costs, consistent with the statutory purpose. We also request comment on the potential competitive effects of the manner in which the proposed rule implements the statute.[361]

In addition to the questions posed throughout Part II of the Supplemental Information with respect to the potential costs and benefits of particular aspects of the statute and proposed rule, in order to assist in the analysis of the economic impacts associated with the final rule and any alternatives the Agencies may evaluate, the Agencies encourage commenters to provide quantitative information about the rule's impact on banking entities, their clients, customers, and counterparties, specific markets or asset classes, and any other entities potentially affected by the proposed rule with respect to:

1. The direct and indirect costs and benefits of compliance with section 13 of the BHC Act, as proposed to be implemented;
2. The effect of section 13 of the BHC Act, as proposed to be implemented, on competition; and
3. Any other economic impacts of the proposal.

In addition, to assist with potential estimates of the proposed rule's quantitative impacts, we request specific comment on: (i) The extent to which banking entities currently engage in proprietary trading activity or covered funds activities or investments that are prohibited or restricted by the statute, or have otherwise divested or conformed such activities; and (ii) the potential costs and benefits or other quantitative impacts of various aspects of the proposed rule, such as the compliance program requirement, the required reporting of quantitative measurements, and the conditions and requirements for relying on the proposed exemptions.

To further facilitate public comment on the economic effects of the manner in which the proposed rule implements the statute, the Agencies have identified below a number of significant aspects of the proposed rule and potential economic impacts that may result from section 13 of the BHC Act's requirements, as proposed to be implemented. We seek commenters' views on the likelihood of the potential economic impacts identified in this Part and whether there are additional costs, benefits, or other impacts that may arise from the proposed rule. To the extent that such costs, benefits, or other impacts are quantifiable, commenters are encouraged to identify, discuss, analyze, and supply relevant data, information, or statistics related to such costs, benefits, and other impacts and the quantification of such costs, benefits, and other impacts. In addition, commenters are asked to identify or estimate start-up, or non-recurring, costs separately from costs or effects they believe would be ongoing.

A. Proprietary Trading Provisions

1. Definition of Trading Account

Section __.3 of the proposed rule, which implements the statutory definition of ''trading account,'' provides a multi-pronged definition of that term that is intended to ensure that banking entities do not engage in ''hidden'' proprietary trading by characterizing trading activity as being conducted outside a trading account. In addition to positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position, the proposed definition also includes: (i) With respect to a banking entity subject to the Federal banking agencies' Market Risk Capital Rules, all positions in financial instruments subject to the prohibition on proprietary trading that are treated as ''covered positions'' under those capital rules, other than certain foreign exchange and commodities positions; and (ii) all positions acquired or taken by certain registered securities and derivatives dealers (or, in the case of financial institutions that are government securities dealers, that have filed notice with an appropriate regulatory agency) in connection with their activities that require such registration or notice. Although these prongs of the definition are proposed to prevent evasion of the statutory requirements, we seek comment on the extent to which either of these two prongs may create a competitive disadvantage for certain banking entities vis-à-vis competitors that are either not subject to section 13 of the BHC Act and/or competitors subject to different prongs of the proposed definition.

2. Exemption for Underwriting Activities

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for purchases and sales in connection with underwriting activities, to the extent

[358] As noted above in connection with the conformance and extended transition periods, the proposed rule would not require an immediate application of these restrictions for any activity or investment entered into prior to the effective date of section 13 of the BHC Act (July 21, 2012). However, any activity or investment entered into after the effective date would be required to comply with section 13 of the BHC Act and the proposed rule, if adopted. *See* Supplemental Information Part III.E.

[359] *See* Supplemental Information Part II.A.

[360] *See* 12 U.S.C. 1851(b)(2)(A); *see also* Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 2011), *available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.*

[361] For example, implementation of section 13(d)(1)(H) of the BHC Act may result in a competitive advantage for foreign-controlled banking entities over U.S.-controlled banking entities with respect to activities that occur solely outside of the United States.

that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. In implementing this exemption in § __.4(a) of the proposed rule, the Agencies have endeavored to establish a regime that clearly sets forth the requirements for relying on the underwriting exemption established in the statute to facilitate banking entities' compliance with the statutory requirements. In considering potential requirements for the underwriting exemption, and assessing the potential economic impacts of each such requirement, the Agencies strived to propose an appropriate balance between considerations related to: (i) The potential for evasion of the statutory prohibition on proprietary trading through misuse of the underwriting exemption; and (ii) the potential costs that may arise from constraints on legitimate underwriting activities.

The Agencies have proposed to use, wherever practicable, common terms from existing laws and regulations in the context of underwriting to facilitate market participants' understanding and use of the exemption and to promote consistency across laws and regulations. Specifically, the proposed definitions of ''distribution'' and ''underwriter'' established in the proposed rule largely mirror the definitions provided for these terms in the SEC's Regulation M. Because the proposed rule uses a modified version of the Regulation M definition of ''underwriter'' to include selling group members, the proposed definition would permit the current market practice of members of the underwriting syndicate entering into an agreement with other selling group members to collectively distribute the securities, rather than requiring all members of a distribution to join the underwriting syndicate.

In addition, the definition of ''distribution'' from Regulation M that the Agencies have proposed in § __.4(a) of the proposed rule is intended to ensure that the underwriting exemption does not unduly constrain banking entities from providing underwriting services, while at the same time preventing banking entities from relying on the underwriting exemption to evade the proposed rule and the statutory prohibition on proprietary trading. The Agencies anticipate that the proposed approach to implementing the underwriting exemption should permit legitimate forms of underwriting in which market participants currently engage and, thus, should not unduly burden capital formation. In addition, the proposed rule would permit underwriters to continue to employ existing practices to stabilize a distribution of securities, which stabilization promotes confidence among issuers, selling security holders, and investors and further supports capital formation.

Under the proposed rule, the underwriting activities of a banking entity must be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, not from appreciation in value of covered financial positions that the banking entity holds related to such activities or the hedging of such covered financial positions. This proposed requirement should promote investor confidence by ensuring that the activities conducted in reliance on the underwriting exemption are designed to benefit the interests of clients seeking to bring their securities to market, not the interests of the underwriters themselves. The proposed requirement should also help prevent evasion of the statutory prohibition on proprietary trading, as trading activity designed to generate revenues from appreciation in the value of positions held by the banking entity would be indicative of prohibited proprietary trading, not underwriting activity. We seek comment on whether this approach of identifying underwriting activity by reference to revenue source could also make underwriting less profitable to the extent that it precludes or discourages certain types of profitability for *bona fide* underwriting services.

In addition to commenters' views on the potential economic impacts identified above, we request comment on whether the proposed rule may cause some banking entities to choose to decrease the supply of underwriting services in response to potential costs of the proposed rule and whether this result would adversely affect competition among underwriters or have a harmful impact on capital formation. In addition, if banking entities were to pass the increased costs of complying with the proposed exemption on to issuers, selling security holders, or their customers, we seek comment on whether the effect would be to increase the cost of raising capital and whether this would harm capital formation to the extent that such cost increases were sufficient to preclude issuers from accessing the capital markets. As described above, the Agencies have designed the proposal to balance such potential costs with provisions intended to permit banking entities' legitimate underwriting activities to continue as provided by the statute, while also establishing sufficient requirements to prevent evasion of the statutory goals through misuse of the underwriting exemption.

3. Exemption for Market Making-Related Activities

Section 13(d)(1)(B) of the BHC Act provides an exemption from the prohibition on proprietary trading for purchases and sales in connection with market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. In setting forth the requirements for eligibility for this exemption in § __.4(b) of the proposed rule, the Agencies have endeavored to establish a regime that clearly sets forth the requirements for relying on the exemption for market making-related activity established in the statute to facilitate banking entities' compliance with the statutory requirements. In considering potential requirements for the market-making exemption, and assessing the potential economic impacts of each such requirement, the Agencies tried to strike an appropriate balance between considerations related to: (i) The potential for evasion of the statutory prohibition on proprietary trading through misuse of the exemption for market making-related activity; (ii) the potential difficulties related to distinguishing market making-related activity from prohibited proprietary trading; and (iii) potential costs that may arise from constraints on legitimate market making-related activities.

The Agencies have proposed to use, where practicable, terms and concepts used in current laws and regulations in the context of market making to promote clarity and consistency. Recognizing that there are differences in market making activities between different types of asset classes (e.g., liquid and illiquid instruments) and market structures (e.g., organized trading facilities and the over-the-counter markets), the Agencies have proposed to implement the market-making exemption in a manner that accounts for these distinctions and permits market making activities in different asset classes and market structures. Permitting legitimate market making in its different forms should promote market liquidity and efficiency by allowing banking entities to continue to provide customer intermediation and liquidity services in both liquid and illiquid instruments. The Agencies also recognize, however, that market making-related activities in the over-the-counter markets or activities involving less liquid instruments are sometimes less transparent than similar activities on organized trading facilities or in liquid markets. We seek comment on whether, in order to comply with the statutory prohibition on proprietary trading, some banking entities may be inclined to abstain from some market-making activities in an effort to reduce the risk of noncompliance. We also request comment on whether, if banking entities did so, this could result in reduced liquidity for certain types of trades or for certain less liquid instruments.

In addition, the proposed exemption permits anticipatory market making, block positioning, and hedging of market making positions under certain circumstances, which should further facilitate customer intermediation and market liquidity and efficiency. However, certain conditions are placed on such market making-related activities in the proposal in an effort to ensure that such activities are, in fact, market making-related activities, and are not hidden proprietary trading activities subject to the statutory prohibition.

The proposal requires that the market making-related activities be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to appreciation in the value of covered financial positions a banking entity holds in trading accounts or the hedging of such positions. This proposed requirement should promote investor confidence by helping to ensure that market making serves customer needs. The proposed requirement should also help prevent evasion of the statutory prohibition on proprietary trading, as trading activity designed to generate revenues from appreciation in the value of positions held by the banking entity would be indicative of prohibited proprietary trading, not market making-related activity. The Agencies request comment on whether this approach of identifying market making activity by reference to a market making trading unit's revenue source would also make market making activity less profitable and whether it would preclude or discourage certain types of profitability for *bona fide* market making services. Commenters should also address whether this requirement would reduce the willingness of some banking entities to continue to provide market making-related services and whether this could reduce liquidity, harm capital formation, or make market making-related services more expensive. The Agencies note that, in order to balance the potential for such effects with the statutory purpose, the proposed rule does not expressly prohibit all types of non-client income, and recognizes that the precise type and source of revenues generated by *bona fide* market making services can and will vary depending on the relevant market, asset, and facts and circumstances.

4. Exemption for Risk-Mitigating Hedging Activities

Section 13(d)(1)(C) provides an exemption from the prohibition on proprietary trading for risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. The proposed exemption requires that the hedging transaction be reasonably correlated to these risks that the transaction is intended to hedge or otherwise mitigate. This proposed requirement is intended to address the potential for misuse of the exemption where a transaction is not closely tied to risk mitigation, while also providing some flexibility in the degree of correlation that is required in order to promote consistency with the statutory goals and requirements.

In addition, the proposed exemption requires that the hedging transaction: (i) Not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction; and (ii) be subject to continuing review, monitoring, and management. Together, these proposed requirements are designed to ensure that a banking entity does not use the hedging exemption to conduct prohibited proprietary trading in the guise of hedging activity and to prevent evasion of the proprietary trading prohibition contained in section 13 of the BHC Act and the proposed rule. These proposed requirements are intended to ensure that an exempt hedging transaction will mitigate, not amplify, risk. Moreover, such requirements should further the goals of compliance with the statutory requirements and reducing banking entities' risks.

We seek comment on whether the proposed requirements for relying on the hedging exemption are more restrictive than necessary to implement the statutory language and purpose, and to prevent evasion of the statutory provisions, and whether a banking entity's hedging activities could be unduly constrained by the proposed rule. Further, commenters should address the extent to which a banking entity may be unable or unwilling to execute certain hedges and whether, as a result, a banking entity could be limited in its means to reduce its risk. In addition, would banking entities be dissuaded from engaging in other permitted activities or activities outside the scope of the statute (e.g., long-term investments) if the requirements of the proposed hedging exemption unduly limits or prevents them from mitigating the risks associated with such activities? We request comment on whether a reduction in efficiency could result from a reduced ability of covered banking entities to transfer risks to those more willing to bear them. Commenters should also address whether the proposed rule would reduce a banking entity's willingness to engage in permitted risk-mitigating hedging activities in order to avoid costs related to ensuring compliance with the exemption's requirements and whether this would increase the banking entity's risk exposure. In order to balance the potential for such effects with the statutory purpose, the proposed rule attempts to implement the risk-mitigating hedging exemption in a manner that recognizes that the precise nature and execution of risk mitigation through hedging transactions can and will vary depending on the relevant market, asset, and facts and circumstances, while also establishing requirements designed to ensure that transactions relying on the hedging exemption are, in fact, hedges and not hidden proprietary trading prohibited by the statute.

The proposed exemption would require documentation with respect to hedges established at a different level of organization than that responsible for the underlying positions or risks that are being hedged. This proposed documentation requirement is intended to facilitate review by banking entities and Agency supervisors and examiners in assessing whether the hedge position was established to hedge or otherwise mitigate another unit's risks. Without such documentation, there could be an increased risk of evasion of the statute's prohibition on proprietary trading, as it would be difficult to assess whether a purported hedging transaction was established to mitigate another level of organization's risk or solely to profit from price appreciation of the position established by the purported hedge. We seek comment on the costs of the proposed documentation requirement for certain hedging transactions, such as the costs related to systems changes and maintenance, employee resources and time, and recordkeeping.[362] The

[362] The Agencies note that, for some costs of the proposed rule, hour burden estimates are provided in Part [internal cite to PRA] of this Supplementary

Agencies also request comment on the extent to which the proposed documentation requirement would reduce the speed in which a banking entity could execute a hedge at a different level within the entity and whether this could reduce efficiency or result in a banking entity being exposed to a greater amount of risk. Further, we seek commenters' views on whether potentially slower execution times could also reduce profitability associated with the position as it remains unhedged (or, alternatively, increase profitability, depending on whether the value of the unhedged position is increasing or decreasing in the market). To balance the potential for such consequences with the statutory purpose, the Agencies have proposed to apply the documentation requirement to only a subset of hedging transactions that pose the greatest compliance risk (i.e., hedges that are established at a different level of organization than that establishing or responsible for the underlying positions or risks that are being hedged). In addition, the Agencies expect that the preparation of required documentation would become less burdensome and more efficient over time as systems are developed and personnel become more accustomed to the proposed requirement.

5. Compensation Related to Permitted Activities

The proposed rule would require that the compensation arrangements of persons performing underwriting, market making-related, and risk-mitigating hedging activities be designed not to reward proprietary risk-taking. These proposed requirements are intended to reduce incentives for personnel of the banking entity to violate the statutory prohibition on proprietary trading and expose the banking entity to risks arising from prohibited proprietary trading. We request comment on whether the proposed rule's requirements regarding compensation arrangements would reduce the banking entity's ability to attract talented and experienced trading personnel or would harm the banking entity's ability to compete with entities that are not subject to section 13 of the BHC Act and the proposed rule. In order to balance the potential for such effects with the statutory goals, the proposed rule does not expressly prescribe how a banking entity must compensate its personnel or prohibit all types of compensation incentives related to non-client income, but instead proposes an approach that leaves banking entities with a degree of flexibility to compensate their personnel as they deem appropriate.

6. Exemption for Trading on Behalf of Customers

Section __.6(b) of the proposed rule implements section 13(d)(1)(D) of the BHC Act, which permits a banking entity, notwithstanding the prohibition on proprietary trading, to purchase or sell a covered financial position on behalf of customers. Because the statute does not define when a transaction would be conducted on behalf of customers, the proposed rule identifies three categories of transactions that would qualify under this exemption. By providing that only transactions meeting the terms of the three categories would be considered to be on behalf of customers for purposes of the exemption, the proposed rule addresses the potential for evasion of the statutory prohibition. At the same time, the proposed rule also would not permit banking entities to rely on the exemption with respect to other, unanticipated transactions that banking entities may undertake on behalf of customers. The Agencies seek comment on whether banking entities currently engage in principal transactions on behalf of customers that are not covered by the proposed exemption or other permitted activities and whether the lack of an exemption in the proposed rule for such activities would impact beneficial customer facilitation, market liquidity, efficiency, or capital formation.

7. Exemption for Trading Outside of the United States

Section __.6(d) of the proposed rule implements section 13(d)(1)(H) of the BHC Act, which permits certain foreign banking entities to engage in proprietary trading that occurs ''solely outside of the United States.'' The proposed exemption provides a number of specific criteria for determining when trading will be considered to have occurred solely outside of the United States to help prevent evasion of the statutory restriction. The proposed exemption also provides a definition of ''resident of the United States'' that is similar to the SEC's definition of ''U.S. person'' in Regulation S, which should promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S. In addition, the proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) and 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity that is not a ''foreign banking organization'' under the Board's Regulation K. This implementation of section 13(d)(1)(H) of the BHC Act would permit certain foreign banking entities that are not ''qualifying foreign banking organizations'' under the Board's Regulation K to also rely on the exemption, notwithstanding the fact such foreign banking entities are not currently subject to the BHC Act generally or the Board's Regulation K. As a result, such foreign banking entities should encounter fewer costs related to complying with the proprietary trading prohibitions than if they were unable to rely on the exemption in section 13(d)(1)(H) of the BHC Act.

Despite the reference to section 4(c)(13) of the BHC Act, the statute provides that the exemption for trading outside of the United States is only available to banking entities that are not directly or indirectly controlled by U.S. banking entities (i.e., not any U.S. banking entities or their foreign subsidiaries and affiliates). Under the statute, the prohibition on proprietary trading applies to the consolidated, worldwide operations of U.S. firms. As required by statute, the proposal prohibits U.S. banking entities from engaging in proprietary trading unless the requirements of one or more relevant exemptions (other than the exemption for trading by foreign banking entities) are satisfied. As a result, the statute creates a competitive difference between the foreign activities of U.S. banking entities, which must monitor and limit their foreign activities in accordance with the requirements of section 13 of the BHC Act, relative to the foreign activities of foreign-based banking entities, which may not be subject to restrictions similar to those in section 13 of BHC Act. The Agencies seek commenters' views on whether the proposed rule's implementation of section 13(d)(1)(H) of the BHC Act imposes additional competitive differences, beyond those recognized above, and the potential economic impact of such competitive differences.

8. Quantitative Measurements

Section __.7 of the proposed rule, which implements in part section 13(e)(1) of the BHC Act,[363] requires

Information for purposes of the Agencies' compliance with the Paperwork Reduction Act.

[363] 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

Continued

certain banking entities to comply with the reporting and recordkeeping requirements specified in Appendix A of the proposed rule. Proposed Appendix A requires a banking entity with significant trading activities to furnish periodic reports to the relevant Agency regarding various quantitative measurements of its trading activities and create and retain records documenting the preparation and content of these reports. The proposed measurements would vary depending on the scope, type, and size of trading activities. In addition, proposed Appendix B contains a detailed commentary regarding the characteristics of permitted market making-related activities and how such activities may be distinguished from trading activities that, even if conducted in the context of banking entity's market making operations, would constitute prohibited proprietary trading. These proposed requirements are intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk strategies. In combination, § __.7 and Appendix A of the proposed rule provide a quantitative overlay designed to help banking entities and the Agencies identify trading activities that warrant further analysis or review in a variety of levels and contexts.

The various quantitative measurements that would be required to be reported focus on assessing banking entities' risk management, sources of revenue, revenues in relation to risk, customer servicing, and fee generation. Aberrant patterns among the measurements with respect to these areas would warrant further review to determine whether trading activities have occurred that are proprietary in nature and whether such activities may be exposing banking entities to disproportionate risk. For example, quantitative measurements should provide banking entities with a useful starting point for assessing whether their trading activities are consistent with the proposed rule and whether traders are exposing the entity to disproportionate risks. In addition, proposed Appendix A applies a standardized description and general method of calculating each quantitative measurement that, while taking into account the potential variation among trading practices and asset classes, is intended to facilitate reporting of sufficiently uniform information across different banking entities so as to permit horizontal reviews and comparisons of the quantitative profile of trading units across firms. This proposed approach, which recognizes that quantitative measurements must be applied with respect to differences within a banking entity's structure, business lines, and trading desks, should facilitate efficient application within firms and efficient examination across firms. The proposed use of a suite of quantitative measurements for these purposes may also limit erroneous indications of potential violations or erroneous indications of compliance (i.e., false positives and false negatives), thus allowing banking entities and examiners and supervisors to focus upon the measurements that may be most relevant in identifying prohibited conduct. The uniformity of the proposed measurements across different types of banking entities is also intended to ensure that banking entities are calculating comparable measurements consistently and that comparable measurements are being evaluated consistently by Agencies. The Agencies expect that as the implementation of quantitative measurements and the internal compliance and external oversight processes become more efficient over time, banking entities will find compliance efforts less burdensome.

The Agencies seek comment on the extent to which banking entities will incur costs associated with implementing, monitoring, and attributing financial and personnel resources for purposes of complying with the requirements of proposed Appendix A. Specifically, please discuss the extent to which banking entities are unlikely to currently calculate certain quantitative measurements in the manner required under the proposal (e.g., Spread Profit and Loss or Customer-facing Trade Ratio) and whether this may result in significant start-up costs associated with developing these measurements. Under the proposal, banking entities would also need to dedicate personnel and supervisory staff to review for potential aberrant patterns of activity that warrant further review, as well as maintain appropriate records of that review. In order to limit these calculation and surveillance costs to the greatest extent practicable, the Agencies have proposed measurements that, in many cases, are already calculated by many banking entities to measure and manage trading risks and activities. The costs to banking entities associated with calculating the proposed quantitative metrics should also be mitigated by the tiered application of Appendix A, which would require banking entities with the most extensive trading activities to report the largest number of quantitative measurements, while imposing fewer or no reporting requirements on banking entities with smaller trading activities. By limiting the application of aspects of Appendix A to firms with greater than $1 billion in trading assets and liabilities, and all aspects of the appendix only to entities with greater than $5 billion in trading assets and liabilities, the costs imposed should be proportional to the market reach and complexity of a banking entity's trading activities.

B. Covered Fund Activities

Subpart C implements the statutory provisions of section 13(a)(1)(B) of the BHC Act, which prohibit banking entities from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring, a covered fund, and other provisions of section 13 of the BHC Act which provide exemptions from, or otherwise relate to, that prohibition. In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies have proposed to define and interpret several terms used in implementing these provisions and the goals of section 13. We seek comment on whether the proposed rule represents a balanced and effective approach to implementing the covered fund provisions of the statute.

1. General Scope

For banking entities that invest in, sponsor or have relationships with one or more covered funds, the economic impact of complying with the statute and the implementing rule will vary, depending on the size, scope and complexity of their respective business, operations and relationships with clients, customers and counterparties. Moreover, the types of covered funds advised or sponsored by an adviser, the types of business and other relationships that an adviser may conduct with such funds and the adviser's other business activities, including relationships with other third party advised covered funds, will affect whether a covered fund activity would be subject to the statutory prohibition, eligible for a particular exemption or subject to particular internal control requirements as specified by the proposed rule.

For example, with respect to a banking entity that does not ''sponsor,''

__.20 and Appendix C of the proposed rule also implement section 13(e)(1) of the BHC Act.

invest in, or otherwise provide ''prime brokerage transactions'' to, a ''covered fund,'' the statute, as implemented by the proposed rule, would not substantively restrict the banking entity's activity; instead, the proposed rule would only require the minimum internal controls reasonably designed to prevent the entity from engaging in the prohibited activities. As a result, we do not expect that the proposed rule would have a significant effect on most banking entities, such as investment advisers, that are primarily engaged in providing *bona fide* trust, fiduciary, or advisory services to unrelated parties. Although such advisers may incur some incremental costs to develop and implement a compliance program reasonably designed to ensure that they do not engage in otherwise prohibited activities, there should be no significant costs associated with modifying existing business practices and procedures. We request comment on the extent to which such banking entities would be required to modify their existing business practices and procedures to comply with the proposed rule. For instance, would a registered investment adviser that only advises registered investment companies and that does not trade for its own account incur costs, benefits or other impacts in addition to costs to implement the minimum internal controls reasonably designed to prevent it from engaging in prohibited activities? Would an adviser that trades on behalf of itself incur, with respect to such trading activities, additional costs, benefits or other impacts described above relating to the proposed restrictions on proprietary trading?

In contrast, a banking entity that seeks to invest in a covered fund could only do so in reliance on an exemption specified in the statute or the proposed rule, such as the exemption for organizing and offering certain covered funds provided in section 13(d)(1)(G), as implemented in § __.11 of the proposed rule. Similarly, a banking entity that seeks to enter into ''prime brokerage transactions'' with a covered fund could only do so by meeting certain requirements under the proposed rule. Accordingly, the economic impact of the proposed rule will depend on whether an adviser's activities fall within the scope of the terms as proposed such that the banking entity would be subject to the limitations on covered fund activities. To the extent that these terms or exemptions would result in more, or fewer, activities being captured by the proposed rule, what are the attendant costs and benefits that a covered banking may incur? We request commenters provide empirical data where possible.

Definition of Covered Fund. The proposed rule's definition of ''covered fund'' includes hedge funds and private equity funds as defined by statute, but also identifies two types of similar funds—commodity pools and certain non-U.S. funds—that are subject to the covered fund restrictions and prohibitions of section 13 of the BHC Act, as implemented by the proposed rule. The Agencies have proposed to include these funds since they are generally managed and structured similar to a covered fund, but are not generally subject to the Federal securities laws due to the instruments in which they invest or the fact that they are not organized in the United States or one or more States. We request comment on whether applying the definition of covered fund in this way as proposed would increase the number of investment vehicles or similar entities that would be subject to the limitations under the proposed rule. Would this approach increase compliance costs for banking entities that sponsor, invest in, or have certain relationships with these types of funds?

The proposed rule also excludes certain types of investments in covered funds, pursuant to section 13(d)(1)(J) of the BHC Act, which authorizes the Agencies to exclude from the general covered fund activity prohibition those activities that would promote the safety and soundness of a banking entity. Section __.14 of the proposed rule would exclude from the prohibition, among other things, a banking entity's investments in covered funds related to bank owned life insurance, certain joint ventures and interests in securitization vehicles retained in compliance with the minimum credit risk retention requirements of section 15G of the Exchange Act. We request comment on the potential economic impact of the proposal to exclude these types of investments from the general prohibition. For banking entities whose only covered fund activities are those described in § __.14, what economic impact would be attributed to complying with this provision of the proposed rule? Would these costs and benefits differ from those of banking entities that conduct covered fund activities as well as engage in activities described in § __.14? As described in the Supplementary Information, a banking entity that generally does not engage in any prohibited activities is only required to adopt and implement a compliance program reasonably designed to ensure that the entity does not engage in prohibited activities. To what extent will the proposed provisions in § __.14 increase or mitigate any costs, benefits or other impacts associated with the foregoing minimum internal controls requirement?

Definition of Sponsor. Under the proposed rule, the term ''sponsor'' is defined by incorporating the definition set forth in section 13(h)(5) of the BHC Act, but the Agencies have proposed to clarify that the term trustee, as used in the definition of sponsor, does not include a trustee that does not provide discretionary investment services to a covered fund. This exception distinguishes a trustee providing non-discretionary advisory services from trustees providing services similar to those associated with entities serving as general partner, managing member, commodity pool operator or investment adviser of a covered fund. We request comment on the economic impact associated with the proposed definition of ''sponsor.'' Will the economic impact differ depending on the scope of a banking entity's covered fund activities? For example, a banking entity whose only relationship with a covered fund involves the provision of non-discretionary investment services would not be a sponsor under the proposed rule. We request comment on whether such a banking entity would benefit from this exception. We also request comment on whether a covered fund's investors and counterparties would bear any costs associated with a banking entity's modification of its business practices or its relationship to the covered fund.

Other Definitions. The covered fund provisions also define, among other things, ''director'' and ''prime brokerage transaction.'' What are the costs, benefits or other impacts associated with the way the proposed rule defines these terms? For example, would the proposed definition of ''prime brokerage transaction'' enable a banking entity to provide services to a covered fund that would not ordinarily be understood to be prime brokerage as long as it met certain conditions? What costs, or benefits, for banking entities, clients, customers or counterparties may be associated with this approach to defining prime brokerage transaction?

2. Exemptions

In implementing the covered funds provisions of section 13 of the BHC Act, the Agencies also have interpreted or defined terms contained in the three principal exemptions related to covered fund activities by a banking entity: (i) The exemption for organizing and offering covered funds; (ii) the exemption for investment in a covered fund in the case of risk-mitigating hedging; and (iii) the exemption for covered fund activities outside of the United States. We request comment generally on the potential impact of these statutory exemptions, as implemented by the proposed rule. The Agencies note that there are multiple factors that could affect the impact of the statute and the proposed rule on a banking entity's covered fund activities, including other conditions set forth in the statute or the proposed rule that could mitigate costs or enhance benefits associated with a particular element or condition of an exemption.

Organize and Offer Exemption. Section __.11 of the proposed rule implements the exemption set forth in section 13(d)(1)(G) of the BHC Act and generally incorporates all of the conditions specified in the statute. As required by the statute, the exemption for organizing and offering covered funds is available only to banking entities that provide *bona fide* trust, fiduciary, commodity trading or investment advisory services, which must meet certain requirements. As a result, the exemption should not preclude banking entities, such as registered advisers or other advisers, from providing trust or advisory services to their clients. We request comment on whether the proposed requirements of the exemption would result in a banking entity modifying its business practices or bearing higher costs to comply with the limitations and requirements applicable to this statutory exemption, as implemented by the proposed rule. These costs may include, for example, developing a credible plan that documents how advisory services would be provided to banking entity customers through organizing and offering covered funds and making the specified disclosures required by the exemption. We also request comment on whether the banking entity will pass these costs on to covered fund investors and counterparties.

In implementing this statutory exemption, the Agencies have defined or clarified several key terms or requirements, including (i) the definition of ownership interest and (ii) the method for calculating the 3% ownership interest limit. The proposed definition of ownership interest is designed to describe the typical types of relationships through which an investor has exposure to the profits and losses of a covered fund. Consistent with this approach, carried interest is not included within the proposed definition of ownership interest. As discussed in the Supplementary Information above, carried interest generally entitles service providers, such as banking entities that provide advisory services, to receive compensation for such services determined as a share of a covered fund's profits. As a result, the proposed rule does not treat carried interest as an ownership interest, which could have costs and benefits. To help discern these costs and benefits, we request comment on whether this is consistent with how providers of advisory services view the receipt of such ''carried interest'' (i.e., as compensation for services rather than as an ''ownership interest'' equivalent to an investor's interest that shares in a fund's profits and losses). The proposed definition of carried interest has limitations designed to prevent a banking entity from circumscribing the proposed rule's limitations on ownership. For instance, among other things, the proposed definition requires that the ''sole purpose and effect of the interest is to allow banking entity * * * to share in the profits of the covered fund.'' [364] For banking entities receiving compensation that would satisfy all of the elements of the proposed definition, there should be no burden associated with modifying existing business practices. For other banking entities, however, the conditions specified in the proposed definition could result in more banking entities being deemed to hold ''ownership interests'' and hence subject to the limitations under the statute and the proposed rule, including the limitations on material conflicts of interest, high-risk trading activities and exposure to high-risk assets. We request comment on whether these banking entities would need to modify their existing practices and develop alternatives, and, if so, whether these modifications will impose costs and benefits. For example, costs associated with modifying business practices could include developing and implementing a compliance program in accordance with the proposed rule; benefits that may arise as a result of modifying business practices could include limiting the extent to which material conflicts of interest may arise between clients, customer and counterparties of banking entities. We also request comment on whether such costs, if any, are likely to be passed on to fund investors, clients and counterparties.

As required by statute, a banking entity that seeks to invest in a covered fund under the exemption for organizing and offering covered funds could not, after the expiration of an initial one-year period (plus any applicable extensions), hold more than 3% of the total outstanding ownership interests of such fund. The proposed rule would require that a banking entity calculate the per-fund limit whenever the covered fund calculates its value or permits investor investments or redemptions, but in no case less frequently than quarterly. We request comment on whether this approach will limit any additional burden associated with calculating the per-fund limit for banking entities that invest in covered funds that determine their value on at least a quarterly basis. We also request comment on whether such banking entities will incur any additional significant costs in determining their compliance with the 3% ownership limitation.

Risk-mitigating Hedging Exemption. The proposed rule specifies an exemption from the general prohibition on covered fund activities in the case of risk-mitigating hedging. Similar to the hedging exemption in the case of proprietary trading (discussed above), the hedging exemption for covered fund activities specifies a number of conditions that are identical except for two conditions. In the case of the hedging exemption for covered fund activities, the hedging must generally ''offset'' the exposure of the banking entity to the liabilities associated with (i) the facilitation of customer transactions or (ii) compensation arrangements for certain employees. Consistent with the statute, the proposed exemption would enable a banking entity to invest in a covered fund without limit if the investment is for risk-mitigating hedging purposes.

We request comment on whether the proposed requirements will have benefits of furthering the goals of compliance with the statute and reducing banking entities' risks. We also request comment on whether the proposed requirements are more restrictive than necessary to implement the statute and whether they could unnecessarily limit a banking entity's hedging activities and ability to reduce risk. Commenters should also address whether the proposed requirements will dissuade banking entities from engaging in other permitted activities (e.g., organizing and offering covered funds) or those activities outside the scope of the statute to the extent that the exemption prevents them from mitigating the risks associated with such activities. We request comment on whether a reduction in efficiency could result from a reduced ability of covered banking entities to transfer risks to those more willing to bear them. Commentators should also address whether the proposed rule could reduce

[364] Proposed rule § __.10(b)(3)(i).

a banking entity's willingness to engage in permitted risk-mitigating hedging activities in order to avoid costs related to ensuring compliance with the exemption's requirements, and whether this would increase the banking entity's risk exposure.

Exemption for Covered Fund Activities Outside of the United States. Section __.13(c) of the proposed rule implements section 13(d)(1)(I) of the BHC Act, which permits certain foreign banking entities to sponsor or invest in covered funds ''solely outside of the United States,'' so long as the covered fund is not offered or sold to a resident of the United States. The proposed exemption provides a number of specific criteria for determining when a banking entity will be considered to have invested or sponsored a covered fund solely outside of the United States. The proposed exemption provides a definition of ''resident of the United States'' that is similar, but not identical, to the SEC's definition of ''U.S. person'' in Regulation S, which should promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S. In addition, the proposed exemption clarifies when a foreign banking entity will be considered to engage in such trading pursuant to sections 4(c)(9) and 4(c)(13) of the BHC Act, as required by the statute, including with respect to a foreign banking entity that is not a ''foreign banking organization'' under the Board's Regulation K. This implementation of section 13(d)(1)(I) of the BHC Act would permit certain foreign banking entities that are not ''qualifying foreign banking organizations'' under the Board's Regulation K to also rely on the exemption, notwithstanding the fact such foreign banking entities are not currently subject to the BHC Act generally or the Board's Regulation K. As a result, such foreign banking entities should encounter fewer costs related to complying with the covered fund activity prohibitions than if they were unable to rely on the exemption in section 13(d)(1)(I) of the BHC Act.

Despite the reference to section 4(c)(13) of the BHC Act, the statute provides that the exemption for covered fund activities outside of the United States is only available to banking entities that are not directly or indirectly controlled by U.S. banking entities (i.e., not any U.S. banking entities or their foreign subsidiaries and affiliates). Under the statute, the prohibition and restrictions on covered fund activities apply to the consolidated, worldwide operations of U.S. firms. As required by statute, the proposal prohibits U.S. banking entities from investing in or sponsoring covered funds unless the requirements of one or more relevant exemptions (other than the exemption for trading by foreign banking entities) are satisfied. As a result, the statute creates a competitive difference between the foreign activities of U.S. banking entities, which must monitor and limit their foreign activities in accordance with the requirements of section 13 of the BHC Act, relative to the foreign activities of foreign-based banking entities, which may not be subject to restrictions similar to those in section 13 of BHC Act. The Agencies seek commenters' views on whether the proposed rule's implementation of section 13(d)(1)(I) of the BHC Act imposes additional competitive differences, beyond those discussed above, and the potential economic impact of such competitive differences.

3. Securitizations

The Agencies recognize that by defining ''covered fund'' and ''banking entity'' broadly, securitization vehicles may be affected by the restrictions and requirements of the proposed rule, and this may give rise to various economic effects. The Agencies preliminarily believe that the proposed rule should mitigate the impact of securitization market participants and investors in some non-loan asset classes (including, for example, banking entities that are participants in a securitization that may acquire or retain ownership interests in a securitization vehicle that falls within the definition of covered fund) by excluding loan securitizations from the restrictions on sponsoring or acquiring and retaining ownership interests in covered funds.

Costs may be incurred to establish internal compliance programs to track compliance for any securitization vehicle that falls within the definition of banking entity. These costs may be minimized for future securitization vehicles, however, because such securitizations may be able both to incorporate any internal compliance program requirements into their documentation prior to execution, and to minimize (or eliminate) any activities that may trigger greater compliance costs. The proposed rule should further minimize the costs of the internal compliance programs by (i) allowing for enterprise-wide compliance programs and minimal requirements for banking entities that do not engage in covered trading activities and/or covered fund activities or investments (each as described below), and (ii) allowing for reduced compliance program requirements by establishing financial thresholds for ''significant'' covered trading activities or covered fund activities or investments (as described below).

There could be initial costs both for banking entities that have an ownership interest in a securitization vehicle and for other securitization participants to determine if a particular vehicle falls within the definition of covered fund. Additional costs could be incurred to the extent that banking entities divest their ownership interests in any securitization vehicle that is a covered fund and is not otherwise eligible for one of the exceptions allowed under the proposed rule. This divestment could result in selling pressure that may have a negative impact on the market prices for the vehicles that fall within the definition of covered fund, which in turn could impact all investors in those securitization vehicles. Additionally, under the proposed rule banking entities would no longer be allowed to acquire and retain such ownership interests, which may result in fewer potential investors and reduced liquidity in the market for ownership interests in these covered funds.

For example, the proposed rule could lead to significant potential market impacts if, with respect to an issuance of asset-backed securities secured by assets which are not loans, the market requires credit risk retention in excess of the minimum requirements to be adopted pursuant to Section 941 of the Dodd-Frank Act (i.e., the market believes that 5% credit risk retention is insufficient to address potential misalignment of incentives in a particular transaction). In such circumstances, the proposed rule could reduce potential investors' demand for such securitizations and could make such securitizations more expensive.

C. Limitations on Permitted Activities for Material Conflicts of Interest and High-Risk Assets and High-Risk Trading Strategies

Section 13(d)(2)(A)(i) of the BHC Act provides that an otherwise-permitted activity would not qualify for a statutory exemption if it would involve or result in a material conflict of interest. The proposed rule's definition of material conflict of interest, as discussed in more detail in Part II of the **SUPPLEMENTARY INFORMATION**, would provide flexibility to banking entities and their clients, customers, and counterparties with respect to how transactions are structured, while also establishing a structure to prevent banking entities from engaging in transactions and activities in reliance on a statutory exemption when the transaction or activity would have a materially adverse effect on the clients, customers, or counterparties of the banking entity. Specifically, the proposed definition would permit the use of timely and effective disclosure and/or information barriers in certain circumstances to address and mitigate conflicts of interest, while prohibiting transactions or activities where such a conflict of interest cannot be addressed or mitigated in the specified manner. The Agencies have endeavored to establish a workable definition that sets forth when a banking entity may not rely on an exemption because it would involve or result in a material conflict of interest, consistent with the statutory goals, to facilitate banking entities' compliance with the statutory requirements. We seek comment on whether the statutory prohibition, as implemented by the proposal, may impose costs on banking entities or their clients, customers, or counterparties. For instance, by permitting a client, customer or counterparty the option of negating or mitigating the conflict after the banking entity has disclosed the conflict, would the banking entity incur certain costs related to terminating the transaction, providing compensation or other means of mitigating the conflict, or administrative costs associated with negotiating the extent of any such compensation or other means of mitigating the conflict, depending on the actions of the client, customer, or counterparty in response to the disclosure?

In addition, section 13(d)(2)(A)(ii) of the BHC Act provides that an otherwise-permitted activity would not qualify for a statutory exemption if it would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies. This statutory limitation, as implemented in the proposed rule, would prevent a banking entity from engaging in certain high-risk activity. The Agencies request comment on whether the proposed definitions of high-risk asset and high-risk trading strategy would potentially reduce liquidity or create a reduction in efficiency for assets or markets related to that high-risk activity.

D. Compliance Program

Under § __.20 of the proposed rule, all covered banking entities that are engaged in covered trading activities or covered fund activities or investments would be required to have a compliance program that provides for the following six elements, at a minimum: (i) Internal written policies and procedures; (ii) internal controls; (iii) a management framework; (iv) independent testing; (v) training; and (vi) recordkeeping. For those banking entities with significant covered trading activities or covered fund activities or investments under § __.20(c) of the proposed rule, additional standards in proposed Appendix C must be met with respect to these six elements.[365] Collectively, the six proposed requirements would facilitate a banking entity's review and assessment of its compliance with section 13 of the BHC Act and the proposed rule, including identifying potential areas of deficiency in a banking entity's compliance program and providing the banking entity the opportunity to take appropriate corrective or disciplinary action, where warranted. The proposed compliance program would also facilitate Agency examination and supervision for compliance with the requirements of the statute and the proposed rule. By requiring that a banking entity have in place specific, documented elements (e.g., written policies and procedures and internal controls, recordkeeping requirements), the proposed rule would ensure that Agency examiners and supervisors can effectively review a banking entity's activities and investments to assess compliance and, where a banking entity is not in compliance with the proposed rule, take appropriate action.

Beyond the benefits recognized above, the individual elements of the proposed compliance program should also provide certain benefits. For example, the proposed management framework requirement is designed to give management a greater incentive to comply with the proposed rule and to ascertain that the employees they are responsible for overseeing are also complying with the proposed rule. Further, by establishing a management framework for compliance, the banking entity would be required to set a strong compliance tone at the top of the banking entity's organization and signal to its employees that management is serious about compliance, which should foster a strong culture of compliance throughout the banking entity. Similarly, the proposed independent testing requirement would provide a third-party assessment of a banking entity's compliance with the proposed rule, which should provide assurances to the banking entity, its clients, customers, and counterparties, and current or prospective investors that the banking entity is in compliance with the proposed rule. In addition, the proposed training requirement should help the various employees of a banking entity that have responsibilities and obligations under the proposed rule (e.g., complying with the requirements for permitted market making-related activity) understand such responsibilities and obligations and facilitate the banking entity's compliance with the proposed rule. This proposed requirement may also promote market confidence by assuring that trading personnel, and other appropriate personnel of the banking entity, are familiar with their regulatory responsibilities and are complying with the applicable laws and regulations in their interactions with clients, customers, and counterparties.

Because the six elements would be required to be established by all banking entities, other than those that are not engaged in covered trading activities or covered fund activities or investments, the proposed compliance program requirement should promote consistency across banking entities. However, the proposed elements are also intended to give a banking entity a degree of flexibility in establishing and maintaining its compliance program in order to address the varying nature of activities or investments conducted by different units of the banking entity's organization, including the size, scope, complexity, and risks of the activity or investment.

We seek comment on whether developing and providing for the continued administration of a compliance program under § __.20 of the proposed rule is likely to impose material costs on banking entities. Costs related to the proposed compliance program requirement are likely to be higher for those banking entities that are engaged in significant covered trading or covered fund activities or investments and, as a result, are required to comply with the more detailed, specific requirements of proposed Appendix C. Potential costs related to implementation of a compliance program under the proposal include those associated with: Hiring additional personnel or other personnel modifications, new or additional systems (including computer hardware or software), developing exception reports, and consultation with outside experts (e.g., attorneys, accountants). The proposed compliance program requirement would also impose ongoing costs related to maintenance and enforcement of the compliance program

[365] Proposed rule § __.20 and Appendix C implement section 13(e) of the BHC Act, which requires the Agencies to issue regulations regarding internal controls and recordkeeping to ensure compliance with section 13.

elements, which may include those associated with: Ongoing system maintenance, surveillance (e.g., reviewing and monitoring exception reports), recordkeeping, independent testing, and training. For example, the independent testing requirement in the proposal may necessitate that additional resources be provided to the internal audit department of the covered banking entity that is a registered broker-dealer or security-based swap dealer, if such testing is conducted by a qualified internal tester. Alternatively, if an outside party is used to conduct the independent testing, the covered banking entity would incur costs associated with paying the qualified outside party's for its services. The Agencies do not anticipate significant costs related to the proposed management framework requirement, as banking entities should already have relevant management structures in place.

The tiered approach with which the proposal applies the proposed compliance program requirement to banking entities of varying size should reduce the costs associated with developing and providing for the continued administration of a compliance program. In setting forth the proposed compliance program requirement in § __.20 of the proposed rule and Appendix C, the Agencies have taken into consideration the size, scope, and complexity of a banking entity's covered trading activities and covered fund activities and investments in developing requirements targeted to the compliance risks of large and small banking entities. Specifically, banking entities that do not meet the thresholds established in § __.20(c) of the proposed rule would not be required to comply with the more detailed and burdensome requirements set forth in Appendix C. In addition, banking entities that do not engage in covered trading activities and covered fund activities and investments would not be required to establish a compliance program under the proposed rule, and therefore should incur only minimal costs associated with adding measures to their existing compliance policies and procedures to prevent the banking entity from becoming engaged in such activities or making such investments. Together, these provisions have been proposed in order to permit a banking entity to tailor its compliance program to its activities and investments and, where possible, leverage its existing compliance structures, all of which should minimize the incremental costs associated with establishing a compliance program under the proposed rule. However, banking entities that are engaged in significant covered trading and covered fund activities and investments and thereby present a heightened compliance risk due to the size and nature of their activities and investments would be required to comply with the additional standards set forth in proposed Appendix C.

Costs associated with the requirements of proposed Appendix C should also be reduced by aspects of the proposed rule that would permit a banking entity to establish an enterprise-wide compliance program under certain circumstances. An enterprise-wide compliance program would generally permit one compliance program to be established for a banking entity and all of its affiliates and subsidiaries collectively, rather than each legal entity being required to establish its own separate compliance program. The Agencies expect that an enterprise-wide compliance program should promote efficiencies and economies of scale, and reduce costs, associated with establishing separate compliance programs.

E. Additional Request for Comment

In addition to the requests for comment discussed above, we seek commenters' views on the following additional questions related to the potential economic impacts of the proposed framework for implementing section 13 of the BHC Act:

Question 348. What are the expected costs and benefits of complying with the requirements of the proposed rule? We seek commenters' estimates of the aggregate cost or benefit that would be incurred or received by banking entities subject to section 13 of the BHC Act to comply. We also ask commenters to break out the costs or benefits of compliance to banking entities with each individual aspect of the proposed rule. Please provide an explanation of how cost or benefit estimates were derived. Please also identify any costs or benefits that would occur on a one time basis and costs that would recur. Would particular costs or benefits decrease or increase over time? If certain costs or benefits cannot be estimated, please discuss why such costs or benefits cannot be estimated.

Question 349. Please identify any costs or benefits that would occur on a one-time basis and costs or benefits that would recur (e.g., training and compliance monitoring). Please identify any costs or benefits that you believe would decrease over time. Please identify any costs or benefits that you believe may increase over time or remain static.

Question 350. Are there circumstances in which registered dealers, security-based swap dealers, and/or swap dealers (i) hold accounts other than trading accounts or (ii) hold investment positions for activities for which they are required to be registered? If so, would including all such dealer positions within the trading account definition create competitive burdens as well as additional burdens on the operations of such dealers that may not be consistent with the language and purpose of the statute? Please describe how this may occur, and to what extent it may occur.

Question 351. Please identify the ways, if any, that banking entities might alter the ways they currently conduct business as a result of the costs that could be incurred to comply with the requirements of the proposed rule. Do you anticipate that banking entities will terminate any services or products currently offered to clients, customers, or counterparties due to the proposed rule, if adopted? Please explain.

Question 352. How would trading systems and practices used in today's marketplace be impacted by the proposed rule? What would be the costs and/or benefits of such changes in trading practices and systems?

Question 353. Would the proposed rule create any additional implementation or operational costs or benefits associated with systems (including computer hardware and software), surveillance, procedural, recordkeeping, or personnel modifications, beyond those discussed in the above analysis? Would smaller banking entities be disproportionately impacted by any of these additional implementation or operational costs?

Question 354. We seek specific comments on the costs and benefits associated with systems changes on banking entities with respect to the proposed rule, including the type of systems changes necessary and quantification of costs associated with changing the systems, including both start-up and maintenance costs. We request comments on the types of jobs and staff that would be affected by systems modifications and training with respect to the proposed rule, the number of labor hours that would be required to accomplish these matters, and the compensation rates of these staff members.

Question 355. Please discuss any human resources costs associated with the proposed rule, along with any associated overhead costs.

Question 356. What are the benefits and costs associated with the requirements for relying on the underwriting exemption? What impact will these requirements have on capital formation, efficiency, competition, liquidity, price efficiency, if any? Please estimate any resulting benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 357. What are the benefits and costs associated with the requirements for relying on the exemption for market making-related activity, including the requirement that such activity be consistent with the commentary in Appendix B? What impact will these requirements have on liquidity, price efficiency, capital formation, efficiency, and competition, if any? Please estimate any resulting benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 358. What are the benefits and costs associated with the requirements for relying on the exemption for risk-mitigating hedging activity, including the requirement that certain hedge transactions be documented? What impact will these requirements have on liquidity, price efficiency, capital formation, efficiency, and competition, if any? Please estimate any resulting benefits and costs or discuss why such benefits and costs cannot be estimated. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 359. Are there traditional risk management activities of banking entities that are not covered by the liquidity management and risk-mitigating hedging exemptions as currently proposed? What risks do banking entities face that go beyond market, counterparty/credit, currency/foreign exchange, interest rate, and basis risk? Could the proposed construction of the liquidity management and risk-mitigating hedging exemptions increase the costs of management or impede the ability of banking entities to effectively manage risk?

Question 360. To rely on the exemptions from the proposed rule for permitted underwriting, market making-related activity, and risk-mitigating hedging, banking entities must establish, maintain, and enforce a compliance program, including written policies and procedures and internal controls. Please discuss how the costs incurred, or benefits received, by banking entities related to initial implementation and ongoing maintenance of the compliance program would impact their customers and their businesses with respect to underwriting, market making, and hedging activity.

Question 361. Please discuss benefits and costs related to the limitations on permitted activities for material conflicts of interest, high-risk assets and trading strategies, and threats to the safety and soundness of banking entities or to the financial stability of the U.S. in the proposed rule. Are there particular benefits and costs related to the proposed definitions of material conflict of interest, high-risk asset, and high-risk trading strategy in the proposed rule? Would these definitions have any unintended costs, such as creating undue burdens and limitations on permitted underwriting, market making-related, or hedging activity? Please explain. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 362. Please discuss the benefits and costs related to the definition of derivative in the proposed rule and the application of the restrictions on proprietary trading to transactions in the different types of derivatives covered by the definition. What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 363. What costs and benefits would be associated with calculating, reviewing, and analyzing the proposed quantitative measurements? What costs and benefits would be associated with reporting the proposed quantitative measurements to an Agency? Please identify any of the proposed quantitative measurements that are already reported to an Agency and discuss whether the current reporting regime would mitigate costs associated with the proposed rule. With respect to any quantitative measurement that is not already reported to an Agency, what are the costs and benefits of beginning to report the measurement? Would banking entities have to create or purchase new systems or implement changes to existing systems in order to report these quantitative measurements? Please discuss the costs and benefits associated with such systems changes.

Question 364. How much of the data necessary to calculate the quantitative measurements in Appendix A is currently captured, retained, and utilized by banking entities? If the applicable data is not currently used by banking entities, is it readily available? Is it possible to collect all of the data that is necessary for calculating the required measurements? Please identify any data that banking entities do not currently utilize that would need to be captured and retained for purposes of proposed Appendix A and discuss the costs and benefits of capturing and retaining such data.

Question 365. Do the costs and benefits of calculating, analyzing, and reporting certain or all quantitative measurements differ between trading units and their trading activities, including trading strategies, asset classes, market structure, experience and market share, and market competitiveness? Are any quantitative measurements particularly costly to calculate or analyze for specific trading activities or, alternatively, particularly beneficial? If so, which quantitative measurement, what type of trading activity, and what factor(s) of that trading activity makes the quantitative measurement particularly costly or beneficial? Please discuss how these costs, if any, could be mitigated or benefits, if any, could be enhanced.

Question 366. The proposed definition of trading unit would require a tiered approach to calculating and reporting quantitative measurements, such that the measurements would be calculated and reported for different levels within the banking entity, with higher levels encompassing smaller units (e.g., trading desks, business lines, and all trading operations). What are the costs and benefits of calculating the quantitative measurements for each level within the definition of trading unit? Can the higher level calculations incorporate the lower level calculations such that the higher level calculations result in small, incremental costs? Why or why not? Are there particular costs or benefits associated with calculating, analyzing, and reporting a quantitative measurement at one of the levels within the definition of trading unit that would not be experienced at the other levels? Please explain. What are the costs, if any, of "noise," "false positives," or "false negatives" with respect to the quantitative measurements and calculations at different levels? Can these costs be mitigated and, if so, how? What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 367. We seek comment on whether the requirement that banking entities employ a suite of quantitative measurements may lead to redundancies and/or inefficiencies in the application of the measurements for some types of trading units within some banking entities. Despite the flexibility of Appendix A via recognition that quantitative measurements will be applied with respect to differences within a banking entity's structure, business lines, and trading desks, we seek comment on whether the requirement of a mandatory suite of quantitative measurements may prove burdensome. For instance, is the application of certain quantitative measurements not efficient, appropriate, or calculable for certain asset classes or trading units or would the benefits of applying such quantitative measurements be negligible in relation to the costs of applying such measurements? In addition, would the overlay divert a banking entity from allocating resources toward quantitative—or other—measurements that might prove more useful and better tailored to its specific and unique trading practices?

Question 368. What are the benefits and costs of the recordkeeping requirement in proposed Appendix A? Please explain and quantify, to the extent possible. To what extent would the proposed recordkeeping requirement impose new or additional costs and benefits beyond the current recordkeeping obligations of different types of banking entities (e.g., affiliated broker-dealers, affiliated investment advisers, insured depository institutions, etc.)? What alternatives, if any, may be more cost-effective while still being consistent with the purpose and language of the statute?

Question 369. Please identify any cost savings that would be achieved through the use of an enterprise-wide compliance program. Alternatively, would you expect certain costs to increase when using an enterprise-wide compliance program? Please explain. Please identify any benefits that might be amplified or reduced when using an enterprise-wide compliance program.

Question 370. Are there tools or elements in the contents of the compliance program set forth in § __.20(b) for which the costs may be negligible because banking entities use the same or similar elements for other purposes (e.g., satisfying other regulatory requirements, risk management, etc.) and could utilize existing infrastructure for purposes of the proposed rule? For example, could existing trader mandates or an existing training program be expanded to meet the requirements of the proposed rule, rather than developing an entirely new infrastructure? Alternatively, would the proposed rule require redundancies or duplications within a banking entity's infrastructure (e.g., the trader mandates currently used for one purpose do not conform to the requirements of the proposed rule, so a banking entity would have to utilize both in different circumstances)? Please identify and explain any such redundancies and how the rule could be modified to reduce or eliminate such redundancies, if possible.

Question 371. How would the proposed rule affect compliance costs (e.g., personnel or system changes) or benefits for each category of banking entity: Small, medium, and large? Please discuss any differences between the costs and benefits of the compliance program required under § __.20(b) for smaller banking entities and the compliance program requirements of Appendix C for larger banking entities. Are the differences between these benefits and costs justified due to the differences in size and complexity of smaller and larger banking entities?

Question 372. The definition of trading unit in proposed Appendix C covers different levels of a banking entity and, as a result, requires a tiered approach to establishing, maintaining, and enforcing the compliance program requirements with respect to covered trading activities. What are the costs and benefits of applying the compliance program requirements at several levels within the banking entity? To what extent does the ability to incorporate written policies and procedures of lower-level units by reference, rather than establishing separate written policies and procedures, mitigate the costs of the proposed requirements? Are there other ways that the proposed requirements could be made more cost-effective for the different levels within the banking entity?

Question 373. How will the proposed definition of ''covered fund'' affect a banking entity's investment advisory activities, in particular activities and relationships with investment funds that would be treated as ''covered funds''? Please estimate any resulting costs or benefits or discuss why such costs or benefits cannot be estimated.

Question 374. How have banking entities traditionally organized and offered covered funds? What are the benefits and costs associated with the proposed requirements for relying on the exception for organizing and offering covered funds? Please estimate any resulting costs or benefits or discuss why such costs or benefits cannot be estimated.

Question 375. What are the costs and benefits associated with the way the proposed rule implements the ''customers of such services'' requirement in the exception for organizing and offering covered funds? What alternative, if any, may be more cost-effective while still being consistent with the language and purpose of the statute?

Question 376. Is it common for a banking entity to share a name with the covered funds that it invests in or sponsors? If yes, what entity in the banking structure typically shares a name with such covered funds? What costs and benefits will result from the proposed rule's implementation of the name sharing requirement in exception for organizing and offering a covered fund? What alternatives, if any, may be more cost-effective while still being consistent with the purpose of the statute?

Question 377. Under what circumstances do directors and employees of a banking entity invest in covered funds? What are the benefits and costs associated with the proposed provisions regarding director and employee investments in covered funds? What alternatives, if any, may be more cost-effective while still being consistent with the purpose of the statute?

Question 378. Do banking entities currently invest in or sponsor SBICs and public welfare and qualified rehabilitation investments? If yes, to what extent? What are the benefits and costs associated with the proposed rule's implementation of the exception for investment in SBICs and public welfare and qualified rehabilitation investments?

Question 379. Do banking entities currently invest in or sponsor each of the vehicles that the proposed rule permits banking entities to continue to invest in and sponsor under section 12(d)(1)(J) of the BHC Act? If yes, to what extent? What are the benefits and costs associated with the proposed rule's implementation of these exceptions?

Question 380. For banking entities that are affiliated investment advisers, are there additional costs or benefits to complying with section 13 of the BHC Act and the proposed rule? For example, do affiliated investment advisers typically maintain records that would enable them to demonstrate compliance with the 3% ownership limits or restrictions on transactions that would be subject to sections 23A and 23B of the FR Act?

Question 381. Would complying with section 13 of the BHC Act and the proposed rule affect an affiliated investment adviser's other business activities (benefit or burden) that are not subject to restrictions on proprietary trading or other covered fund activities? For example, would advisers incur additional burdens to distinguish covered fund activities from non-covered fund activities?

Question 382. For banking entities that are affiliated investment advisers, are there particular costs or benefits to complying with the portions of Appendix C that are applicable to each asset management unit of the adviser? Do these costs and benefits differ depending on whether the adviser complies with Appendix C individually or on an enterprise basis? Does the rule provide sufficient clarify for how Appendix C applies to unregistered affiliates of an affiliated investment adviser?

Question 383. To the extent applicable, please address each of the questions above with respect to securitization vehicles that would be included in the proposed definition of covered fund.

VII. Administrative Law Matters

A. Paperwork Reduction Act Analysis Request for Comment on Proposed Information Collection

In accordance with section 3512 of the Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3521) (''PRA''), the Agencies may not conduct or sponsor, and a respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (''OMB'') control number. The OCC, FDIC, and Board will obtain OMB control numbers. The information collection requirements contained in this joint notice of proposed rulemaking, to the extent they apply to insured financial institutions that are not under a holding company, have been submitted by the OCC and FDIC to OMB for review and approval under section 3506 of the PRA and section 1320.11 of OMB's implementing regulations (5 CFR 1320). The Board reviewed the proposed rule under the authority delegated to the Board by OMB. The Board will submit to OMB once the final rule is published and the submission will include burden for Federal Reserve-supervised institutions, as well as burden for OCC-, FDIC-, SEC-, and CFTC-supervised institutions under a holding company. The OCC and the FDIC will take burden for banking entities that are not under a holding company. The CFTC has stated that it will be publishing a separate proposed rulemaking in the near future. The burden estimates for CFTC-supervised institutions, published in this proposed rule, are based on the requirements set forth below and the assumption that the CFTC's proposed rulemaking would contain substantively similar requirements.

The proposed rule contains requirements subject to the PRA. The reporting requirements are found in sections __.7(a) and __.12(d); the recordkeeping requirements are found in sections __.3(b)(2)(iii)(C), __.5(c), __.7(a), __.11(b), __.13(b)(3), __.20(b), __.20(c), and __.20(d); and the disclosure requirement is found in section __.11(h)(1). The recordkeeping and disclosure burden for the following sections is accounted for in the __.20(b) burden: __.4(a)(2)(i), __.4(b)(2)(i), __.5(b)(1), __.5(b)(2)(i), __.5(b)(2)(v), __.13(b)(2)(i), __.13(b)(2)(ii)(A), __.13(b)(2)(ii)(D), __.15(a)(1), and __.17(b)(1). These information collection requirements would implement section 619 of the Dodd-Frank Act, as mentioned in the Abstract below. The respondent/recordkeepers are for-profit financial institutions, including small businesses. A covered entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [Agency] on request.

Comments are invited on:

(a) Whether the collections of information are necessary for the proper performance of the Agencies' functions, including whether the information has practical utility;

(b) The accuracy of the estimates of the burden of the information collections, including the validity of the methodology and assumptions used;

(c) Ways to enhance the quality, utility, and clarity of the information to be collected;

(d) Ways to minimize the burden of the information collections on respondents, including through the use of automated collection techniques or other forms of information technology; and

(e) Estimates of capital or start up costs and costs of operation, maintenance, and purchase of services to provide information.

All comments will become a matter of public record. Comments on aspects of this notice that may affect reporting, recordkeeping, or disclosure requirements and burden estimates should be sent to the addresses listed in the **ADDRESSES** section of this Supplementary Information. A copy of the comments may also be submitted to the OMB desk officer for the Agencies: By mail to U.S. Office of Management and Budget, 725 17th Street NW., #10235, Washington, DC 20503 or by facsimile to (202) 395–5806, Attention, Commission and Federal Banking Agency Desk Officer.

Proposed Information Collection

Title of Information Collection: Reporting, Recordkeeping, and Disclosure Requirements Associated with Restrictions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds.

Frequency of Response: Annual, monthly, and on occasion.

Affected Public: Businesses or other for-profit.

Respondents

Board: State member banks, bank holding companies, savings and loan holding companies, mutual holding companies, foreign banking organizations, and other holding companies that control an insured depository institution. The Board will take burden for all institutions under a holding company including:

• OCC-supervised institutions,
• FDIC-supervised institutions,
• Banking entities for which the CFTC is the primary financial regulatory agency, as defined in section 2(12)(C) of the Dodd-Frank Act, and
• Banking entities for which the SEC is the primary financial regulatory agency, as defined in section 2(12)(B) of the Dodd-Frank Act.

OCC: National banks, federal savings associations, and federal savings banks not under a holding company, and their respective subsidiaries, and their affiliates not under a holding company. The OCC will take the burden with respect to registered investment advisers and commodity trading advisers and commodity pool operators that are subsidiaries of national banks, federal savings associations, and federal savings banks not under a bank holding company.

FDIC: State nonmember banks not under a holding company; state savings associations and state savings banks not under a holding company; subsidiaries of state nonmember banks, state savings associations and state savings banks not under a holding company; and foreign banks having an insured branch.

Abstract: Section 619 of the Dodd-Frank Act added a new section 13 to the BHC Act (to be codified at 12 U.S.C. 1851) that generally prohibits any banking entity from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to certain exemptions. New section 13 of the BHC Act also provides for nonbank financial companies supervised by the Board that engage in such activities or have such investments or relationships to be subject to additional capital requirements, quantitative limits, or other restrictions.

Section __.3(b)(2)(iii)(C) would require a covered banking entity to establish a documented liquidity management plan in order to rely on an exclusion from the definition of ''trading account'' for certain positions taken for the bona fide purpose of liquidity management.

Section __.5(c) would require that, with respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to section __.5 for risk-mitigating hedging purposes that is established at a level of organization that is different than the level of organization establishing the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce, the covered banking entity document, at the time the purchase, sale, or series of purchases or sales are conducted:

(1) The risk-mitigating purpose of the purchase, sale, or series of purchases or sales;

(2) The risks of the individual or aggregated positions, contracts, or other holdings of a covered banking entity that the purchase, sale, or series of purchases or sales are designed to reduce; and

(3) The level of organization that is establishing the hedge.

Section __.7(a) would require a covered banking entity engaged in any proprietary trading activity pursuant to sections __.4 through __.6 to comply with the reporting and recordkeeping requirements described in Appendix A if the covered banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion, as well as such other reporting and recordkeeping requirements as a relevant Agency may impose to evaluate the covered banking entity's compliance with this subpart.

Section __.11(b) would require that, with respect to any covered fund that is organized and offered by a covered banking entity in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and to persons that are customers of such services of the covered banking entity, the covered banking entity document how the covered banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund.

Section __.11(h)(1) would require that, with respect to any covered fund that is organized and offered by a covered banking entity in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and to persons that are customers of such services of the covered banking entity, the covered banking entity clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents):

(1) That ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the covered banking entity and its affiliates or subsidiaries]; therefore, [the covered banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [covered banking entity and its affiliates or subsidiaries] in their capacity as investors in the [covered fund]'';

(2) That such investor should read the fund offering documents before investing in the covered fund;

(3) That the ''ownership interests in the covered fund are not insured by the FDIC, and are not deposits, obligations of, or endorsed or guaranteed in any way, by any banking entity'' (unless that happens to be the case); and

(4) The role of the covered banking entity and its affiliates, subsidiaries and employees in sponsoring or providing any services to the covered fund.

Section __.12(d) would extend the time to divest an ownership interest in a covered fund. Upon receipt of an application from a covered banking entity, the Board may extend the period of time to meet the requirements under paragraphs (a)(2)(i)(A) and (B) of that section for up to 2 additional years, if the Board finds that an extension would be consistent with safety and soundness and not detrimental to the public interest. An application for extension must:

(1) Be submitted to the Board at least 90 days prior to the expiration of the applicable time period;

(2) Provide the reasons for application, including information that addresses the factors in paragraph (e)(2) of that section; and

(3) Explain the covered banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2)(i) of that section.

Section __.13(b)(3) would require that, with respect to any acquisition or retention of an ownership interest in a covered fund by a covered banking entity pursuant to § __.13(b), the covered banking entity must document, at the time the transaction is conducted:

(1) The risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund;

(2) The risks of the individual or aggregated obligation or liability of a covered banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce; and

(3) The level of organization that is establishing the hedge.

Section __.20(b) would require a compliance program with respect to covered fund activities and investments that shall, at a minimum, include:

(1) Internal written policies and procedures reasonably designed to document, describe, and monitor the covered trading and covered fund activities and investments of the covered banking entity to ensure that such activities and investments are compliant with section 13 of the BHC Act and this part;

(2) A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and this part in the covered banking entity's covered trading and covered fund activities and investments and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;

(3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part;

(4) Independent testing for the effectiveness of the compliance program conducted by qualified personnel of the covered banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Maintenance of records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to the Agency upon request and retain for a period of no less than 5 years.

Section __.20(c) would require the compliance program of a covered banking entity to also comply with the requirements and other standards contained in Appendix C if the covered banking entity: (i) Engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters (A) is equal to or greater than $1 billion, or (B) equals 10 percent or more of its total assets; or (ii) invests in, or has relationships with, a covered fund and (A) the covered banking entity has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion, or (B) sponsors and advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion.

Section __.20(d) would require a covered banking entity that does not engage in activities or investments prohibited or restricted in subpart B or subpart C of the proposed rule, in order to be deemed to have satisfied the requirements of § __.20, to ensure that its existing compliance policies and procedures include measures that are designed to prevent the covered banking entity from becoming engaged in such activities or making such investments and which require the covered banking entity to develop and provide for establishment of the compliance program required under § __.20(a) of the proposed rule prior to engaging in such activities or making such investments.

Estimated Paperwork Burden

In determining the method for estimating the paperwork burden the Agencies made the assumption that affiliated entities under a holding company would act in concert with one another to take advantage of efficiencies that may exist. The Agencies invite comment on whether it is reasonable to assume that affiliated entities would act jointly to implement a firm-wide program or whether they would act independently to implement programs tailored to each entity. In addition, the Agencies invite comment as to the accuracy of our estimates of the burdens concerning the proposed collections of information and whether all banking entities subject to the rule are appropriately accounted for by the Agencies.

Estimated Burden Per Response

Section __.3(b)(2)(iii)(C) recordkeeping—1 hour (Initial setup 3 hours).

Section __.5(c) recordkeeping—6 hours for entities with $1 billion or more in trading assets/liabilities, 35 hours for entities with $5 billion or more in trading assets/liabilities.

Section __.7(a) reporting—2 hours for entities with $1 billion or more in trading assets/liabilities, 2 hours for entities with $5 billion or more in trading assets/liabilities (Initial setup 6 hours for entities with $1 billion or more in trading assets/liabilities, 6 hours for entities with $5 billion or more in trading assets/liabilities).

Section __.7(a) recordkeeping—350 hours for entities with $1 billion or more in trading assets/liabilities, 440 hours for entities with $5 billion or more in trading assets/liabilities.

Section __.11(b) recordkeeping—10 hours.

Section __.11(h)(1) disclosure—0.10 hours.

Section __.12(d) reporting—20 hours (Initial setup 50 hours).

Section __.13(b)(3) recordkeeping—10 hours.

Section __.20(b) recordkeeping—265 hours (Initial setup 795 hours).[366]

Section __.20(c) recordkeeping—1,200 hours (Initial setup 3,600 hours).

Section __.20(d) recordkeeping—8 hours.

Board

Number of respondents: 10,000.

Total estimated annual burden: 6,283,620 hours (4,541,070 hours for initial setup and 1,742,550 hours for ongoing compliance).

FDIC

Number of respondents: 1,139.

Total estimated annual burden: 46,428 hours (29,934 hours for initial setup and 16,494 hours for ongoing compliance).

OCC

Number of respondents: 469.

Total estimated annual burden: 253,796 hours (187,643 hours for initial setup and 66,153 hours for ongoing compliance).

B. Initial Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (''RFA''), 5 U.S.C. 601 *et seq.,* requires an agency to consider whether the rules it proposes will have a significant economic impact on a substantial number of small entities.[367] If so, the agency must prepare an initial and final regulatory flexibility analysis respecting the significant economic impact. Pursuant to section 605(b) of the RFA, the regulatory flexibility analysis otherwise required under sections 603 and 604 of the RFA is not required if an agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. The Agencies have considered the potential impact of the proposed rule on small entities in accordance with the RFA. The proposed rule would not appear to have a significant economic impact on small entities for several reasons.

First, while the proposed rule will affect all banking organizations, including those that have been defined to be ''small businesses'' under the RFA, only certain limited requirements would be imposed on entities that engage in little or no covered trading activities or covered fund activities and investments. Significantly, the reporting and recordkeeping requirements of § __.7 and Appendix A of the proposed rule apply only to banking entities with average trading assets and liabilities on a consolidated, worldwide basis equal to or greater than $1 billion for the preceding year. This is a threshold that a small banking entity typically would not meet.

Second, the scope and size of the compliance program requirements set forth in subpart D and Appendix C of the proposed rule would vary based on the size and activities of each covered banking entity. Only banking entities with average trading assets and liabilities on a worldwide consolidated basis equal to or greater than $1 billion or 10 percent or more of their total assets, or that have aggregate investments in, or sponsor or advise, covered funds with aggregate total assets of more than $1 billion must establish, maintain and enforce a full compliance program under the proposed rule. Banking entities that engage in trading activities or covered fund activities and investments under these thresholds must adopt, at a minimum, only the six core compliance requirements set forth in § __.20 of the proposed rule. Banking entities that do not engage in any covered trading or fund activities, typical of small banking entities, must ensure only that their compliance programs include measures designed to

[366] For the Board, the section __.20(b) burden hours are 266 hours (ongoing) and 796 hours (initial setup) because the Board is accounting for the 1 hour disclosure burden for certain SEC- and CFTC-supervised entities.

[367] A banking organization is generally considered to be a small banking entity for the purposes of the RFA if it has assets less than or equal to $175 million. *See also* 13 CFR 121.1302(a)(6) (noting factors that the Small Business Administration considers in determining whether an entity qualifies as a small business, including receipts, employees, and other measures of its domestic and foreign affiliates).

prevent the entities from becoming engaged in covered activities unless they first adopt a compliance program. These compliance requirements would not appear to have a significant economic impact on a substantial number of small entities.

OCC, FDIC, and SEC: For the reasons stated above, the head of the OCC, FDIC, and the SEC certifies, for the covered banking entities subject to each such Agency's jurisdiction, that the proposed rule would not result in a significant economic impact on a substantial number of small entities. The OCC, FDIC, and SEC encourage written comments regarding this certification, and request that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact.

Board: For the reasons stated above, the proposed rules would not appear to have a significant economic impact on small entities subject to the Board's jurisdiction. The Board welcomes written comments regarding this initial regulatory flexibility analysis, and requests that commenters describe the nature of any impact on small entities and provide empirical data to illustrate and support the extent of the impact. A final regulatory flexibility analysis will be conducted after consideration of comment received during the public comment period.

C. OCC Unfunded Mandates Reform Act of 1995 Determination

Section 202 of the Unfunded Mandates Reform Act of 1995, Public Law 104–4 (2 U.S.C. 1532) (''Unfunded Mandates Act''), requires that an agency prepare a budgetary impact statement before promulgating any rule likely to result in a Federal mandate that may result in the expenditure by state, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more, as adjusted by inflation, in any one year. If a budgetary impact statement is required, Section 205 of the Unfunded Mandates Act also requires an agency to identify and consider a reasonable number of regulatory alternatives before promulgating a rule.

The OCC has completed an assessment whether any mandates imposed by the proposed rule may result in expenditures of $100 million or more annually, as adjusted by inflation, by state, local, and tribal governments, or by the private sector as required by the Unfunded Mandates Act. The OCC focused its analysis on the impact of the various compliance, recordkeeping, reporting, disclosure, and training requirements in the proposed rule and, as provided for under section 201 of the Unfunded Mandates Act (2 U.S.C. 1531), excluded the cost of requirements specifically set forth in the statute. Overall, the OCC determined that this proposed rule will not result in expenditures by state, local, and tribal governments, or by the private sector, of $100 million or more in any one year. Accordingly, this proposal is not subject to Section 202 of the Unfunded Mandates Act.

The OCC also will need to prepare an impact statement for the final rule, for purposes of the Unfunded Mandates Act and the Congressional Review Act, Public Law 104–121 (5 U.S.C. 801–808). Comments provided on the costs and benefits of the proposed rule, in response to the analysis and questions posed in the Supplemental Information Part VII.D, will help to inform this assessment.

D. SEC: Small Business Regulatory Enforcement Fairness Act

Under the Small Business Regulatory Enforcement Fairness Act of 1996,[368] a rule is ''major'' if it has resulted, or is likely to result, in:

• An annual effect on the U.S. economy of $100 million or more;
• A major increase in costs or prices for consumers or individual industries; or
• Significant adverse effects on competition, investment, or innovation.

The SEC requests comment on whether its proposed rule would be a ''major'' rule for purposes of the Small Business Regulatory Enforcement Fairness Act. In addition, the SEC solicits comment and empirical data on:

• The potential effect on the U.S. economy on an annual basis;
• Any potential increase in costs or prices for consumer or individual industries; and
• Any potential effect on competition, investment, or innovation.

VIII. SEC: Additional Matters

A. Statutory Authority and ''Covered Banking Entity'' Definition

1. Statutory authority

Section __.1 of the proposed rule implementing section 13 of the BHC Act cites section 13 of the BHC Act, pursuant to which the SEC is adopting the entirety of the proposed rule with respect to ''covered banking entities,'' as that term is defined in the SEC's proposed rule.[369] Section __.1 also cites the SEC's independent authority under certain sections of the Exchange Act to adopt §§ __.5(c), __.7(a), __.20, and Appendices A and C of the proposed rule.[370] Compliance with such provisions, if adopted, will be subject to examination and enforcement under the Exchange Act for certain covered banking entities.

2. ''Covered Banking Entity'' Definition

The proprietary trading and covered fund activity prohibition set forth in section 13 of the BHC Act, as proposed to be implemented in § __.3(a) and § __.10(a) of the proposed rule, would apply to any ''covered banking entity.''[371] The term ''banking entity'' is generally defined under section 13 of the BHC Act to include any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliates and subsidiaries of these entities.[372] Section __.2(j) of the proposed rule implementing section 13 of BHC Act would define the term ''covered banking entity.'' This term is used in each Agency's proposed rule to describe the specific types of banking entities to which that Agency's rule would apply.

As discussed in Part I of the Supplementary Information, the authority for adopting regulations to implement section 13 of the BHC Act is divided between the Agencies in the manner provided in section 13(b)(2).[373]

[368] Public Law 104–121, Title II, 110 Stat. 857 (1996).

[369] The SEC notes that the SEC is only proposing rules as they would be applicable to the banking entities for which the SEC has regulatory authority, as set forth in section 13(b)(2)(B)(IV) of the BHC Act, *e.g.*, registered broker-dealers. Accordingly, the SEC proposal should be read in the context of these regulated entities and comments to the SEC should focus on these entities. For instance, the SEC is particularly interested in the impact of the proposed rules on the activities of such entities.

[370] 15 U.S.C. 78*o*(c)(3)(A), 78*o*–10(f), (j), 78q(a), 78w.

[371] Proposed rule § __.3(a) provides ''Except as otherwise provided in this subpart, a covered banking entity may not engage in proprietary trading.'' Proposed rule § __.10(a) provides ''Except as otherwise provided in this subpart, a covered banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.''

[372] *See* 12 U.S.C. 1851(h)(1); proposed rule § __.2(e).

[373] *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 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

Continued

Section 13 of the BHC Act generally prohibits a banking entity from engaging in proprietary trading or investing in or sponsoring a hedge fund or private equity fund, and section 13(b)(2)(B)(i)(IV) of the BHC Act directs the SEC to issue rules implementing that section with respect to any entity for which the SEC is the primary financial regulatory agency, as that term is defined in section 2 of the Dodd-Frank Act.[374] The SEC has proposed to restate that statutory provision in defining ''covered banking entity'' for purposes of the SEC's proposed rule.[375]

The SEC recognizes that some entities that would be included in the SEC's proposed definition of ''covered banking entity'' generally do not engage in covered trading activities and covered fund activities and investments. The SEC notes that, to the extent the covered banking entity does not engage in activities and investments covered by section 13 of the BHC Act and the proposed rule, the proposal is reasonably designed to reduce and alleviate any burdens on such a covered banking entity, while also preventing evasion of the proposed rule. Specifically, a covered banking entity that does not engage in activities and investments prohibited or restricted by section 13 of the BHC Act and the proposed rule would only be required to include measures in its existing compliance policies and procedures that are reasonably designed to prevent the covered banking entity from becoming engaged in such activities and making such investments under the proposed rule.[376]

The SEC requests comment on the proposed definition of ''covered banking entity.'' In particular, the SEC requests comment on the following questions:

Question SEC–1. Is the SEC's proposed definition of the term ''covered banking entity'' sufficiently clear? If not, why not? Please suggest an alternative definition.

Question SEC–2. Is the SEC's proposed definition of the term ''covered banking entity'' appropriate, or is it over- or under-inclusive? Please explain.

Question SEC–3. Should any of the covered banking entities included in the SEC's proposed definition of ''covered banking entity'' be excluded? If so, which entities, why, and on what basis? Should the SEC's proposed rule provide specific guidance or exemptions for any such entities?

Question SEC–4. Would particular types of entities incur costs or burdens that are greater than other types of entities that are included in the SEC's proposed definition of ''covered banking entity''? If so, should any such difference be addressed or mitigated? How?

Question SEC–5. Are all of the provisions in the proposed rule relevant to the business conducted by SEC covered banking entities? If not, which provisions are not relevant and how should this be addressed in the rule? Are there differences between the SEC's covered banking entities and other types of banking entities subject to the rules of the Federal banking agencies or the CFTC that have not been sufficiently accounted for in the proposed rule? If so, what are these differences and how should the SEC's rule account for such differences in a manner that is consistent with the statutory requirement that the Agencies' rules be consistent and comparable, to the extent possible?

B. Consideration of the Impact of Reporting and Recordkeeping and Compliance Program Proposed Rules on Competition and on the Promotion of Efficiency, Competition, and Capital Formation

Section 3(f) of the Exchange Act requires the SEC, whenever it engages in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, to consider, in addition to the protection of investors, whether the action would promote efficiency, competition, and capital formation.[377] In addition, section 23(a)(2) of the Exchange Act requires the SEC, when adopting rules under the Exchange Act, to consider the impact such rules would have on competition.[378] Section 23(a)(2) of the Exchange Act also prohibits the SEC from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The SEC's consideration of the factors specified in Exchange Act sections 3(f) and 23(a)(2) is limited to those portions of the proposal that, in addition to being proposed under section 13 of the BHC Act, are also being proposed pursuant to the SEC's authority under the Exchange Act with respect to covered banking entities that are registered broker-dealers and security-based swap dealers. The remaining portions of the joint proposed rule are being proposed exclusively under the authority set forth in Section 13 of the BHC Act, which does not require consideration of the factors specified in Exchange Act sections 3(f) and 23(a)(2).

As discussed above in Part III.B.5 of the Supplementary Information, § __.7(a) of the proposed rule and proposed Appendix A require covered banking entities that meet, together with their affiliates and subsidiaries, the $1 billion gross trading assets and liabilities threshold to: (i) Calculate and report certain quantitative measurements, and (ii) create and retain records related to such quantitative measurements. Further, under § __.7(a) of the proposed rule and proposed Appendix A, a larger number of

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.*

[374] Under section 2(12)(B) of the Dodd-Frank Act, the term ''primary financial regulatory agency'' means the SEC with respect to (i) SEC-registered brokers and dealers, with respect to the activities of the broker or dealer that require the broker or dealer to be registered as such under the Exchange Act; (ii) SEC-registered investment companies, with respect to the activities of the investment company that require the investment company to be registered under the Investment Company Act; (iii) SEC-registered investment advisers, with respect to the investment advisory activities of such company and activities that are incidental to such advisory activities; (iv) SEC-registered clearing agencies, with respect to the activities of the clearing agency that require the agency to be registered under the Exchange Act; (v) SEC-registered nationally recognized statistical rating organizations; (vi) SEC-registered transfer agents; (vii) national securities exchanges registered with the SEC; (viii) national securities associations registered with the SEC; (ix) SEC-registered securities information processors; (x) the Municipal Securities Rulemaking Board; (xi) the Public Company Accounting Oversight Board; (xii) the Securities Investor Protection Corporation; and (xiii) SEC-registered security-based swap execution facilities, security-based swap data repositories, security-based swap dealers, and major security-based swap participants, with respect to the security-based swap activities of the person that require such person to be registered under the Exchange Act. *See* section 2(12)(B) of the Dodd-Frank Act. The SEC notes that, with respect to SEC-registered clearing agencies, to the extent a clearing agency acquires or takes a position in one or more covered financial positions in connection with clearing securities transactions, such positions would be excluded from the definition of trading account under the proposal. *See* proposed rule § __.3(b)(2)(iii)(D). As a result of this proposed exclusion, clearing agencies' positions taken in connection with clearing securities transactions would not involve proprietary trading, as defined under the proposal, and would not be subject to the prohibition on proprietary trading in § __.3(a) of the proposed rule. As discussed further below, the proposal is designed to reduce any burdens on covered banking entities that do not engage in proprietary trading and covered fund activities and investments.

[375] *See* SEC proposed rule § __.2(j).

[376] *See* proposed rule § __.20(d). However, to the extent that the covered banking entity becomes engaged in such activities or investments, it would be required to develop a more detailed compliance program, as set forth in § __.20(b) of the proposed rule.

[377] 15 U.S.C. 78c(f).

[378] 15 U.S.C. 78w(a)(2).

quantitative measurements are required to be calculated and reported by covered banking entities that, together with their affiliates and subsidiaries, have over $5 billion gross trading assets and liabilities. In addition, such measurements are required to be calculated and reported for a broader scope of trading activities if a covered banking entity meets the $5 billion threshold.

The reporting and recordkeeping requirements in § __.7(a) and Appendix A of the proposed rule are likely to impose certain costs on covered banking entities that meet the $1 billion gross trading assets and liabilities threshold, including costs associated with implementing, monitoring, and attributing financial and personnel resources for purposes of complying with the reporting and recordkeeping requirements. Moreover, such costs will likely be greater for covered banking entities that meet the $5 billion threshold. Incurring these costs may marginally reduce the ability of covered banking entities that are registered broker-dealers and security-based swap dealers to compete with their non-banking entity counterparts or with banking entities that do not meet the $1 billion threshold. Further, as a result of these costs, the proposal may impose additional competitive burdens on registered broker-dealers and security-based swap dealers that, together with their affiliates and subsidiaries, meet the $5 billion threshold, and may affect their ability to compete with: (i) Banking entities with $1 to $5 billion gross trading assets and liabilities; (ii) banking entities below the $1 billion threshold; and (iii) non-banking entities. In addition, registered broker-dealers and security-based swap dealers that are covered banking entities meeting the $1 billion threshold may need to redirect resources from other functions of the broker-dealer or security-based swap dealer in order to comply with the reporting and recordkeeping requirements. Reallocating available resources within the registered broker-dealer or security-based swap dealer may reduce efficiency within the covered banking entity and may have a marginal negative impact on the extent to which the registered broker-dealer or security-based swap dealer continues to perform certain functions, which may include those that serve customers or provide other market benefits. If this were to occur, registered broker-dealers and security-based swap dealers that are covered banking entities meeting the $5 billion threshold may face greater efficiency effects because they will likely need to devote more time and resources to the enhanced reporting and recordkeeping requirements set forth in the proposal for such covered banking entities. The increased cost of doing business that may result from the proposed reporting and recordkeeping requirements could also cause a registered broker-dealer or security-based swap dealer that is a covered banking entity to pass some of the costs along to customers and clients of their services, such as market making or underwriting. On the other hand, the reporting and recordkeeping requirements in § __.7(a) and Appendix A could have positive efficiency effects because these measures generally may improve compliance within covered banking entities and thereby reduce the potential consequences associated with noncompliance.

The reporting and recordkeeping requirements may create an incentive for covered banking entities that are registered broker-dealers and security-based swap dealers to reduce their average gross sum of trading assets and liabilities, together with their affiliates and subsidiaries, below the $5 billion threshold or $1 billion in order to avoid the costs of complying with some or all of the requirements in § __.7(a) of the proposed rule and Appendix A. To the extent the proposed rule creates such an incentive, a covered banking entity that is a registered broker-dealer or security-based swap dealer may reduce the amount of its trading activities to be below the applicable threshold. If a registered broker-dealer or security-based swap dealer that is a covered banking entity decreased the extent to which it engaged in trading activities, the resulting effects could be decreased competitiveness of the registered broker-dealer or security-based swap dealer in the broader market and reduced market efficiency and liquidity. Whether there will be a competitive impact will depend on the way in which a registered broker-dealer or security-based swap dealer that is a covered banking entity chooses to reduce its trading activities. For example, if the reporting and recordkeeping requirement lead a covered banking entity to minimize its trading in a particular product, this may lead to a decreased competitiveness in the trading of that particular product. The reporting and recordkeeping requirements, however, could enhance efficiency by improving covered banking entities' compliance and thereby reduce the potential consequences associated with noncompliance.

Further, a majority of the quantitative measurements in proposed Appendix A would only be required to be calculated and reported for trading units engaged in market making-related activity under § __.4(b) of the proposed rule. To the extent that the costs associated with the requirements in Appendix A create a disincentive for covered banking entities that are registered broker-dealers or security-based swap dealers to engage in the full range of market making-related activity that is permitted under the rule, such covered banking entities may reduce the size or scope of their market making activities. If this were to occur to a significant extent, the overall reduction in market making activities would likely have a negative impact on market efficiency and liquidity and, as a related matter, capital formation by causing certain banking entities to provide fewer market making-related services. This potential reduction in market making on the part of certain registered broker-dealers or security-based swap dealers that are covered banking entities may cause some demand for market making-related services to migrate to smaller banking entities not meeting the $1 billion threshold and non-banking entities. At the same time, the quantitative measurements required under Appendix A could have positive efficiency effects by generally improving compliance and thereby reduce the potential consequences associated with noncompliance.

The documentation requirements of § __.5(c) of the proposed rule, which provides that risk-mitigating hedging transactions must be documented in a specified manner if the hedging transaction is established at a level of organization that is different than the level of organization establishing or responsible for the position, contract, or other holding that is being hedged, may have a negative impact on efficiency by reducing the speed with which a covered banking entity could execute a hedge at a different level within the entity. To the extent that the proposed documentation requirement makes it more costly or difficult for a covered banking entity that is a registered broker-dealer or security-based swap dealer to establish hedges at a different level within the entity, this requirement may result in increased risks or reduced profitability of the broker-dealer or security-based swap dealer, which could negatively affect the competitiveness of the broker-dealer or security-based swap dealer. Further, greater difficulties or increased costs, such as those related to potential systems changes and maintenance, employee resources and time, and recordkeeping, related to establishing a hedge at a different level within the covered banking entity may cause the registered broker-dealer or security-based swap dealer to reduce its underwriting or market making-related activities under the proposed rule in order to avoid costs related to hedging underwriting or market making positions, which could likewise harm efficiency and capital formation. Alternatively, such costs could be passed through to clients or customers of the registered broker-dealer or security-based swap dealer which, in turn, could harm capital formation.

As discussed above in Part III.D of the Supplemental Information, § __.20 of the proposed rule requires all covered 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 of section 13 of the BHC Act and the proposed rule, unless such covered banking entity does not engage in activities or investments prohibited or restricted by subpart B or subpart C of the proposed rule.[379] In addition, covered banking entities that meet the thresholds in § __.20(c) of the proposed rule are required to satisfy the additional standards and requirements in proposed Appendix C with respect to their compliance program.

The SEC recognizes that the compliance program requirements in the proposal are likely to impose certain costs, including implementation and ongoing maintenance costs associated with hiring additional personnel or other personnel modifications, new or additional systems (including computer hardware or software), ongoing system maintenance, developing exception reports, surveillance (e.g., reviewing and monitoring exception reports), consultation with outside experts (e.g., attorneys, accountants), recordkeeping, independent testing, and training. These costs may increase competitive burdens on registered broker-dealers and security-based swap dealers that are covered banking entities. For example, the increased compliance costs related to implementation and ongoing maintenance of the six elements of the compliance program (i.e., written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping), as part of the overall cost of doing business, may make it more difficult for covered banking entities that are registered broker-dealers and security-based swap dealers to compete with non-banking entity broker-dealers and security-based swap dealers. Further, there may be additional competitive burdens for covered banking entities that are registered broker-dealers and security-based swap dealers that, together with their affiliates and subsidiaries, meet the thresholds in § __.20(c), which determines the covered banking entities that must comply with the minimum standards in proposed Appendix C, as there are likely to be increased compliance costs related to the more specific requirements for the compliance program requirements set forth in Appendix C. Since the thresholds in § __.20(c) are based on the size of the registered broker-dealer or security-based swap dealer, together with its affiliates and subsidiaries, and the size of their collective covered trading activities and covered fund activities and investments, the demand for these trading activities may migrate to smaller banking entities or non-banking entities.

In addition, the costs associated with implementation and ongoing maintenance of the compliance program requirements in § __.20 of the proposed rule and Appendix C, where applicable, could cause the covered banking entity to redirect resources from other business activities that are generally beneficial to market efficiency, such as market making and other customer-related services. This potential reallocation of resources could have a marginal negative effect on competition, efficiency, and capital formation. For example, the independent testing requirement in the proposal may necessitate that additional resources be provided to the internal audit department of the covered banking entity that is a registered broker-dealer or security-based swap dealer, if such testing is conducted by a qualified internal tester. Alternatively, if an outside party is used to conduct the independent testing, the covered banking entity would incur costs associated with paying the qualified outside party for its services, which would reduce the resources available for other activities of the covered banking entity.

Further, §§ __.4(a), __.4(b), and __.5 of the proposed rule, which permit underwriting, market making-related, and risk-mitigating hedging activities, require a covered banking entity to establish the compliance program required in the proposed rule in order to rely on the exemptions. To the extent that the burdens associated with the compliance program requirements in the proposed rule create an incentive for registered broker-dealers and security-based swap dealers that are covered banking entities to forgo these permitted activities, rather than incur the costs related to establishing and maintaining a compliance program, there would likely be a negative impact on efficiency, competition, and capital formation as a result of reduced market making and underwriting services available to customers and clients of such services.

The SEC requests comment on the competitive or anticompetitive effects of the elements of the proposed rule that are proposed under Exchange Act authority with respect to covered banking entities that are registered broker-dealers and security-based swap dealers. The SEC also seeks comment on the efficiency and capital formation effects of these components of the proposal, if adopted. The SEC encourages commenters to identify, discuss, analyze, and supply relevant data, information, or statistics regarding any such effects.

C. Registered Investment Advisers

As discussed above, under the proposed rule, a covered banking entity as defined in § __.2(j) would generally be subject to the substantive requirements contained in the SEC's rule. These substantive requirements implement the provisions on proprietary trading and covered fund activities under section 13 of the BHC Act. Thus for example, a covered banking entity that is a registered dealer would be required to comply with subparts A through D of the SEC's proposed rule, including Appendices A, B and C, where applicable. With respect to covered fund activities, investments or relationships set forth in subpart C and § __.20 of subpart D (''covered fund restrictions''), however, the SEC's proposed rule would require that a covered banking entity that is a covered banking entity because it is an investment adviser for which the SEC is the primary financial regulatory agency under section 2(12)(B)(iii) of the Dodd-Frank Act (a ''registered adviser'') comply with the covered fund restrictions issued by the appropriate Federal banking agency that regulates the banking entity specified in § __.2(e)(1), (2) and (3) with which the registered adviser is affiliated.[380] Under

[379] *See* proposed rule §§ __.20(a), (d).

[380] A registered adviser would, however, be required to comply with the provisions that implement the proprietary trading restrictions set forth in subparts A, B and § __.20 of subpart D of the proposed rule as promulgated by the SEC, including Appendix C, where applicable.

this approach, a registered adviser would be required to comply with the rules and related guidance issued by the appropriate Federal banking agency. The SEC would, however, retain enforcement authority over all activities of registered advisers (i.e., both proprietary trading and covered fund restrictions).

The covered fund restrictions of section 13 of the BHC Act and the proposed implementing rules make reference to or incorporate a number of banking law and supervision concepts that traditionally appear in Federal banking law and are interpreted and applied by the Federal banking agencies. For example, as discussed in greater detail in the Supplementary Information, the limitations on ownership interests in a covered fund set forth in the statute and the proposed rule generally reference the tier 1 capital of the affiliated insured depository institution or the affiliated holding company. Similarly, capital deductions under the proposed rule refer to the tier 1 capital of the affiliated insured depository institution or the affiliated holding company. In addition, the covered fund restrictions of the statute and the proposed rule incorporate by reference sections 23A and 23B of the FR Act and are administered by the Federal banking agencies. These sections of the FR Act restrict and limit transactions between certain banking organizations and their affiliates, some of which are based on a percentage of bank capital. Further, other covered fund restrictions, including for example exemptions for investments involving the public welfare and bank-owned life insurance and the extension of time to divest of investments after the seeding period, reference other banking laws or regulations that are administered by the Federal banking agencies.

In light of these considerations, the SEC's proposed rule would require a registered adviser to comply with the covered fund restrictions contained in subpart C and § .__20 of subpart D of rules implementing section 13 of the BHC that are issued by the appropriate Federal banking agency that regulates the banking entity with which the registered adviser is affiliated. Under the proposed approach, a registered adviser complying with the SEC's rule would do so by complying with the rule issued by the appropriate Federal banking agency, including any related interpretations or guidance regarding such requirements. Similarly, under the proposed approach, the foregoing determinations regarding capital or other banking law requirements that may be applicable to a registered adviser would be made by the appropriate Federal banking agency that regulates the banking entity with which the registered adviser is affiliated. This approach would mitigate the burdens of complying with the covered fund restrictions for registered advisers and would avoid creating incentives for covered fund activities to be moved from a registered adviser to a bank.[381]

The SEC's proposed rule specifies that a registered adviser must comply with the covered fund restrictions contained in subpart C and § __.20 of subpart D that are issued by the appropriate Federal banking agency that regulates the banking entity with which the registered adviser is affiliated. Subpart C, which uses terms defined in subpart A, specifies the covered fund restrictions. Subpart D § __.20 requires the establishment of a compliance program when engaging in covered fund activities. A registered adviser complying with subpart C and § __.20 of subpart D, as issued by the appropriate Federal banking agency, would also rely on interpretative guidance issued by the appropriate Federal banking agency with respect to those subparts of the proposed rule. Because § __.20 of subpart D relates to both the prohibitions and restrictions on proprietary trading activity as well as the prohibitions and restrictions on covered fund activities and investments, a registered adviser would be required to comply with the relevant covered fund provisions issued by the appropriate Federal banking agency. A registered adviser, however, would be subject to the provisions set forth in subpart D of the SEC's proposed rule, including § __.20, that relate to covered trading activities.

Nothing set forth in the discussion above, or in § __.10(a)(2) of the SEC's proposed rule, however, is intended, or shall be deemed, to limit the SEC's authority under any other provision of law, including pursuant to section 13 of the BHC Act.

The SEC request comment on its proposed approach to implementing section 13 of the BHC Act as it applies to registered advisers with respect to the covered fund restrictions. In particular, the SEC requests comment on the following:

Question SEC–5. Should the SEC instead require registered advisers to comply with the covered fund restrictions proposed by the SEC, instead of those issued the appropriate Federal banking agency? If so, could this create incentives to move the advisory business between the registered adviser and its affiliated bank? Are there benefits to this alternate approach? If so, please explain.

Question SEC–6. Are there other alternative approaches to the proposed rule that would be more effective? If yes, what alternatives and why?

Question SEC–7. Would registered advisers affiliated with insured depository institutions benefit from the proposed approach? Why or why not?

Question SEC–8. Would a registered adviser that is affiliated with insured depository institutions that are regulated by multiple Federal banking agencies encounter additional burdens in implementing the proposed approach? With respect to these registered advisers, which Federal banking agency's rules should be applicable to the registered adviser? For example, should the registered adviser be subject to the rules applicable to the registered adviser's immediate parent that is an insured depository institution?

Question SEC–9. Is the proposed requirement that registered advisers comply with the covered fund restrictions in § __.20 issued by the Federal banking agency that regulates the banking entity specified in § __.2(e)(1), (2) and (3) of the proposed rule with which the registered adviser is affiliated sufficiently clear? Are there particular compliance program requirements in § __.20 with respect to the covered fund restrictions that overlap with the proprietary trading restrictions, such that it would be difficult to identify which requirements are related to the covered fund restrictions and which requirements are related to the proprietary trading restrictions? If so, which requirements and how should this overlap be addressed? Should registered advisers be required to comply with § __.20 of the SEC's rule in its entirety? Why or why not?

Question SEC–10. Will the SEC's proposed approach limit the potential for inconsistent application of the proposed rules with respect to affiliates of entities specified in § __.2(e)(1), (2) and (3)? Why or why not?

Question SEC–11. Will the SEC's proposed approach be effective in avoiding the creation of incentives for covered fund activities to move from a

[381] Unless it advises a registered investment company, a bank (as defined in section 202(a)(2) of the Advisers Act) that relies on the exclusion from the definition of investment adviser under section 202(a)(11)(A) of the Advisers Act would not be required to register under the Advisers Act. If such a bank provided advisory services, the bank would not be a ''covered banking entity'' under the SEC's proposed rules because its primary financial regulatory agency would not be the SEC.

registered adviser to a bank? Why or why not?

Text of the Proposed Common Rules

(All Agencies)

The text of the proposed common rules appears below:

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

Subpart A—Authority and Definitions

Subpart A—Authority and Definitions

§ __.1 Authority, purpose, scope, and relationship to other authorities. [Reserved]

§ __.2 Definitions.

Unless otherwise specified, for purposes of this part:

(a) *Affiliate* has the same meaning as in section 2(k) of the BHC Act (12 U.S.C. 1841(k)).

(b) *Applicable accounting standards* means U.S. generally accepted accounting principles or such other accounting standards applicable to a covered banking entity that [Agency] determines are appropriate, that the covered banking entity uses in the ordinary course of its business in preparing its consolidated financial statements.

(c) *BHC Act* means the Bank Holding Company Act of 1956 (12 U.S.C. 1841 *et seq.*).

(d) *Bank holding company* has the same meaning as in section 2 of the BHC Act (12 U.S.C. 1841).

(e) *Banking entity* means:

(1) Any insured depository institution;

(2) Any company that controls an insured depository institution;

(3) 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

(4) Any affiliate or subsidiary of any entity described in paragraphs (e)(1), (2), or (3) of this section, other than an affiliate or subsidiary that is:

(i) A covered fund that is organized, offered and held by a banking entity pursuant to § __.11 and in accordance with the provisions of subpart C of this part, including the provisions governing relationships between a covered fund and a banking entity; or

(ii) An entity that is controlled by a covered fund described in paragraph (e)(4)(i) of this section.

(f) *Board* means the Board of Governors of the Federal Reserve System.

(g) *Buy* and *purchase* each include any contract to buy, purchase, or otherwise acquire. 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.

(h) *CFTC* means the Commodity Futures Trading Commission.

(i) *Commodity Exchange Act* means the Commodity Exchange Act (7 U.S.C. 1 *et seq.*).

(j) [Reserved]

(k) *Depository institution* has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)).

(l) (i) *Derivative* means:

(A) 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)), and as those terms are further jointly 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 Wall Street Reform and Consumer Protection Act (15 U.S.C. 8302(d));

(B) Any purchase or sale of a nonfinancial commodity for deferred shipment or delivery that is intended to be physically settled;

(C) 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));

(D) 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));

(E) Any agreement, contract, or transactions in a commodity other than foreign currency described in section 2(c)(2)(D)(i) of the Commodity Exchange Act (7 U.S.C. 2(c)(2)(D)(i)); and

(F) Any transaction authorized under section 19 of the Commodity Exchange Act (7 U.S.C. 23(a) or (b));

(ii) A derivative does not include:

(A) 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));

(B) 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)).

(m) *Exchange Act* means the Securities Exchange Act of 1934 (15 U.S.C. 78a *et seq.*).

(n) *Federal banking agencies* means the Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

(o) *Foreign banking organization* has the same meaning as in § 211.21(o) of the Board's Regulation K (12 CFR 211.21(o)).

(p) *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 any insured depository institution that is described in section 2(c)(2)(D) of the BHC Act (12 U.S.C. 1841(c)(2)(D)).

(q) *Loan* means any loan, lease, extension of credit, or secured or unsecured receivable.

(r) *Nonbank financial company supervised by the Board* has the meaning specified in section 102 of the Financial Stability Act of 2010 (12 U.S.C. 5311).

(s) *Qualifying foreign banking organization* means a foreign banking organization that qualifies as such under § 211.23(a) of the Board's Regulation K (12 CFR 211.23(a)).

(t) *Resident of the United States* means:

(1) Any natural person resident in the United States;

(2) Any partnership, corporation or other business entity organized or incorporated under the laws of the United States or any State;

(3) Any estate of which any executor or administrator is a resident of the United States;

(4) Any trust of which any trustee, beneficiary or, if the trust is revocable, any settlor is a resident of the United States;

(5) Any agency or branch of a foreign entity located in the United States;

(6) Any discretionary or non-discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary for the benefit or account of a resident of the United States;

(7) Any discretionary account or similar account (other than an estate or trust) held by a dealer or fiduciary organized or incorporated in the United States, or (if an individual) a resident of the United States; or

(8) Any person organized or incorporated under the laws of any foreign jurisdiction formed by or for a resident of the United States principally for the purpose of engaging in one or more transactions described in § __.6(d)(1) or § __.13(c)(1).

(u) *SEC* means the Securities and Exchange Commission.

(v) *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.

(w) *Security* has the meaning specified in section 3(a)(10) of the Exchange Act (15 U.S.C. 78c(a)(10)).

(x) *Security future* has the meaning specified in section 3(a)(55) of the Exchange Act (15 U.S.C. 78c(a)(55)).

(y) *Securities Act* means the Securities Act of 1933 (15 U.S.C. 77a *et seq.*).

(z) *Separate account* means an account established and maintained by an insurance company subject to regulation by a State insurance regulator or a foreign insurance regulator under which income, gains, and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(aa) *State* means any State, territory or possession of the United States, and the District of Columbia.

(bb) *Subsidiary* has the same meaning as in section 2(d) of the BHC Act (12 U.S.C. 1841(d)).

Subpart B—Proprietary Trading

§ __.3 Prohibition on proprietary trading.

(a) *Prohibition.* Except as otherwise provided in this subpart, a covered banking entity may not engage in proprietary trading.

(b) *Definition of "proprietary trading" and related terms.* For purposes of this subpart:

(1) *Proprietary trading* means engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more covered financial positions. Proprietary trading does not include acting solely as agent, broker, or custodian for an unaffiliated third party.

(2) *Trading account.*

(i) *Trading account* means any account that is used by a covered banking entity to:

(A) Acquire or take one or more covered financial positions principally for the purpose of:

(1) Short-term resale;

(2) Benefitting from actual or expected short-term price movements;

(3) Realizing short-term arbitrage profits; or

(4) Hedging one or more positions described in paragraphs (b)(2)(i)(A)(*1*), (*2*), or (*3*) of this section;

(B) Acquire or take one or more covered financial positions, other than positions that are foreign exchange derivatives, commodity derivatives, or contracts of sale of a commodity for future delivery, that are market risk capital rule covered positions, if the covered banking entity, or any affiliate of the covered banking entity that is a bank holding company, calculates risk-based capital ratios under the market risk capital rule as defined in paragraph (c)(8) of this section; or

(C) Acquire or take one or more covered financial position for any purpose, if the covered banking entity is:

(1) A dealer or municipal securities dealer that is registered with the SEC under the Exchange Act, to the extent the position is acquired or taken in connection with the activities of the dealer or municipal securities dealer that require it to be registered under that Act;

(2) A government securities dealer that is registered, or that has filed notice, with an appropriate regulatory agency (as that term is defined in section 3(a)(34) of the Exchange Act (15 U.S.C. 78c(a)(34)), to the extent the position is acquired or taken in connection with the activities of the government securities dealer that require it to be registered, or to file notice, under that Act;

(3) A swap dealer that is registered with the CFTC under the Commodity Exchange Act, to the extent the position is acquired or taken in connection with the activities of the swap dealer that require it to be registered under that Act;

(4) A security-based swap dealer that is registered with the SEC under the Exchange Act, to the extent the position is acquired or taken in connection with the activities of the security-based swap dealer that require it to be registered under that Act; or

(5) Engaged in the business of a dealer, swap dealer, or security-based swap dealer outside of the United States to the extent the position is acquired or taken in connection with the activities of such business.

(ii) *Rebuttable presumption for certain positions.* An account shall be presumed to be a trading account if it is used to acquire or take a covered financial position, other than a covered financial position described in paragraph (b)(2)(i)(B) or (C) of this section, that the covered banking entity holds for a period of sixty days or less, unless the covered banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken principally for any of the purposes described in paragraph (b)(2)(i)(A) of this section.

(iii) An account shall not be deemed a trading account for purposes of paragraph (b)(2)(i) of this section to the extent that such account is used to acquire or take a position in one or more covered financial positions:

(A) That arise under a repurchase or reverse repurchase agreement pursuant to which the covered 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;

(B) That arise under a transaction in which the covered 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;

(C) For the *bona fide* purpose of liquidity management and in accordance with a documented liquidity management plan of the covered banking entity that:

(1) Specifically contemplates and authorizes the particular instrument to be used for liquidity management purposes, its profile with respect to market, credit and other risks, and the liquidity circumstances in which the particular instrument may or must be used;

(2) Requires that any transaction contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the covered 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;

(3) Requires that any position taken for liquidity management purposes be highly liquid and limited to financial instruments the market, credit and other risks of which the covered banking entity does not expect to give rise to appreciable profits or losses as a result of short-term price movements;

(4) Limits any position taken for liquidity management purposes, together with any other positions taken for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations, as estimated and documented pursuant to methods specified in the plan; and

(5) Is consistent with [Agency]'s supervisory requirements, guidance and expectations regarding liquidity management; or

(D) That are acquired or taken by a covered banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) or a clearing agency registered with the SEC under section 17A of the Exchange Act (15 U.S.C. 78q–1) in connection with clearing derivatives or securities transactions.

(3) *Covered financial position.*

(i) *Covered financial position* means any position, including any long, short, synthetic or other position, in:

(A) A security, including an option on a security;

(B) A derivative, including an option on a derivative; or

(C) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery.

(ii) A covered financial position does not include any position that is:

(A) A loan;

(B) A commodity; or

(C) Foreign exchange or currency.

(c) *Definition of other terms related to proprietary trading.* For purposes of this subpart:

(1) *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;

(2) *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)).

(3) *Exempted security* has the same meaning as in section 3(a)(12)(A) of the Exchange Act (15 U.S.C. 78c(a)(12)(A)).

(4) *Foreign insurance regulator* means the insurance commission, or a similar official or agency, of one or more countries other than the United States that is engaged in the supervision of insurance companies under foreign insurance law.

(5) General account means, with respect to an insurance company, all of the assets of the insurance company that are not legally segregated and allocated to separate accounts under applicable State or foreign law.

(6) *Government securities* has the same meaning as in section 3(a)(42) of the Exchange Act (15 U.S.C. 78c(a)(42)).

(7) *Market risk capital rule covered position* means a covered position as that term is defined for purposes of:

(i) In the case of a covered banking entity that is a bank holding company or insured depository institution, the market risk capital rule that is applicable to the covered banking entity; and

(ii) In the case of a covered banking entity that is affiliated with a bank holding company, other than a covered banking entity to which a market risk capital rule is applicable, the market risk capital rule that is applicable to the affiliated bank holding company.

(8) *Market risk capital rule* means 12 CFR 3, Appendix B, 12 CFR 208, Appendix E, 12 CFR 225, Appendix E, and 12 CFR 325, Appendix C, as applicable.

(9) *Municipal securities* has the same meaning as in section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)).

(10) *Security-based swap* has the meaning specified in section 3(a)(68) of the Exchange Act (15 U.S.C. 78c(a)(68)).

(11) *Swap* has the meaning specified in section 1a(47) of the Commodity Exchange Act (7 U.S.C. 1a(47)).

(12) *State insurance regulator* means the insurance commission, or a similar official or agency, of a State that is engaged in the supervision of insurance companies under State insurance law.

§ __.4 Permitted underwriting and market making-related activities.

(a) *Underwriting activities.*

(1) *Permitted underwriting activities.* The prohibition on proprietary trading contained in § ____.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's underwriting activities.

(2) *Requirements.* For purposes of paragraph (a)(1) of this section, a purchase or sale of a covered financial position shall be deemed to be made in connection with a covered banking entity's underwriting activities only if:

(i) The covered banking entity has established the internal compliance program required by subpart D of this part that is designed to ensure the covered banking entity's compliance with the requirements of paragraph (a)(2) of this section, including reasonably designed written policies and procedures, internal controls, and independent testing;

(ii) The covered financial position is a security;

(iii) The purchase or sale is effected solely in connection with a distribution of securities for which the covered banking entity is acting as underwriter;

(iv) The covered banking entity is:

(A) With respect to a purchase or sale effected in connection with a distribution of one or more covered financial positions that are securities, other than exempted securities, security-based swaps, commercial paper, bankers' acceptances, or commercial bills:

(1) A dealer that is registered with the SEC under section 15 of the Exchange Act (15 U.S.C. 78*o*), or a person that is exempt from registration or excluded from regulation as a dealer thereunder; or

(2) Engaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located;

(B) With respect to a purchase or sale effected as part of a distribution of one or more covered financial positions that are municipal securities, a municipal securities dealer that is registered under section 15B of the Exchange Act (15 U.S.C. 78*o*–4) or exempt from registration thereunder; or

(C) With respect to a purchase or sale effected as part of a distribution of one or more covered financial positions that are government securities, a government securities dealer that is registered, or that has filed notice, under section 15C of the Exchange Act (15 U.S.C. 78*o*–5) or exempt from registration thereunder;

(v) The underwriting activities of the covered banking entity with respect to the covered financial position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;

(vi) The underwriting activities of the covered banking entity are designed to generate revenues primarily from fees, commissions, underwriting spreads or other income not attributable to:

(A) Appreciation in the value of covered financial positions related to such activities; or

(B) The hedging of covered financial positions related to such activities; and

(vii) The compensation arrangements of persons performing underwriting activities are designed not to reward proprietary risk-taking.

(3) *Definition of distribution.* For purposes of paragraph (a) of this section, a *distribution* of securities means 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.

(4) *Definition of underwriter.* For purposes of paragraph (a) of this section, *underwriter* means:

(i) A person who has agreed with an issuer of securities or selling security holder:

(A) To purchase securities for distribution;

(B) To engage in a distribution of securities for or on behalf of such issuer or selling security holder; or

(C) To 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 paragraph (a)(4)(i) of this section to engage in a distribution of such securities for or on behalf of the issuer or selling security holder.

(b) *Market making-related activities.*

(1) *Permitted market making-related activities.* The prohibition on proprietary trading contained in § ____.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making-related activities.

(2) *Requirements.* For purposes of paragraph (b)(1) of this section, a purchase or sale of a covered financial position shall be deemed to be made in connection with a covered banking entity's market making-related activities only if:

(i) The covered banking entity has established the internal compliance program required by subpart D that is designed to ensure the covered banking entity's compliance with the requirements of paragraph (b)(2) of this section, including reasonably designed written policies and procedures, internal controls, and independent testing;

(ii) The trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular or continuous basis;

(iii) The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are, with respect to the covered financial position, designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties;

(iv) The covered banking entity is:

(A) With respect to a purchase or sale of one or more covered financial positions that are securities, other than exempted securities, security-based swaps, commercial paper, bankers' acceptances, or commercial bills:

(1) A dealer that is registered with the SEC under section 15 of the Exchange Act (15 U.S.C. 78*o*), or a person that is exempt from registration or excluded from regulation as a dealer thereunder; or

(2) Engaged in the business of a dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located;

(B) With respect to a purchase or sale of one or more covered financial positions that are swaps:

(1) A swap dealer that is registered with the CFTC under the Commodity Exchange Act (7 U.S.C. 1a) or a person that is exempt from registration thereunder; or

(2) Engaged in the business of a swap dealer outside the United States and subject to substantive regulation of such business in the jurisdiction where the business is located;

(C) With respect to a purchase or sale of one or more covered financial positions that are security-based swaps:

(1) A security-based swap dealer that is registered with the SEC under section 15F of the Exchange Act (15 U.S.C. 78*o*–10) or a person that is exempt from registration thereunder; or

(2) Engaged in the business of a security-based swap dealer outside of the United States and subject to substantive regulation of such business in the jurisdiction where the business is located;

(D) With respect to a purchase or sale of one or more covered financial positions that are municipal securities, a municipal securities dealer that is registered under section 15B of the Exchange Act (15 U.S.C. 78*o*–4) or a person that is exempt from registration thereunder; or

(E) With respect to a purchase or sale of one or more covered financial positions that are government securities, a government securities dealer that is registered, or that has filed notice, under section 15C of the Exchange Act (15 U.S.C. 78*o*–5) or a person that is exempt from registration thereunder;

(v) The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are designed to generate revenues primarily from fees, commissions, bid/ask spreads or other income not attributable to:

(A) Appreciation in the value of covered financial positions it holds in trading accounts; or

(B) The hedging of covered financial positions it holds in trading accounts;

(vi) The market making-related activities of the trading desk or other organizational unit that conducts the purchase or sale are consistent with the commentary provided in Appendix B; and

(vii) The compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.

(3) *Market making-related hedging.* For purposes of paragraph (b)(1) of this section, a purchase or sale of a covered financial position shall also be deemed to be made in connection with a covered banking entity's market making-related activities if:

(i) The covered financial position is purchased or sold to reduce the specific risks to the covered banking entity in connection with and related to individual or aggregated positions, contracts, or other holdings acquired pursuant to paragraph (b) of this section; and

(ii) The purchase or sale meets all of the requirements described in § __.5(b) and, if applicable, § __.5(c).

§ ____.5 Permitted risk-mitigating hedging activities.

(a) *Permitted risk-mitigating hedging activities.* The prohibition on proprietary trading contained in § ____.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity and is designed to reduce the specific risks to the covered banking entity in connection with and related to such positions, contracts, or other holdings.

(b) *Requirements.* For purposes of paragraph (a) of this section, a purchase or sale of a covered financial position shall be deemed to be in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity and designed to reduce the specific risks to the covered banking entity in connection with and related to such positions, contracts, or other holdings only if:

(1) The covered banking entity has established the internal compliance program required by subpart D designed to ensure the covered banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing;

(2) The purchase or sale:

(i) Is made in accordance with the written policies, procedures and internal controls established by the covered banking entity pursuant to subpart D of this part;

(ii) Hedges or otherwise mitigates 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 covered banking entity;

(iii) Is 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 purchase or sale is intended to hedge or otherwise mitigate;

(iv) Does not give rise, at the inception of the hedge, to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings of a covered banking entity and that are not hedged contemporaneously;

(v) Is subject to continuing review, monitoring and management by the covered banking entity that:

(A) Is consistent with the written hedging policies and procedures required under paragraph (b)(1) of this section; and

(B) Maintains a reasonable level of correlation, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and

(C) Mitigates any significant exposure arising out of the hedge after inception; and

(vi) The compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.

(c) *Documentation.* With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this § __.5 for risk-mitigating hedging purposes that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce, the covered banking entity must, at a minimum, document, at the time the purchase, sale, or series of purchases or sales are conducted:

(1) The risk-mitigating purpose of the purchase, sale, or series of purchases or sales;

(2) The risks of the individual or aggregated positions, contracts, or other holdings of a covered banking entity that the purchase, sale, or series of purchases or sales are designed to reduce; and

(3) The level of organization that is establishing the hedge.

§ __.6 Other permitted proprietary trading activities.

(a) *Permitted trading in government obligations.*

(1) The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that is:

(i) An obligation of the United States or any agency thereof;

(ii) An obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 *et seq.*); or

(iii) An obligation of any State or any political subdivision thereof.

(2) An obligation or other instrument described in paragraphs (a)(1)(i), (ii) or (iii) of this section shall include both general obligations and limited obligations, such as revenue bonds.

(b) *Permitted trading on behalf of customers.* (1) The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity on behalf of customers.

(2) For purposes of paragraph (b)(1) of this section, a purchase or sale of a covered financial position by a covered banking entity shall be considered to be on behalf of customers if:

(i) The purchase or sale:

(A) Is conducted by a covered banking entity acting as investment adviser, commodity trading advisor, trustee, or in a similar fiduciary capacity for a customer;

(B) Is conducted for the account of the customer; and

(C) Involves solely covered financial positions of which the customer, and not the covered banking entity or any subsidiary or affiliate of the covered banking entity, is beneficial owner (including as a result of having long or short exposure under the relevant covered financial position);

(ii) The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account to offset a contemporaneous sale to (or purchase from) the customer; or

(iii) The covered banking entity is an insurance company that purchases or sells a covered financial position for a separate account, if:

(A) The insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;

(B) The insurance company purchases or sells the covered financial position solely for a separate account established by the insurance company in connection with one or more insurance policies issued by that insurance company;

(C) All profits and losses arising from the purchase or sale of a covered financial position are allocated to the separate account and inure to the benefit or detriment of the owners of the insurance policies supported by the separate account, and not the insurance company; and

(D) 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.

(c) *Permitted trading by a regulated insurance company.* The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by an insurance company or any affiliate of an insurance company if:

(1) The insurance company is directly engaged in the business of insurance and subject to regulation by a State insurance regulator or foreign insurance regulator;

(2) The insurance company or its affiliate purchases or sells the covered financial position solely for the general account of the insurance company;

(3) 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

(4) The appropriate Federal banking agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in paragraph (c)(3) of this section is insufficient to protect the safety and soundness of the covered banking entity, or of the financial stability of the United States.

(d) *Permitted trading outside of the United States.*

(1) The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity if:

(i) The covered 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;

(ii) The purchase or sale is conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act; and

(iii) The purchase or sale occurs solely outside of the United States.

(2) A purchase or sale shall be deemed to be conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act only if:

(i) With respect to a covered banking entity that is a foreign banking organization, the banking entity is a qualifying foreign banking organization and is conducting the purchase or sale in compliance with subpart B of the Board's Regulation K (12 CFR 211.20 through 211.30); or

(ii) With respect to a covered banking entity that is not a foreign banking organization, the covered banking entity meets at least two of the following requirements:

(A) Total assets of the covered banking entity held outside of the United States exceed total assets of the covered banking entity held in the United States;

(B) Total revenues derived from the business of the covered banking entity outside of the United States exceed total revenues derived from the business of the covered banking entity in the United States; or

(C) Total net income derived from the business of the covered banking entity outside of the United States exceeds total net income derived from the business of the covered banking entity in the United States.

(3) A purchase or sale shall be deemed to have occurred solely outside of the United States only if:

(i) The covered banking entity conducting the purchase or sale is not organized under the laws of the United States or of one or more States;

(ii) No party to the purchase or sale is a resident of the United States;

(iii) No personnel of the covered banking entity who is directly involved in the purchase or sale is physically located in the United States; and

(iv) The purchase or sale is executed wholly outside of the United States.

§ __.7 Reporting and recordkeeping requirements applicable to trading activities.

A covered banking entity engaged in any proprietary trading activity permitted under §§ __.4 through __.6 shall comply with:

(a) The reporting and recordkeeping requirements described in Appendix A to this part, if the covered banking entity has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion;

(b) The recordkeeping requirements required under § __.20 and appendix C to this part, as applicable; and

(c) Such other reporting and recordkeeping requirements as [Agency] may impose to evaluate the covered banking entity's compliance with this subpart.

§ __.8 Limitations on permitted proprietary trading activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ __.4 through __.6 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the covered 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 covered banking entity or to the financial stability of the United States.

(b) *Definition of material conflict of interest.* For purposes of this section, a material conflict of interest between a covered banking entity and its clients, customers, or counterparties exists if the covered banking entity engages in any transaction, class of transactions, or activity that would involve or result in the covered 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:

(1) *Timely and effective disclosure and opportunity to negate or substantially mitigate.* Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict of interest may arise, the covered banking entity:

(i) Makes 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

(ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(2) *Information barriers.* The covered banking entity 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 covered 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 covered 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 covered 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 covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail.

§ __.9 [Reserved]

Subpart C—Covered Funds Activities and Investments

§ __.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

(a) *Prohibition.* Except as otherwise provided in this subpart, a covered banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.

(b) *Definitions.* For purposes of this part:

(1) *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) A commodity pool, as defined in section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10));

(iii) Any issuer, as defined in section 2(a)(22) of the Investment Company Act of 1940 (15 U.S.C. 80a–2(a)(22)), that is organized or offered outside of the United States that would be a covered fund as defined in paragraphs (b)(1)(i), (ii), or (iv) of this section, were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States; and

(iv) Any such similar fund as the appropriate Federal banking agencies, the SEC, and the CFTC may determine, by rule, as provided in section 13(b)(2) of the BHC Act.

(2) *Director* has the same meaning as provided in § 215.2(d)(1) of the Board's Regulation O (12 CFR 215.2(d)(1)).

(3) *Ownership interest.*

(i) *Ownership interest* means 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, or any derivative of such interest.

(ii) *Ownership interest* does not include, with respect to a covered fund:

(A) *Carried interest.* An interest held by a covered banking entity (or an affiliate, subsidiary or employee thereof) in a covered fund for which the covered banking entity (or an affiliate, subsidiary or employee thereof) serves as investment manager, investment adviser or commodity trading adviser, so long as:

(*1*) The sole purpose and effect of the interest is to allow the covered banking entity (or the affiliate, subsidiary or employee thereof) to share in the profits of the covered fund as performance compensation for services provided to the covered fund by the covered banking entity (or the affiliate, subsidiary or employee thereof), provided that the covered banking entity (or the affiliate, subsidiary or employee thereof) may be obligated under the terms of such interest to return profits previously received;

(*2*) All such profit, once allocated, is distributed to the covered banking entity (or the affiliate, subsidiary or employee thereof) promptly after being earned or, if not so distributed, the reinvested profit of the covered banking entity (or the affiliate, subsidiary or employee thereof) does not share in the subsequent profits and losses of the covered fund;

(*3*) The covered banking entity (or the affiliate, subsidiary or employee thereof) does not provide funds to the covered fund in connection with acquiring or retaining this interest; and

(*4*) The interest is not transferable by the covered banking entity (or the affiliate, subsidiary or employee thereof) except to another affiliate or subsidiary thereof.

(4) *Prime brokerage transaction* means one or more products or services provided by a covered banking entity to a covered fund, such as custody, clearance, securities borrowing or lending services, trade execution, or financing, data, operational, and portfolio management support.

(5) *Sponsor,* with respect to a covered fund, means:

(i) To serve as a general partner, managing member, trustee, or commodity pool operator of a covered fund;

(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.

(6) *Trustee.* (i) For purposes of this subpart, a trustee does not include 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 (29 U.S.C. 1103(a)(1)).

(ii) Any covered banking entity that directs a person identified in paragraph (b)(6)(i) of this section, or that possesses authority and discretion to manage and control the assets of a covered fund for which such person identified in paragraph (b)(6)(i) of this section serves as trustee, shall be considered a trustee of such covered fund.

§ __.11 Permitted organizing and offering of a covered fund.

Section __.10(a) does not prohibit a covered banking entity from, 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:

(a) The covered banking entity provides *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services;

(b) 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 covered banking entity, pursuant to a credible plan or similar documentation outlining how the covered banking entity intends to provide advisory or similar services to its customers through organizing and offering such fund;

(c) The covered banking entity does not acquire or retain an ownership interest in the covered fund except as permitted under this subpart;

(d) The covered banking entity complies with the restrictions under § __.16 of this subpart;

(e) The covered 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;

(f) The covered fund, for corporate, marketing, promotional, or other purposes:

(1) Does not share the same name or a variation of the same name with the covered banking entity (or an affiliate or subsidiary thereof); and

(2) Does not use the word ''bank'' in its name;

(g) No director or employee of the covered banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the covered banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and

(h) The covered banking entity:

(1) 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):

(i) That ''any losses in [such covered fund] will be borne solely by investors in [the covered fund] and not by [the covered banking entity and its affiliates or subsidiaries]; therefore, [the covered banking entity's and its affiliates' or subsidiaries'] losses in [such covered fund] will be limited to losses attributable to the ownership interests in the covered fund held by the [covered banking entity and its affiliates or subsidiaries] in their capacity as investors in the [covered fund]'';

(ii) That such investor should read the fund offering documents before investing in the covered fund;

(iii) 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);

(iv) The role of the covered banking entity and its affiliates, subsidiaries and employees in sponsoring or providing any services to the covered fund; and

(2) 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 or subsidiaries.

§ __.12 Permitted investment in a covered fund.

(a) *Authority and limitations on permitted investments in covered funds.* (1) The prohibition contained in § __.10(a) does not apply with respect to a covered banking entity acquiring and retaining any ownership interest in a covered fund that the covered banking entity or an affiliate or subsidiary thereof organizes and offers, for the purposes of:

(i) *Establishment.* Establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors as required by paragraph (a)(2)(i) of this section; or

(ii) *De minimis investment.* Making and retaining an investment in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund.

(2) *Ownership limits.*

(i) With respect to an investment in any covered fund pursuant to paragraph (a)(1)(i) of this section, the covered banking entity:

(A) Must actively seek unaffiliated investors to reduce through redemption, sale, dilution, or other methods the aggregate amount of all ownership interests of the covered banking entity in any covered fund under § __.12 to the amount permitted in paragraph (a)(2)(i)(B) of this section; and

(B) May not exceed 3 percent of the total amount or value of outstanding ownership interests of the fund not later than 1 year after the date of establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section); and

(ii) The aggregate value of all ownership interests of the covered banking entity in all covered funds under § __.12 may not exceed 3 percent of the tier 1 capital of the covered banking entity, as provided under paragraph (c) of this section.

(b) *Limitations on investments in a single covered fund.* For purposes of determining whether a covered banking entity is in compliance with the limitations and restrictions on permitted investments in covered funds contained in paragraph (a) of this section, a covered banking entity shall calculate its amount and value of a permitted investment in a single covered fund as follows:

(1) *Attribution of ownership interests to a covered banking entity.* The amount and value of a banking entity's permitted investment in any single covered fund shall include:

(i) *Controlled investments.* Any ownership interest held under § __.12 by any entity that is controlled, directly or indirectly, by the covered banking entity for purposes of this part; and

(ii) *Noncontrolled investments.* The *pro rata* share of any ownership interest held under § __.12 by any covered fund that is not controlled by the covered banking entity but in which the covered banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares.

(2) *Calculation of amount of ownership interests in a single covered fund.* For purposes of determining whether an investment in a single covered fund does not exceed 3 percent of the total outstanding ownership interests of the fund under paragraph (a)(2)(i)(B) of this section:

(i) The aggregate amount of all ownership interests of the covered banking entity shall be the greater of (without regard to committed funds not yet called for investment):

(A) The value of any investment or capital contribution made with respect to all ownership interests held under § __.12 by the covered banking entity in the covered fund, divided by the value of all investments or capital contributions, respectively, made by all persons in that covered fund; or

(B) The total number of ownership interests held under § __.12 by the covered banking entity in a covered fund divided by the total number of ownership interests held by all persons in that covered fund.

(ii) *Inclusion of certain parallel investments.* To the extent that a covered banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the covered banking entity, whether or not pursuant to an express agreement, such investments shall be included in any calculation required under paragraph (a)(2) of this section.

(3) *Timing of single covered fund investment calculation.* The aggregate amount of all ownership interests of a covered banking entity in a single covered fund may at no time exceed the limits in this paragraph after the conclusion of the period provided in paragraph (a)(2)(i)(B) of this section.

(4) *Methodology and standards for calculation.* For purposes of determining the amount or value of its investment in a covered fund under this paragraph (b), a covered banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests.

(c) *Aggregate permitted investments in all covered funds.* (1) For purposes of determining the aggregate value of all permitted investments in all covered funds by a covered banking entity under paragraph (a)(2)(ii) of this section, the aggregate value of all ownership interests held by that covered banking entity shall be the sum of the value of each investment in a covered fund held under § __.12, as determined in accordance with applicable accounting standards.

(2) *Calculation of tier 1 capital.* For purposes of determining compliance with paragraph (a)(2)(ii) of this section:

(i) *Entities that are required to hold and report tier 1 capital.* If a covered banking entity is required to calculate and report tier 1 capital, the covered banking entity's tier 1 capital shall be equal to the amount of tier 1 capital calculated by that covered banking entity as of the last day of the most recent calendar quarter that has ended, as reported to its primary financial regulatory agency, as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act; and

(ii) If a covered banking entity is not required to calculate and report tier 1 capital, the covered banking entity's tier 1 capital shall be determined to be equal to:

(A) In the case of a covered banking entity that is controlled, directly or indirectly, by a depository institution that calculates and reports tier 1 capital, the amount of tier 1 capital reported by such controlling depository institution pursuant to paragraph (c)(2)(i) of this section;

(B) In the case of a covered 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 covered banking entity is a subsidiary of a bank holding company or company that is treated as a bank holding company, the amount of tier 1 capital reported by the top-tier affiliate of such covered banking entity that calculates and reports tier 1 capital, pursuant to paragraph (c)(2)(i) of this section; and

(*2*) *Other holding companies and any subsidiary or affiliate thereof.* If the covered banking entity is not a subsidiary of a bank holding company or a company that is treated as a bank holding company, 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.

(3) A covered banking entity's aggregate permitted investment in all covered funds shall be calculated as of the last day of each calendar quarter.

(d) *Capital treatment for a permitted investment in a covered fund.* For purposes of calculating capital pursuant to the applicable capital rules, a covered banking entity shall deduct the aggregate value of all permitted investments in all covered funds made or retained by a covered banking entity pursuant to this section (as determined under paragraph (c)(1) of this section) from the banking entity's tier 1 capital (as determined under paragraph (c)(2) of this section).

(e) *Extension of time to divest an ownership interest.* (1) Upon application by a covered banking entity, the Board may extend the period of time to meet the requirements under paragraphs (a)(2)(i)(A) and (B) of 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 covered banking entity's plan for reducing the permitted investment in a covered fund through redemption, sale, dilution or other methods as required in paragraph (a)(2)(i) of 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:

(A) Involve or result in material conflicts of interest between the covered banking entity and its clients, customers or counterparties;

(B) Result, directly or indirectly, in a material exposure by the covered banking entity to high-risk assets or high-risk trading strategies;

(C) Pose a threat to the safety and soundness of the covered banking entity; or

(D) Pose a threat to the financial stability of the United States;

(ii) Market conditions;

(iii) The contractual terms governing the covered banking entity's interest in the covered fund;

(iv) The date on which the covered fund is expected to have attracted sufficient investments from investors unaffiliated with the covered banking entity to enable the covered banking entity to comply with the limitations in paragraph (a)(2)(i) of this section;

(v) 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 covered banking entity and the financial stability of the United States;

(vi) The cost to the covered banking entity of divesting or disposing of the investment within the applicable period;

(vii) Whether the divestiture or conformance of the investment would involve or result in a material conflict of interest between the covered banking entity and unaffiliated clients, customers or counterparties to which it owes a duty;

(viii) The covered 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; and

(ix) Any other factor that the Board believes appropriate.

(3) *Consultation.* In the case of a covered 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 approval of an application by the covered banking entity for an extension under paragraph (e)(1) of this section.

(4) *Authority to impose restrictions on activities or investment during any extension period.* (i) 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 covered 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 (12 U.S.C. 1851) and this part.

(ii) *Consultation.* In the case of a covered 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 imposing conditions on the approval of a request by the covered banking entity for an extension under paragraph (e)(1) of this section.

§ __.13 Other permitted covered fund activities and investments.

(a) *Permitted investments in SBICs and related investments.* The prohibition contained in § __.10(a) does not apply with respect to acquiring or retaining an ownership interest in, or acting as sponsor to, a covered fund by a covered banking entity or an affiliate or subsidiary thereof:

(1) In one or more small business investment companies, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662);

(2) That is designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs); or

(3) That is a qualified rehabilitation expenditure with respect to a qualified rehabilitation building or certified historic structure, as such terms are defined in section 47 of the Internal Revenue Code of 1986 or a similar State historic tax credit program.

(b) *Permitted risk-mitigating hedging activities.*

(1) The prohibition contained in § __.10(a) does not apply with respect to an ownership interest in a covered fund by a covered banking entity, provided that the acquisition or retention of the ownership interest is:

(i) Made in connection with and related to individual or aggregated obligations or liabilities of the covered banking entity that are:

(A) Taken by the covered banking entity when acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund, or

(B) Directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund; and

(ii) Designed to reduce the specific risks to the covered banking entity in connection with and related to such obligations or liabilities.

(2) *Requirements.* For purposes of paragraph (b)(1) of this section, acquiring or retaining an ownership interest in a covered fund by a covered banking entity shall be a permissible risk-mitigating hedging activity under this section only if:

(i) The covered banking entity has established the internal compliance program required by subpart D designed to ensure the covered banking entity's compliance with the requirements of this paragraph (b)(2) of this section including reasonably designed written policies and procedures regarding the instruments, techniques and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing;

(ii) The acquisition or retention of an ownership interest in a covered fund:

(A) Is made in accordance with the written policies, procedures and internal controls established by the covered banking entity pursuant to subpart D;

(B) Hedges or otherwise mitigates an exposure to a covered fund through an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that:

(*1*) Arises out of a transaction conducted solely to accommodate a specific customer request with respect to, or

(*2*) Is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund;

(C) Does not give rise, at the inception of the hedge, to significant exposures that were not already present in individual or aggregated positions, contracts, or other holdings of a covered banking entity and that are not hedged contemporaneously; and

(D) Is subject to continuing review, monitoring and management by the covered banking entity that:

(*1*) Is consistent with its written hedging policies and procedures;

(*2*) Maintains a substantially similar offsetting exposure to the same amount and type of ownership interest, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate; and

(*3*) Mitigates any significant exposure arising out of the hedge after inception; and

(iii) The compensation arrangements of persons performing the risk-mitigating hedging activities are designed not to reward proprietary risk-taking.

(3) *Documentation.* With respect to any acquisition or retention of an ownership interest in a covered fund by a covered banking entity pursuant to this paragraph (b), the covered banking entity must document, at the time the transaction is conducted:

(i) The risk-mitigating purpose of the acquisition or retention of an ownership interest in a covered fund;

(ii) The risks of the individual or aggregated obligation or liability of a covered banking entity that the acquisition or retention of an ownership interest in a covered fund is designed to reduce; and

(iii) The level of organization that is establishing the hedge.

(c) *Certain permitted covered fund activities and investments outside of the United States.*

(1) The prohibition contained in § __.10(a) does not apply to the acquisition or retention of any ownership interest in, or the sponsorship of, a covered fund by a covered banking entity if:

(i) The covered 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;

(ii) The activity is conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act;

(iii) No ownership interest in such covered fund is offered for sale or sold to a resident of the United States; and

(iv) The activity occurs solely outside of the United States.

(2) An activity shall be considered to be conducted pursuant to paragraph (9) or (13) of section 4(c) of the BHC Act only if:

(i) With respect to a covered banking entity that is a foreign banking organization, the covered banking entity is a qualifying foreign banking organization and is conducting the activity in compliance with subpart B of the Board's Regulation K (12 CFR 211.20 *et seq.*); or

(ii) With respect to a covered banking entity that is not a foreign banking organization, the covered banking entity meets at least two of the following requirements:

(A) Total assets of the covered banking entity held outside of the United States exceed total assets of the covered banking entity held in the United States;

(B) Total revenues derived from the business of the covered banking entity outside of the United States exceed total revenues derived from the business of the covered banking entity in the United States; or

(C) Total net income derived from the business of the covered banking entity outside of the United States exceeds total net income derived from the business of the covered banking entity in the United States.

(3) An activity shall be considered to have occurred solely outside of the United States only if:

(i) The covered banking entity engaging in the activity is not organized under the laws of the United States or of one or more States;

(ii) No subsidiary, affiliate, or employee of the covered 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 or in one or more States; and

(iii) No ownership interest in such covered fund is offered for sale or sold to a resident of the United States.

(d) *Loan securitizations.* The prohibition contained in § __.10(a) does not apply with respect to the acquisition or retention by a covered banking entity of any ownership interest in, or acting as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of:

(1) Loans;

(2) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and

(3) Interest rate or foreign exchange derivatives that:

(i) Materially relate to the terms of such loans or contractual rights or assets; and

(ii) Are used for hedging purposes with respect to the securitization structure.

§ __.14 Covered fund activities determined to be permissible.

(a) The prohibition contained in § __.10(a) does not apply to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to:

(1) *Bank owned life insurance.* A separate account which is used solely for the purpose of allowing a covered banking entity to purchase an insurance policy for which the covered banking entity is the beneficiary, provided that the covered banking entity that purchases the insurance policy:

(i) Does not control the investment decisions regarding the underlying assets or holdings of the separate account; and

(ii) Holds its ownership interest in the separate account in compliance with applicable supervisory guidance regarding bank owned life insurance.

(2) *Certain other covered funds.* Any of the following entities that would otherwise qualify as a covered fund:

(i) A joint venture between the covered banking entity or one of its affiliates and any other person, provided that the joint venture:

(A) Is an operating company; and

(B) Does not engage in any activity or make any investment that is prohibited under this part;

(ii) An acquisition vehicle, provided that the sole purpose and effect of such entity is to effectuate a transaction involving the acquisition or merger of one entity with or into the covered banking entity or one of its affiliates;

(iii) An issuer of an asset-backed security, but only with respect to that amount or value of economic interest in a portion of the credit risk for an asset-backed security that is retained by a covered banking entity that is a "securitizer" or "originator" in compliance with the minimum requirements of section 15G of the Exchange Act (15 U.S.C. 78*o*–11) and any implementing regulations issued thereunder;

(iv) A wholly-owned subsidiary of the covered banking entity that is:

(A) Engaged principally in performing *bona fide* liquidity management activities described in § __.3(b)(2)(iii)(C); and

(B) Carried on the balance sheet of the covered banking entity; and

(v) A covered fund that is an issuer of asset-backed securities described in § __.13(d), the assets or holdings of which are solely comprised of:

(A) Loans;

(B) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and

(C) Interest rate or foreign exchange derivatives that:

(*1*) Materially relate to the terms of such loans or contractual rights or assets, and

(*2*) Are used for hedging purposes with respect to the securitization structure.

(b) The prohibition contained in § __.10(a) does not apply to the acquisition or retention by a covered banking entity of any ownership interest in, or acting as sponsor to, a covered fund, but only if such ownership interest is acquired or retained by a covered banking entity (or an affiliate or subsidiary thereof):

(1) In the ordinary course of collecting a debt previously contracted in good faith, if the covered banking entity divests the ownership interest within applicable time periods provided for by [Agency]; or

(2) Pursuant to and in compliance with the conformance or extended transition period authorities provided for in subpart E of the Board's rules implementing section 13 of the BHC Act (12 CFR 248.30 through 248.35).

§ __.15 Internal controls, reporting and recordkeeping requirements applicable to covered fund activities and investments.

A covered banking entity engaged in any covered fund activity or making or holding any investment permitted under this subpart shall comply with:

(a) The internal controls, reporting, and recordkeeping requirements required under § __.20 and appendix C to this part, as applicable; and

(b) Such other reporting and recordkeeping requirements as [Agency] may deem necessary to appropriately evaluate the covered banking entity's compliance with this subpart.

§ __.16 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 covered 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 § __.11, 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), as if such covered 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 covered banking entity may:

(i) Acquire and retain any ownership interest in a covered fund in accordance with the requirements of this subpart; and

(ii) Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

(A) The covered banking entity is in compliance with each of the limitations set forth in § __.11 with respect to a covered fund organized and offered by such covered banking entity (or an affiliate or subsidiary thereof);

(B) The chief executive officer (or equivalent officer) of the top-tier affiliate of the covered banking entity certifies in writing annually (with a duty to update the certification if the information in the certification materially changes) that the covered 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 covered banking entity.

(b) *Restrictions on transactions with covered funds.* A covered 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 § __.11, shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c–1), as if such covered 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 covered banking entity.

§ __.17 Other limitations on permitted covered fund activities.

(a) No transaction, class of transactions, or activity may be deemed permissible under §§ __.11 through __.14 and § __.16 if the transaction, class of transactions, or activity would:

(1) Involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties;

(2) Result, directly or indirectly, in a material exposure by the covered 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 covered banking entity or the financial stability of the United States.

(b) *Definition of material conflict of interest.* For purposes of this section, a material conflict of interest between a covered banking entity and its clients, customers, or counterparties exists if the covered banking entity engages in any transaction, class of transactions, or activity that would involve or result in the covered 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:

(1) *Timely and effective disclosure and opportunity to negate or substantially mitigate.* Prior to effecting the specific transaction or class or type of transactions, or engaging in the specific activity, for which a conflict of interest may arise, the covered banking entity:

(i) Makes 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

(ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

(2) *Information barriers.* The covered banking entity 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 covered 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 covered 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 covered 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 covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail.

(2) *High-risk trading strategy* means a trading strategy that would, if engaged in by a covered banking entity, significantly increase the likelihood that the covered banking entity would incur a substantial financial loss or would fail.

§ __.18 [Reserved]

§ __.19 [Reserved]

Subpart D—Compliance Program Requirement; Violations

§ __.20 Program for monitoring compliance; enforcement.

(a) *Program requirement.* Except as provided in paragraph (d) of this section, each covered banking entity shall 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 and covered fund activities and investments set forth in section 13 of the BHC Act and this part, and such program shall be appropriate for the size, scope and complexity of activities and business structure of the covered banking entity.

(b) *Contents of compliance program.* The compliance program required by paragraph (a) of this section, at a minimum, shall include:

(1) Internal written policies and procedures reasonably designed to document, describe, and monitor trading activities subject to subpart B of this part and activities and investments with respect to a covered fund subject to subpart C of this part (including those permitted under §§ __.4 through __.6 or §§ __.11 through __.16) to ensure that such activities and investments comply with section 13 of the BHC Act and this part;

(2) A system of internal controls reasonably designed to monitor and identify potential areas of noncompliance with section 13 of the BHC Act and this part in the covered banking entity's trading activities subject to subpart B of this part and activities and investments with respect to a covered fund subject to subpart C of this part (including those permitted under §§ __.4 through __.6 or §§ __.11 through __.16) and to prevent the occurrence of activities or investments that are prohibited by section 13 of the BHC Act and this part;

(3) A management framework that clearly delineates responsibility and accountability for compliance with section 13 of the BHC Act and this part;

(4) Independent testing for the effectiveness of the compliance program

conducted by qualified personnel of the covered banking entity or by a qualified outside party;

(5) Training for trading personnel and managers, as well as other appropriate personnel, to effectively implement and enforce the compliance program; and

(6) Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to [Agency] upon request and retain for a period of no less than 5 years.

(c) *Additional standards.* (1) In the case of any covered banking entity described in paragraph (c)(2) of this section, the compliance program required by paragraph (a) of this section shall also satisfy the requirements and other standards contained in Appendix C to this part.

(2) A covered banking entity is subject to paragraph (c)(1) of this section if:

(i) The covered banking entity engages in proprietary trading and has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis), as measured as of the last day of each of the four prior calendar quarters:

(A) Is equal to or greater than $1 billion; or

(B) Equals 10 percent or more of its total assets;

(ii) The covered banking entity invests in, or has relationships with, a covered fund and:

(A) The covered banking entity has, together with its affiliates and subsidiaries, aggregate investments in one or more covered funds, the average value of which is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or

(B) Sponsors or advises, together with its affiliates and subsidiaries, one or more covered funds, the average total assets of which are, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion; or

(iii) [The Agency] deems it appropriate.

(d) *No program required for certain banking entities.* To the extent that a covered banking entity does not engage in activities or investments prohibited or restricted by subpart B or subpart C of this part, a covered banking entity will have satisfied the requirements of this section if its existing compliance policies and procedures include measures that are designed to prevent the covered banking entity from becoming engaged in such activities or making such investments and which require the covered banking entity to develop and provide for the compliance program required under paragraph (a) of this section prior to engaging in such activities or making such investments.

§ __.21 Termination of activities or investments; penalties for violations.

(a) Any covered banking entity that engages in an activity or makes an investment in violation of section 13 of the BHC Act or this part or 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, or otherwise violates the restrictions and requirements of section 13 of the BHC Act or this part, shall terminate the activity and, as relevant, dispose of the investment.

(b) After due notice and an opportunity for hearing, if [Agency] finds reasonable cause to believe any covered banking entity has engaged in an activity or made an investment described in paragraph (a), the [Agency] may, by order, direct the banking entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment.

(c) [Reserved]

Appendix A to Part [ ]—Reporting and Recordkeeping Requirements for Covered Trading Activities

I. Purpose

This appendix sets forth reporting and recordkeeping requirements that certain covered 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 § __.7, this appendix generally applies to a covered banking entity that has, together with its affiliates and subsidiaries, trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion. These entities are required to furnish periodic reports to [Agency] regarding a variety of quantitative measurements of their covered trading activities, which vary depending on the scope and size of covered trading activities, and create and maintain records documenting the preparation and content of these reports. The requirements of this appendix should be incorporated into the covered banking entity's internal compliance program under § __.20 and appendix C to this part.

The purpose of this appendix is to assist covered banking entities and [Agency] in:

(i) Better understanding and evaluating the scope, type, and profile of the covered banking entity's trading activities;

(ii) Monitoring the covered banking entity's trading activities;

(iii) Identifying trading activities that warrant further review or examination by the covered banking entity to verify compliance with the proprietary trading restrictions;

(iv) Evaluating whether the trading activities of trading units engaged in market making-related activities subject to § __.4(b) are consistent with the requirements governing permitted market making-related activities;

(v) Evaluating whether the covered trading activities of trading units that are engaged in permitted trading activity subject to §§ __.4, __.5, or __.6(a) (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 trading activities of the covered banking entity, and the individual trading units of the banking entity, to help establish the appropriate frequency and scope of examination by [Agency] of such activities; and

(vii) Assessing and addressing the risks associated with the covered banking entity's covered trading activities.

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.

In addition to the quantitative measurements required in this appendix, a covered 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 § __.20 and appendix C to 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 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, covered 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 covered banking entity, and to monitor and examine for compliance with the proprietary trading restrictions in this part.

On an ongoing basis, covered banking entities should 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 §§ __.4 through __.6 that result in a material exposure to high-risk assets or high-risk trading strategies, should be escalated within the banking entity for review, further analysis, explanation to [Agency], and remediation, where appropriate. Many of the quantitative measurements discussed in this appendix will also be helpful to covered 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 §§ __.2 and __.3. In addition, for purposes of this appendix, the following definitions apply:

Covered trading activity means proprietary trading, as defined in paragraph (b)(1) of § __.3.

Trading unit means each of the following units of organization of a covered 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; [1]

(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); [2]

(iii) All trading operations, collectively; and

(iv) Any other unit of organization specified by [Agency] with respect to a particular banking entity.

Calculation period means the period of time for which a particular quantitative measurement must be calculated.

III. Reporting and Recordkeeping of Quantitative Measurements

A. Scope of Required Reporting

General scope. The quantitative measurements that must be furnished by a covered banking entity depend on the aggregate size of the covered banking entity's trading activities and the activities in which its trading units engage, as follows:

(i) With respect to any covered banking entity that is engaged in any covered trading activity, and has trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $5 billion:

(a) Each trading unit of the covered banking entity that is engaged in market making-related activities subject to § __.4(b) must furnish the following quantitative measurements, calculated in accordance with this appendix:

- Value-at-Risk and Stress VaR;
- VaR Exceedance;
- Risk Factor Sensitivities;
- Risk and Position Limits;
- Comprehensive Profit and Loss;
- Portfolio Profit and Loss;
- Fee Income and Expense;
- Spread Profit and Loss;
- Comprehensive Profit and Loss Attribution;
- Pay-to-Receive Spread Ratio;
- Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss;
- Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss;
- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss;
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio;
- Inventory Risk Turnover;
- Inventory Aging; and
- Customer-facing Trade Ratio; and

(b) Each trading unit of the covered banking entity that is engaged in permitted trading activity subject to §§ __.4(a), __.5, or __.6(a) must furnish the following quantitative measurements, calculated in accordance with this appendix:

- Value-at-Risk and Stress VaR;
- Risk Factor Sensitivities;
- Risk and Position Limits;
- Comprehensive Profit and Loss; and
- Comprehensive Profit and Loss Attribution; and

(ii) With respect to any covered banking entity that is engaged in any covered trading activity, and has trading assets and liabilities the average gross sum of which (on a worldwide consolidated basis) is, as measured as of the last day of each of the four prior calendar quarters, equal to or greater than $1 billion and less than $5 billion, each trading unit of the covered banking entity that is engaged in market making-related activities under § __.4(b) must furnish the following quantitative measurement, calculated in accordance with this appendix:

- Comprehensive Profit and Loss;
- Portfolio Profit and Loss;
- Fee Income and Expense;
- Spread Profit and Loss;
- Value-at-Risk;
- Comprehensive Profit and Loss Attribution;
- Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss; and
- Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio.

B. Frequency of Required Calculation and Reporting

A covered banking entity must calculate any applicable quantitative measurement for each trading day. A covered banking entity must report each applicable quantitative measurement to [Agency] on a monthly basis, or on any other reporting schedule requested by [Agency]. All quantitative measurements for any calendar month must be reported to [Agency] no later than 30 days after the end of that calendar month or on any other time basis requested by [Agency].[3]

C. Recordkeeping

A covered banking entity must, for any quantitative measurement furnished to [Agency] pursuant to this appendix and § __.7, create and maintain records documenting the preparation and content of these reports, as well as such information as is necessary to permit [Agency] to verify the accuracy of such reports, for a period of 5 years.

IV. Quantitative Measurements

A. Risk-Management Measurements

1. Value-at-Risk and Stress Value-at-Risk

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 portfolio 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 portfolio over a specified period of time, based on market conditions during a period of significant financial stress.

General Calculation Guidance: Banking entities should compute and report VaR and Stress VaR by employing generally accepted standards and methods of calculation. VaR should reflect a loss in a trading unit 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 should be computed and reported in a manner that is consistent with such regulatory capital requirements. In cases where a trading unit does not have a standalone VaR or Stress VaR calculation but is part of a larger portfolio for which a VaR or Stress VaR calculation is performed, a VaR or Stress VaR calculation that includes only the trading unit's holdings should be performed consistent with the VaR or Stress VaR model and methodology used by the larger portfolio.

Calculation Period: One trading day.

2. VaR Exceedance

Description: For purposes of this appendix, VaR Exceedance is the difference between VaR and Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit for any given calculation period.

Calculation Period: One trading day.

3. Risk Factor Sensitivities

Description: For purposes of this appendix, Risk Factor Sensitivities are changes in a trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, that are expected to occur in the event of a change in a trading unit's ''risk factors'' (i.e., one or more underlying market variables that are

[1] [The Agency] expects that this will generally be the smallest unit of organization used by the covered banking entity to structure and control its risk-taking activities and employees, and will include each unit generally understood to be a single ''trading desk.''

[2] [The Agency] expects that this will generally include management or reporting divisions, groups, sub-groups, or other intermediate units of organization used by the covered banking entity to manage one or more discrete trading units (e.g., ''North American Credit Trading,'' ''Global Credit Trading,'' etc.).

[3] For example, under section IV.B.1 of this appendix, a banking entity is required to report to [Agency] the Comprehensive Profit and Loss quantitative measurement, as calculated for all trading days in June of any year, no later than July 30 of that year.

significant sources of the trading unit's profitability and risk).

General Calculation Guidance: A covered banking entity should report the Risk Factor Sensitivities that are monitored and managed as part of the trading unit's overall risk management policy. The underlying data and methods used to compute a trading unit's Risk Factor Sensitivities should depend on the specific function of the trading unit and the internal risk management models employed. The number and type of Risk Factor Sensitivities that are monitored and managed by a trading unit, and furnished to [Agency], should depend on the explicit risks assumed by the trading unit. In general, however, reported Risk Factor Sensitivities should be sufficient to account for a preponderance of the price variation in the trading unit's holdings.

Trading units should 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:* sensitivities with respect to the related commodity type (e.g., precious metals, oil and petroleum or agricultural products), 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:* sensitivities with respect to credit spread factors that are sufficiently granular to account for specific credit sectors and market segments, the maturity profile of the positions, and sensitivities to interest rates at all relevant maturities;
- *Credit-related derivative positions:* credit positions sensitivities and volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Equity positions:* sensitivity to equity prices and sensitivities that differentiate between important equity market sectors and segments, such as a small capitalization equities and international equities;
- *Equity derivative positions:* equity position sensitivities and volatility and/or correlation sensitivities (expressed in a manner that demonstrates any significant non-linearities), and the maturity profile of the positions;
- *Foreign exchange derivative positions:* sensitivities with respect to major currency pairs and maturities, sensitivity to interest rates at relevant maturities, and 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:* sensitivities 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), as well as the maturity profile of the positions.

The methods used by a covered banking entity to calculate sensitivities to a common factor shared by multiple trading units, such as an equity price factor, should be applied consistently across its trading units so that the sensitivities can be compared from one trading unit to another.

Calculation Period: One trading day.

4. Risk and Position Limits

Description: For purposes of this appendix, Risk and Position Limits are the constraints that define the amount of risk that a trading unit is permitted to take at a point in time, as defined by the covered banking entity for a specific trading unit.

General Calculation Guidance: Risk and Position Limits should be reported in the format used by the covered banking entity for the purposes of risk management of each trading unit. 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 should be reported.

Calculation Period: One trading day.

B. Source-of-Revenue Measurements

1. Comprehensive Profit and Loss

Description: For purposes of this appendix, Comprehensive Profit and Loss is the net profit or loss of a trading unit's material sources of trading revenue, including, for example, dividend and interest income and expense, over a specific period of time. A trading unit's Comprehensive Profit and Loss for any given calculation period should generally equal the sum of the trading unit's (i) Portfolio Profit and Loss and (ii) Fee Income.

General Calculation Guidance: Comprehensive Profit and Loss generally should be computed using data on the value of a trading unit's underlying holdings, the prices at which those holdings were bought and sold, and the value of any fees, commissions, sales credits, spreads, dividends, interest income and expense, or other sources of income from trading activities, whether realized or unrealized. Comprehensive Profit and Loss should not include: (i) compensation costs or other costs required to operate the unit, such as information technology costs; or (ii) charges and adjustments made for internal reporting and management purposes, such as accounting reserves.

Calculation Period: One trading day.

2. Portfolio Profit and Loss

Description: For purposes of this appendix, Portfolio Profit and Loss is a trading unit's net profit or loss on its underlying holdings over a specific period of time, whether realized or unrealized. Portfolio Profit and Loss should generally include any increase or decrease in the market value of a trading unit's holdings, including, for example, any dividend, interest income, or expense of a trading unit's holdings. Portfolio Profit and Loss should not include direct fees, commissions, sales credits, or other sources of trading revenue that are not directly related to the market value of the trading unit's holdings.

General Calculation Guidance: In general, Portfolio Profit and Loss should be computed using data on a trading unit's underlying holdings and the prices at which those holdings are marked for valuation purposes. Portfolio Profit and Loss should not include: compensation costs or other costs required to operate the trading unit, such as information technology costs; or charges and adjustments made for internal reporting and management purposes, such as accounting reserves.

Calculation Period: One trading day.

3. Fee Income and Expense

Description: For purposes of this appendix, Fee Income and Expense generally includes direct fees, commissions and other distinct income for services provided by or to a trading unit over a specific period of time.

General Calculation Guidance: Fee Income and Expense should be computed using data on direct fees that are earned by the trading unit for services it provides to clients, customers, or counterparties, such as fees earned for structured transactions or sales commissions and credits earned for fulfilling a customer request, whether realized or unrealized, and similar fees paid by the trading unit to other service providers.

Calculation Period: One trading day.

4. Spread Profit and Loss

Description: For purposes of this appendix, Spread Profit and Loss is the portion of Portfolio Profit and Loss that generally includes revenue generated by a trading unit from charging higher prices to buyers than the trading unit pays to sellers of comparable instruments over the same period of time (i.e., charging a ''spread,'' such as the bid-ask spread).

General Calculation Guidance: Spread Profit and Loss generally should be computed using data on the prices at which comparable instruments are either bought or sold by the trading unit, as well as the turnover of these instruments. Spread Profit and Loss should be measured with respect to both the purchase and the sale of any position, and should include both (i) the spreads that are earned by the trading unit to execute transactions (expressed as positive amounts), and (ii) the spreads that are paid by the trading unit to initiate transactions (expressed as negative amounts). Spread Profit and Loss should be computed by calculating the difference between the bid price or the ask price (whichever is paid or received) and the mid-market price. The mid-market price is the average of bid and ask.

For some asset classes in which a trading unit is engaged in market making-related activities, bid-ask or similar spreads are widely disseminated, constantly updated, and readily available, or otherwise reasonably ascertainable. For purposes of calculating the Spread Profit and Loss attributable to a transaction in such asset classes, the trading unit should utilize the prevailing bid-ask or similar spread on the relevant position at the time the purchase or sale is completed.

For other asset classes in which a trading unit is engaged in market making-related activities, bid-ask or similar spreads may not be widely disseminated on a consistent basis or otherwise reasonably ascertainable. A covered banking entity must identify any trading unit engaged in market making-related activities in an asset class for which the covered banking entity believes bid-ask or similar spreads are not widely disseminated on a consistent basis or are not otherwise reasonably ascertainable and must be able to demonstrate that bid-ask or similar spreads for the asset class are not reasonably ascertainable. In such cases, the trading unit should calculate the Spread Profit and Loss for the relevant purchase or sale of a position in a particular asset class by using whichever of the following three alternatives the banking entity believes more accurately reflects prevailing bid-ask or similar spreads for transactions in that asset class:

(i) End of Day Spread Proxy: A proxy based on the bid-ask or similar spread that is used to estimate, or is otherwise implied by, the market price at which the trading entity marks (or in the case of a sale, would have marked) the position for accounting purposes at the close of business on the day it executes the purchase or sale (''End of Day Spread Proxy'');

(ii) Historical Data Spread Proxy: A proxy based on historical bid-ask or similar spread data in similar market conditions (''Historical Data Spread Proxy''); or

(iii) Any other proxy that the banking entity can demonstrate accurately reflects prevailing bid-ask or similar spreads for transactions in the specific asset class.

A covered banking entity selecting any of these alternatives should be able to demonstrate that the alternative it has chosen most accurately reflects prevailing bid-ask or similar spreads for the relevant asset class. If a covered banking entity chooses to calculate Spread Profit and Loss for a particular trading unit using the End of Day Spread Proxy, then the banking entity should separately identify the portion of Spread Profit and Loss that is attributable to positions acquired and disposed of on the same trading day. If a banking entity chooses to calculate Spread Profit and Loss for a particular trading unit using the Historical Data Spread Proxy, the covered banking entity should be able to demonstrate that the Historical Data Proxy is appropriate and continually monitor market conditions and adjust, as necessary, the Historical Data Proxy to reflect any changes.

Calculation Period: One trading day.

5. Comprehensive Profit and Loss Attribution

Description: For purposes of this appendix, Comprehensive Profit and Loss Attribution is an attribution analysis that divides the trading unit's Comprehensive Profit and Loss into the separate sources of risk and revenue that have caused any observed variation in Comprehensive Profit and Loss. This attribution analysis should attribute Comprehensive Profit and Loss to specific market and risk factors that can be accurately and consistently measured over time. Any component of Comprehensive Profit and Loss that cannot be specifically identified in the attribution analysis should be identified as an unexplained portion of the Comprehensive Profit and Loss.

General Calculation Guidance: The specific market and risk factors used by a trading unit in the attribution analysis should be tailored to the trading activities undertaken by the unit. These factors should be measured consistently over time to facilitate historical comparisons. The attribution analysis should also identify any significant factors that have a consistent and regular influence on Comprehensive Profit and Loss, such as Risk Factor Sensitivities that have a significant influence on portfolio income, customer spreads, bid-ask spreads, or commissions that are earned. Factors that influence Comprehensive Profit and Loss across different trading units should be measured and included in the attribution analysis in a comparable fashion.

Calculation Period: One trading day.

C. Revenue-Relative-to-Risk Measurements

1. Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss

Description: For purposes of this appendix, Volatility of Comprehensive Profit and Loss generally is the standard deviation of the trading unit's Comprehensive Profit and Loss estimated over a given calculation period. For purposes of this appendix, Volatility of Portfolio Profit and Loss generally is the standard deviation of the trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, estimated over a given calculation period.

Calculation Period: 30 days, 60 days, and 90 days.

2. Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio

Description: For purposes of this appendix, Comprehensive Profit and Loss to Volatility Ratio is a ratio of Comprehensive Profit and Loss to the Volatility of Comprehensive Profit and Loss for a trading unit over a given calculation period. For purposes of this appendix, Portfolio Profit and Loss to Volatility Ratio is a ratio of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, to the Volatility of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit over a given calculation period.

Calculation Period: 30 days, 60 days, and 90 days.

3. Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss

Description: For purposes of this appendix, Unprofitable Trading Days Based on Comprehensive Profit and Loss is the number or proportion of trading days on which a trading unit's Comprehensive Profit and Loss is less than zero over a given calculation period. For purposes of this appendix, Unprofitable Trading Days Based on Portfolio Profit and Loss, exclusive of Spread Profit and Loss, is the number or proportion of trading days on which a trading unit's Portfolio Profit and Loss, exclusive of Spread Profit and Loss, is less than zero over a given calculation period.

Calculation Period: 30 days, 90 days, and 360 days.

4. Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss

Description: Skewness of Portfolio Profit and Loss and Kurtosis of Portfolio Profit and Loss should be calculated using standard statistical methods with respect to Portfolio Profit and Loss, exclusive of Spread Profit and Loss.

Calculation Period: 30 days, 60 days, and 90 days.

D. Customer-Facing Activity Measurements

1. Inventory Risk Turnover

Description: For purposes of this appendix, Inventory Risk Turnover is a ratio that measures the amount of risk associated with a trading unit's inventory, as measured by Risk Factor Sensitivities, that is turned over by the trading unit over a specific period of time. For each Risk Factor Sensitivity, the numerator of the Inventory Risk Turnover ratio generally should be the absolute value of the Risk Factor Sensitivity associated with each transaction over the calculation period. The denominator of the Inventory Risk Turnover ratio generally should be the value of each Risk Factor Sensitivity for all of the trading unit's holdings at the beginning of the calculation period.

General Calculation Guidance: As a general matter, a trading unit should measure and report the Inventory Risk Turnover ratio for each of the Risk Factor Sensitivities calculated and furnished for that trading unit.

Calculation Period: 30 days, 60 days, and 90 days.

2. Inventory Aging

Description: For purposes of this appendix, Inventory Aging generally describes the trading unit's aggregate assets and liabilities and the amount of time that those assets and liabilities have been held for the following periods: 0–30 days; 30–60 days; 60–90 days; 90–180 days; 80–360 days; and greater than 360 days. Inventory Aging should measure the age profile of the trading unit's assets and liabilities.

General Calculation Guidance: In general, Inventory Aging should be computed using a trading unit's trading activity data and should identify the trading unit's aggregate assets and liabilities. In addition, Inventory Aging should include two schedules, an asset-aging schedule and a liability-aging schedule. The asset-aging schedule should record the value of the trading unit's assets that have been held for: 0–30 days; 30–60 days; 60–90 days; 90–180 days; 180–360 days; and greater than 360 days. The liability-aging schedule should record the value of the trading unit's liabilities that have been held for: 0–30 days; 30–60 days; 60–90 days; 90–180 days; 180–360 days; and more than 360 days.

Calculation Period: 30 days, 60 days, and 90 days.

3. Customer-Facing Trade Ratio

Description: For purposes of this appendix, the Customer-Facing Trade Ratio is a ratio comparing the number of transactions involving a counterparty that is a customer of the trading unit to the number of transactions involving a counterparty that is not a customer of the trading unit. For purposes of calculating the Customer-Facing Trade Ratio, a counterparty is considered to be a customer of the trading unit if the counterparty is neither a counterparty to a transaction executed on a designated contract market registered under the Commodity Exchange Act or national securities exchange registered under the Exchange Act, nor a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof. A broker-dealer, swap dealer, or security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof may be considered a customer of the trading unit for these purposes if the covered banking entity treats that entity as a customer and has documented how and why the entity is treated as such.

Calculation Period: 30 days, 60 days, and 90 days.

E. Payment of Fees, Commissions, and Spreads Measurement

1. Pay-to-Receive Spread Ratio

Description: For purposes of this appendix, the Pay-to-Receive Spread Ratio is a ratio comparing the amount of Spread Profit and Loss and Fee Income that is earned by a trading unit to the amount of Spread Profit and Loss and Fee Income that is paid by the trading unit.

General Calculation Guidance: The Pay-to-Receive Spread Ratio will depend on the amount of Spread Profit and Loss and Fee Income that is earned by the trading unit for facilitating buy and sell orders and the amount of Spread Profit and Loss that is paid by a trading unit as it initiates buy and sell orders. The Pay-to-Receive Spread Ratio generally should be computed using the calculation of Spread Profit and Loss described in this appendix, except that spread paid should include the aggregate Spread Profit and Loss of all transactions producing a negative Spread Profit and Loss, and spread received should include the aggregate Spread Profit and Loss of all transactions producing a positive Spread Profit and Loss.

Calculation Period: One trading day.

Appendix B: Commentary Regarding Identification of Permitted Market Making-Related Activities

I. Purpose

This appendix provides commentary describing the features of permitted market making-related activities and distinctions between permitted market making-related activities and prohibited proprietary trading. The appendix applies to all covered banking entities that are engaged in market making-related activities in reliance on § __.4(b). The following commentary must be incorporated into the covered banking entity's internal compliance program under § __.20, as applicable.

II. Definitions

The terms used in this appendix have the same meanings as those set forth in §§ __.2 and __.3 and Appendix A.

III. Commentary

Section 13 of the BHC Act and § __.3 prohibit any covered banking entity from engaging in proprietary trading, which is generally defined as engaging as principal for the trading account of the covered banking entity in any transaction to purchase or sell a covered financial position. However, section 13(d)(1)(B) of the BHC Act and § __.4(b) permit a covered banking entity to engage in proprietary trading that would otherwise be prohibited if the activity is conducted in connection with the covered banking entity's market making-related activities, to the extent that such activities are designed not to exceed the reasonably expected near term demands of clients, customers, and counterparties. This commentary is intended to assist covered banking entities in identifying permitted market making-related activities and distinguishing such activities from trading activities that, even if conducted in the context of the covered banking entity's market making operations, would constitute prohibited proprietary trading.

A. Overview of Market Making-Related Activities

In the context of trading activities in which a covered banking entity acts as principal, market making-related activities generally involve the covered banking entity either (i) in the case of market making in a security that is executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker, where such exchange or organized trading facility provides the ability to register as a market maker,[1] or (ii) in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy. A market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. In the context of market making in a security that is executed on an organized trading facility or an exchange, a "customer" is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a covered financial position in an over-the-counter market, a "customer" generally would be a market participant that makes use of the market maker's intermediation services, either by requesting such services or entering into a continuing relationship with the market maker with respect to such services.[2]

The primary purpose of market making-related activities is to intermediate between buyers and sellers of similar positions, for which service market makers are compensated, resulting in more liquid markets and less volatile prices. The purpose of such activities is *not* to earn profits as a result of movements in the price of positions and risks acquired or retained; rather, a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains, or in the price of one or more material elements of those positions. To the extent that it can, a market maker will eliminate some or all of the price risks to which it is exposed. However, in some cases, the risks posed by one or more positions may be sufficiently complex or specific that the risk cannot be fully hedged. In other cases, although it may be possible to hedge the risks posed by one or more positions, the cost of doing so may be so high as to effectively make market making in those positions uneconomic if complete hedges were acquired. In such cases, in order to provide effective intermediation services, market makers are required to retain at least some risk for at least some period of time with respect to price movements of retained principal positions and risks. The size and type of risk that must be retained in such cases may vary widely depending on the type and size of the positions, the liquidity of the specific market, and the market's structure. As the liquidity of positions increases, the frequency with which a market maker must take or retain risk in order to make a market in those positions generally decreases.

The profitability of market making-related activities relies on forms of revenue that reflect the value of the intermediation services that are provided to the market maker's customers. These revenues typically take the form of explicit fees and commissions or, in markets where no such fees or commission are charged, a bid-ask or similar spread that is generated by charging higher prices to buyers than is paid to sellers of comparable instruments. 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. These types of "customer revenues" provide the primary source of a market maker's profitability. Typically, a market maker holds at least some risk with respect to price movements of retained principal positions and risks. As a result, the market maker also incurs losses or generates profits as price movements actually occur, but such losses or profits are incidental to customer revenues and significantly limited by the banking entity's hedging activities. Customer revenues, not revenues from price movements, predominate. The appropriate proportion of "customer revenues" to profits

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

[2] In certain cases, depending on the conventions of the relevant market (e.g., the over-the-counter derivatives market), such a "customer" may consider itself or refer to itself more generally as a "counterparty."

and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved, the typical fees, commissions, and spreads payable for transactions in those positions, and the risks of those positions. As a general matter, the proportion of ''customer revenues'' generated when making a market in certain positions increases as the fees, commissions, or spreads payable for those positions increase, the volatility of those positions' prices decrease, and the prices for those positions are less transparent.

Because a market maker's business model entails managing and limiting the extent to which it is exposed to movements in the prices of retained principal positions and risks while generating customer revenues that are earned, regardless of movements in the price of retained principal positions and risks, a market maker typically generates significant revenue relative to the risks that it retains. Accordingly, a market maker will typically demonstrate consistent profitability and low earnings volatility under normal market conditions. The appropriate extent to which a market maker will demonstrate consistent profitability and low earnings volatility varies depending on the type of positions involved, the liquidity of the positions, the price transparency of the positions, and the volatility of the positions' prices. As a general matter, consistent profitability will decrease and earnings volatility will increase as the liquidity of the positions decrease, the volatility of the positions' prices increase, and the prices for the positions are less transparent.

As the primary purpose of market making-related activities is to provide intermediation services to its customers, market makers focus their activities on servicing customer demands and typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions. In particular, 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 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. In the case of a derivatives market maker that engages in dynamic hedging, the number of non-customer transactions significantly outweighs the number of customer transactions, as the derivatives market maker must constantly enter into transactions to appropriately manage its retained principal positions and risks as market prices for the positions and risks move and additional transactions with customers change the risk profile of the market maker's retained principal positions.

Because a market maker generates revenues primarily by transacting with, and providing intermediation services to, customers, a market maker typically engages in transactions that earn fees, commissions, or spreads as payment for its services. Transactions in which the market maker pays fees, commissions, or spreads—i.e., where it pays another market maker for providing it with liquidity services—are much less frequent, although in some cases obtaining liquidity services from another market maker and paying fees, commissions, or spreads may be necessary to prudently manage its risk with respect to price movements of retained principal positions and risks. The appropriate proportion of a market maker's transactions that earn, rather than pay, fees, commissions or spreads varies depending on the type of positions involved, the liquidity of the positions, and the extent to which market trends increase the volatility of its risk with respect to price movements of retained principal positions and risks. As a general matter, the proportion of a market maker's transactions that earn rather than pay fees, commissions or spreads decreases as the liquidity of the positions decreases, and the extent to which the price volatility of retained principal positions and risks increases.

Finally, because the primary purpose of market making-related activities is to provide intermediation services to its customers, a market maker does not provide compensation incentives to its personnel that primarily reward proprietary risk-taking. Although a market maker may take into account revenues resulting from movements in the price of retained principal positions and risks to the extent that such revenues reflect the effectiveness with which personnel have effectively managed the risk of movements in the price of retained principal positions and risks, a market maker that provides compensation incentives relating to revenues generally does so through incentives that primarily reward customer revenues and effective customer service.

B. Overview of Prohibited Proprietary Trading Activities

Like permitted market making-related activities, prohibited proprietary trading involves the taking of principal positions by a covered banking entity. Unlike permitted market making-related activities, the purpose of prohibited proprietary trading is to generate profits as a result of, or otherwise benefit from, changes in the price of positions and risks taken. Whereas a market maker attempts to eliminate some or all of the price risks inherent in its retained principal positions and risks by hedging or otherwise managing those risks in a reasonable period of time after positions are acquired or risks arise, 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. A proprietary trader does not have ''customers'' because a proprietary trader simply seeks to obtain the best price and execution in purchasing or selling its proprietary positions. A proprietary trader generates few if any fees, commissions, or spreads from its trading activities because it is not providing an intermediation service to any customer or other third party. Instead, a proprietary trader is likely to pay fees, commissions, or spreads to other market makers when obtaining their liquidity services is beneficial to execution of its trading strategy. Because a proprietary trader seeks to generate profits from changes in the price of positions taken, a proprietary trader typically provides compensation incentives to its personnel that primarily reward successful proprietary risk taking.

C. Distinguishing Permitted Market Making-Related Activities From Prohibited Proprietary Trading

Because both permitted market making-related activities and prohibited proprietary trading involve the taking of principal positions, certain challenges arise in distinguishing permitted market making-related activities and prohibited proprietary trading, particularly in cases where both of these activities occur in the context of a market making operation. Particularly during periods of significant market disruption, it may be difficult to distinguish between retained principal positions and risks that appropriately support market making-related activities and positions taken, or positions or risks not hedged, for proprietary purposes.

In connection with these challenges, [Agency] will apply the following factors in distinguishing permitted market making-related activities from trading activities that, even if conducted in the context of the covered banking entity's market making operations, would constitute prohibited proprietary trading. 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. In addition to meeting the terms of this appendix, any transaction or activity for which a covered banking entity intends to rely on the market making exemption in § __.4(b) must also satisfy all the requirements specified in § __.4(b), as well as the other applicable requirements and conditions of this part.

1. Risk Management

Absent explanatory facts and circumstances, particular trading activity in which a trading unit retains risk in excess of the size and type required to provide intermediation services to customers will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

[The Agency] will base a determination of whether a trading unit retains risk in excess of the size and type required for these purposes on all available facts and circumstances, including a comparison of retained principal risk to: The amount of risk that is generally required to execute a particular market making function; hedging options that are available in the market and permissible under the covered banking entity's hedging policy at the time the particular trading activity occurred; the trading unit's prior levels of retained risk and its hedging practices with respect to similar positions; and the levels of retained risk and the hedging practices of other trading units with respect to similar positions.

To help assess the extent to which a trading unit's risks are potentially being retained in excess of amounts required to provide intermediation services to customers, [Agency] will utilize the VaR and Stress VaR, VaR Exceedance, and Risk Factor Sensitivities quantitative measurements, as applicable, among other risk measurements described in appendix A to this part and any other relevant factor. This assessment will focus primarily on the risk measurements relative to: The risk required for conducting market making-related activities, and any significant changes in the risk over time and across similarly situated trading units and banking entities.

Explanatory facts and circumstances might include, among other things, market-wide changes in risk, changes in the specific composition of market making-related activities, temporary market disruptions, or other market changes that result in previously used hedging or other risk management techniques no longer being possible or cost-effective.

2. Source of Revenues

Absent explanatory facts and circumstances, particular trading activity in which a trading unit primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues, will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

[The Agency] will base a determination of whether a trading activity primarily generates revenues from price movements of retained principal positions and risks, rather than customer revenues, on all available facts and circumstances, including: an evaluation of the revenues derived from price movements of retained principal positions and risks relative to its customer revenues; and a comparison of these revenue figures to the trading unit's prior revenues with respect to similar positions, and the revenues of other covered banking entities' trading units with respect to similar positions.

To help assess the extent to which a trading unit's revenues are potentially derived from movements in the price of retained principal positions and risks, [Agency] will utilize the Comprehensive Profit and Loss, Portfolio Profit and Loss, Fee Income and Expense, and Spread Profit and Loss quantitative measurements, as applicable, both individually and in combination with one another (e.g., by comparing the ratio of Spread Profit and Loss to Portfolio Profit and Loss), and any other relevant factor.

Explanatory facts and circumstances might include, among other things: general upward or downward price trends in the broader markets in which the trading unit is making a market, provided revenues from price movements in retained principal positions and risks are consistent; sudden market disruptions or other changes causing significant, unanticipated alterations in the price of retained principal positions and risks; sudden and/or temporary changes in the market (e.g., narrowing of bid/ask spreads) that cause significant, unanticipated reductions in customer revenues; or efforts to expand or contract a trading unit's market share.

3. Revenues Relative to Risk

Absent explanatory facts and circumstances, particular trading activity will be considered to be prohibited proprietary trading, and not permitted market making-related activity, if the trading unit: generates only very small or very large amounts of revenue per unit of risk taken; does not demonstrate consistent profitability; or demonstrates high earnings volatility.

[The Agency] will base such a determination on all available facts and circumstances, including: an evaluation of the amount of revenue per unit of risk taken, earnings volatility, profitability, exposure to risks, and overall level of risk taking for the particular trading activities; and a comparison of these figures to the trading unit's prior results with respect to similar positions, and the results of other covered banking entities' trading units with respect to similar positions.

To help assess the riskiness of revenues and the amount of revenue per unit of risk taken, [Agency] will utilize the Volatility of Comprehensive Profit and Loss and Volatility of Portfolio Profit and Loss, Comprehensive Profit and Loss to Volatility Ratio and Portfolio Profit and Loss to Volatility Ratio, and Comprehensive Profit and Loss Attribution quantitative measurements, as applicable, and any other relevant factor.

To help assess the extent to which a trading unit demonstrates consistent profitability, [Agency] will utilize the Unprofitable Trading Days Based on Comprehensive Profit and Loss and Unprofitable Trading Days Based on Portfolio Profit and Loss quantitative measurements, as applicable, and any other relevant factor.

To help assess the extent to which a trading unit is exposed to outsized risk, [Agency] will utilize the Skewness of Portfolio Profit and Loss and Kurtosis of Profit and Loss quantitative measurements, as applicable, and any other relevant factor.

Explanatory facts and circumstances might include, among other things: market disruptions or other changes causing significant, unanticipated increases in a trading unit's risk with respect to movements in the price of retained principal positions and risks; market disruptions or other changes causing significant, unanticipated increases in the volatility of positions in which the trading unit makes a market; sudden and/or temporary changes in the market (e.g., narrowing of bid-ask spreads) that cause significant, unanticipated reductions in customer revenues and decrease overall profitability; or efforts to expand or contract a trading unit's market share.

4. Customer-Facing Activity

Absent explanatory facts and circumstances, particular trading activity will be considered to be prohibited proprietary trading, and not permitted market making-related activity, if the trading unit: does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services; or retains principal positions and risks in excess of reasonably expected near term customer demands.

[The Agency] will base such a determination on all available facts and circumstances, including, among other things: An evaluation of the extent to which a trading unit's transactions are with customers versus non-customers and the frequency with which the trading unit's retained principal positions and risks turn over; and a comparison of these figures to the trading unit's prior results with respect to similar positions and market situations, and the results of other covered banking entities' trading units with respect to similar positions.

To help assess the extent to which a trading unit's transactions are with customers versus non-customers, [Agency] will utilize the Customer-Facing Trade Ratio quantitative measurement, as applicable, and any other relevant factor. To help assess the frequency with which the trading unit's retained principal positions and risks turn over, [Agency] will utilize the Inventory Risk Turnover and Inventory Aging quantitative measurements, as applicable, and any other relevant factor.

With respect to a particular trading activity in which a trading unit either does not transact through a trading system that interacts with orders of others or primarily with customers of the banking entity's market making desk to provide liquidity services, explanatory facts and circumstances might include, among other things: sudden market disruptions or other changes causing significant increases in a trading unit's hedging transactions with non-customers; or substantial intermediary trading required to satisfy customer demands and hedging management. With respect to particular trading activity in which a trading unit retains principal positions and risks in excess of reasonably expected near term customer demands, explanatory facts and circumstances might include, among other things: sudden market disruptions or other changes causing a significant reduction in actual customer demand relative to expected customer demand; documented and reasonable expectations for temporary increases in customer demand in the near term; and sudden market disruptions or other changes causing a significant reduction in the value of retained principal positions and risks, such that it would be imprudent for the trading unit to dispose of the positions in the near term.

5. Payment of Fees, Commissions, and Spreads

Absent explanatory facts and circumstances, particular trading activity in which a trading unit routinely pays rather than earns fees, commissions, or spreads will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

[The Agency] will base such a determination on all available facts and circumstances, including, among other things: An evaluation of the frequency with which the trading unit pay fees, commissions, or spreads and the relative amount of fees, commissions, or spreads that is paid versus earned; and a comparison of these figures to the trading unit's prior results with respect to similar positions, and the results of other covered banking entities' trading units with respect to similar positions.

To help assess the extent to which a trading unit is paying versus earning fees, commissions, and spreads, [Agency] will utilize the Pay-to-Receive Spread Ratio quantitative measurement, as applicable, and any other relevant factor.

Explanatory facts and circumstances might include, among other things, sudden market disruptions or other changes causing significant, increases in a trading unit's hedging transactions with non-customers for which it must pay fees, commissions, or spreads, sudden, unanticipated customer demand for liquidity that requires the trading unit itself to pay fees, commissions, or spreads to other market makers for liquidity services to obtain the inventory needed to meet that customer demand, or significant, unanticipated reductions in fees, commissions, or spreads earned by the trading unit. Explanatory facts and circumstances might also include a trading unit's efforts to expand or contract its market share.

6. Compensation Incentives

Absent explanatory facts and circumstances, the trading activity of a trading unit that provides compensation incentives to employees that primarily reward proprietary risk taking will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

[The Agency] will base such a determination on all available facts and circumstances, including, among other things, an evaluation of: the extent to which compensation incentives are provided to trading unit personnel that reward revenues from movements in the price of retained principal positions and risks; the extent to which compensation incentives are provided to trading unit personnel that reward customer revenues; and the compensation incentives provided by other covered banking entities to similarly-situated personnel.

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Appendix C: Minimum Standards for Programmatic Compliance

I. Overview

A. Purpose

This appendix sets forth the minimum standards with respect to the establishment, maintenance, and enforcement by banking entities of internal compliance programs for ensuring and monitoring compliance with the prohibitions and restrictions on proprietary trading and covered fund activities or investments set forth in section 13 of the BHC Act and this part.

This appendix requires that banking entities establish, maintain, and enforce an effective compliance program, consisting of written policies and procedures, internal controls, a management framework, independent testing, training, and recordkeeping, that:

- Is reasonably designed to clearly document, describe, and monitor the covered trading and covered fund activities or investments and the risks of the covered banking entity related to such activities or investments, identify potential areas of noncompliance, and prevent activities or investments prohibited by, or that do not comply with, section 13 of the BHC Act and this part;
- Specifically addresses the varying nature of activities or investments conducted by different units of the covered banking entity's organization, including the size, scope, complexity, and risks of the individual activities or investments;
- Subjects the effectiveness of the compliance program to independent review and testing;
- Makes senior management and intermediate managers accountable for the effective implementation of the compliance program, and ensures that the board of directors and CEO review the effectiveness of the compliance program; and
- Facilitates supervision and examination of the covered banking entity's covered trading and covered fund activities or investments by the Agencies.

B. Definitions

The terms used in this Appendix have the same meanings as set forth in §§ __.2, __.3, and __.10. In addition, for purposes of this appendix, the following definitions apply:

Asset management unit means any unit of organization of a covered banking entity that makes investments in, or acts as sponsor to, covered funds, or has relationships with covered funds, that the covered banking entity (or an affiliate of subsidiary thereof) has sponsored, organized and offered, or in which a covered fund sponsored or advised by the covered banking entity invests.

Compliance program means the internal compliance program established by a covered banking entity in accordance with § __.20 and this appendix.

Covered fund activity or investment means sponsoring any covered fund or making investments in, or otherwise having relationships with, any covered fund for which the covered banking entity (or an affiliate or subsidiary thereof) acts as sponsor or organizes and offers.

Covered fund restrictions means the restrictions on covered fund activities or investments set forth in subpart C.

Covered trading activity means proprietary trading, as defined in § __.3(b)(1).

Trading unit means each of the following units of organization of a covered 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; [1]

(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); [2]

(iii) All trading operations, collectively; and

(iv) Any other unit of organization specified by [Agency] with respect to a particular banking entity.

C. Required Elements

Section __.20 requires that covered banking entities establish, maintain, and enforce a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities or investments that effectively implements, at a minimum, the six elements required under paragraph (b) of § __.20.

D. Compliance Program Structure

Each covered banking entity subject to § __.20(c) must be governed by a compliance program meeting the requirements of this appendix. A covered banking entity may establish a compliance program on an enterprise-wide basis to satisfy the requirements of § __.20 and this appendix with respect to the covered banking entity and all of its affiliates and subsidiaries collectively, provided that: the program is clearly applicable, both by its terms and in operation, to all such affiliates and subsidiaries; the program specifically addresses the requirements set forth in this appendix; the program takes into account and addresses the consolidated organization's business structure, size, and complexity, as well as the particular activities, risks, and applicable legal requirements of each subsidiary and affiliate; and the program is determined through periodic independent testing to be effective for the covered banking entity and all of its subsidiaries and affiliates. An enterprise-wide program established pursuant to this Appendix will be subject to supervisory review and examination by any Agency vested with rulewriting authority under section 13 of the BHC Act with respect to the compliance program and the activities or investments of any banking entity for which the Agency has such authority. Further, such Agency will have access to all records related to the enterprise-wide compliance program pertaining to any banking entity that is supervised by the Agency vested with such rulewriting authority.

E. Applicability

This appendix applies only to covered banking entities described in § __.20(c)(2). In addition, [Agency] may require any covered banking entity to comply with all or portions of this appendix if [Agency] deems it appropriate for purposes the covered banking entity's compliance with this part.

[1] [The Agency] expects that this will generally be the smallest unit of organization used by the covered banking entity to structure and control its risk-taking activities and employees, and will include each unit generally understood to be a single ''trading desk.''

[2] [The Agency] expects that this will generally include management or reporting divisions, groups, sub-groups, or other intermediate units of organization used by the covered banking entity to manage one or more discrete trading units (e.g., ''North American Credit Trading,'' ''Global Credit Trading,'' etc.).

Nothing in this appendix limits the authority of [Agency] under any other provision of law or regulation to take supervisory, examination, or enforcement action, including action to address unsafe or unsound practices or conditions, deficient capital levels, or violations of law.

II. Internal Policies and Procedures

A. Covered Trading Activities

A covered banking entity must establish, maintain, and enforce written policies and procedures reasonably designed to document, describe, and monitor the covered banking entity's covered trading activities and the risks taken in these activities, as follows:[3]

Identification of trading account: The covered banking entity's policies and procedures must specify how the banking entity evaluates the covered financial positions it acquires or takes and determines which of its accounts are trading accounts for purposes of subpart B of this part.

Identification of trading units and organization structure: The covered banking entity's written policies and procedures must identify and document each trading unit within the organization and map each trading unit to the division, business line, or other organizational structure that the covered banking entity uses to manage or oversee the trading unit's activities.

Description of missions and strategies: The covered banking entity's written policies and procedures for each trading unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., business model for the generation of revenues) of the trading unit, and include a description of:

- How revenues are intended to be generated by the trading unit;
- The activities that the trading unit is authorized to conduct, including (i) authorized instruments and products and (ii) authorized hedging strategies and instruments;
- The expected holding period of, and the market risk associated with, covered financial positions in its trading account;
- The types of clients, customers, and counterparties with whom trading is conducted by the trading unit;
- How the trading unit, if engaged in market making-related activity under § __.4(b) of this part, identifies its customers for purposes of computing the Customer-Facing Trade Ratio, if applicable, including documentation explaining when, how, and why a broker-dealer, swap dealer, security-based swap dealer, any other entity engaged in market making-related activities, or any affiliate thereof is considered to be a customer of the trading unit for those purposes; and
- The compensation structure of the employees associated with the trading unit.

Trader mandates: The covered banking entity must establish, maintain, document, and enforce trader mandates for each trading unit. At a minimum, trader mandates must:

- Clearly inform each trader of the prohibitions and requirements set forth in section 13 of the BHC Act and this part and his or her responsibilities for compliance with such requirements;
- Set forth appropriate parameters for each trader engaged in covered trading activities, including:
  - The conditions for relying on the applicable exemptions in §§ __.4 through __.6;
  - The financial contracts, products, and underlying assets that the trader is permitted to trade pursuant to the covered banking entity's internal controls;
  - The risk limits of the trader's trading unit, and the types and levels of risk that may be taken; and
  - The applicable trading unit's hedging policy.

Description of risks and risk management processes: The written policies and procedures for each trading unit must clearly articulate and document a comprehensive description of the risks associated with the trading unit. Such descriptions must include, at a minimum, the following elements:

- A description of the supervisory and risk management structure governing the trading units, including a description of processes for initial and senior-level review of new products and new strategies;
- A description of the types of risks that may be taken to implement the mission and strategy of the trading unit, including an enumeration of material risks resulting from the activities in which the trading unit is engaged (including but not limited to all significant price risks, such as basis, volatility and correlation risks, as well as any significant counterparty credit risk associated with the trading activity);
- An articulation of the amount of risk allocated by the covered banking entity to such trading unit to implement the documented mission and strategy of the trading unit;
- An explanation of how the risks allocated to such trading unit will be measured; and
- An explanation of why the allocated risk levels are appropriate to the mission and strategy of the trading unit.

Hedging policies and procedures. The covered banking entity must establish, maintain, and enforce policies and procedures for all of its trading units regarding the use of risk-mitigating hedging instruments and strategies. At a minimum, these hedging policies and procedures must articulate the following:

- The manner in which the covered banking entity will determine that the risks generated by each trading unit have been properly and effectively hedged;
- The instruments, techniques and strategies the covered entity will use to hedge the risk of the positions or portfolios;
- The level of the organization at which hedging activity and management will occur;
- The manner in which hedging strategies will be monitored;
- The risk management processes used to control unhedged or residual risks; and
- The independent testing of hedging techniques and strategies.

Explanation of compliance. The covered banking entity's written policies and procedures must clearly articulate and document a comprehensive explanation of how the mission and strategy of each trading unit, and its related risk levels, comply with this part. Such explanation must:

- Identify which portions of the risk-taking activity of the trading unit would or would not constitute covered trading activity;
- Identify activities of the trading unit that will be conducted in reliance on exemptions contained in §§ __.4 through __.6, including an explanation of:

o How and where the activity occurs; and

o Which exemption is being relied on and how the activity meets the specific requirements for reliance on the applicable exemption.

- Describe how the covered banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by each trading unit, which must take into account potential or actual exposure to:
  - Assets whose values cannot be externally priced or, where valuation is reliant on pricing models, whose model inputs cannot be externally validated;
  - Assets whose changes in values cannot be adequately mitigated by effective hedging;
  - New products with rapid growth, including those that do not have a market history;
  - Assets or strategies that include significant embedded leverage;
  - Assets or strategies that have demonstrated significant historical volatility;
  - Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and
  - Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;
- Explain how each trading unit will comply with the reporting and recordkeeping requirements of § __.7 and Appendix A ;
- Describe how the covered banking entity monitors for and prohibits potential or actual material conflicts of interest between the covered banking entity and its clients, customers, or counterparties present in each trading unit; and
- Describe how the covered banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness of the covered banking entity.

Remediation of violations. The covered banking entity's written policies and procedures must require the covered banking entity 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. Further, such policies and procedures must include specific procedures that are reasonably designed to implement and monitor any required remediation and that assess the extent to which any violation indicates that modification to the covered banking entity's compliance program is warranted.

[3] These policies and procedures must be updated with a frequency sufficient for the covered banking entity to adequately control the applicable trading unit for purposes of this part.

With respect to any trading unit that is either used by the covered banking entity to structure and control the aggregate risk-taking activities and employees of one or more other trading units, or comprised of the entire trading operation of the covered banking entity, the description of missions and strategies, description of risks and risk management processes, and explanation of compliance for such trading units may incorporate by reference the policies and procedures of the underlying trading units that the trading unit oversees and manages in the aggregate.

B. Covered Fund Activities or Investments

A covered banking entity must establish, maintain, and enforce written policies and procedures that are reasonably designed to document, describe, and monitor the covered banking entity's covered fund activities or investments and the risks taken in these activities or investments, as follows.

Identification of covered funds: The covered banking entity's policies and procedures must specify how the covered banking entity identifies covered funds that the covered banking entity sponsors, organizes and offers, or in which covered banking entity invests.

Identification of asset management units and organization structure: The covered banking entity's written policies and procedures must identify and document each asset management unit within the organization and map each asset management unit to the division, business line, or other organizational structure that the covered banking entity uses to manage or oversee the asset management unit's activities or investments.

Description of sponsorship activities related to covered funds: The covered banking entity's written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., business model for the generation of revenues) of the asset management unit related to its sponsorship or organizing and offering of covered funds, including a description of how such activities comply with this part and, in particular:

- The activities that the asset management unit is authorized to conduct, including the nature of any trust, fiduciary, investment advisory, or commodity trading advisory services offered to customers of the covered banking entity;
- The types of customers to whom the asset management unit provides such services and to whom ownership interests in covered funds are sold;
- The extent of any co-investment activities of the covered banking entity (including its directors or employees) in covered funds offered to such customers; and
- How the asset management unit complies with the requirements of subpart C of this part.

Description of investment activities of covered funds: The covered banking entity's written policies and procedures for each asset management unit must clearly articulate and document a comprehensive description of the mission (i.e., the nature of the business conducted) and strategy (i.e., business model for the generation of revenues) of the asset management unit related to its investments in covered funds, including a description of how such activities comply with this part and, in particular:

- The asset management unit's practices with respect to seed capital investments in covered funds, including how the asset management unit reduces its investments in covered funds to amounts that are permitted *de minimis* investments within the required period of time;
- The asset management unit's practices with respect to co-investments in covered funds, including certain parallel investments as identified in § __.12;
- How the asset management unit complies with the requirements of § __.12 with respect to individual and aggregate investments in covered funds;
- With respect to other permitted covered fund activities or investment, how the asset management unit complies with the requirements of §§ __.13 and __.14;
- How the asset management unit complies with the limitations on relationships with a covered fund under § __.16;
- How the covered banking entity monitors for and prohibits potential or actual material conflicts of interest between the covered banking entity and its clients, customers, or counterparties related to the asset management unit;
- How the covered banking entity monitors for and prohibits potential or actual transactions or activities that may threaten the safety and soundness of the covered banking entity related to the asset management unit; and
- How the covered banking entity monitors for and prohibits potential or actual material exposure to high-risk assets or high-risk trading strategies presented by each asset management unit.

Remediation of violations. The covered banking entity's written policies and procedures must require the covered banking entity 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. Further, such policies and procedures must include specific procedures that are designed to implement, monitor, and enforce any required remediation and that assess the extent to which any violation indicates that modification to the covered banking entity's compliance program is warranted.

III. Internal Controls

A. Covered Trading Activities

A covered banking entity must establish, maintain, and enforce written internal controls that are reasonably designed to ensure that the trading activity of each trading unit is appropriate and consistent with the description of mission, strategy, and risk mitigation for each trading unit contained in its written policies and procedures. These written internal controls must also be reasonably designed and established to effectively monitor and identify for further analysis any covered 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. Further, the internal controls must describe procedures for remedying violations of section 13 of the BHC Act and this part. The written internal controls must include, at a minimum, the following.

Authorized risks, instruments, and products. The covered banking entity must implement and enforce internal controls for each trading unit that are reasonably designed to ensure that trading activity is conducted in conformance with the trading unit's authorized risks, instruments, and products, as documented in the covered banking entity's written policies and procedures and trader mandates. At a minimum, these internal controls must monitor and govern:

- The types and levels of risks that may be taken by each trading unit, consistent with the covered banking entity's written policies and procedures;
- The type of hedging instruments used, hedging strategies employed, and the amount of risk effectively hedged, consistent with the covered banking entity's written policies and procedures; and
- The financial contracts, products and underlying assets that the trading unit may trade, consistent with covered banking entity's written policies and procedures.

Risk limits. The covered banking entity must establish and enforce risk limits appropriate for each trading unit, which shall include limits based on probabilistic and non-probabilistic measures of potential loss (e.g., Value-at-Risk and notional exposure, respectively), measured under normal and stress market conditions.

Analysis and quantitative measurements. The covered banking entity must perform robust analysis and quantitative measurement of its covered trading activities that is reasonably designed to ensure that the trading activity of each trading unit is consistent with its mission, strategy and risk management process, as documented in the covered banking entity's written policies and procedures; monitor and assist in the identification of potential and actual prohibited proprietary trading activity; and prevent the occurrence of prohibited proprietary trading. In addition to the quantitative measurements reported by the covered banking entity to [Agency] pursuant to appendix A to this part, each covered banking must develop and implement, to the extent necessary to facilitate compliance with this part, additional quantitative measurements specifically tailored to the particular risks, practices, and strategies of its trading units. The covered banking entity's analysis and quantitative measurement must incorporate the quantitative measurements reported by the covered banking entity to [Agency] pursuant to Appendix A and include, at minimum, the following:

- Internal controls and written policies and procedures reasonably designed to ensure the accuracy and integrity of quantitative measurements;

- Ongoing, timely monitoring and review of calculated quantitative measurements;
- Heightened review of a quantitative measurement when such quantitative measurement raises any question regarding compliance with section 13 of the BHC Act and this part, which shall include in-depth analysis, appropriate escalation procedures, and documentation related to the review, including the establishment of numerical thresholds for each trading unit for purposes of triggering such heightened review; and
- Immediate review and compliance investigation of the trading unit's activities, escalation to senior management with oversight responsibilities for the applicable trading unit, timely notification to [Agency], 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 the quantitative measurement, considered together with the facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of section 13 of the BHC Act and this part.

Surveillance of compliance program effectiveness. The covered banking entity must regularly monitor the effectiveness of its compliance program and take prompt action to address and remedy any deficiencies identified. Any actions taken to remedy deficiencies and violations shall be documented and maintained as a record of the banking entity.

B. Covered Fund Activities

A covered banking entity must establish, maintain, and enforce internal controls that are reasonably designed to ensure that the covered fund activities or investments of its asset management units are appropriate and consistent with the description of the asset management unit's mission, strategy, and risk management process contained in the covered banking entity's written policies and procedures. The internal controls must, at a minimum, be designed to ensure that the covered banking entity complies with the requirements of § __.11 for any covered fund in which it invests, acts as sponsor, or organizes and offers, as well as the following:

Monitoring investments in a covered fund. The covered banking entity must implement and enforce internal controls in a way that monitors and limits the covered banking entity's individual and aggregate investments in covered funds. At a minimum, the covered banking entity shall establish, maintain, and enforce internal controls reasonably designed to ensure that such investments are in compliance with section 13 of the BHC Act and this part at all times, including:

- Monitoring the amount and timing of seed capital investments for compliance with the limitations (including but not limited to the redemption, sale or disposition requirements of § __.12);
- Calculating the individual and aggregate levels of ownership interests in covered funds required by § __.12;
- Describing procedures for remedying violations of section 13 of the BHC Act and this part;
- Attributing the appropriate instruments to the individual and aggregate ownership interest calculations above; and
- Making the appropriate required disclosures, in writing, to prospective and actual investors in any covered fund organized and offered or sponsored by the covered banking entity, as provided under § __.11(h).

Monitoring relationships with a covered fund. The covered banking entity must implement and enforce internal controls in a way that monitors and limits the covered banking entity's sponsorship of, and relationships with, covered funds. At a minimum, the covered banking entity shall establish, maintain, and enforce internal controls reasonably designed to ensure that such activities and relationships are in compliance with section 13 of the BHC Act and this part at all times, including monitoring for and preventing any relationship or transaction between the covered banking entity and a covered fund that is prohibited under § __.16.

Surveillance of compliance program effectiveness. The covered banking entity must regularly monitor the effectiveness of its compliance program and take prompt action to address and remedy any deficiencies identified. Any actions taken to remedy deficiencies and violations shall be documented and maintained as a record of the covered banking entity.

IV. Responsibility and Accountability for the Compliance Program

A covered banking entity must establish, maintain, and enforce a 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 covered banking entity must have an appropriate management framework reasonably designed to ensure that: appropriate personnel are made 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 board of directors, or similar corporate body, and CEO reviews and approves the compliance program. This management framework must include, at a minimum:

Corporate governance. The covered banking entity must ensure that its compliance program is reduced to writing, approved by the board of directors or similar corporate body, and noted in the minutes.

Trader mandates. The covered banking entity must establish, maintain, and enforce the trader mandates required by this appendix to clearly inform each trader within a trading unit of his or her responsibilities for compliance with section 13 of the BHC Act and this part.

Management procedures. The covered banking entity must establish, maintain, and enforce management procedures that are reasonably designed to achieve compliance with section 13 of the BHC Act and this part, which, at a minimum, provide for:

- The designation of at least one person with authority to carry out the management responsibilities of the covered banking entity for each trading unit;
- Written procedures addressing the management of the activities of the covered banking entity that are reasonably designed to achieve compliance with section 13 of the BHC Act and this part, including:
  - Procedures for the review by a manager of activities of the trading unit and the quantitative measurements pursuant to appendix A and any other quantitative measurements developed and tailored to the particular risks, practices, and strategies of the covered banking entity's trading units;
  - 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 covered banking entity's trading units; and
  - Procedures for determining compensation arrangements for traders engaged in underwriting or market making-related activities under § __.4 or risk-mitigating hedging activities under § __.5 so that such compensation arrangements are designed not to reward proprietary risk taking.

Business line managers. Managers with responsibility for one or more trading units or asset management units of the covered banking entity engaged in covered trading activities or covered fund activities or investments are accountable for the effective implementation and enforcement of the compliance program with respect to the applicable trading unit or asset management unit.

Senior management. Senior management is responsible for communicating and reinforcing the culture of compliance with section 13 of the BHC Act and this part, as established by the board of directors or similar corporate body, and 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.[4] Senior management and control personnel charged with overseeing compliance with section 13 of the BHC Act and this part should 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 covered banking entity's covered trading activities and covered fund activities or investments, which shall be at least once every twelve months.

Board of directors, or similar corporate body, and CEO. The board of directors, or similar corporate body, and CEO are responsible for setting an appropriate culture of compliance with this part and establishing clear policies regarding the management of covered trading activities and covered fund activities or investments in compliance with section 13 of the BHC Act and this part. The board of directors or similar corporate body must ensure that senior management is fully capable, qualified, and properly motivated to manage compliance with this part in light of

[4] Such corrective action may include, among other things divesture of the position, cessation of the activity, or disciplinary measures.

the organization's business activities. The board of directors or similar corporate body must also ensure that senior management has established appropriate incentives 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 covered banking entity.

V. Independent Testing

A covered banking entity must ensure that independent testing is conducted by a qualified independent party, such as the covered banking entity's internal audit department, outside auditors, consultants, or other qualified independent parties, regarding the effectiveness of the covered banking entity's compliance program established pursuant to this appendix and §__.20 and the covered banking entity's compliance with this part. A banking entity must take appropriate action to remedy any concerns identified by the independent testing (e.g., remedying deficiencies in its written policies and procedures and internal controls, etc.).

The required independent testing must occur with a frequency appropriate to the size, scope, and risk profile of the covered banking entity's covered trading and covered fund activities or investments, which shall be no less than once every twelve months. This independent testing must include an evaluation of:

- The overall adequacy and effectiveness of the covered banking entity's compliance program, including an analysis of the extent to which the program contains all the required elements of this appendix;
- The effectiveness of the covered banking entity's written policies and procedures;
- The effectiveness of the covered 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
- The effectiveness of the covered banking entity's management procedures.

VI. Training

Covered banking entities must provide adequate training to trading personnel and managers of the covered banking entity, as well as other appropriate personnel, as determined by the covered banking entity, 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 covered banking entity's covered trading activities and covered fund activities or investments. The training may be conducted by internal personnel or independent parties deemed appropriate by the covered banking entity based on its size and risk profile.

VII. Recordkeeping

Covered banking entities must create and retain records sufficient to demonstrate compliance and support the operations and effectiveness of the compliance program. A covered banking entity must retain these records for a period that is no less than 5 years in a form that allows it to promptly produce such records to [Agency] on request.

END OF COMMON RULE

[END OF COMMON TEXT]

Adoption of the Common Rule Text

The proposed adoption of the common rules by the agencies, as modified by agency-specific text, is set forth below:

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Chapter I

List of Subjects in 12 CFR Part 44

Banks, Banking, Compensation, Credit, Derivatives, Government securities, Insurance, Investments, National banks, Penalties, Reporting and recordkeeping requirements, Risk, Risk retention, Securities, Trusts and trustees.

Authority and Issuance

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

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

1. The authority citation for part 44 is added to read as follows:

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

2. Part 44 is added as set forth at the end of the Common Preamble.

3. Part 44 is amended by

a. Removing ''[Agency]'' wherever it appears and adding in its place ''the OCC''; and

b. Removing ''[The Agency]'' wherever it appears and adding in its place ''The OCC''.

4. Section 44.1 is added to read as follows:

§ 44.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued by [Agency] 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 and investments in or relationships with covered funds by certain banking entities, including national banks, Federal branches and agencies of foreign banks, Federal savings associations, and certain subsidiaries thereof. 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 explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to covered banking entities described in § 44.2(j). This part takes effect on July 21, 2012.

(d) *Relationship to other authorities.* Except as otherwise provided under section 13 of the Bank Holding Company Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of Bank Holding Company Act shall apply to the activities of a covered banking entity, even if such activities are authorized for a covered banking entity under other applicable provisions of law.

(e) *Preservation of authority.* Nothing in this part limits in any way the authority of the OCC to impose penalties for violation of this part by any covered banking entity provided under any other applicable statute.

5. Paragraph (j) of § 44.2 is added to read as follows:

§ 44.2 Definitions.

* * * * *

(j) Covered banking entity means any banking entity that is:

(1) A national bank;

(2) A Federal branch or agency of a foreign bank;

(3) A Federal savings association or a Federal savings bank; and

(4) Any subsidiary of a company described in paragraph (j)(1) through (3) of this section, other than a subsidiary for which the CFTC or SEC is the primary financial regulatory agency as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)).

* * * * *

BOARD OF GOVERNORS OF THE FEDERAL RESERVE

12 CFR Chapter II

List of Subjects in 12 CFR Part 248

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

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Board of Governors of the Federal Reserve System proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 248 to 12 CFR Chapter II as follows:

PART 248—PROPRIETARY TRADING AND RELATIONSHIPS WITH COVERED FUNDS (REGULATION VV)

6. The authority citation for part 248 is added to read as follows:

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

7. Part 248 is added as set forth at the end of the Common Preamble.

8. Part 248 is amended by:

A. Removing ''[Agency]'' wherever it appears and adding in its place ''the Board''; and

B. Removing ''[The Agency]'' wherever it appears and adding in its place ''The Board''.

9. Section 248.1 is added to read as follows:

§ 248.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part [1] (Regulation VV) is issued by the Board under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851), as well as under the Federal Reserve Act, as amended (12 U.S.C. 221 *et seq.*); section 8 of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818); the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 *et seq.*); and the International Banking Act of 1978, as amended (12 U.S.C. 3101 *et seq.*).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds by certain banking entities, including state members banks, bank holding companies, savings and loan holding companies, other companies that control an insured depository, foreign banking organizations, and certain subsidiaries thereof. 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 explaining the statute's requirements.

[1] Code of Federal Regulations, title 12, chapter II, part 248.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to covered banking entities described in § 248.2(j). This part takes effect on July 21, 2012.

(d) *Relationship to other authorities.* Except as otherwise provided in under section 13 of the Bank Holding Company Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of Bank Holding Company Act shall apply to the activities of a covered banking entity, even if such activities are authorized for a covered banking entity under other applicable provisions of law.

10. In § 248.2, paragraph (c) is revised, and paragraph (j) is added to read as follows:

§ 248.2 Definitions.

* * * * *

(c) Nothing in this part limits in any way the authority of the Board, under the BHC Act (including section 8 of such Act) and other provisions of law, to impose penalties for violation by any company or individual.

* * * * *

(j) *Covered banking entity* means any banking entity that is:

(1) A state member bank (as defined in 12 CFR 208.2(g));

(2) A bank holding company;

(3) A savings and loan holding company (as defined in 12 U.S.C. 1467a);

(4) A foreign banking organization (as defined in 12 CFR 211.21(o));

(5) Any company that controls an insured depository institution; and

(6) Any subsidiary of a company described in paragraph (j)(1) through (5) of this section, other than a subsidiary for which the OCC, FDIC, CFTC, or SEC is the primary financial regulatory agency (as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5301(12)).

11–12. Add subpart E to read as follows:

Subpart E—Conformance Period and Extended Transition Period Authorities

Subpart E—Conformance Period and Extended Transition Period Authorities

§ 248.30 Definitions.

For purposes of this subpart:

(a) *Illiquid fund* means a covered fund that:

(1) As of May 1, 2010:

(i) Was principally invested in illiquid assets; or

(ii) Was invested in, and contractually committed to principally invest in, illiquid assets; and

(2) Makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.

(b) *Illiquid assets* means any real property, security, obligation, or other asset that:

(1) Is not a liquid asset;

(2) Because of statutory or regulatory restrictions applicable to the covered fund or asset, cannot be offered, sold, or otherwise transferred by covered fund to a person that is unaffiliated with the relevant banking entity; or

(3) Because of contractual restrictions applicable to the covered fund or asset, cannot be offered, sold, or otherwise transferred by the covered fund for a period of 3 years or more to a person that is unaffiliated with the relevant banking entity.

(c) *Liquid asset* means:

(1) Cash or cash equivalents;

(2) An asset that is traded on a recognized, established exchange, trading facility or other market on which there exist independent, *bona fide* offers to buy and sell so that a price reasonably related to the last sales price or current *bona fide* competitive bid and offer quotations can be determined for the particular asset almost instantaneously;

(3) An asset for which there are *bona fide,* competitive bid and offer quotations in a recognized inter-dealer quotation system or similar system or for which multiple dealers furnish *bona fide,* competitive bid and offer quotations to other brokers and dealers on request;

(4) An asset the price of which is quoted routinely in a widely disseminated publication that is readily available to the general public or through an electronic service that provides indicative data from real-time financial networks;

(5) An asset with an initial term of one year or less and the payments on which at maturity may be settled, closed-out, or paid in cash or one or more other liquid assets described in paragraphs (c)(1), (2), (3), or (4) of this section; and

(6) Any other asset that the Board determines, based on all the facts and circumstances, is a liquid asset.

(d) *Principally invested* and related definitions.—A covered fund:

(1) Is *principally invested* in illiquid assets if at least 75 percent of the fund's consolidated total assets are—

(i) Illiquid assets; or

(ii) Risk-mitigating hedges entered into in connection with and related to individual or aggregated positions in, or holdings of, illiquid assets;

(2) Is *contractually committed to principally invest* in illiquid assets if the fund's organizational documents, other documents that constitute a contractual obligation of the fund, or written representations contained in the fund's offering materials distributed to potential investors provide for the fund to be principally invested in assets described in paragraph (d)(1) of this section at all times other than during temporary periods, such as the period prior to the initial receipt of capital contributions from investors or the period during which the fund's investments are being liquidated and capital and profits are being returned to investors; and

(3) Has an *investment strategy to principally invest* in illiquid assets if the fund:

(i) Markets or holds itself out to investors as intending to principally invest in assets described in paragraph (d)(1) of this section; or

(ii) Has a documented investment policy of principally investing in assets described in paragraph (d)(1) of this section.

§ 248.31 Conformance periods for banking entities engaged in prohibited proprietary trading or covered fund activities or investments.

(a) *Conformance Period.* (1) *In general.*—Except as provided in paragraph (a)(2) or (3) of this section, a banking entity shall bring its activities and investments into compliance with the requirements of section 13 of the BHC Act (12 U.S.C. 1851) and this part no later than 2 years after July 21, 2012.

(2) *New banking entities.*—A company that was not a banking entity, or a subsidiary or affiliate of a banking entity, as of July 21, 2010, and becomes a banking entity, or a subsidiary or affiliate of a banking entity, after that date shall bring its activities and investments into compliance with the requirements of section 13 of the BHC Act (12 U.S.C. 1851) and this part before the later of:

(i) The conformance date determined in accordance with paragraph (a)(1) of this section; or

(ii) 2 years after the date on which the company becomes a banking entity or a subsidiary or affiliate of a banking entity.

(3) *Extended conformance period.* The Board may extend the two-year period under paragraph (a) (1) or (2) of this section by not more than three separate one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the BHC Act (12 U.S.C. 1851) and this part and would not be detrimental to the public interest.

(b) *Illiquid funds.* (1) *Extended transition period.* The Board may further extend the period provided by paragraph (a) of this section during which a banking entity may acquire or retain an ownership interest in, or otherwise provide additional capital to, a covered fund if:

(i) The fund is an illiquid fund; and

(ii) The acquisition or retention of such interest, or provision of additional capital, is necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010.

(2) *Duration limited.* The Board may grant a banking entity only one extension under paragraph (b)(1) of this section and such extension:

(i) May not exceed 5 years beyond any conformance period granted under paragraph (a)(3) of this section; and

(ii) Shall terminate automatically on the date during any such extension on which the banking entity is no longer under a contractual obligation described in paragraph (b)(1)(ii) of this section.

(3) *Contractual obligation.* For purposes of this paragraph (b):

(i) A banking entity has a contractual obligation to take or retain an ownership interest in an illiquid fund if the banking entity is prohibited from redeeming all of its ownership interests in the fund, and from selling or otherwise transferring all such ownership interests to a person that is not an affiliate of the banking entity—

(A) Under the terms of the banking entity's ownership interest in the fund or the banking entity's other contractual arrangements with the fund or unaffiliated investors in the fund; or

(B) If the banking entity is the sponsor of the fund, under the terms of a written representation made by the banking entity in the fund's offering materials distributed to potential investors;

(ii) A banking entity has a contractual obligation to provide additional capital to an illiquid fund if the banking entity is required to provide additional capital to such fund—

(A) Under the terms of its ownership interest in the fund or the banking entity's other contractual arrangements with the fund or unaffiliated investors in the fund; or

(B) If the banking entity is the sponsor of the fund, under the terms of a written representation made by the banking entity in the fund's offering materials distributed to potential investors; and

(iii) A banking entity shall be considered to have a contractual obligation for purposes of paragraph (b)(3)(i) or (ii) of this section only if:

(A) The obligation may not be terminated by the banking entity or any of its subsidiaries or affiliates under the terms of its agreement with the fund; and

(B) In the case of an obligation that may be terminated with the consent of other persons, the banking entity and its subsidiaries and affiliates have used their reasonable best efforts to obtain such consent and such consent has been denied.

(c) *Approval Required to Hold Interests in Excess of Time Limit.* The conformance period in paragraph (a) of this section may be extended in accordance with paragraph (a)(3) or (b) only with the approval of the Board. A banking entity that seeks the Board's approval for an extension of the conformance period under paragraph (a)(3) or for an extended transition period under paragraph (b)(1) must:

(1) Submit a request in writing to the Board at least 180 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the banking entity believes the extension should be granted, including information that addresses the factors in paragraph (d)(1) of this section; and

(3) Provide a detailed explanation of the banking entity's plan for divesting or conforming the activity or investment(s).

(d) *Factors governing Board determinations.*

(1) *Extension requests generally.*—In reviewing any application by a specific company for an extension under paragraph (a)(3) or (b)(1) of this section, the Board may consider all the facts and circumstances related to the activity, investment, or fund, including, to the extent relevant:

(i) Whether the activity or investment:

(A) Involves or results in material conflicts of interest between the banking entity and its clients, customers or counterparties;

(B) Would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies;

(C) Would pose a threat to the safety and soundness of the banking entity; or

(D) Would pose a threat to the financial stability of the United States;

(ii) Market conditions;

(iii) The nature of the activity or investment;

(iv) The date that the banking entity's contractual obligation to make or retain an investment in the fund was incurred and when it expires;

(v) The contractual terms governing the banking entity's interest in the fund;

(vi) The degree of control held by the banking entity over investment decisions of the fund;

(vii) The types of assets held by the fund, including whether any assets that were illiquid when first acquired by the fund have become liquid assets, such as, for example, because any statutory, regulatory, or contractual restrictions on the offer, sale, or transfer of such assets have expired;

(viii) The date on which the fund is expected to wind up its activities and liquidate, or its investments may be redeemed or sold;

(ix) The total exposure of the banking entity to the activity or investment and the risks that disposing of, or maintaining, the investment or activity may pose to the banking entity or the financial stability of the United States;

(x) The cost to the banking entity of divesting or disposing of the activity or investment within the applicable period;

(xi) Whether the divestiture or conformance of the activity or investment would involve or result in a material conflict of interest between the banking entity and unaffiliated clients, customers or counterparties to which it owes a duty;

(xii) The banking entity's prior efforts to divest or conform the activity or investment(s), including, with respect to an illiquid fund, the extent to which the banking entity has made efforts to terminate or obtain a waiver of its contractual obligation to take or retain an equity, partnership, or other ownership interest in, or provide additional capital to, the illiquid fund; and

(xiii) Any other factor that the Board believes appropriate.

(2) *Timing of Board review.* The Board will seek to act on any request for an extension under paragraph (a)(3) or (b)(1) of this section no later than 90 calendar days after the receipt of a complete record with respect to such request.

(3) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the SEC, or the CFTC, the Board will consult with such agency prior to the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

(e) *Authority to impose restrictions on activities or investments during any extension period.*

(1) *In general.* The Board may impose such conditions on any extension approved under paragraph (a)(3) or (b)(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 (12 U.S.C. 1851) and this part.

(2) *Consultation.* In the case of a banking entity that is primarily supervised by another Federal banking agency, the SEC, or the CFTC, the Board will consult with such agency prior to imposing conditions on the approval of a request by the banking entity for an extension under paragraph (a)(3) or (b)(1) of this section.

§ 248.32 Conformance period for nonbank financial companies supervised by the Board engaged in prohibited proprietary trading or covered fund activities and investments.

(a) *Divestiture requirement.* A nonbank financial company supervised by the Board shall come into compliance with all applicable requirements of section 13 of the Bank Holding Company Act (12 U.S.C. 1851) and this subpart, including any capital requirements or quantitative limitations adopted thereunder and applicable to the company, not later than 2 years after the date the company becomes a nonbank financial company supervised by the Board.

(b) *Extensions.* The Board may, by rule or order, extend the two-year period under paragraph (a) of this section by not more than three separate one-year periods, if, in the judgment of the Board, each such one-year extension is consistent with the purposes of section 13 of the BHC Act (12 U.S.C. 1851) and this part and would not be detrimental to the public interest.

(c) *Approval required to hold interests in excess of time limit.* A nonbank financial company supervised by the Board that seeks the Board's approval for an extension of the conformance period under paragraph (b) of this section must:

(1) Submit a request in writing to the Board at least 180 days prior to the expiration of the applicable time period;

(2) Provide the reasons why the nonbank financial company supervised by the Board believes the extension should be granted; and

(3) Provide a detailed explanation of the company's plan for conforming the activity or investment(s) to any applicable requirements established under section 13(a)(2) or (f)(4) of the Bank Holding Company Act (12 U.S.C. 1851(a)(2) and (f)(4)).

(d) *Factors governing Board determinations.*

(1) *In general.* In reviewing any application for an extension under paragraph (b) of this section, the Board may consider all the facts and circumstances related to the nonbank financial company and the request including, to the extent determined relevant by the Board, the factors described in § 225.181(d)(1) of this chapter.

(2) *Timing.* The Board will seek to act on any request for an extension under paragraph (b) of this section no later than 90 calendar days after the receipt of a complete record with respect to such request.

(e) *Authority to impose restrictions on activities or investments during any extension period.* The Board may impose conditions on any extension approved under paragraph (b) of this section as the Board determines are necessary or appropriate to protect the safety and soundness of the nonbank financial company or the financial stability of the United States, address material conflicts of interest or other unsound practices, or otherwise further the purposes of section 13 of the BHC Act (12 U.S.C. 1851) and this part.

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

List of Subjects in 12 CFR Part 351

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

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Federal Deposit Insurance Corporation proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 351 to chapter III of Title 12, Code of Federal Regulations, modified as follows:

PART 351—PROPRIETARY TRADING AND RELATIONSHIPS WITH COVERED FUNDS

13. The authority citation for part 351 is added to read as follows:

Authority: 12 U.S.C. 1851; 12 U.S.C. 1801 *et seq.,* and 3103 *et seq.*

14. Part 351 is added as set forth at the end of the Common Preamble.

15. Part 351 is amended by:

a. Removing ''[Agency]'' wherever it appears and adding in its place ''the FDIC''; and

b. Removing ''[The Agency]'' wherever it appears and adding in its place ''The FDIC''.

16. Section 351.1 is added to read as follows:

§ 351.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part is issued by the FDIC 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 and investments in or relationships with covered funds by certain banking entities, including any insured depository institution for which the FDIC is the appropriate Federal banking agency. 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 explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to any insured depository institution for which the FDIC is the appropriate Federal banking agency. This part takes effect on July 21, 2012.

(d) *Relationship to other authorities.* Except as otherwise provided in under section 13 of the Bank Holding Company Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of Bank Holding Company Act shall apply to the activities of a covered banking entity, even if such activities are authorized for a covered banking entity under other applicable provisions of law.

17. Paragraph (j) of § 351.2 is added to read as follows:

§ 351.2 Definitions.

* * * * *

(j) *Covered banking entity* means any banking entity that is an insured depository institution for which the FDIC is the appropriate Federal banking agency, as that term is defined in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)).

* * * * *

SECURITIES AND EXCHANGE COMMISSION

List of Subjects in 17 CFR Part 255

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

Authority and Issuance

For the reasons set forth in the Supplementary Information, the Securities and Exchange Commission proposes to add the text of the common rule as set forth at the end of the Supplementary Information as Part 255 to chapter II of Title 17, Code of Federal Regulations, modified as follows:

PART 255—PROPRIETARY TRADING AND RELATIONSHIPS WITH COVERED FUNDS

18. The authority for part 255 is added to read as follows:

Authority: 12 U.S.C. 1851, 15 U.S.C. 78*o*(c)(3)(A), 78*o*–10(f), (j), 78q(a), 78w.

19. Part 255 is added as set forth at the end of the Common Preamble.

20. Part 255 is amended by:

a. Removing ''[Agency]'' wherever it appears and adding in its place ''SEC''; and

b. Removing ''[The Agency]'' wherever it appears and adding in its place ''The SEC.''

21. Section 255.1 is added to read as follows:

§ 255.1 Authority, purpose, scope, and relationship to other authorities.

(a) *Authority.* This part [1] is issued by the SEC under section 13 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1851) and sections 15(c)(3)(A), 15F(f), 15F(j), 17(a), and 23 of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*(c)(3)(A), 78*o*-10(f), (j), 78q(a), 78w.).

(b) *Purpose.* Section 13 of the Bank Holding Company Act establishes prohibitions and restrictions on proprietary trading and investments in or relationships with covered funds by certain banking entities, including registered broker-dealers, registered investment advisers, and registered security-based swap dealers, among others identified in section 2(12)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5301(12)(B)). 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 explaining the statute's requirements.

(c) *Scope.* This part implements section 13 of the Bank Holding Company Act with respect to covered banking entities described in § 255.2(j). This part takes effect on July 21, 2012.

(d) *Relationship to other authorities.* Except as otherwise provided in under section 13 of the BHC Act, and notwithstanding any other provision of law, the prohibitions and restrictions under section 13 of BHC Act shall apply to the activities of a covered banking entity, even if such activities are authorized for a covered banking entity under other applicable provisions of law.

22. Paragraph (j) of § 255.2 is added to read as follows:

§ 225.2 Definitions.

* * * * *

(j) *Covered banking entity* means any entity described in paragraph (e) of this section for which the SEC is the primary financial regulatory agency, as defined in section 2(12)(B) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (12 U.S.C. 5301(12)(B)).

23. Section 225.10(a) is revised to read as follows:

§ 255.10 Prohibition on acquiring or retaining an ownership interest in and having certain relationships with a covered fund.

* * * * *

(a)(1) *General prohibition.* Except as otherwise provided in this subpart, a covered banking entity may not, as principal, directly or indirectly, acquire or retain any ownership interest in or sponsor a covered fund.

(2) *Registered investment advisers.* A covered banking entity that is a covered banking entity because it is an investment adviser identified in section 2(12)(B)(iii) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 shall comply with the restrictions on covered fund activities or investments set forth in subpart C and § ____.20 of subpart D issued by the agency identified in section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)) that regulates the banking entity described in § 255.2 (e)(1), (2) or (3) with which the investment adviser is affiliated.

[1] Code of Federal Regulations, title 17, chapter II, part 255.

Note to paragraph (a): Nothing set forth in paragraph (a)(2) of this section shall limit the SEC's authority under any other provision of law, including pursuant to section 13 of the Bank Holding Company Act.

* * * * *

Dated: October 7, 2011.

John Walsh,

Acting Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, October 11, 2011.

Jennifer J. Johnson,

Secretary of the Board.

By order of the Board of Directors.

Dated at Washington, DC, this 11th day of October, 2011.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

By the Securities and Exchange Commission.

Dated: October 12, 2011.

Elizabeth M. Murphy,

Secretary.

[FR Doc. 2011–27184 Filed 11–4–11; 8:45 am]

BILLING CODE 6210–01–P; 8011–11–P; 4810–33–P; 6714–01–P