DATE: October 11, 2011

MEMORANDUM TO: Board of Directors

FROM: Sandra L. Thompson, Director
Division of Risk Management Supervision

SUBJECT: Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

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Recommendation: Staff recommends that the FDIC Board ("Board") approve a Notice of Proposed Rulemaking ("NPR") to implement new section 13 of the Bank Holding Company Act ("BHC Act"), as enacted as section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 13 of the BHC Act contains certain prohibitions and restrictions on the ability of banking entities to engage in proprietary trading and restricts the ability of banking entities to hold certain investments in, and have certain relationships with, hedge funds and private equity funds. The provisions contained in section 13 of the BHC Act are generally referred to as the "Volcker Rule."

If approved, the NPR will be issued jointly by the FDIC, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Securities and Exchange Commission (collectively, the "Agencies"). Section 13(b)(2)(B)(i) of the BHC Act does require that the Federal banking agencies issue jointly the implementing regulations that cover insured depository institutions. However, those issued by the Securities and Exchange Commission and the Commodity Futures Trading Commission are not required to be issued with the Federal banking agencies. The Securities and Exchange Commission is jointly issuing its NPR with the Federal banking agencies by mutual agreement. The Agencies will issue this joint NPR in the *Federal Register* with a public comment period that closes on January 13, 2012.

Concurrence:

Michael H. Krimminger
General Counsel

I. Introduction

Section 13 of the BHC Act generally prohibits, subject to certain exceptions, any banking entity from engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund ("covered fund"), subject to certain permitted activity exemptions. Section 13(d)(1) of the BHC Act expressly includes exemptions from these prohibitions for certain permitted activities, including:

- Trading in 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.

The proposed rule provides certain conditions that would be applied to the application of these permitted activity exemptions.

Section 13 of the BHC Act contains two additional limits on the amount by which banking entity may invest in funds organized and offered by the banking entity or an affiliate or a subsidiary. First, for any particular covered fund, a banking entity may not own directly, and/or indirectly, more than 3 percent of the value or ownership interests of that fund. Second, a banking entity's aggregate direct and/or indirect ownership in all covered funds may not exceed

3 percent of the banking entity's Tier 1 capital. Further, any ownership interest in a covered fund that is held by a banking entity must be deducted from the banking entity's Tier 1 capital, including ownership amounts that fall within the limitations described above.

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

Section 619 of the Dodd-Frank Act required the Financial Stability Oversight Counsel ("Council") to conduct a study ("Council study") and make recommendations 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 regulations. 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: (1) a programmatic compliance regime requirement for banking entities, (2) analysis and reporting of quantitative metrics by banking entities, (3) supervisory review and oversight by the Agencies, and (4) enforcement procedures for violations. The Agencies fully considered the Council study in the development of the proposed rule.

The provisions of section 13 of the BHC Act generally apply to all banking entities, including insured depository institutions ("IDIs"), companies controlling IDIs, companies treated

as bank holding companies, and any affiliate or subsidiary (including subsidiaries that are broker-dealers and futures commission merchants) of the foregoing.

Section 13(b)(2)(B)(ii) of the BHC Act requires that each agency's implementing regulations be comparable, and provide for consistent application and implementation of the applicable provisions of the Act. Accordingly, the Commodities Futures Trading Commission is expected to issue a comparable NPR for the implementation of section 13 of the BHC at a later date. With respect to facilitating the consistent application and implementation of the applicable provisions of the Act, the Agencies have included various requests for comments in the preamble of this NPR, including whether such mechanisms as a central data repository would be appropriate and effective for compliance purposes. FDIC staff believes that it is important for such purposes that the Agencies have a process in place to share metrics data and other important aspects of their respective implementation of the compliance sections of the proposed rule and appendices.

II. Overview of the Proposed Rule

A. General Approach.

The proposed rule provides a framework that: (i) describes the key characteristics of prohibited and permitted activities; (ii) requires banking entities to establish a comprehensive programmatic compliance regime; and (iii) requires covered banking entities to calculate and report quantitative data that will assist in identifying activity that warrants additional scrutiny to distinguish prohibited proprietary trading from otherwise permissible activities, such as underwriting, market-making, and hedging activities under the relevant statutory exemptions.

Structurally, the proposed rule is generally divided into four subparts and contains three appendices:

- Subpart A describes the authority, scope, purpose, and relationship to other authorities of the rule and defines terms used commonly throughout the rule;

- Subpart B prohibits proprietary trading, defines terms relevant to covered trading activity, establishes exemptions from the prohibition on proprietary trading and limitations on those exemptions, and requires certain banking entities to report quantitative measurements with respect to their trading activities;

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

- Subpart D requires banking entities to establish an enhanced compliance program (including written policies and procedures), internal controls, a management framework, independent testing of the compliance program, training, and recordkeeping;

- Appendix A details the quantitative measurements that certain banking entities may be required to compute and report with respect to their trading activities;

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

- Appendix C details the minimum requirements and standards that certain banking entities must meet with respect to the compliance program required under subpart D.

B. Proprietary Trading Restrictions.

Subpart B implements the statutory prohibition on proprietary trading and the various exemptions to prohibition that are included in the statute. Section __.3 contains the core prohibition on proprietary trading and defines a number of key terms, including "proprietary trading" and "trading account." The proposed definition of proprietary trading 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.

The proposed definition of trading account delineates which positions 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, which ultimately defines the scope of accounts subject to the prohibition on proprietary trading. In particular, the proposed definition of trading account identifies three classes of positions that would cause positions to be in the trading account.

First, the definition of trading account 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. This language is substantially the same as the language for a "trading position" used in the Federal banking agencies' market risk capital rules 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 provides that all positions in financial instruments that are treated

as "covered positions" under those capital rules are subject to the prohibition on proprietary trading, other than certain foreign exchange and commodities positions.

Third, the definition includes all positions acquired or taken by certain registered securities and derivatives dealers in connection with their activities that require such registration or notice.

The definition of trading account 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.

Section __.3 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.

Section __.4 implements the statutory exemption for underwriting and market making-related activities. For both of these permitted activities, the proposed rule articulates a number of requirements that must be met in order for a banking entity to rely on the applicable exemption. These requirements are 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 and not prohibited proprietary trading. These requirements are intended to

support and augment other requirements in the proposed rule, including the compliance program requirement and the reporting of quantitative measurements, in order to assist in the identification of prohibited trading activities that may be conducted in the guise of permitted underwriting or market making activities.

Section __.5 implements the statutory exemption for risk-mitigating hedging. To rely on this exemption, a banking entity must meet a number of requirements included in this section that are designed to ensure that the banking entity's trading activity is truly risk-mitigating hedging. For example, banking entities must (1) document the hedging rationale for certain transactions that present heightened compliance risks at the time the transaction is executed, and (2) delineate those risks from the individual and aggregate positions of the covered banking entity that the hedging activities are designed to reduce. 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 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. This section describes the exempted government obligations in which a banking entity may trade, which include U.S. government and agency obligations, obligations and other instruments of certain government sponsored entities, and State and municipal obligations. This section also describes permitted trading on behalf of customers and identifies three categories of transactions that would qualify for the exemption: (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. Finally, this section describes permitted trading by a regulated insurance company for its general account and permitted trading outside of the United States by a foreign banking entity.

Section __.7 requires 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, this section requires a banking entity to comply with the recordkeeping requirements in section __.20, including, where applicable, the recordkeeping requirements in Appendix C.

Appendix A requires 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 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, greater than $1 billion. The NPR would require these banking entities to submit standardized metrics related to trading activities to their primary regulator. However, the preamble to the NPR asks whether a chief executive officer ("CEO") attestation or a central data repository for compliance purposes would be a preferable approach for purposes of facilitating the Agencies'

capacity to compare their respective implementation of the compliance sections of the proposed rule and appendices. The 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 section __.20, are likely to be less burdensome and equally effective methods for ensuring compliance by smaller, less complex banking entities.

The quantitative measurements required under Appendix A are designed to reflect 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 trading activities result in a material exposure to high-risk assets and high-risk trading strategies. In addition, proposed Appendix B contains commentary regarding identification of permitted market making activities and distinguishing such activities from prohibited proprietary trading.

Section __.8 prohibits a banking entity from relying on any exemption to the prohibition on proprietary trading if the permitted activity would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States. This section also defines material conflicts of interest, high-risk assets, and high-risk trading strategies for these purposes. The definition of "material conflict of interest" includes requirements for (1) timely and effective disclosure and opportunity to negate or substantially mitigate the transaction(s), or (2) certain information barriers imposed by the covered banking entity.

C. Covered Fund Activities and Investments.

Subpart C implements the statutory prohibition on acquiring and retaining an ownership interest in, or having certain relationships with, a covered fund, as well as the various exemptions to this prohibition included in the statute. Section __.10 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 definition of covered fund parallels the statutory definition of "hedge fund" and "private equity fund," and delineates entities considered a "covered fund" and subject to the general prohibition.

The proposed definition of "ownership interest" clarifies the types of interests that would be considered to be an ownership interest in a covered fund. While these interests may take various forms, the definition of ownership interest explicitly excludes "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).

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

Section __.11 implements the exemption for organizing and offering a covered fund provided for under section 13(d)(1)(G) of the BHC Act. This section 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 continue to engage in certain traditional asset management and advisory businesses.

Section __.12 permits a banking entity to acquire and retain an ownership interest in a covered fund that the banking entity organizes and offers. This section permits a banking entity to make an investment in a covered fund that the banking entity organizes and offers, or for which it acts as sponsor, for the purposes of (i) establishing the covered fund and providing the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors, or (ii) making a *de minimis* investment in the covered fund in compliance with applicable requirements. Section __.12 imposes strict limitations regarding the amount and value of any individual per-fund investment and the aggregate value of all such permitted investments. This section also clarifies how a banking entity must calculate its compliance with these investment limitations (including by deducting such investments from Tier 1 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.

Section __.13 implements statutory exemptions 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. 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.

This section also 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; or (ii) a compensation arrangement with an employee of the banking entity that directly provides investment advisory or other services to that fund. Additionally, certain hedging positions are permitted, in the event that such positions 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. In addition, the banking entity must (1) document the hedging rationale at the time the transaction is executed for all hedging transactions involving an ownership interest in a covered fund, and (2) delineate the specific risks for individual and aggregate obligations of a covered banking entity that the investment in a covered fund is designed to reduce.

This section also 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 section also implements in part the statutory rule of construction that permits the sale and securitization of loans. The section clarifies that a banking entity may acquire and retain an ownership interest in, or act as sponsor to, a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (i) loans; (ii) contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (iii) a limited amount of interest rate or foreign exchange derivatives that materially relate to such loans and that are used for hedging purposes with respect to the securitization structure. 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 that the banking entity organizes and offers, or acts as sponsor to, in excess of the 3 percent limits specified in section 12 of the proposed rule.

Section __.14 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. The Agencies have proposed to permit three activities at this time under this authority: (i) acquiring and retaining an ownership interest in, or acting as sponsor to, certain bank owned life insurance separate accounts, (ii) investments in and sponsoring of certain asset-backed securitizations, and (iii) 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.) that are common corporate organizational vehicles. 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.

Section __.15 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 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.

Section __.16 generally prohibits a banking entity from entering into certain transactions with a covered fund that would be a covered transaction as defined in section 23A of the Federal Reserve Act. This section clarifies that certain transactions between a banking entity and a covered fund remain permissible. This section also implements the statute's requirement that any transaction permitted under section 13(f) of the BHC Act (including a prime brokerage transaction) between the banking entity and a covered fund is subject to section 23B of the Federal Reserve Act, which generally 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 prohibits a banking entity from relying on any exemption to the prohibition on acquiring and retaining an ownership interest in, acting as sponsor to, or having certain relationships with, a covered fund, if the permitted activity or investment would involve or result in a material conflict of interest, result in a material exposure to high-risk assets or high-risk trading strategies, or pose a threat to the safety and soundness of the banking entity or to the financial stability of the United States. This section also defines material conflict of interest, high-risk asset, and high-risk trading strategy for these purposes, consistent with the definitions of those terms in Subpart B..

D. Compliance Program Requirement.

Subpart D 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 in the proposed rule. The proposed rule specifies six elements that each compliance program 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.

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. 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. This appendix requires that these types of banking entities must, at a minimum, 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:

- Are 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;

- 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.

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.

III. Conclusion

Staff recommends that the Board approve for publication in the *Federal Register* the attached NPR to implement section 13 of the BHC Act. The NPR provides for a public comment period that closes on January 13, 2012, during which time the Agencies will solicit comment on all aspects of the proposed rule. The NPR will be submitted for publication after all of the Agencies have completed their review and approval processes.

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