

**STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING  
& CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS**

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FINANCIAL STABILITY OVERSIGHT COUNCIL

*Completed pursuant to section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act*  
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# OVERVIEW OF STUDY AND RECOMMENDATIONS

## INTRODUCTION

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”).<sup>1</sup> The Dodd-Frank Act is intended to strengthen the financial system and constrain risk taking at banking entities. Section 619 of the Dodd-Frank Act, also known as the Volcker Rule, is a key component of this effort. The Volcker Rule prohibits banking entities, which benefit from federal insurance on customer deposits or access to the discount window, from engaging in proprietary trading and from investing in or sponsoring hedge funds and private equity funds, subject to certain exceptions.<sup>2</sup>

The proprietary trading provisions prohibit a banking entity<sup>3</sup> from engaging in trading activity in which it acts as a principal in order to profit from near-term price movements.<sup>4</sup> The hedge fund and private equity fund provisions generally prohibit a banking entity from investing in, or having certain relationships with, any fund that is structured under exclusions commonly used by hedge funds and private equity funds under the Investment Company Act of 1940 (the “Investment Company Act”).<sup>5</sup>

However, to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation, the Volcker Rule provides for certain “permitted activities” that represent core banking functions such as certain types of market making, asset management, underwriting, and transactions in government securities. These permitted activities – in particular, market making, hedging, underwriting, and other transactions on behalf of customers – often evidence outwardly similar characteristics to proprietary trading, even as they pursue different objectives, and it will be important for Agencies<sup>6</sup> to carefully weigh all

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<sup>1</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010).

<sup>2</sup> Section 619 amends the Bank Holding Company Act of 1956, 12 U.S.C. § 1841 et seq. (to be codified at 12 U.S.C. § 1851), by adding at the end the following:

“SEC. 13. PROHIBITIONS ON PROPRIETARY TRADING AND CERTAIN RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.

(a) IN GENERAL.—

(1) PROHIBITION.—Unless otherwise provided in this section, a banking entity shall not—

(A) engage in proprietary trading; or

(B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund . . .”

<sup>3</sup> 12 U.S.C. § 1851(h)(1).

<sup>4</sup> Id. at § 1851(a) and (h)(4).

<sup>5</sup> The Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq.

<sup>6</sup> The Office of the Comptroller of the Currency (the “OCC”), the Federal Deposit Insurance Corporation (the “FDIC”), the Board of Governors of the Federal Reserve System (the “Board”), the Securities and Exchange Commission (the “SEC”) and the Commodity Futures Trading Commission (the “CFTC”) (collectively, “Agencies”).

characteristics of permitted and prohibited activities as they design the Volcker Rule implementation framework.

These permitted activities are subject to a prudential “backstop” that prohibits such activity if it would result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to the financial stability of the United States.

For nonbank financial companies that are supervised by the Board, the Volcker Rule does not expressly prohibit or limit any activities. Instead, the Volcker Rule requires that the Board adopt rules imposing additional capital charges or other restrictions on such companies to address the risks and conflicts of interest that the Volcker Rule was designed to address.<sup>7</sup>

Since the enactment of the Dodd-Frank Act, a number of banking entities have shut down, or announced plans to shut down, their operationally distinct, dedicated proprietary trading operations (“bright line” proprietary trading) and hedge fund and private equity fund businesses that were a source of losses during the crisis. While these actions have reduced proprietary trading activity, impermissible proprietary trading may continue to occur, including within permitted activities that are not organized solely to conduct impermissible proprietary trading.

As Paul Volcker, former Chairman of the Board of Governors of the Federal Reserve System, explained in his testimony to the Senate Banking Committee when he urged adoption of this provision:

What we can do, what we should do, is recognize that curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility and uncertainties are inherent in our market-oriented, profit-seeking financial system. By appropriately defining the business of commercial banks . . . we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.<sup>8</sup>

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<sup>7</sup> 12 U.S.C. § 1851(a)(2).

<sup>8</sup> *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies before the S. Comm. on Banking, Housing & Urban Affairs*, 111<sup>th</sup> Cong. 5 (2010) (testimony of the Honorable Paul Volcker, Chairman, President’s Economic Recovery Advisory Board).

## **RECOMMENDED ACTIONS TO EFFECTIVELY IMPLEMENT THE VOLCKER RULE**

The Council strongly supports the robust implementation of the Volcker Rule and recommends that Agencies consider taking the following actions:

1. Require banking entities to sell or wind down all impermissible proprietary trading desks.
2. Require banking entities to implement a robust compliance regime, including public attestation by the CEO of the regime's effectiveness.
3. Require banking entities to perform quantitative analysis to detect potentially impermissible proprietary trading without provisions for safe harbors.
4. Perform supervisory review of trading activity to distinguish permitted activities from impermissible proprietary trading.
5. Require banking entities to implement a mechanism that identifies to Agencies which trades are customer-initiated.
6. Require divestiture of impermissible proprietary trading positions and impose penalties when warranted.
7. Prohibit banking entities from investing in or sponsoring any hedge fund or private equity fund, except to bona fide trust, fiduciary or investment advisory customers.
8. Prohibit banking entities from engaging in transactions that would allow them to "bail out" a hedge fund or private equity fund.
9. Identify "similar funds" that should be brought within the scope of the Volcker Rule prohibitions in order to prevent evasion of the intent of the rule.
10. Require banking entities to publicly disclose permitted exposure to hedge funds and private equity funds.

## **SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS**

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In this study, the Council sets forth recommendations that seek to identify and eliminate prohibited proprietary trading activities and investments in or sponsorships of hedge funds and private equity funds by banking entities. The proprietary trading section of the study outlines criteria for defining prohibited activities, rigorous tests to identify permitted activities, and grounds to prohibit activities that would involve or result in a material conflict of interest, result in a material exposure to a high-risk asset or high-risk trading strategies, pose a threat to the safety and soundness of such banking entity, or pose a threat to the financial stability of the United States.

The private funds section of the study focuses on key issues raised in the implementation of the Volcker Rule's hedge fund and private equity funds provisions, and recommends certain substantive criteria that Agencies should use to guide legal interpretations in the rulemaking. It also recommends a compliance and supervisory framework.

### **PROPRIETARY TRADING**

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The Volcker Rule mandates that banking entities cease proprietary trading, subject to certain exceptions for “permitted activities,” such as market making, trading in government securities, hedging, and underwriting. Although “bright line” proprietary trading desks are readily identifiable, in current practice, significant proprietary trading activity can take place in the context of activities that would otherwise be permitted by the statute. Therefore, an essential part of implementing the statute is the creation of rules and a supervisory framework that effectively prohibit proprietary trading activities throughout a banking entity – not just within certain business units – and that appropriately distinguish prohibited proprietary trading from permitted activities.

In developing these rules, the study recommends that Agencies' rulemaking and implementation efforts be guided by five fundamental principles:

1. The regulations should prohibit improper proprietary trading activity using whatever combination of tools and methods are necessary to monitor and enforce compliance with the Volcker Rule.
2. The regulations and supervision should be dynamic and flexible so Agencies can identify and eliminate proprietary trading as new products and business practices emerge.
3. The regulations and supervision should be applied consistently across similar banking entities (e.g., large banks, hedge fund advisers, investment banks) and their affiliates to facilitate comparisons. The regulations and supervision should endeavor to provide banking entities with clarity about criteria for designating trading activity as impermissible proprietary trading.

4. The regulations and supervision should facilitate predictable evaluations of outcomes so Agencies and banking entities can discern what constitutes a prohibited and a permitted trading activity.
5. The regulations and supervision should be sufficiently robust to account for differences among asset classes as necessary, e.g., cash and derivatives markets.

The recommendations also identify indicia of permitted activities that will help prevent banking entities from migrating proprietary trading activities into areas of the banking entity that otherwise conduct permitted activities. Implementing these indicia-based tests would require certain banking entities to change their business practices to bring trading activities into compliance with the statutory definitions of the permitted activities. However, these tests are also designed to preserve banking entities' ability to engage in critical financial intermediation in financial markets.

To effectively apply and monitor these substantive tests, the Council recommends a four-part implementation and supervisory framework that would assist Agencies in identifying proprietary trading activities that must be eliminated, consisting of:

1. ***Programmatic compliance regime***: The Council recommends that banking entities be required to develop robust internal controls and programmatic compliance regimes (that will include strong investment and risk oversight) designed to ensure that proprietary trading does not migrate into permitted activities. The compliance regime may require:
  - The establishment of internal policies and procedures to detect and eliminate proprietary trading;
  - The development and implementation of a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule policies and procedures.
  - The creation of recordkeeping and reporting systems to enable internal compliance reviews and supervisory examinations;
  - The implementation of independent testing of the compliance regime by a banking entity's internal audit department or by outside auditors, consultants or other qualified independent parties; and
  - Robust review of permitted activities to ensure that internal policies and procedures are being followed, combined with engagement by the Board of Directors and public attestation of compliance by the Chief Executive Officer ("CEO").
2. ***Analysis and reporting of quantitative metrics***: This study outlines four categories of metrics that banking entities could be required to analyze and report to Agencies to help identify impermissible proprietary trading, including:
  - Revenue-based metrics;
  - Revenue-to-risk metrics;
  - Inventory metrics; and

- Customer-flow metrics.

The use of appropriate metrics to identify possible proprietary trading should be important for management and supervisors to ensure compliance with the Volcker Rule. Although this study puts forth specific metrics that Agencies should consider for these purposes, Agencies may also consider other metrics they identify in the future.

3. ***Supervisory review and oversight:*** Agencies can engage in supervisory review and oversight of trading operations to review and test internal controls, monitor for potentially problematic trends or incidents, and investigate specific trading activity, including position-level data, where warranted.
4. ***Enforcement procedures for violations:*** If a violation is identified through the examination process, the statute requires that the activity be terminated and that the investment be liquidated. This remedy should not preclude Agencies from considering other potential supervisory or enforcement actions such as increased oversight, reductions in risk limits, increased capital charges, or monetary penalties. Also, it should not insulate proprietary trading from other applicable provisions of law. The statute also provides for an adjudication process, including notice and opportunity for hearing, which supervisors must develop as part of the implementation process.

This section also outlines key issues in the application of the prudential “backstop” provisions that limit the scope of permitted activities. The section closes by outlining other important elements of the U.S. financial regulatory system that will further support the objectives of the Volcker Rule, including more stringent capital standards, comprehensive supervision of derivatives markets and stronger “firewalls” between depository institutions and their affiliates.

## **SPONSORSHIP OF AND INVESTMENTS IN HEDGE FUNDS AND PRIVATE EQUITY FUNDS**

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In addition to the restrictions on proprietary trading, the Volcker Rule generally prohibits banking entities from making investments in or sponsoring hedge funds or private equity funds that are not connected to the provision of bona fide trust, fiduciary, or investment advisory services to its customers. The purpose of this additional prohibition is to:

1. Ensure that banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker Rule’s restrictions on proprietary trading;
2. Confine the private fund activities of banking entities to customer-related services; and
3. Eliminate incentives and opportunities for banking entities to “bail out” funds that they sponsor, advise, or where they have a significant investment.

The Volcker Rule prohibits hedge fund and private equity fund sponsorship or investment by banking entities except in narrow circumstances. A banking entity is allowed to organize and offer a fund to its bona fide trust, fiduciary, and investment advisory customers. Further,



banking entities are not permitted to invest in these types of funds beyond a specified *de minimis* amount in order to establish funds and attract unaffiliated investors in connection with its customer-related business.

The Volcker Rule relies on two commonly-used exclusions from the definition of the term “investment company” under section 3(c) of the Investment Company Act to define hedge funds and private equity funds. Although widely used by traditional hedge funds and private equity funds, these statutory exclusions were not designed to apply only to such funds. As such, they do not specifically address or closely relate to the activities or characteristics that are typically associated with hedge funds or private equity funds. In implementing the Volcker Rule, Agencies should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the “hedge fund” and “private equity fund” definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute.

The study makes recommendations in three areas below:

1. ***Customer requirement:*** The Volcker Rule requires that organized or sponsored funds only be offered to “customers” of a banking entity. The term “customer” is not defined in the statute. The study outlines factors that Agencies should consider in determining who is a customer and the necessary nature of that relationship.
2. ***Calculation of de minimis investment:*** The *de minimis* investment calculation applies both to restrict the exposure of a banking entity to 3% of any single fund and to limit the banking entity’s aggregate exposure to 3% of Tier 1 capital. Agencies should consider calculating these limits in a manner that will require full accounting of the banking entity’s risk and requiring ongoing monitoring of these limits through the life of the fund.
3. ***Monitoring compliance, attestation, and public reporting:*** Agencies should consider requiring banking entities to establish internal programmatic compliance regimes that will involve strong investment and risk oversight of permissible hedge fund and private equity fund activities with engagement by the Board of Directors and public attestation of the adequacy of such compliance regime by the CEO. In addition, in the limited instances in which a banking entity is permitted to invest in a hedge fund or private equity fund to facilitate customer-related business, Agencies should consider requirements for banking entities to disclose the nature and amount of any such investment.

## THE STATUTORY MANDATE AND OBJECTIVES OF THE STUDY

The Dodd-Frank Act requires the Council to conduct a study and make recommendations on effectively implementing the Volcker Rule not later than six months after the date of enactment:

- (1) STUDY.—Not later than 6 months after the date of enactment of this section, the Financial Stability Oversight Council shall study and make recommendations on implementing the provisions of this section so as to—
- (A) promote and enhance the safety and soundness of banking entities;
  - (B) protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;
  - (C) limit the inappropriate transfer of Federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal Government to unregulated entities;
  - (D) reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board, and the interests of the customers of such entities and companies;
  - (E) limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;
  - (F) appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and
  - (G) appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under subsection (a) [of Section 13 of the Bank Holding Company Act of 1956].

Agencies are required, not later than nine months after the completion of this study, to adopt rules to implement the Volcker Rule and must consider the recommendations of the Council in developing and adopting such regulations. In so doing, Agencies are required to consult and coordinate with each other so that, to the extent possible, these regulations are comparable across Agencies and provide for consistent application and implementation of the Volcker Rule. The Chairperson of the Council is responsible for coordination of the regulations issued under Section 619 of the Dodd-Frank Act.

The recommendations in this study are designed to assist Agencies in effectively implementing the prohibition on proprietary trading in line with the study's statutory objectives. Key objectives of the study are to make recommendations related to reducing risk and promoting safety and soundness of banking entities and nonbank financial companies designated for

heightened supervision by the Board.<sup>9</sup> These recommendations directly address the objectives of the study by proposing a framework that would:

- Require a comprehensive compliance and oversight regime focused on monitoring and enforcing (i) the prohibition on impermissible proprietary trading and (ii) impermissible investments in and sponsorship of hedge fund and private equity fund activities, thereby minimizing unsafe and unsound activities;
- Build on existing risk management and supervisory tools by integrating the particular risk characteristics of proprietary trading into Agencies' existing framework for safety and soundness, and recommending an oversight and risk monitoring structure for hedge fund and private equity fund activities; and
- Implement the statutory requirement to prohibit proprietary trading and investment in or sponsorship of impermissible hedge funds and private equity funds, so as to limit the transfer of subsidies from the federal support provided to depository institutions to speculative activities.

The study also includes explicit recommendations to address conflicts of interest and accommodations for the insurance industry.

With respect to appropriately timing the divestiture of illiquid assets required by the ban, the Volcker Rule provides for a conformance period during which banking entities and nonbank financial companies supervised by the Board must bring their activities and investments into compliance with the Volcker Rule, and requires the Board to issue rules not later than 6 months after the enactment of the Dodd-Frank Act to implement the conformance period. The Board recently issued a Notice of Proposed Rulemaking in the Federal Register requesting comment on a proposed rule, which includes the Board's position on the appropriate conformance period for the divestiture of illiquid funds.<sup>10</sup>

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<sup>9</sup> 12 U.S.C. § 1851(b)(1).

<sup>10</sup> Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 75 Federal Register 72741 (November 26, 2010).

## PUBLIC OUTREACH AND COMMENTS

To assist the Council in conducting the study and formulating its recommendations, the Council published a Notice and Request for Information in the Federal Register on October 6, 2010.<sup>11</sup> An excerpt from the Notice and Request for Information containing the questions posed is attached as Annex A. At the time the comment period closed on November 5, 2010, the Council had received more than 8,000 comments. Approximately 6,550 of these comments were substantially the same letter arguing for strong implementation of the Volcker Rule. The remaining 1,450 comments each set forth individual perspectives from financial services market participants, Congress, and the public. Further, staff of the Council's member agencies conducted meetings with parties representing a wide range of perspectives on the issues raised by implementation of the Volcker Rule.

In general, many commenters urged Agencies to implement the Volcker Rule so as to:

- Unambiguously prohibit banking entities from engaging in speculative proprietary trading or sponsoring or investing in hedge funds or private equity funds;
- Define terms and eliminate potential loopholes; and
- Provide clear guidance to banking entities as to the definition of permitted and prohibited activities.

Selected written and oral comments are summarized below.

### PROPRIETARY TRADING

A large number of commenters recommended that the Volcker Rule regulations prescribe clear and predictable rules that distinguish prohibited proprietary trading from permitted activities and noted that ambiguity would hinder compliance and potentially reduce market liquidity. Several commenters drew a distinction between impermissible proprietary trading and "principal trading," including asset-liability, liquidity, interest-rate and treasury management and similar core banking activities.

With respect to "market making," which is a statutorily-permitted activity, several commenters expressed concern that market making could be defined so broadly as to allow proprietary trading to be disguised as market making and suggested that Agencies seek to limit the potential breadth of this exemption. Many commenters advocated for a narrow and clear definition that would clearly distinguish genuine market making for the

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<sup>11</sup> Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds, 75 Federal Register 61758 (October 6, 2010).

benefit of customers from impermissible proprietary trading. Some commenters advocated for a broad definition, arguing that market makers engage in a wide variety of activities that provide liquidity and enhance efficiency in the market. These commenters noted that market making often requires the assumption of principal risk, as market makers take on liquidity and inventory risk for the benefit of customers. Further, some commenters voiced strong concern that a restrictive definition of market making might damage U.S. markets and place U.S. banking entities and their customers at a competitive disadvantage internationally.

In addition, some commenters argued that implementation of the underwriting exception, another statutorily-permitted activity, should permit a broad range of “traditional” underwriting activities, including related price stabilization and overallotment activities.

Commenters advanced a number of approaches for distinguishing between permitted and prohibited activities and for testing compliance. Many commenters noted that trading activity varies by asset class and, as a result, implementation of the Volcker Rule should be tailored to particular markets and asset classes. A number of commenters emphasized the importance of using specific, quantitative risk metrics to assess the extent of risk in banking entities. Other commenters observed that existing risk management tools may provide a useful guide, but that such tools are currently used and designed to predict and limit losses and not to identify proprietary trading.

Some commenters proposed that Agencies test compliance with the Volcker Rule as part of their established supervisory review process, while others contended that supervisors should have the ability to closely scrutinize trading books if and when there is reason to suspect that a banking entity is engaging in impermissible proprietary activity. Some commenters suggested that there should be a “supervisory conversation,” in which the banking entity would explain the intent of trading activity, rather than a forced unwind of the relevant position, if a banking entity’s trading activity appears to violate Agency-adopted standards, guidelines, or metrics. Other commenters recommended that banking entities establish internal policies and procedures designed to ensure compliance with the Volcker Rule.

Further, certain commenters advocated for a “circuit breaker” mechanism for relaxing or lifting the Volcker Rule’s restrictions during periods of market stress or if certain Volcker-related limitations were found to be inconsistent with normal market functioning. Other commenters suggested that Agencies consider setting broader ranges of permissible behavior at the outset and narrowing and refining these ranges over time as the requisite trading data is analyzed.

With respect to risk-mitigating hedging, another statutorily-permitted activity, some commenters stated that transactions that reduced identifiable risks should be permitted but that the direct relationship to the underlying exposure should be clear. Several commenters noted that, in practice, banking entities often manage and hedge risks on an aggregate basis (i.e., at the portfolio level), instead of on an individual trade basis. Several commenters stated that such hedging reduces risk and facilitates customer trading

activity by allowing banking entities to profit from capturing the “spread” in market making without being exposed to general price movements.

Further, commenters representing the insurance industry argued that investment activities are essential to the insurance industry and should be excluded from the scope of the Volcker Rule’s restrictions. These commenters noted that the statute defines certain investment activities by regulated insurance companies and their affiliates as permitted activities.

A number of commenters also cautioned that proprietary trading creates potentially hazardous exposures and conflicts of interest, especially at institutions that operate with explicit or implicit government guarantees. To avoid such conflicts, many commenters recommended that the terms “material conflicts of interest,” “high-risk assets,” and “high-risk trading strategies” be defined. Specifically, some commenters expressed concern that conflicts of interest might continue to exist on market making desks if proprietary trading activity were only prohibited on non-customer facing desks.

Commenters expressed a range of opinions regarding the definition of “trading account,” which is an element of the Volcker Rule’s definition of proprietary trading. Some commenters advocated in favor of a very clear definition to reduce compliance costs and uncertainty. Several commenters argued that there are several types of accounts that are used to conduct traditional banking activities that should be expressly exempted from any restrictions under the Volcker Rule. Other commenters indicated that the definition of trading account should be broad to ensure that any account that may be used to conduct proprietary trading is covered.

The Volcker Rule’s definition of “trading account” references the term “near term.” Several commenters advocated for detailed tests or specific timeframes that should be used to define “near term.” Some commenters argued that any restrictions on proprietary trading should be limited to very short-term activities. Other commenters observed that turnover is not necessarily a good proxy for risk. Lastly, some commenters indicated that the definition should be broad enough to capture the full range of activities targeted by the statute while still permitting traditional banking activities.

## **SPONSORSHIP OF AND INVESTMENTS IN HEDGE FUNDS AND PRIVATE EQUITY FUNDS**

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A number of commenters focused on the broad definitions used for private equity funds and hedge funds in the Volcker Rule. Specifically, many commenters expressed concern that unless the definition of “private equity fund” and “hedge fund” is narrowed, the Volcker Rule’s prohibitions would capture funds that Congress did not intend to bring within the scope of the Rule; in other words, there are a number of entities that rely on exclusions from the definition of an investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act that the commenters do not consider to be “hedge funds” or “private equity funds.” In addition, some commenters noted that the words “such

similar funds” should be construed to encompass funds that are functionally similar to “hedge funds” and “private equity funds” and requested a clear definition to address what “similar funds” means.

Many commenters also argued that venture capital funds should be excluded from the definition of “private equity fund” and “hedge fund.” In arguing for this exclusion, these commenters focused on ways in which the venture capital business model is distinct, the potential economic impact of curtailing investments in venture capital, and congressional intent.

With respect to the statutory provision allowing *de minimis* investments in private equity funds and hedge funds, commenters recommended that Agencies provide more clarity regarding how and when the *de minimis* calculation would be applied. Also, a number of commenters recommended that restrictions be coupled with an effective disclosure regime that clearly delineates each banking entity’s relationship with hedge funds and private equity funds.

Commenters also addressed one of the statutory limitations on permitted activities—material conflicts of interest. Some commenters maintained that the Volcker Rule’s restrictions on transactions between a banking entity and any hedge fund or private equity fund, if appropriately implemented in conjunction with existing disclosure and consent requirements, should ensure that material conflicts of interest are appropriately addressed. Other commenters argued that disclosure requirements need to be supplemented by additional limitations.

In general, commenters stated that among the key considerations in implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds are: preventing banks from using their relationships with hedge funds and private equity funds to evade the prohibitions on proprietary trading, and prohibiting banks from bailing out affiliated hedge funds and private equity funds.

## **OTHER COMMENTS**

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Commenters addressed the scope of the term “banking entity,” in particular whether depository institution affiliates and foreign banking entities are covered. A number of commenters expressed concerns that if the term is not properly defined, the activities of certain banking entities, such as employee pension funds, funds of funds, and asset managers, would be curtailed due to their affiliation with an insured depository institution.

Several commenters suggested that the regulations provide transition provisions to give banking entities sufficient time to conform to new rules, particularly with respect to illiquid funds because the contractual term of illiquid hedge funds and private equity funds may extend for 15 years or more. Commenters contend that a transition period is

essential to minimizing the economic impact of divestiture and avoiding disruption to the markets.

A number of commenters pointed out that extensive and ongoing data collection is a key tool to limit the inappropriate transfer of federal subsidies to unregulated entities. A subset of commenters asserted that further recommendations on how to limit the spread of the subsidy from deposit insurance are not necessary due to existing provisions of law, including sections 23A and 23B of the Federal Reserve Act and the anti-guarantee provision of the Volcker Rule that prohibits the guarantee of the obligations and performance of hedge funds or private equity funds.<sup>12</sup>

Some commenters argued that proprietary trading and investments in hedge funds and private equity funds provide important income diversification for banking entities. These commenters also argued that banking entities provide an important source of capital for private equity and venture capital, and an important source of liquidity to financial markets. However, the vast majority of comments asserted that a robust implementation of the Volcker Rule, limiting banking entities' ability to engage in speculative proprietary trading with customer deposits, is essential to the safety and soundness of the banking industry. In addition, many commenters supported strong anti-evasion provisions to prevent unanticipated tactics from undermining the intent of the Volcker Rule.

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<sup>12</sup> 12 U.S.C. § 1851(d)(1)(G)(v).



# PROPRIETARY TRADING

## INTRODUCTION

The Volcker Rule requires banking entities to cease prohibited proprietary trading activities. The Council recommends that Agencies implement the Volcker Rule in a manner that both places compliance obligations on banking entities and establishes supervisory programs for monitoring, identifying, and responding to potential violations. The purpose of the Volcker Rule is three-fold:

1. Separate federal support for the banking system from speculative trading activity with the banking entity's own capital;
2. Reduce potential conflicts of interest between a banking entity and its customers; and
3. Reduce risk to banking entities and nonbank financial companies designated for supervision by the Board.

This section of the study outlines recommendations for Agencies to consider when implementing the Volcker Rule. These recommendations are designed to eliminate prohibited proprietary trading activities, prevent evasion of the Volcker Rule's prohibition under the guise of permitted activities, and minimize any related capital markets disruption.

Many of the key considerations in implementation arise from the potential for proprietary trading and permitted activities to be commingled. The study recommends Agencies consider a four-part supervisory framework to assist banking entities and Agencies in distinguishing prohibited proprietary trading from permitted activities, consisting of:

1. Programmatic compliance regime;
2. Analysis and reporting quantitative metrics;
3. Supervisory review and oversight; and
4. Enforcement procedures for violations.

## STATUTORY OVERVIEW

Under the Volcker Rule, banking entities are prohibited from engaging in proprietary trading, with certain exceptions for permitted activities.<sup>13</sup> Congress intended to strictly restrain speculative risk taking in the form of proprietary trading by banking entities,

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<sup>13</sup> Id. at § 1851(a)(1)(A) and (d)(1).

which benefit from the support of federal deposit insurance and access to discount window borrowing.

The statute defines “proprietary trading” as:

[E]ngaging as a principal for the trading account of [a] banking entity or [systemically important nonbank financial company] in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule . . . determine.<sup>14</sup>

The statute defines “trading account” as:

[A]ny account used for acquiring or taking positions in the securities and instruments described in [the definition of “proprietary trading”] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the appropriate Federal banking agencies, the [SEC], and the [CFTC] may, by rule . . . determine.<sup>15</sup>

The statute also provides limited and narrow exceptions for “permitted activities.”<sup>16</sup> These permitted activities are limited to important forms of financial intermediation that Congress concluded are permissible in the context of entities that have the support of federal deposit insurance and discount window access. The enumerated permitted activities suggest a consistent view that activities of banking entities should be for the ultimate benefit of the broader economy while maintaining the safety and soundness of the institutions. Permitted activities related to trading under the Volcker Rule, in general terms, include the following:

- Market making-related activity;
- Risk-mitigating hedging;
- Underwriting;
- Transactions on behalf of customers;
- Transacting in government securities;
- Certain insurance activity;
- Investments in small business investment companies, public welfare investments and certain qualified rehabilitation expenditures under federal or state tax laws;
- Certain offshore activities; and
- Other activities that Agencies determine would promote and protect the safety and soundness of banking entities and U.S. financial stability.

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<sup>14</sup> *Id.* at § 1851(h)(4).

<sup>15</sup> *Id.* at § 1851(h)(6).

<sup>16</sup> *Id.* at § 1851(d)(1).

Under the Volcker Rule, permitted activities are subject to a “backstop” that prohibits these permitted activities if they result in a material conflict of interest, result in material exposure to high-risk assets or high-risk trading strategies, pose a threat to safety and soundness of the banking entity, or pose a threat to financial stability.<sup>17</sup> Additionally, the Volcker Rule requires the appropriate agencies to impose additional capital requirements and quantitative limitations if necessary to protect the safety and soundness of these banking entities.

The statute also recognizes the critical function that loan creation plays in the nation’s economy and provides that the Volcker Rule shall not 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.<sup>18</sup>

Under the statute, Agencies are also required to impose rules that ensure compliance with and prevent evasion of the Volcker Rule.<sup>19</sup> The Volcker Rule specifies that in implementing these requirements, Agencies should require banking entities to terminate any activity or investment that “functions as an evasion” or “otherwise violates the restrictions” of the Volcker Rule.<sup>20</sup> This provision is in addition to other enforcement powers that Agencies have through their existing authorities.

## **IMPLEMENTATION CONSIDERATIONS**

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Of the permitted activities listed in the prior section that relate to trading, the first four present the greatest challenge in distinguishing impermissible proprietary trading activities from permissible activities. Key to implementing the Volcker Rule is the creation of rules that prevent prohibited proprietary trading activities from occurring throughout a banking entity – not just within certain business units. Absent robust rules and protections, banking entities may have the opportunity to migrate existing proprietary trading activities from the standalone business units that are presently recognized as “proprietary trading operations” into more mainstream “sales and trading” or other operations that otherwise engage in permitted activities.

Following the enactment of the Volcker Rule, major banking entities have taken or announced steps to sell, spin off, or close down their standalone “bright line” proprietary trading businesses. Certain market making and underwriting businesses, as permitted activities under the Volcker Rule, will continue to operate even after the Volcker Rule’s prohibitions become effective. These businesses require banking entities to maintain an active presence in the capital markets, often to assume principal risk, and, in the case of market making, to hold inventory for sale.

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<sup>17</sup> *Id.* at § 1851(d)(2).

<sup>18</sup> *Id.* at § 1851(g)(2).

<sup>19</sup> *Id.* at § 1851(b)(2).

<sup>20</sup> *Id.* at § 1851(e)(2).

During the Council’s outreach process, several banking entities noted that some individuals employed in the proprietary trading operations have been transferred to those capital markets roles, such as market making, that are defined as permitted activities. Some commenters expressed concern that individuals may be able to continue to engage in proprietary trading in their new roles and suggested the need for a regulatory framework that ensures a thorough prohibition on impermissible proprietary trading, irrespective of where such activity may take place within an organization. Other commenters indicated that proprietary trading already occurs within existing market making and other activities.

## **PERMITTED ACTIVITIES THAT ARE DIFFICULT TO DISTINGUISH FROM PROPRIETARY TRADING ACTIVITIES**

The challenge inherent in creating a robust implementation framework is that certain classes of permitted activities – in particular, market making, hedging, underwriting, and other transactions on behalf of customers – often evidence outwardly similar characteristics to proprietary trading, even as they pursue different objectives. In addition, characteristics of permitted activities in one market or asset class may not be the same in another market (e.g., permitted activities in a liquid equity securities market may vary significantly from an illiquid over-the-counter derivatives market).

Broadly gauged restrictions on proprietary trading may deter permitted market making, hedging, and underwriting activities. However, more loosely defined restrictions are likely to provide an opportunity for prohibited proprietary trading.

### **MARKET MAKING**

Section 619 designates “market making-related” activity as a permitted activity, provided that it is “designed not to exceed the reasonably expected near term demands of clients, customers or counterparties.” Current “market making” businesses often include elements of proprietary trading. Agencies therefore must be vigilant to ensure that banking entities do not conceal impermissible proprietary trading activities within larger market making operations.

The size of the exposure and the amount of risk required to perform market making vary widely. At one end of the spectrum lie those activities in which the market maker assumes very little risk in a transaction (“agency” or “riskless principal” transactions). At the other end of the spectrum lie those activities in which the market maker commits capital to complete transactions (“principal transactions”).

In the simple form of agency or riskless principal transactions, market making involves the market maker either matching a buyer and seller, who then transact

together, or securing commitments from both the buyer and the seller and then purchasing the financial instrument<sup>21</sup> from the seller and immediately selling it to the buyer. These activities present minimal opportunity for impermissible proprietary trading. However, the “riskless” form of market making is limited in practice to highly active and liquid markets that are characterized by a consistent, large and diverse pool of willing buyers and sellers. Even within these activities, however, the results of the Council’s outreach suggest that the majority of trading utilizes some broker capital commitments in a principal transaction model as described below.

In principal transactions, market makers are asked to assume the role of counterparty in the absence of a ready buyer or seller on the other side of the transaction. In such transactions, market makers commit capital to provide liquidity to their customers and ensure market continuity. In doing so, the market maker assumes risk by holding the purchased position on its balance sheet as “inventory” until such time that the transaction can be completed. Moreover, as some prior transactions are completed, other new transactions will be initiated such that the market maker will always be taking risk as long as the market making activity is performed. This activity is especially complex in illiquid markets or in a liquid market where an order is very large, as a market maker may be required to assume significant market risk between the time that the large order is purchased and sold back into the market.

For example, in the case of over-the-counter derivatives markets, which are structured differently from liquid securities markets, market making typically entails a customer-initiated transaction involving a bespoke financial instrument. The trading desk provides the customer with a price and upon execution will hold the financial instrument in its portfolio. As these are customized derivatives, they do not typically have a matching offset (i.e., matched book). The market making desk will typically dynamically hedge to offset the exposures.

The ability to hold inventory in this context is a principal complexity: the same inventory built with the intention of facilitating liquidity for clients could also be built with the intention of engaging in impermissible proprietary trading. Consequently, a key challenge is the identification of inventory levels that are appropriate to facilitate client-driven transactions but not to take prohibited proprietary risks.

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<sup>21</sup> For purposes of this study, the definition of a financial instrument includes “any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that [Agencies] may, by rule as provided... determine.” 12 U.S.C. § 1851(h)(4).

Banking entities utilize hedging as a risk mitigation tool. Hedging is an integral part of the market making function that is permitted under the Volcker Rule. Hedging is also an important tool of firm-wide risk management.

With respect to market making, client-driven transactions create an unbalanced book of positions temporarily held for disposal. A market maker must then find a way to reduce the risk of these positions while they remain on their balance sheet. As a specific example, a market maker in equity options may fill a number of buy orders for call options on a particular stock without receiving any offsetting sell orders for the same call option. As a result, the market maker will be exposed to upside risk in the stock. A market maker will often seek to hedge this risk by purchasing shares to reduce its exposure to the underlying stock until offsetting sell orders can be found or the options expire.

On a firm-wide basis, banking entities often need to hedge interest rate risk and credit risk. Banking entities create substantial amounts of credit risk by originating loans to businesses and households. In addition, banking entities face substantial interest rate risk as the maturity of their interest bearing assets (loans) and obligations (deposits and debt) often do not match. Accordingly, banking entities often seek to use credit and interest rate derivatives to reduce their exposure. Many banking entities use hedging as part of their traditional asset-liability, credit and business risk management functions.

However, hedging, or alternatively, the flexibility not to hedge a position, also presents a potential avenue to evade the proprietary trading prohibition if hedges do not correlate with owned assets or if a banking entity seeks an independent return through the application of a hedge.

To address this concern, a banking entity's hedging strategy should be clearly defined and directly related to an underlying set of fundamental risk factors to which the entity is exposed.

One of the most basic considerations in the implementation of any hedging strategy is how closely to hedge the underlying risk exposure. Most trading assets are exposed to a number of risk factors. In the context of nonlinear derivative contracts, such as options, the risks are compounded by complex interactions among the underlying risk factors. In general, it may be uneconomical to completely hedge all of the risk to which a trading desk is exposed. In addition to factor-based risk, there is risk exposure that is created by the imperfect nature of the hedge. This is typically referred to as basis risk. If not properly managed, the unhedged portion of the factor-based risk and the basis risk can both be sources of large losses and also should be monitored for indications of impermissible proprietary trading.

At the same time, hedging activity serves a critical role by allowing banking entities to manage their risk exposures while they engage in a variety of market making and banking activities. Prudent risk management is at the core of both institution-specific safety and soundness, as well as macroprudential and financial stability. The Volcker Rule should not be applied in a way that interferes with a banking entity's ability to use risk-mitigating hedging.

As previously noted, the statute includes an exception for "risk-mitigating hedging" activities in recognition of banking entities' need to reduce the risk they face from exposures to "individual" or "aggregated" positions. Banking entities hedge the risks that they face in a number of ways based on the nature of the risks and the entity's exposure to these risks. For example, multiple market making desks in an entity may be exposed to similar risk factors. Therefore, hedging may be conducted at a level above that of a specific trading desk, on a portfolio basis, to more efficiently hedge an entity's exposure to the risk factors.

Despite its utility, such portfolio hedging activities can be difficult to link to the rest of an entity's trading operations in a clear and fully transparent manner. In particular, it is possible that such portfolio hedging could be commingled with and difficult to distinguish from impermissible proprietary trading activities. This is because the commitment of principal risk is inherent to banks' hedging activities and therefore needs to be carefully monitored to limit the potential for hedging activities to mask proprietary activity.

Accordingly, the Council suggests that Agencies consider how the Volcker Rule should be implemented with respect to portfolio hedging. Agencies could consider factors such as the nature of the risks being hedged; the extent to which banks measure, monitor and control risks at a portfolio level; the extent to which portfolio hedging is part of an entity's formal hedging strategy; whether traders are compensated based on earnings generated by portfolio hedging activity; and the overall efficacy of portfolio hedging activities in reducing risk throughout the banking entity, and the methods allowing Agencies to ensure and determine which desk-specific positions are being hedged on an aggregate basis.

## UNDERWRITING

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Like market making, underwriting requires the assumption of principal risk. Underwriting services provided by banking entities are essential for facilitating equity and debt issuance for capital raising. Most commonly, underwriting requires an underwriter or underwriting syndicate to make commitments in advance to purchase a set amount of the securities issued if they are not purchased fully by other market participants (known as a "firm commitment underwriting"). During and after issuance, institutions will sometimes intervene in the market as a mechanism for supporting the offered security. As a result, a key challenge is the identification of activity that is not necessary to allow for underwriters to

adequately support their clients' equity and debt issuances and may indicate impermissible proprietary trading.

#### OTHER TRANSACTIONS ON BEHALF OF CUSTOMERS

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The statute also allows for the “purchase, sale, acquisition, or disposition of securities and other instruments . . . on behalf of customers.”<sup>22</sup> This language recognizes the important role that banks can play in facilitating transactions on behalf of customers, and reflects the intent of the Volcker Rule to permit activities that are customer-serving, such as traditional market making or underwriting activities, as opposed to speculative activity with the banking entities' capital.

#### **CHALLENGES IN DELINEATING PROPRIETARY TRADING ACTIVITIES FROM PERMITTED ACTIVITIES**

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In general, a market maker seeks to earn a return by participating in the flow of trading – intermediating between clients who seek to purchase financial assets or other forms of risk and those that seek to sell them. Similarly, an underwriter typically purchases a large block of securities at a discount from a seller, with the intention to resell these securities over time in the market.

Conversely, a proprietary trader accumulates positions with the intention of benefiting from an expected appreciation in the value of such positions. Proprietary traders will generally seek to capture movements in the price of a financial instrument, while market makers will seek to minimize the impact of such movements.

It can be difficult, however, to differentiate a position intended to make a proprietary profit from one designed to satisfy current or expected customer demand or to provide liquidity to markets. Differences among asset classes add further complexity as liquidity and risk varies among them, and varies even more in times of stress. Consequently, any implementation framework for the Volcker Rule should consider the following challenges:

- ***Inventory that is required for market making or underwriting could also be used to conduct proprietary trading:*** Banking entities may acquire inventory and maintain risk exposures to satisfy current or expected customer demand. However, proprietary traders also build inventory but do so with the expectation that inventory will appreciate in the near term rather than using the inventory to facilitate customer transactions as would a market maker. Discerning differences in the characteristics of inventory used to facilitate market making and underwriting versus inventory held for proprietary trading is a key challenge in implementing the Volcker Rule.

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<sup>22</sup> 12 U.S.C. § 1851(d)(1)(D).



- ***The amount of risk required for permitted activities varies considerably by asset class:*** Accommodating customers by trading as principal may be reasonable in one market, in a particular amount, or at a particular time, but not in another market, size, or time. For example, exchange-traded equity markets tend to have extensive depth and breadth and so dealers do not often need to provide substantial amount of liquidity to their clients. In contrast, debt markets tend to be less liquid and more fragmented for both buyers and sellers in the normal course of business. Similarly, dealing in over-the-counter derivatives is characterized by long-term, bilateral contracts with risks that must be hedged across the portfolio by a combination of other contracts and trades in other financial instruments.
- ***Accumulation of inventory in “anticipation” of customer demand can resemble proprietary trading:*** The Volcker Rule allows for the accumulation of inventory in anticipation of “reasonably expected near term demands of clients...”<sup>23</sup> Anticipating customer demand, however, can be closely correlated with a prediction of price movements, as financial instruments that are in high demand tend to appreciate in price. In this sense, building inventory in a position on the presumption that the position will appreciate can strongly resemble proprietary trading, which is likewise predicated on taking positions that a trader believes will increase in value in the near term. However, building inventory as part of a market making business is more likely to have a predictable inventory profile in terms of volume and in relation to customer demand than would a proprietary trading business.
- ***Banking entities can engage in impermissible proprietary trading through inconsistent or incomplete hedging in the context of their market making activities:*** In executing principal transactions for which there is no natural subsequent buyer of the financial instrument, market makers will often hold the instrument in their portfolio but then hedge it using correlated instruments that they sell to other customers. However, banking entities do not always hedge such positions fully or consistently. In some cases, it may not be possible or cost-effective to fully hedge a position. In other cases, however, a refusal to hedge could indicate a proactive choice to take on a proprietary position.
- ***Agencies should consider the combined effects of permitted activities:*** Agencies should consider how the combination of permitted activities might be used to circumvent the proprietary trading restrictions. For example, the Agencies should consider whether combining the underwriting and the hedging exemption to create an on-going proprietary trading book layered on top of an underwritten security held in inventory functions as an evasion of the Volcker Rule.<sup>24</sup>

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<sup>23</sup> Id. at § 1851(d)(1)(B).

<sup>24</sup> For example, if a firm underwrites a set of convertible bonds and then holds those in inventory, it can selectively hedge in various dimensions of the bonds’ exposure to alternative factors to create an equity trade (by holding all but the equity exposure hedged), a volatility trade (by keeping all components but the volatility exposure hedged), a credit trade or a correlation trade (by using a market index such as the S&P as the hedge).

- ***Discerning the source of a market maker’s profit is challenging, especially for less-liquid financial instruments:*** Understanding the source of a market maker’s profits would ordinarily provide a strong indication of whether the firm is profiting from bona fide market making or proprietary trading. Market making activities should be characterized by rapid inventory turnover and minimal profits on inventory held, while proprietary trading activities should evidence more modest turnover with the bulk of profits derived from inventory appreciation. However, evaluating whether a firm tends to trade at the “bid” price for a financial instrument (an indication of providing liquidity and market making) or the “offer” price (an indication of consuming liquidity, and potentially proprietary trading) has less relevance in markets where such spreads are infrequently or inconsistently quoted.
- ***Disentangling different sources of revenue is challenging:*** As a specific example, measuring the revenue that is attributable to the “bid-ask” spread is difficult and not consistently observable especially in illiquid markets. Moreover, to the extent that market makers need to assume some risk to facilitate customer transactions, a portion of trading revenues will always derive from underlying market movements.
- ***Market makers often deal with other intermediaries in order to manage their overall risk exposure and maintain market continuity:*** A principal goal of market making activity is to facilitate as many offsetting customer transactions as possible while earning a spread or a fee from each transaction. While end users are the ultimate beneficiaries of market making activities, market makers are often forced to trade with non-customers in order to appropriately meet the future expected customer demand. Market makers will often trade with other large financial intermediaries that can handle large trade volumes quickly and efficiently. This so-called inter-dealer trading is an important and necessary part of managing the risk exposure of a market maker. This common practice can be abused, however, whereby inter-dealer trading is undertaken not for the purposes of market making but rather proprietary trading. A challenge for implementation of the Volcker Rule is thus distinguishing appropriate volumes of inter-dealer trading for market makers.
- ***Measures of “near term” trading accounts and “short-term” price movements are dependent on market instrument characteristics:*** Agencies should consider that in the context of principal trading, the measurement of time may be more appropriately tied to the liquidity of a financial instrument.<sup>25</sup> In many instances, a financial instrument may have little or no immediate liquidity after it is acquired by a firm. What constitutes trading in the “near term,” therefore, may depend on the characteristics and the trading volume of the particular market; as a result, a trading account would not preclude illiquid financial instruments, such as swaps. For instance, in the case of over-the-counter derivatives, a swap dealer may match

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<sup>25</sup> The Council recommends that each Agency consider utilizing FAS 157 level analysis as a possible tool in determining the liquidity of a financial instrument and any temporal metrics utilized.

a customer transaction by entering into offsetting long-term hedges (i.e., match the duration of the customer contract). Alternatively, the swap dealer may also dynamically hedge the position (i.e., enter into a series of continuous, short-term hedges over the period of the customer transaction). For such types of trades, the effectiveness of these hedges is far more consequential than the length of the holding period of the customer transaction.

Agencies should consider that proprietary trading can occur in short, mid, and long-term maturity financial instruments. In many instances, a financial instrument may have a long maturity date, e.g., a thirty-year swap, and have little or no immediate liquidity after it is acquired by a firm but is placed in its trading portfolio.

The language regarding short-term price movements employed in the Volcker Rule is similar to (i) language used by FASB accounting standards to determine whether positions are “held for trading” and (ii) a broader definition of “covered positions” that are subject to the federal banking agencies’ market risk capital rules.<sup>26</sup> Accordingly, possible definitions of “trading account” might be similar to these definitions. To the extent that Agencies choose to incorporate some type of accounting or similar term in defining “trading account,” the Council recommends that Agencies carefully consider how they might ensure that the prohibition on proprietary trading cannot be avoided through changes in accounting designations (e.g., by designating a position as “available for sale” rather than “trading”). Additionally, if accounting standards are used as the basis for the definition of “trading account” for purposes of the Volcker Rule, it is important that Agencies monitor changes to those accounting standards.

## **PRINCIPLES FOR IMPLEMENTATION OF THE VOLCKER RULE**

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The Council recommends that the implementation of the Volcker Rule be guided by the following five principles. These principles are intended to ensure that the Volcker Rule will strictly prohibit banking entities from engaging in impermissible proprietary trading while allowing them to continue to engage in permitted activities that benefit consumers and the economy.

### **RULES AND SUPERVISION SHOULD PROHIBIT IMPROPER PROPRIETARY TRADING USING ALL NECESSARY TOOLS**

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The mandate of the Volcker Rule is clear: banking entities can no longer engage in impermissible proprietary trading. As discussed in this study, distinguishing prohibited proprietary trading from permitted activities can be challenging. Accordingly, effective implementation requires a programmatic compliance regime

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<sup>26</sup> See e.g., 12 C.F.R. Part 3, Appendix B, § 2(a)(2010).

including attestation, analytical metrics, and examination resources to evaluate metrics and to detect prohibited proprietary trading.

### **RULES AND SUPERVISION SHOULD BE DYNAMIC AND FLEXIBLE**

The Volcker Rule should be implemented with the understanding that markets, products and trading activity will continue to evolve. Agencies' supervisory approaches should be flexible enough to account for this evolution. As new products, hedging strategies, and trading platforms are introduced, supervisory methods should also evolve to monitor for new impermissible proprietary trading practices.

Moreover, Agencies should work together to assess the effectiveness of the methods of supervision, in particular the success of different metrics in identifying impermissible proprietary trading activity. Agencies should also consider reviewing new data collection technologies that develop after the initial implementation.

### **RULES AND SUPERVISION SHOULD ENABLE COMPARISONS AMONG BANKING ENTITIES**

Standards should be consistent across similar banking entities. Additionally, Agencies should be able to conduct horizontal reviews in which they compare specific attributes of similar desks at different banking entities and evaluate applicable metrics. Horizontal reviews of similar institutions should involve not only reviews of policies and data, but also the application of supervisory methods at each firm to ensure consistency. Standards and regulatory treatment should not result in uneven competitive dynamics.

### **RULES AND SUPERVISION SHOULD FACILITATE PREDICTABLE EVALUATION OF OUTCOMES**

Agencies and banking entities should be able to discern what constitutes a prohibited and a permitted trading activity. Banking entities may refrain from essential financial intermediation or risk mitigation if they are unable to ascertain what constitutes permitted activities. Rules and supervision should allow for predictable evaluation outcomes, wherever possible.

### **RULES AND SUPERVISION SHOULD ACCOUNT FOR DIFFERENCES AMONG ASSET CLASSES**

The new rules and supervisory systems should account for the fact that market characteristics vary significantly by asset class. The differences include: the volume of transactions, the number of market participants, protocols for trading, strategies for hedging risk, and trading forums. Within an asset class, these variables will change

over time, from both normal market fluctuation (e.g., liquidity in any given market varies over time) as well as structural changes (e.g., introduction of new products, trading platforms). In addition, multiple desks within a single entity may trade in the same asset classes – or cross into overlapping asset classes – often with differing objectives (e.g., convertible bond traders will often take derivative and equity positions to hedge bond risk). These activities are often central to the trading strategies of the desk and should be properly understood within a regulatory regime.

Agencies should be cognizant that each asset class and trading desk will not specifically comport to all the descriptions of certain permitted activities and indicia that these activities may provide. Each Agency, in designing its regime, must account for the unique nature of the asset class, markets, and trading desks.

## **DELINEATION OF PROPRIETARY TRADING AND CERTAIN PERMITTED ACTIVITIES**

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### **IDENTIFICATION OF “BRIGHT LINE” PROPRIETARY TRADING**

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Agencies should develop criteria to identify “bright line” proprietary trading. There is a general consensus among commenters and market participants that certain types of trading activity, in which banking entities have historically engaged, is unambiguously “proprietary trading” within the context of the Volcker Rule.

Agencies should ensure that banking entities eliminate proprietary trading desks, while remaining vigilant thereafter for any reemergence of these operations. Indeed, in response to the adoption of the Volcker Rule, a number of institutions have already shut down or spun off their proprietary trading desks that formerly engaged in so-called “bright line” proprietary trading. Although “bright line” proprietary trading represents only a portion of banking entities’ proprietary trades, shutting down these desks is an important first step in the implementation of the Volcker Rule.

A key requisite element of “bright line” proprietary trading is that the activity involves the use of the banking entity’s capital and is organized and conducted for the purpose of benefiting from future price movements. In addition, “bright line” proprietary trading is typically characterized by one or more of the following additional characteristics:

- Organized to conduct trading activities for the sole purpose of generating profits from trading strategies;
- No formal market making responsibilities or customer exposure (or customer exposure that is not commensurate with the level of trading);
- Physical and/or operational separation from market making and other operations having customer contact;

- Trades with or is provided the services of, sell side analysts, brokers, and dealers;
- Receives and utilizes research or soft dollar credits provided by other broker-dealers; and/or
- Compensation structures similar to those of hedge fund managers and other managers of private pools of capital.

## **INDICIA OF CERTAIN PERMITTED ACTIVITIES**

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Banking entities assume principal risk during the normal course of their permitted trading activities, including market making, hedging and underwriting securities. In considering whether these activities are fully consistent with activities permitted under the Volcker Rule, Agencies should consider the following indicia of permitted market making, hedging, and underwriting activities.

### INDICIA OF MARKET MAKING

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The Volcker Rule provides an explicit exception for market making-related activities but requires that they be “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” To ensure that “market making” does not mask prohibited proprietary trading, Agencies should provide guidance that will assist banking entities in determining what constitutes prohibited trading activity, and will establish the basis for considering subsequent determinations as to whether a violation occurred. Accordingly, set forth below are some of the indicia of permitted market making that could be used to distinguish it from impermissible proprietary trading. To ensure full compliance with permitted activities, banking entities would likely need to change their business practices and implement comprehensive compliance programs.

The Council recommends that Agencies consider the SEC’s guidance set forth in its 2008 Release, SEC Release No. 34-58775 (Oct. 14, 2008), which established indicia of bona fide market making in equity markets, including:

- Making continuous, two-sided quotes and holding oneself out as willing to buy and sell on a continuous basis;
- Making a comparable pattern of purchases and sales of a financial instrument in a manner that provides liquidity;
- Making continuous quotations that are at or near the market on both sides; and
- Providing widely accessible and broadly disseminated quotes.

In addition, the SEC has stated that, generally, market makers post quotes at a price above the national best bid and provide liquidity on the opposite side of the market. Demonstrating these indicia while conducting prohibited proprietary

trading would be extremely challenging and will likely require banking entities to change their business practices on trading desks to conform to the Volcker Rule.

In its 2008 Release and a predecessor release, SEC Release No. 34-50103 (July 28, 2004), the SEC also discussed activities that would not be considered market making:

Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception. Further, bona-fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with Rule 203(b)(1) [the short sale rule] by the other broker-dealer or customer.<sup>27</sup>

While this guidance was developed in the context of short sale rules, it may be useful as a consideration for determining some elements of market making activity in liquid markets generally. It is important to consider, however, that the indicia described above represent general guidelines that cannot be applied at all times and under all circumstances. As a specific example, the guidelines above do not consider the market making role of block positioners.

Although the SEC has not provided similar guidance for less liquid markets, such as debt, derivatives, or asset-backed security markets, which generally lack mechanisms for widely-disseminated quotations, the following indicia could be applied in less liquid markets to determine if market making activity is in compliance with the Volcker Rule:

- Purchasing or selling the financial instrument from or to investors in the secondary market;
- Holding oneself out as willing and available to provide liquidity on both sides of the market (i.e., regardless of the direction of the transaction);
- Transaction volumes and risk proportionate to historical customer liquidity and investment needs; and
- Generally does not include accumulating positions that remain open and exposed to gains or losses for a period of time instead of being promptly closed out or hedged out to the extent possible. For example, an aged open position taken to facilitate customer trading interest would be hedged rather than exposed to gains and losses for a period of time.

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<sup>27</sup> SEC Release No. 34-50103 (July 28, 2004).

## INDICIA OF HEDGING

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Hedging, like market making, presents significant challenges for the delineation of prohibited proprietary trading. Accordingly, the Volcker Rule imposes a clear limitation on hedging by requiring that it be “risk-mitigating.” Risk-mitigating hedging is defined by two essential characteristics: (i) the hedge is tied to a specific risk exposure, and (ii) there is a documented correlation between the hedging instrument and the exposure it is meant to hedge with a reasonable level of hedge effectiveness at the time the hedge is put in place. When applying this definition it is important to recognize that risk exposure is not synonymous with position or transaction: much hedging is done on a portfolio basis.

In examining the activities of a trading desk to determine whether a hedge is risk-mitigating or is instead proprietary trading, the following indicia should be considered:

- Hedging activity should be designed to reduce the key risk factors in the banking entities’ existing exposure, and should offset gains or losses that would arise from those exposures. Hedging activity should adjust over time based on changes in a banking entity’s underlying exposures.
- Hedging activity should also adjust over time if market conditions alter the effectiveness of the hedge even if the underlying positions remain unchanged.
- Material changes in risk should generate a corresponding change in hedging activity and should be consistent with the desk’s hedging policy.

## INDICIA OF UNDERWRITING

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As with market making, underwriting poses a risk of masking impermissible prohibited proprietary trading, and the Volcker Rule imposes the same restriction, i.e., that permitted underwriting activity must be “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.” The Council suggests that Agencies consider the following factors in determining whether a banking entity is engaged in permitted underwriting:

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



Such characteristics of underwriting activities are likely to be readily identifiable. For instance, when a firm is acting as an underwriter, its participation in the due diligence process and role as advisor to the issuer will be significant and clearly documented. Participation in a syndicate should be documented, including allocation of the securities in the offering, so that Agencies may review such documentation at their discretion. Subsequent trading in the issued financial instrument should also generally be determined by the conditions of the offering. If an issuance is oversubscribed, then an underwriter may need to sell the security short in order to provide extra liquidity. If an issuance is undersubscribed, then the underwriter will hold more of the security on its books.

Agencies may wish to look to existing SEC rules that set conditions on trading practices in the context of underwriting for models of how to monitor whether an underwriting activity conforms to current regulatory practice or takes on characteristics of proprietary trading.

## **IMPLEMENTATION OF THE PROPRIETARY TRADING PROHIBITION**

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### **OVERVIEW**

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Implementation of the prohibition of proprietary trading in the statute is not readily achievable using current risk management frameworks. The current risk infrastructure deployed by banking entities is primarily designed to predict and limit losses – not restrict proprietary trading. Consequently, while current risk management frameworks may provide one useful tool for Volcker Rule implementation, effective implementation of the proprietary trading prohibition will likely require the development over time of new, specifically-tailored regulatory and supervisory tools designed to meet these challenges. Beyond recommending an approach for identifying “bright line” proprietary trading activities, this study recommends a framework for effectively addressing the challenge of distinguishing permissible market making and hedging activities from impermissible proprietary trading:

- ***Programmatic compliance regime***: Banking entities should be required to implement an effective, comprehensive program designed to monitor and ensure Volcker Rule compliance, and meet expectations to be articulated by supervisors. Elements of an effective Volcker Rule compliance regime may include internal policies and procedures, internal quantitative and other controls to ensure only permitted activities are transacted, recordkeeping and reporting systems, independent testing for compliance, and public attestation by the CEO that compliance standards are continually being met.
- ***Analysis and reporting of quantitative metrics***: As part of a compliance regime, banking entities should be required to maintain records and provide reports to

supervisors on a periodic basis sufficient to permit robust oversight of covered trading activities. Such reports would include quantitative trading metrics designed to assist Agencies in identifying impermissible proprietary trading activity that might be conducted in the context of market making or hedging activities.

- ***Supervisory review and oversight:*** Agencies should engage in supervisory review and oversight of trading operations, which might include periodic review and testing of the effectiveness of banking entities' internal controls and procedures; supervisory monitoring and review of trading activities for potentially problematic trends or incidents; interviews and other frequent dialogue with traders and management; review and monitoring of quantitative data and metrics reported by banking entities for potential red-flags; and examination and investigation of specific trading activity, including position-level data, on a random basis or in cases in which there is some indication that a violation may have occurred.
- ***Enforcement procedures for violations:*** Banking entities should be subject to strong supervisory consequences and penalties for violations, which should include termination of the activity or disposal of the investment, and other legal sanctions as appropriate.

This framework provides a foundation for implementing the Volcker Rule's proprietary trading prohibition, and Agencies should strongly consider adopting rules that implement it. One benefit of these approaches is that they are likely to be mutually reinforcing and provide a comprehensive regulatory framework; a programmatic compliance regime, supplementary reporting and review of quantitative metrics and supervisory review might be designed to work in concert to constrain proprietary trading ex ante and identify potentially problematic trading activity ex post. Under section 13(e)(2) of the Bank Holding Company Act of 1956 (the "BHC Act")<sup>28</sup>, there is a requirement for due notice and opportunity for a hearing prior to any order issued that would require the termination of any proprietary trading or investment activity by a banking entity or nonbank financial company supervised by the Board.

Although this four-part implementation framework is promising, flexible and dynamic adaptation of each of the four supervisory tools will be important; they should be viewed by Agencies as a set of options to choose from in implementing the Volcker Rule in a way that meets the guiding principles recommended by the Council. All four parts of the framework may not be relevant or helpful in implementing all aspects of the proprietary trading prohibition, and it may be desirable to place a differing degree of emphasis on each part of the framework depending on the specific activity or asset class in question.

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<sup>28</sup> 12 U.S.C. § 1851(e)(2).

## **PROGRAMMATIC COMPLIANCE REGIME**

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The Council recommends that Agencies compel banking entities to develop and integrate into current compliance regimes a new, specifically-tailored program of policies, procedures and other controls designed to ensure adherence to the Volcker Rule and facilitate supervision. Such a programmatic compliance regime may offer a number of benefits by leveraging and strengthening the existing mechanisms banking entities use to conduct business and control risk, providing supervisors with important banking entity- and business-specific information to accurately identify and evaluate risk, allowing banking entities to continue to engage in permitted activities, and minimizing the potential for evasion of the rule.

### **INTERNAL POLICIES AND PROCEDURES**

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Agencies should strongly consider requiring banking entities to develop a robust and comprehensive set of internal policies and procedures to guide trading activity and ensure that only permitted activities are conducted. These policies and procedures would be required to meet supervisory expectations. Among these policies and procedures, Agencies could mandate that banking entities produce and maintain a comprehensive description of the mission and strategy for all permitted trading activity conducted across the banking entity, down to the business- and desk-level. Such statements might be required to include:

- The mandate of each trading unit or profit center;
- A description of how revenues are generated and positions are hedged;
- An enumeration of activities engaged in by the trading unit or profit center;
- Detail of the types of customers served;
- A description of the activity typical of the customer base;
- A listing of the types of products approved for transactions; and
- A description of the compensation policy for those engaged in risk-taking activities.

Developing such policies and procedures could prove useful in ensuring that internal controls and supervisory reviews are appropriately attuned to the specific conditions of each trading unit or profit center within the firm, thus avoiding a “one-size-fits-all” approach that might inadvertently prohibit a permitted activity or permit an activity that is prohibited.

In addition, Agencies could require that the policies and procedures articulate the types and levels of risk that are necessary to execute the articulated mission of each trading unit, as well as a rationale for why the risk types and levels specified are appropriate and necessary in light of the Volcker Rule. Requiring firms to provide this type of justification could serve as an important anchor for the

supervisory assessment of the appropriateness of firms' overall compliance programs. Policies could also establish specific review and escalation procedures for violations of limits and controls.

#### INTERNAL QUANTITATIVE AND OTHER CONTROLS

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Agencies should consider requiring banking entities to develop and implement a program of controls to monitor trading activity and to ensure that the types and levels of risk taken are appropriate and consistent with articulated Volcker Rule policies and procedures. For example, Agencies might require that each type of market-making business a banking entity operates have control structures attuned to the specific risks required to operate in that market in a manner that ensures supervisory expectations are met. This approach is likely to permit Agencies to leverage and potentially strengthen the existing control mechanisms firms—and supervisors—use to understand and manage risk.

Among other things, Agencies may wish to consider requiring firms to:

- Establish authorized risks, instruments and products designed to ensure that all covered trading activity remains consistent with approved policies and procedures;
- Establish procedures to analyze revenues to discern the nature of trading activity conducted, including the key drivers of profitability and losses. Sources of revenue that Agencies may wish to consider include (i) customer income, such as commissions, fees, bid/offer spread and inception booking profit & loss (“P&L”); (ii) risk income or income associated with changes in market variables; (iii) volatility of daily revenues over time, including volatility of customer and risk income; and (iv) other factors, including revenues associated with changes in valuation model structure or assumptions;
- Establish risk limits to ensure that risk-taking is appropriately constrained in a way that disallows prohibited activities. Such limits may be set in light of trading unit mission and strategy statements enumerated in internal policies. Appropriate limits to be considered by Agencies may include constraints on risk-taking as measured by Value at Risk (VaR) models, portfolio stress testing and P&L sensitivities associated with changes in market prices. Such limits could be implemented across profit centers, asset classes and market segments; and
- Establish stop-loss limits in order to trigger reviews and potentially cessation of trading activity when such limits are met or exceeded.

## RECORDKEEPING AND REPORTING SYSTEMS

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Agencies may wish to consider requiring banking entities to establish recordkeeping and reporting systems of a type that will facilitate both internal and supervisory monitoring of the elements described above. These may include the production and retention of reports analyzing data showing trends in trading activity that are relevant to Volcker Rule analysis. For example, trading units could be required to produce regular reports that show how revenues are driven by customer activity or changes in specified market factors. Such reports could be required to be provided to supervisors in order to facilitate regular monitoring and supervisory reviews. In addition to reports, Agencies should consider requiring banking entities to maintain trade-level data to facilitate internal and supervisory review, which would also support independent testing and attestation requirements, if Agencies elect to impose such requirements.

## INDEPENDENT TESTING

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Another element of a programmatic compliance regime is an independent testing requirement. These requirements could be similar to those that the banking agencies have established with respect to Bank Secrecy Act/ Anti-Money Laundering (“BSA/AML”) compliance, and could mandate that independent testing be conducted by a banking entity’s internal audit department or by outside auditors, consultants, or other qualified independent parties. Expectations for the frequency and nature of independent testing would vary by factors such as the size and risk profile of the banking entity. Such independent testing might include an evaluation of the overall adequacy and effectiveness of the compliance regime; testing for specific compliance with the Volcker Rule; an analysis of appropriate breadth of coverage; and an evaluation of pertinent management information systems. The testing could assist the Board of Directors and senior management in identifying areas of weakness or areas where there is a need for enhancements or stronger controls, and could serve as a tool for supervisors to use in assessing a banking entity’s compliance with the Volcker Rule.

## CEO AND BOARD ACCOUNTABILITY

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Agencies should also strongly consider imposing obligations on the Board of Directors and the CEO of banking entities to ensure that they are effectively engaged in and accountable for compliance with the prohibition on impermissible proprietary trading. The Board of Directors and the CEO could be made responsible for developing and maintaining a program reasonably designed to achieve compliance with the Volcker Rule. For example, the Board of Directors could be made responsible for such matters as: approving the compliance program; overseeing the structure and management of the banking entity’s compliance with the Volcker Rule; setting an appropriate culture of compliance; and ensuring that these policies are adhered to in practice.

The CEO could be made responsible for such matters as: communicating and reinforcing the compliance culture established by the Board of Directors; implementing the program; reporting to the Board of Directors and the banking entity's supervisors on the effectiveness of the program; and escalating compliance matters as appropriate. It is expected that programs approved by the Board of Directors and the CEO will designate an individual or individuals responsible for compliance and will include training for appropriate personnel.

Agencies should also strongly consider requiring the CEO to attest publicly to the ongoing effectiveness of the internal compliance regime. This will ensure the highest level of accountability for the satisfaction of these expectations.

## **ANALYSIS AND REPORTING OF QUANTITATIVE METRICS**

In addition to establishing a programmatic compliance regime as part of a comprehensive implementation framework, the Council recommends that Agencies consider requiring banking entities to report and supervisors to review quantitative metrics that may assist Agencies in identifying potential impermissible activities. Such an approach would be designed to provide Agencies with an objective set of data that (i) brings to supervisory attention trading trends or incidents that may suggest that violations have occurred and (ii) facilitates the comparison of such trading data across banking entities, market segments, or trading strategies to inform and strengthen the supervisory process. Agencies should consider utilizing an array of metrics when reviewing trading activity.

Such quantitative metrics would take advantage of the fact that proprietary trading may evidence different quantitative characteristics than permitted activities conducted in response to customer demand. After studying a variety of quantitative metrics described by commenters and market participants, the Council has identified four promising categories of quantitative metrics:

1. ***Revenue-Based Metrics***: These metrics would attempt to measure daily revenue and revenue from specific trades relative to historical revenue and similar data for other banks (i.e., horizontal comparison). Revenues and losses for market making and certain other permitted activities principally derive from both spreads and price movement in the inventory held while impermissible proprietary trading revenue is generated principally from price movements. An analysis of revenue may allow a determination that a particular trade or activity was proprietary in nature.
2. ***Revenue-to-Risk Metrics***: These metrics would attempt to measure revenue generated per unit of risk assumed. Market makers and underwriters endeavor to mitigate risk by quickly reselling or hedging positions that are acquired, whereas proprietary traders actively seek to assume risk by holding positions with the expectation that they will appreciate. Consequently, permitted activities are likely to have greater revenue-to-risk ratios than impermissible proprietary trading.

3. ***Inventory Metrics***: Inventory turnover compares the asset value that is transacted each day to the value of assets that are held in inventory. This measure takes into account the need for market makers to hold inventory, but relates it to observed customer demand. A market maker that retains risk well in excess of customer demand is more likely to be holding an impermissible proprietary position in that risk.
4. ***Customer-Flow Metrics***: These metrics evaluate the volume of customer-initiated orders on a market making desk against those orders that are initiated by a trader for the purposes of building inventory or hedging. Significant trader-initiated, rather than customer-initiated, order volume could indicate that impermissible proprietary activity has occurred.

Although the Council believes that these four categories of quantitative metrics may be useful in helping Agencies identify impermissible proprietary trading, it is important to note that each category, and quantitative metrics in general, have certain limitations as implementation tools. Given the complexity of trading activities any single quantitative metric is likely to produce both “false positives” and “false negatives.” Accordingly, metrics are best utilized by Agencies as a key source of information for identifying potentially problematic trading activities that may require further study, rather than a comprehensive, dispositive tool. In addition, the relevance or utility of any particular metric may vary significantly depending on the asset class, liquidity, trading strategy and market profile of the trading activity in question. There may be other categories of quantitative metrics that Agencies identify over time that may also assist them in identifying impermissible proprietary trading.

Notwithstanding these limitations, the Council believes that quantitative metrics are likely to be a useful tool in implementing the Volcker Rule, and recommends that Agencies strongly consider incorporating the reporting and review of quantitative metrics as part of the comprehensive implementation framework. In particular, although each specific quantitative metric may have certain limitations, a combination of metrics, together with robust supervisory oversight, may prove a powerful tool in assisting Agencies in identifying impermissible proprietary trading.

This study includes a detailed summary of the potential, specific types of metrics that the Council believes Agencies may find useful to consider. We note that this summary is intended to be descriptive, not prescriptive, in nature. Agencies should carefully evaluate these and other potential quantitative tools as they implement the Volcker Rule through their rulemaking processes or subsequent supervisory experience.

#### REVENUE-BASED METRICS

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Revenue trends in market making desks are appropriate benchmarks against which Agencies may compare the current period’s revenue to determine whether a desk is engaging in impermissible proprietary trading.

Agencies should consider the difficulties in applying some of these revenue-based metrics to the review of trading activities in illiquid markets as well as the complexity of comparing historical revenue of trading desks given the impact that market movements would have on desk revenue.

Potential revenue-based metrics that have relevance in this regard might include:

- ***Historical Revenue Comparison***: This measure compares a particular period's revenue to historical trends. If a trading desk's revenue from a particular day, month or quarter is outsized relative to recent trends, that desk could be implementing strategies that include impermissible proprietary trading.
- ***Day One Profit & Loss***: This measure compares the profitability of positions on the first day they are taken with the profitability of all positions held that day. This metric seeks to address the challenge of discerning the source of a firm's profitability. Day One Profit & Loss is likely to be higher for market makers that profit immediately from capturing the spread upfront than for proprietary traders that seek to profit from asset appreciation in the near term.
- ***Bid-Offer Pay-to-Receive Ratio***: This measure compares the profitability of positions on the first day they are taken with the total trading activity on that day. The metric seeks to approximate whether a trader is more likely to be purchasing securities at the "bid" or "offer," even in the absence of continuously quoted markets.

#### REVENUE-TO-RISK METRICS

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Market making activities usually have higher levels of revenue per unit of risk compared with proprietary trading operations.<sup>29</sup> For market makers, who seek to minimize the risk associated with a position held, revenue will derive from high turnover of a position rather than appreciation in the position, while the opposite is true of proprietary traders.

Because revenue-to-risk measures are well-established concepts, these metrics are broadly applicable within a banking entity and across banking entities. Agencies should note that the following set of metrics may be less effective for particular trading strategies, such as high-frequency trading strategies or strategies that are predicated on non-linear trading strategies.

Potential revenue-to-risk metrics include:

- ***Profitable Trading Days as a Percentage of Total Days***: Market makers will tend to evidence more consistent daily profitability than proprietary

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<sup>29</sup> In the context of bank accounting, trading revenue generally refers to net profits from trading rather than gross notional amounts traded on a pass-through basis.



traders. Market makers seek to price into each transaction an appropriate spread and manage inventory tightly. By design, proprietary traders tend to seek exposure to market fluctuations, which do not follow a defined day-to-day pattern.

- **Sharpe Ratios:** This measure compares the annualized total revenue or excess return of the firm or trading desk to the annualized standard deviation of revenue or standard deviation of the portfolio (i.e., how much the firm's trading profit varies from day-to-day) or how much excess return is earned for every unit of risk taken. Similar to the measure of profitable trading days as a percentage of total days, established proprietary trading activities will generally have a lower Sharpe ratio, as proprietary trading generally results in higher earnings volatility.
- **Revenue-to-Value at Risk:** This measure evaluates the revenue per dollar of value-at-risk in the firm. For a given level of profitability, market making should entail less aggregate risk than proprietary trading as market makers retain the risk for a shorter period of time.
- **Value at Risk:** Standard value at risk metrics (VaR) may also provide Agencies with a helpful guide for areas that bear further scrutiny.

## INVENTORY METRICS

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The rate of inventory turnover and aging in a firm's portfolio can provide evidence that a banking entity's market making-related activities are intended to meet "reasonably expected near term demand." Such permitted market making-related activities seek to profit from inventory flow rather than from appreciation of assets held in inventory. Furthermore, a firm's inventory is directly controllable by its management, and so may be a particularly effective lever for management to monitor compliance. To be effective, inventory metrics should be calibrated by asset class so that they can measure *relatively* longer holding periods within the context of trading activities.

- **Inventory Turnover:** This metric calculates the ratio of assets that are transacted each day to assets that are retained in inventory. The metric takes into account the need for market makers to hold inventory (volume of retained assets), but relates it to the asset's observed customer demand (volume of transacted assets).

Impermissible proprietary trading seeks to profit from the appreciation of an asset. Retaining assets well in excess of customer demand may be an indicator that the trader is seeking to profit from the appreciation of inventory. Conversely, market makers with a near term goal of serving customers will acquire and sell (or, for some instruments, hedge) within as short timeframe as possible in order to profit from the bid-ask spread.

- **Inventory Aging:** Inventory aging measures how long inventory has resided on the balance sheet rather than simply how large it is. Retaining inventory

where near term customer demand fails to appear rather than selling such inventory could indicate impermissible proprietary trading.

### *CALCULATING INVENTORY TURNOVER AND AGING*

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For highly liquid financial instruments, inventory turnover and aging are relatively straightforward to measure as banking entities will have both significant daily volume and measurable inventories of each discrete asset. Such financial instruments include most cash equities, high volume foreign exchange rate pairs, commercial paper, and other financial instruments for which risk can be offloaded quickly. For such assets, banking entities may compare the gross notional value traded each day against the amount retained in inventory.

Less-liquid or more complex financial instruments may necessitate a more nuanced measure of inventory turnover. While such financial instruments may be correlated or hedged with other financial instruments, they may be individually distinct in the way in which they are valued. Likewise, two seemingly similar financial instruments may have very different valuation factors (for example, a call option that has an “in the money” strike price versus a deep “out of the money” strike price).

In these situations, it may be possible to develop “factor-based” measures of inventory turnover that relate to the key drivers of valuation for the financial instruments a banking entity holds in inventory. Different asset classes will tend to have different valuation factors based on their underlying characteristics (for example, debt instruments have both credit default risk and interest rate risk). Likewise, for asset classes that vary in maturity, one would need to develop mechanisms to normalize for different tenors of maturity (e.g., the difference between a 1-year and a 2-year contract for a type of derivative).

The specific valuation factors that affect a financial instrument’s value are closely tied to the asset class, and so would likely need to be defined on a desk- or asset class-specific basis. Importantly, these valuation factors are already in widespread use in many instances, as banking entities employ them as essential tools for pricing financial instruments in a trading context as well as for inventory risk management. In this way, inventory turnover and aging measures may reflect a new application for previously established risk management tools.

Analytical reviews of trading activity may also include an analysis of the relative proportion of transactions that are conducted by a trading desk directly with customers. “Customer-initiated” trades are those that come to trading desks unsolicited. These orders typically come to the trader through the dealer’s sales force rather than directly from the customer. This includes trades executed for the banking entity’s investment account if that account is operated independently of the trader. Banking entities are likely to be able to distinguish these trades from “trader-initiated” trades.

Trader-initiated transactions might be solicited by the trader directly, or come indirectly by the trader soliciting an order through a salesperson. Trader-initiated transactions would include hedges that a trader will initiate in an attempt to reduce portfolio risk or transactions that a trader solicits to reduce inventory to acceptable levels. In some cases, however, where an ongoing customer dialogue exists, it may be difficult to establish this distinction. As described in the proposed compliance regime, there should be strong penalties for traders or salespeople that make a practice of mischaracterizing trader-initiated trades as customer-initiated trades.

Because trader-initiated trades are a normal part of market making and hedging activity, the potential metrics outlined below focus on relationships and correlations between these types of activities. The fact that a transaction is trader-initiated should not by itself suggest that the transaction is impermissible.

If Agencies require banking entities to add this data field to their internal recordkeeping of trade ticket data, the Council believes that this information may significantly enrich the analytical ability of both banking entities and Agencies to identify impermissible proprietary trading.

Some examples of customer flow metrics include:

- ***Customer-Initiated Trade Ratio***: This metric compares the amount of customer-initiated flow relative to trader-initiated flow. Trader-initiated flow should be closely correlated with customer-initiated flow, as trader-initiated positions should be established primarily to hedge positions acquired from customers, or to manage inventory to appropriate levels such as in anticipation of customer demand.
- ***Customer-Initiated Flow to Inventory***: This calculates the volume of a desk’s inventory relative to the desk’s average customer-initiated trades. Inventory should remain in proportion to customer-initiated trades in most instances.
- ***Revenue to Customer-Initiated Flow Ratio***: This ratio measures the trading desk’s revenue to the proportion of customer-initiated flow. There should be a strong relationship between the customer-initiated flow on the desk and the revenue it generates.

Using the four types of metrics discussed above, Agencies may find it useful to develop a standard quantitative “profile” of market making for each specific asset class or trading desk. This might entail developing a methodology for analyzing the metrics as well as data that is used to construct each metric to better understand the quantitative profile of different types of trading desk activities and banking entity-specific differences in customer activity and organizational structure.

This study recommends Agencies consider three approaches as a means to developing this “profile.” While each of these approaches carries advantages and drawbacks, they could also be combined to apply this analysis on a banking entity-specific basis.

Agencies should consider requiring banking entities to allocate sufficient resources for the application and testing for these metrics:

- ***Cross-Industry Review:*** This approach may enable a comparison on a desk-by-desk basis across banking entities by Agencies to determine appropriate ranges for each trading operation and a common measurement methodology. Such an approach would help create a consistent standard by which banking entities are evaluated, and allow for a fair application of the Volcker Rule across banking entities.
- ***Firm-Specific Operating Experience:*** This approach would rely on firm-specific historical data to define appropriate parameters for trading operations. Such an approach would help capture differences in business mix and organization across banking entities. However, if applied in isolation, an inconsistent application of the Volcker Rule, and a potential “race to the bottom” among banking entities may result.
- ***Comparisons to Standalone Proprietary Trading Operations:*** This approach would to the extent possible compare appropriate ranges for hedge funds or other independent proprietary trading operations matched by asset class.

Within all of these constructs, it will be important to account for the fact that banking entities often have different customer mixes resulting in different types of trading strategies, volumes as well as risk exposures. Any analysis of metrics will need to take these structural variations among banking entities into account.

In using metrics such as those described above, it is important to carefully define the segmentation of the banking entity to which such metrics apply and the period over which they are measured. Key considerations in considering how best to define this segmentation include:

- ***Banking Entity Segmentation:*** In general, a more granular segmentation (e.g., at a trading desk level versus a line of business level) will be more

likely to identify proprietary trading activities, but may also be more likely to generate false positive results as well as more volatile results. By extension, a segmentation that is insufficiently granular will be less likely to identify proprietary trading activities, as these will be subsumed by the broader portfolio effects of the banking entity's larger market making activities.

- **Measurement Frequency:** Conducting “real time” assessments or “point-in-time” measurements is likely to generate false positives given general variability in market conditions. Further, the fact that proprietary trading requires time to allow for asset appreciation means that most proprietary activities will extend over a longer time period. Consequently, metrics may be measured on a trailing basis – with the period of time to vary by the liquidity of the asset class – provided that the recordkeeping and management supervisory review period is as short as is necessary for the asset class. In addition, Agencies may consider using a time series to analyze changing patterns over time.
- **Additional Metrics:** Importantly, the quantitative metrics employed to identify proprietary trading should not be limited to the metrics explored in this study. If other quantitative metrics are developed, either by banking entities, Agencies or through exogenous research, Agencies should consider exploring the viability and practicality of employing other quantitative metrics.

#### ROLE OF THE OFFICE OF FINANCIAL RESEARCH

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The newly-established Office of Financial Research (“OFR”), when fully operational, might serve a helpful role in assisting Agencies in enforcing the Volcker Rule’s prohibitions. For instance, the SEC and CFTC will have access to significant amounts of new data that must be reported as part of oversight of the derivatives markets. Further, by utilizing this trade data, OFR may be able to help analyze effective metrics over time as a key research project. If support is provided by the OFR, it should be used to augment Agencies’ ongoing efforts.

#### SUPERVISORY REVIEW AND OVERSIGHT

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The Council’s expectation is that the programmatic compliance regime, together with the reporting of certain quantitative metrics, will provide a strong foundation for robust supervisory review and oversight of compliance with the Volcker Rule. Supervisory review is likely to be the ultimate lynchpin in effective implementation by Agencies.

In particular, the Council recommends that Agencies strongly consider incorporating some or all of the following supervisory components in implementation of the Volcker Rule, as Agencies determine appropriate. The Council recognizes, however,

that some Agencies face significant resource constraints and that incorporation of these components, which include a review of trading practices to identify prohibited trading and distinguish permissible trading, would require significant new and specialized resources. For instance, Agencies would need to develop appropriate data points, build infrastructure to obtain and review information, and hire and train additional staff with substantial quantitative and market expertise to identify and investigate outliers and questionable trades.

The application of metrics across an evolving range of products, strategies and market dynamics will require substantial quantitative and market expertise. Therefore, Agencies will also need to develop appropriate experience.

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#### PERIODIC REVIEW AND TESTING OF INTERNAL CONTROLS AND PROCEDURES

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Periodic review and testing by supervisors of banking entities' internal compliance regimes will likely be a key part of any program of supervisory review and oversight. Such reviews could serve as a means for Agencies to develop confidence in the integrity of the banking entities' programs for eliminating prohibited activities and in the data produced to the supervisors. The frequency and scope of specific reviews should be conducted as Agencies deem appropriate, in light of factors such as the size, risk profile, and business mix of each banking entity and/or profit center within such banking entity. In order to focus on the most relevant program elements, Agencies will likely need to engage in supervisory review planning that incorporates analysis conducted through their ongoing monitoring activities, including the review of trading metrics and communication with trading and management of regulated firms.

As part of this review and testing, Agencies would need to elaborate and promulgate the applicable set of standards upon which firms' practices will be evaluated in order to increase the transparency of the review process. Program deficiencies that do not meet specified standards should be remediated within a timeframe deemed appropriate by Agencies. Remediation actions and time frames should be commensurate with the nature of the program deficiency, with special consideration given to repeated deficiencies.

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#### ONGOING SUPERVISORY MONITORING AND REVIEW OF TRADING ACTIVITIES

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Agencies should also strongly consider conducting regular monitoring of trading activity in order to identify impermissible activity and to inform the scope and frequency of periodic targeted supervisory reviews. This monitoring may take the form of the regular collection, review, and analysis by supervisors of trading data relevant to Volcker Rule compliance, such as trading exposures and revenues. It may be useful for such data to be aligned with the metrics tracked and used internally by firms, including those used by business, risk management and compliance personnel, as well as those that may be identified by Agencies as part

of the Volcker Rule implementation. Where it is appropriate in light of the risk profile of the banking entity or specific profit centers within the banking entity, Agencies may consider analyzing data at varying levels of aggregation (that is, from firm-wide to specific desks) and across asset classes. Agencies will need to consider how frequently to require reporting of data from banking entities. In the case of banking entities with sophisticated trading operations, Agencies may decide to collect data on a daily basis for significant firm-wide metrics, such as revenues and VaR, while collecting and analyzing other relevant data on a more periodic basis.

#### FREQUENT COMMUNICATION WITH TRADING PERSONNEL

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The Council recommends that Agencies will strongly consider engaging in regular dialogue with relevant management, trading and control personnel in order to understand and evaluate specific trading behavior by banking entities in light of the Volcker Rule. Such dialogue may prove important to understanding a firm's business model (and the conformance of that business model with Volcker Rule permitted activities) as well as the market context of trading activity.

Such dialogue might occur both through ongoing monitoring efforts as well as in the course of periodic, targeted on- or off-site examinations of trading activity. In establishing the frequency and nature of the examinations that will be desirable to implement the Volcker Rule, Agencies will need to consider the size, risk profile, and business mix of banking entities and available supervisory resources.

#### REVIEW OF QUANTITATIVE METRICS FOR RED FLAGS

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As part of the ongoing monitoring and examinations that Agencies may decide to undertake, the Council recommends that Agencies strongly consider making use of quantitative metrics reported to them by banking entities in order to identify issues that require additional review. Quantitative metrics, such as those discussed above, may prove useful for identifying prohibited activities or weaknesses in banking entity programs, and may be an important mechanism for achieving consistency in Volcker Rule application across banking entities.

The analysis of such quantitative metrics may best be conducted within the context of banking entity compliance programs, and against the backdrop of supervisory oversight plans for the relevant institution.

### **ENFORCEMENT PROCEDURES FOR VIOLATIONS**

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Another key aspect of supervisory review and oversight is likely to be the investigation process that supervisors undertake when they identify evidence of a potential violation – whether identified in the context of ongoing monitoring

activity or a targeted examination, through review of metrics, or as a result of reporting done pursuant to compliance programs.

As a part of establishing this investigation process, Agencies should consider how to ensure its consistency with the mechanisms prescribed by section 13(e)(2) of the Volcker Rule, which provides that Agencies shall take steps to order the termination or disposition of non-compliant activities or investments after providing notice and opportunity for a hearing. Agencies should also consider what other types of enforcement actions they may take to penalize banking entities who engage in impermissible activities, or whose compliance programs are found insufficient by their supervisors.

## **APPLICATION TO OTHER RELATED ACTIVITIES**

The Volcker Rule allows banking entities to engage in certain other permitted activities, which are enumerated below.

- ***Government securities***: The statute allows for the purchase, sale, acquisition, or disposition of federal government debt, federal agency debt, and municipal debt. In contrast to more limited descriptions of particular activities provided in other permitted activities, the statute broadly permits all transactions in these government securities, subject to the statutory “backstop” provisions discussed below. (Please see “Statutory Limitations on Permitted Activities” below.) Banks serve as a critical source of liquidity in these markets. In addition, these instruments have historically served a significant role in traditional banking activities, providing a low-risk, short-term liquidity position and are a commonly utilized source of collateral in transactions.
- ***Small business and public welfare***: In addition to direct lending, banks also provide capital to small businesses through small business investment companies. Such investments are permitted activities, as are public welfare investments. These activities benefit the broader economy.
- ***Insurance***: There are specific allowances for investments made by insurance companies for their general account. This provision reflects the investment method of the insurance industry by which their policies and contracts are funded by a central fund, with risk managed on a portfolio basis. This permitted activity reflects the differing structural nature of banking and insurance, and the nature of the proprietary investments. The industries are also traditionally subjected to different but stringent regulatory treatment and oversight. (Please see “Accommodating the Business of Insurance” below.)
- ***Offshore activities***: The Volcker Rule applies to domestic banking operations of foreign institutions. However, because of U.S. extra-territorial regulatory constraints, the statute does not restrict proprietary trading conducted by non-U.S. entities outside the United States. These entities are not eligible for discount window loans or federal depository insurance.



In addition, the Volcker Rule has a rule of construction with respect to securitization of loans. Commenters also discussed the application of the Volcker Rule with respect to asset-liability management.

- ***Securitization of loans:*** The Volcker Rule provides that “Nothing in this section 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.” In other words, this inviolable rule of construction ensures that the economically essential activity of loan creation is not infringed upon by the Volcker Rule. The creation and securitization of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system. While these activities involve the assumption of principal risk, the broader benefits to the economy reflect the intent of federal borrowing subsidies and protections. Accordingly, Congress determined that none of the restrictions of the Volcker Rule, nor the “backstop” restrictions on permitted activities, will apply to the sale or securitization of loans. However, Agencies should carefully consider the scope of this exclusion and ensure that its implementation does not undermine the prohibition on proprietary trading.
- ***Asset-Liability Management:*** One of the more significant scope issues related to the Volcker Rule is whether the prohibitions should apply to non-trading positions. All commercial banks, regardless of size, conduct asset-liability management (“ALM”) that help the institution manage to a desired interest rate risk and liquidity risk profile. This study recognizes that ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool. In particular, banks use their investment portfolios as liquidity buffers. A finding that these are impermissible under the Volcker Rule would adversely impact liquidity and interest rate risk management capabilities as well as exacerbating excess liquidity conditions. These activities also serve important safety and soundness objectives. However, given that active trading can occur in an asset liability management portfolio, Agencies should consider whether to verify as part of their ordinary supervisory activity that there is no prohibited proprietary trading occurring in ALM portfolios.

## **STATUTORY LIMITATIONS ON PERMITTED ACTIVITIES**

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While the Volcker Rule permits certain activities involving principal risk, the statute also imposes limits on these activities. In relevant part, the statute reads:

(2) LIMITATION ON PERMITTED ACTIVITIES.—

(A) IN GENERAL.—No transaction, class of transactions, or activity may be deemed a permitted activity under paragraph (1) if the transaction, class of transactions, or activity—

- (i) would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in subsection (b)(2)) between the banking entity and its clients, customers, or counterparties;
- (ii) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2));
- (iii) would pose a threat to the safety and soundness of such banking entity; or
- (iv) would pose a threat to the financial stability of the United States.<sup>30</sup>

## **MATERIAL CONFLICTS OF INTEREST**

Under the Volcker Rule, permitted activities are prohibited if they involve or would result in a material conflict of interest.<sup>31</sup> Indeed, such conflicts of interest were among the central concerns motivating the Volcker Rule’s proprietary trading prohibition, and a companion provision, section 621 of the Dodd-Frank Act, which calls for SEC rulemaking on certain material conflicts of interest of the underwriter, placement agent, initial purchaser, or sponsor of an asset-backed securities transaction.<sup>32</sup> In particular, there was concern that banking entities could actively trade against the positions of their customers, or could profit from betting against financial instruments the firm had assembled and sold to customers.

Proprietary trading presents potentially serious conflicts of interest between a firm’s activities that take a directional view and the customer-serving activities that should facilitate proper functioning of markets. A customer could unknowingly suffer financial injury if, for example, the firm were to trade ahead of customer orders or anticipated orders for financial instruments and profit from changes in the market price resulting from the customer’s order. Or the firm could trade based on information about a future underwriting deal for the customer, or knowledge of a customer’s portfolio of securities.<sup>33</sup>

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<sup>30</sup> 12 U.S.C. § 1851(d)(2)(A).

<sup>31</sup> *Id.* at § 1851(d)(2)(A)(i).

<sup>32</sup> 156 CONG. REC. S4100 (daily ed. May 24, 2010) (Floor statement of Sen. Levin); 156 CONG. REC. S5897 (daily ed. July 15, 2010) (Floor statement of Sen. Merkley); 15 U.S.C. § 77z-2a. *See also* Dodd-Frank Act section 989(b)(1)(C) (directing GAO study on proprietary trading, including whether proprietary trading creates material conflicts between firms and customers of the firm who use the firm to execute trades or manage customer assets).

<sup>33</sup> *See* REMARKS BEFORE THE SECURITIES INDUSTRY ASSOCIATION COMPLIANCE AND LEGAL DIVISION, (SEC Division of Market Regulation Director Annette Nazareth, July 19, 2005) (at <http://www.sec.gov/news/speech/spch071905aln.htm>).

Additionally, the combination of banking and trading may present particular conflicts of interest. Most notably, commercial banking operations acquire substantial amounts of nonpublic information about the financial condition of the companies to which they lend. Moreover, banking entities frequently advise corporate customers on debt and equity transactions and other corporate activities through which they accumulate nonpublic information. If information is transmitted from the lending and advising units of banking entities to trading operations, trading desks could use this inside information to make profitable trades, thus creating material distortions in the capital markets at customers' expense. Although firms instituted information barriers designed to prevent information flow between customer-serving activities and proprietary trading desks, the statute goes further with respect to banking entities and imposes a prohibition on proprietary trading.

In imposing a prohibition on proprietary trading, the Volcker Rule directly cuts off a banking entity's opportunity to profit from conflicted proprietary trading, thereby protecting customers from financial injury arising from such conflicts. In implementing the Volcker Rule, Agencies should consider the extent to which the permitted activities present risks that banking entities will conduct transactions that place the banking entity's own interests ahead of its obligations to its customers and counterparties, and where such conflicts might arise, and what steps can be designed to prevent the banking entity from proceeding with the transaction in a manner contrary to those obligations.

Agencies should consider all types of transactions, structures and roles in connection with permitted activities that pose a heightened risk for material conflicts of interest, including cases when the banking entity has a customer's business in two different areas and the transaction could adversely affect the customer or when the banking entity holds an informational advantage over its customers and positions itself to benefit financially from transactions that are financially harmful to customers. Agencies should also consider situations where the financial incentives associated with a banking entity's relationship with one customer might create circumstances under which particular benefits might accrue to the bank as a result of treating another customer less favorably. Agencies should also consider whether particular attention needs to be paid to situations when different departments or units have differing interests and incentives with respect to a customer.

In general, concerns regarding conflicts of interest are elevated when transactions are complex, highly structured, or opaque; involve illiquid or hard-to-value instruments or assets; require the coordination of multiple internal groups (such as multiple trading desks or affiliated entities); involve a significant asymmetry of information; or transactional data among participants.

In considering these issues, Agencies should take into consideration existing conflict of interest laws applicable to banking entities engaged in permitted activities. There are many different laws imposing conflict of interest restrictions in the context of banking entities and their customers, but they tend to fall into three main categories. The broadest form is the duty of loyalty attributable to a full "fiduciary" under state

law. A similar duty of loyalty attaches to investment and commodity trading advisers under federal and state securities and commodities laws, and to benefit plan fiduciaries under ERISA. The third main category arises under provisions of the securities laws that prohibit an institution from obtaining an advantage in the securities markets by using nonpublic information it acquires about a customer or issuer. These categories are not exclusive, of course.

An institution's options for dealing appropriately with a potential conflict of interest will vary depending on the particulars of the law establishing the existence of the conflict. In some instances, as in the case of prohibitions on insider trading, the institution may establish information barriers within the firm, to wall off the information from business units for which the information could create a conflict. In other instances, such as laws governing investment and commodity trading advisers, obtaining the informed consent of the customer may resolve the conflict. State fiduciary law may factor in the terms of the fiduciary engagement, or provide resort to specialized protective measures. For any gaps Agencies identify in the existing protections for customers of banking entities with respect to permitted activities under the Volcker Rule, Agencies should consider whether these protections and remedies provide an effective model that can be extended to address the gap, or whether outright bans are necessary.

Agencies have required institutions subject to their supervision to develop policies and procedures that identify all obligations on the part of the institution to avoid conflicts of interest, monitor the activities of the institution to identify whenever such an obligation is triggered, and establish controls to avoid or resolve the conflict in compliance with applicable law. Agencies evaluate the effectiveness of these policies and procedures as part of the supervisory process. In implementing the Volcker Rule, Agencies should give consideration to applying the same approach.

In addition, all financial companies including banking entities should take precautionary measures to minimize and mitigate conflicts of interest, including the appearance of conflicts of interest, in business conduct.

## **MATERIAL EXPOSURE TO HIGH-RISK ASSETS OR HIGH-RISK TRADING STRATEGIES**

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The Volcker Rule provides for an additional limitation on permitted activities if the activity “would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies.”<sup>34</sup>

As noted above, the primary risk control in existing risk management is through the *limit setting* process. All trading risk is subject to, among other things, the institution's VaR limit. The VaR limit is small, typically about 1% of a banking

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<sup>34</sup> 12 U.S.C. § 1851(d)(2)(A)(ii).

entity's capital. On an annual basis, independent market risk management personnel should review limits assigned to trading desks for proper coverage (type of risk) and size. These limits are assigned at the desk, business, and firm-wide levels. Many desks also employ stop-loss mechanisms that require positions to be closed at predetermined loss thresholds.

Agencies should consider ways to provide guidance on what constitutes a high-risk asset or high-risk trading strategy. One possible approach would be to incorporate risk analyses into the supervisory framework to monitor permitted activities. These analyses could assist Agencies in identifying exposure to high-risk assets and high-risk trading strategies and metrics should be developed in a manner that allows Agencies to focus their supervisory and examination efforts in areas of particular concern. We note that section 620 of the Dodd-Frank Act also requires the banking agencies to conduct a study of bank permissible activities, which can also help define those assets and investments that may pose excessive risk.

Because, as demonstrated during the financial crisis, innovative financial products and strategies will be developed and the risk associated with certain assets and strategies will change over time, Agencies should consider adopting a flexible framework rather than rigid definitions of "high-risk assets" and "high-risk trading strategies." The focus, of course, is on the risk that an asset or strategy could cause a banking entity to fail or sustain serious losses.

In particular, the following characteristics, among others, may be indicative of a high-risk asset or high-risk trading strategy:

- The introduction of new products with rapid growth;
- Assets or strategies that include embedded leverage;
- Historical volatility of the asset or strategy;
- Total VaR of the asset or strategy;
- Assets whose values cannot be externally priced or whose exposure cannot be quantified;
- Assets whose risk cannot be adequately mitigated by effective hedging; and
- The application of capital and liquidity standards would not adequately account for the risk of an asset.

Agencies should also consider requiring banking entities to establish, or integrate into their existing risk management processes, a committee with relevant expertise to assess the firm's potential exposure to high-risk assets and high-risk trading strategies.

## **POSES A THREAT TO SAFETY AND SOUNDNESS OF BANKING ENTITY**

The third statutory limitation requires that Agencies assess whether any permitted activity would pose a threat to the safety and soundness of a banking entity.<sup>35</sup> The metrics and frameworks adopted for the prohibition of proprietary trading and the monitoring of broader risks should be utilized by Agencies to address the financial soundness of banking entities.

## **POSES A THREAT TO FINANCIAL STABILITY OF UNITED STATES**

The fourth statutory limitation provides an outer bound for activities that are otherwise permitted.<sup>36</sup> While it is unlikely that an activity would “pose a threat to the financial stability of the United States” without running afoul of the second or third limitations, it is possible that Agencies would have concerns about an imbalance in the financial system caused by an otherwise permitted activity that would not threaten the safety and soundness of an individual firm or meet a regulatory test set for high-risk assets or high-risk trading strategies. In these instances, the Volcker Rule requires that Agencies take action to prohibit those activities.

## **HOW THE VOLCKER RULE RELATES TO EXISTING AND PENDING REGULATION**

The Volcker Rule will be implemented within the context of a broader framework of existing and pending regulatory reform. Although the Volcker Rule is an essential piece of this regulatory framework designed to reduce risk-taking, it should of course be implemented in a way that benefits from and interacts with existing regulatory practices. This section will describe ongoing regulatory changes that reduce the risk to the FDIC’s Deposit Insurance Fund and help prevent cross-subsidization that occurs when insured depository institutions or their affiliates engage in proprietary trading.

## **RISK TO THE FEDERAL SAFETY NET AND CROSS-SUBSIDIZATION**

The Volcker Rule prohibits banking entities from engaging in proprietary trading and making more than *de minimis* investments in hedge funds and private equity funds. It builds on restrictions in existing law.

Existing federal law prohibits banks from directly engaging in many of the riskiest forms of trading. Banks generally are prohibited from investing in or trading equity securities, junk bonds, and most non-financial commodities. These limitations both protect the bank safety net from harm and prevent banks from using their federal

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<sup>35</sup> Id. at § 1851(d)(2)(A)(iii).

<sup>36</sup> Id. at § 1851(d)(2)(A)(iv).

subsidies to fund volatile trading activities. Beyond these basic limitations, there is also significant reform underway related to banks' derivatives operations that, if implemented properly, should improve the safety and soundness of these operations. Additionally, new capital standards<sup>37</sup> approved by the Basel Committee on Banking Supervision would complement the supervisory changes that the Volcker Rule will require.

#### LIMITS ON RISK TRANSFER

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For a variety of reasons, including the strict activity restrictions on banks, bank holding companies engage in the riskier forms of trading through non-bank subsidiaries of the holding company. Section 23A of the Federal Reserve Act strictly limits the amount of credit and certain other forms of financial support ("covered transactions") that a bank may provide to a trading affiliate. Specifically, Section 23A puts quantitative and qualitative restrictions on extensions of credit by a bank to an affiliate, investments by a bank in an affiliate, asset purchases by a bank from an affiliate, and the issuance of a guarantee by a bank on behalf of an affiliate. Section 23B of the Federal Reserve Act prevents a bank from engaging in almost any financial transaction with a trading affiliate on terms that are disadvantageous to the bank. Although these two statutory provisions limit the amount of harm a bank can suffer in transactions with non-bank affiliates and limit the ability of a bank to subsidize its non-bank affiliates, the Dodd-Frank Act will materially strengthen these important rules through:

- Mandating that all transactions in which a bank has credit exposure to an affiliate are fully collateralized throughout the life of the transaction (existing collateral requirements are "at inception" only);
- Requiring that repurchase agreements and reverse repurchase agreements be treated as covered transactions;
- Ensuring that a bank's credit exposures to affiliates on over-the-counter derivative transactions are treated as covered transactions (they are not today); and
- Constraining the Board's broad authority to provide exemptions from the firewalls.

#### DERIVATIVES REFORM

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The Dodd-Frank Act brings comprehensive reform and extends robust regulation to all participants in the swaps markets for the first time. This reform establishes a framework that brings greater transparency, pricing, oversight, and reduction of overall risk in the derivatives market. Specifically, the Act authorizes:

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<sup>37</sup> [www.bis.org/press/p101216.htm](http://www.bis.org/press/p101216.htm)

- The registration and oversight of swap dealers and security-based swap dealers<sup>38</sup>;
- Requires standardized swaps to be centrally cleared and traded on an exchange or swap execution facility;
- The creation and registration of swap depositories, including data recordkeeping and reporting requirements, such as the reporting of real-time data; and
- The establishment of position limits for certain swaps.

The regulation of swap dealers and major swap participants will include requirements that they register with the CFTC and SEC, comply with newly-established capital and margin standards, adopt and comply with internal and external business conduct standards (dealings with counterparties), and provide for the segregation of customer funds for cleared and uncleared swaps.

In requiring standardized swaps to be centrally cleared and traded on an exchange or swap execution facility, the CFTC and SEC must promulgate rules that establish:

- A process for reviewing and approving swaps for standardized clearing (while exempting end-users from central clearing requirements);
- Governance standards, ownership, and control limits for certain types of clearing entities; and
- Requirements for qualifying as, and registration process for, swap execution facilities.

The Dodd-Frank Act also establishes the CFTC and SEC’s responsibility for collecting relevant trading data. The SEC and CFTC must:

- Develop rules governing registered swap data repositories, which are newly-authorized entities created to collect and maintain data and information related to swap transactions, and which must make such data and information directly and electronically available to Agencies;
- Require that swap transaction data be reported to a registered swap data repository; and
- Require certain data, such as swap price and volume data to be reported to the public as soon as technologically practicable after the swap has been executed.

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<sup>38</sup> If a swap dealer is a banking entity affiliate, as a result of section 716 of the Dodd-Frank Act, also known as the “push-out rule,” that swap dealer must comply with the Volcker Rule.



Existing bank-level capital requirements did not adequately protect against the risks of trading certain assets. These requirements are expected to be significantly strengthened as part of the United States' implementation of new rules from the Basel Committee intended to improve bank safety and soundness. Capital requirements for most positions in the trading book would be increased, and eligibility requirements for trading book capital treatment would be tightened. Trading book capital requirements today are generally lower than capital requirements for assets outside of the trading book, thus creating a serious arbitrage opportunity. The recent Basel capital reforms tighten trading book capital requirements in a number of ways:

- The definition of instruments that can qualify for trading book capital treatment would be tightened.
- The calibration of the market risk capital requirements would reflect periods of market distress and better reflect tail risks of positions.
- The market risk framework would impose higher capital requirements for the specific risks of credit-sensitive and structured trading positions.
- Capital requirements for counterparty credit risk would be changed to reflect price risk associated with deteriorating creditworthiness of counterparties (credit valuation adjustment).
- Capital requirements for all credit exposures to large financial banking entities, including counterparty credit exposure to large financial banking entities on bilateral over-the-counter derivatives, would be increased.

The recent Basel capital reforms also include two other reforms that will likely increase the strength of bank holding companies:

- The proposed leverage ratio requirements could require higher levels of capital for entities with large trading books if not presently subject to similar requirements.
- The proposed liquidity regulations discourage the use of short-term borrowing to fund longer-term corporate debt, private ABS/MBS, and equity securities – a practice common in the trading operations of large financial banking entities in the years leading up to the crisis.

## HEDGE FUND AND PRIVATE EQUITY FUND INVESTMENT RESTRICTIONS

The Volcker Rule's hedge fund and private equity fund investment restrictions generally prohibit a banking entity from acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring a hedge fund or private equity fund.<sup>39</sup> This prohibition is guided by the same purposes as the prohibition on proprietary trading:

- Separate federal support for the banking system from speculative investing activity with the firm's own capital;
- Reduce potential conflicts of interest between a banking entity and its customers; and
- Reduce risk to banking entities and nonbank financial companies designated for supervision by the Board.

The government provides banking entities with a federal safety net at least in part supported by taxpayers to protect the important role of banking entities in the economy as providers of credit and other financial products and services to businesses and consumers.

Under certain circumstances, sponsorship of hedge funds and private equity funds may be a potential source of risk and liquidity stress to banking entities. A banking entity faced with the reputational risk associated with the failure of a sponsored or advised fund may have a strong incentive to voluntarily provide support to investors in those funds. Such support for hedge funds and private equity funds occurred during the recent financial crisis.<sup>40</sup> Further, the complexity of investments in such funds has made it more difficult for the market, investors, and Agencies to understand, properly value, and manage the risks to banking entities.

Under the Volcker Rule, banking entities will generally no longer be allowed to put capital at risk by investing in hedge funds and private equity funds that are completely divorced from serving the needs of their customers.

The statutory prohibitions on relationships with private equity funds and hedge funds should also be implemented to prevent banking entities from having incentives or opportunities to inappropriately provide support to investors in such funds or otherwise transfer the government subsidy inherent in the federal safety net for banks to speculative proprietary investments.

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<sup>39</sup> 12 U.S.C. § 1851(a)(1)(B).

<sup>40</sup> Duffie, Darrell, *The Failure Mechanics of Dealer Banks* (March 1, 2010). BIS Working Paper No. 301, page 9. Available at SSRN: <http://ssrn.com/abstract=1599482>.

This section of the study identifies key issues in implementing the provisions relating to hedge fund and private equity funds.

## **STATUTORY OVERVIEW**

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### **PROHIBITED ACTIVITIES**

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Under the Volcker Rule, a banking entity shall not “acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.”<sup>41</sup>

As noted below, the Volcker Rule generally defines both hedge funds and private equity funds to include any issuer that relies on the exclusion from the definition of investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act. A hedge fund and private equity fund is:

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, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.<sup>42</sup>

### **PERMITTED ACTIVITIES**

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As with the proprietary trading provisions, there are a number of “permitted activities” that constitute exemptions from the broad prohibition described above. In particular, Congress recognized that banking entities serve an important role as financial intermediaries, including as providers of bona fide trust, fiduciary and investment advisory services (collectively, “customer-focused advisory services”). Therefore, the Volcker Rule reflects the basic principle that hedge funds and private equity funds sponsored by a banking entity should be aligned with and supportive of customer-focused advisory services.

In February 2010, Paul Volcker testified to the Senate Banking Committee that certain key customer services should remain permissible, including “prime brokerage” for independent hedge funds and private equity funds; investment management and investment advisory services, including “fund of funds” structure as a means of efficiently providing customers with access to independent hedge funds or

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<sup>41</sup> 12 U.S.C. § 1851(a)(1)(B).

<sup>42</sup> Id. at § 1851(h)(2).

private equity funds; trust and estate planning and administration; and custody and safekeeping arrangements for securities and valuables.<sup>43</sup>

A banking entity is permitted to organize and offer or invest in hedge funds and private equity funds (up to a *de minimis* investment limit) to facilitate customer-focused advisory services.<sup>44</sup> Explicitly, a banking entity is permitted to organize and offer a hedge fund or private equity fund if:

- The banking entity provides bona fide trust, fiduciary, or investment advisory services as part of its business;
- The fund is organized and offered only in connection with such services and only to customers of such services;
- The banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the funds except for a *de minimis* investment;
- The banking entity does not guarantee or otherwise assume or insure the obligations or performance of the fund;
- The banking entity does not share the same name, or variation of the same name, with the fund;
- No director or employee of the banking entity has an ownership interest in the fund unless he or she is directly engaged in providing services to the fund; and
- Certain other conditions are met.<sup>45</sup>

The statute also details the nature of the *de minimis* investments that are permitted. A banking entity may make or retain an investment in a hedge fund or private equity fund that it organizes and offers in connection with bona fide trust, fiduciary and investment advisory functions: (i) for the purpose of establishing the fund; or (ii) to make a *de minimis* investment. Such investments may not represent more than 3% of the total ownership interest of such fund after one year from the fund's establishment, and all aggregated investments of the banking entity in such funds may not represent more than 3% of the Tier 1 capital of the banking entity.<sup>46</sup>

The statute does not prohibit a banking entity from offering prime brokerage services to an independent hedge fund or private equity fund. This activity alone is not considered to be sponsoring or investing in a hedge fund or private equity fund. A banking entity may offer prime brokerage services to a hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by

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<sup>43</sup> *Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies before the S. Comm. on Banking, Housing & Urban Affairs*, 111<sup>th</sup> Cong. 2 (February 2, 2010) (testimony of the Honorable Paul Volcker, Chairman, President's Economic Recovery Advisory Board).

<sup>44</sup> 12 U.S.C. § 1851(d)(1)(G).

<sup>45</sup> Other conditions include that the banking entity complies with the restrictions on affiliate transactions with any fund it sponsors consistent with sections 23A and 23B of the Federal Reserve Act.

<sup>46</sup> 12 U.S.C. § 1851(d)(4).

the banking entity has taken an interest subject to certain limitations. These limitations included in the “arm’s length” requirements of section 23B of the Federal Reserve Act as if the banking entity were a member bank and the fund were an affiliate thereof.

## **LIMITATIONS ON PERMITTED ACTIVITIES**

Pursuant to the permitted activities provisions in the Volcker Rule, the banking entities are allowed to invest in or organize and offer hedge funds and private equity funds subject to the same statutory “backstop” as proprietary trading permitted activities. In the limited circumstances in which a banking entity is permitted to organize and offer or invest in a hedge fund or private equity fund, the Volcker Rule prohibits such a banking entity from engaging in any activity that would result in a material conflict of interest, material exposure to high-risk assets or high-risk trading strategies, a threat to the safety and soundness of the banking entity, or a threat to financial stability of the United States:

(A) IN GENERAL.—No transaction, class of transactions, or activity may be deemed a permitted activity under paragraph (1) if the transaction, class of transactions, or activity—

- (i) would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in subsection (b)(2)) between the banking entity and its clients, customers, or counterparties;
- (ii) would result, directly or indirectly, in a material exposure by the banking entity to high-risk assets or high-risk trading strategies (as such terms shall be defined by rule as provided in subsection (b)(2));
- (iii) would pose a threat to the safety and soundness of such banking entity; or
- (iv) would pose a threat to the financial stability of the United States.<sup>47</sup>

For further discussion of these limitations, please see “Proprietary Trading – Statutory Limitations on Permitted Activities” above.

## **RESTRICTIONS ON RELATIONSHIPS AND TRANSACTIONS WITH PRIVATE EQUITY FUNDS AND HEDGE FUNDS**

The Volcker Rule provides that any banking entity that acts as the investment manager or advisor or sponsor of a permitted private equity fund or hedge fund, and any affiliate of such an entity, is prohibited from entering into a transaction that would be a “covered transaction” as defined in section 23A of the Federal Reserve Act (e.g., making loans, purchasing assets, extending guarantees, etc.)<sup>48</sup> with any such fund.<sup>49</sup>

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<sup>47</sup> Id. at § 1851(d)(2).

<sup>48</sup> 12 C.F.R. 223.3(h) [Regulation W].

<sup>49</sup> 12 U.S.C. § 1851(f).

That section states:

(1) IN GENERAL.—No banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), and no affiliate of such entity, may enter into a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction, as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371-c), with the hedge fund or private equity fund, as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof.

## **ARM’S LENGTH TRANSACTIONS**

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Terms of any transaction between a banking entity and a permitted private equity fund or hedge fund for which that entity has organized and offered or acts as the investment manager or advisor or sponsor, must be determined to be “at arm’s length” on market terms and conditions in accordance with section 23B of the Federal Reserve Act. The relevant section of the Volcker Rule reads:

(2) TREATMENT AS MEMBER BANK.—A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c– 1), as if such banking entity were a member bank and such hedge fund or private equity fund were an affiliate thereof.<sup>50</sup>

## **PRINCIPLES FOR IMPLEMENTATION**

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The recommendations set out in this study regarding investments in or sponsorship of hedge funds and private equity funds are advanced on the basis of three principles for implementation:

1. Significant limits should be placed on the ability of banking entities to invest in hedge funds and private equity funds in order to reduce the risks banking entities face.
2. A banking entity is permitted to organize and offer, or invest in, a hedge fund or private equity fund in connection with the provision of bona fide trust, fiduciary or investment advisory services to its customers.
3. The relationships between banking entities and the hedge funds and private equity funds they organize and offer should not allow those funds to be used to circumvent the prohibition on proprietary trading.

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<sup>50</sup> Id. at § 1851(f)(2).

## **IMPLEMENTATION OF PROHIBITED ACTIVITIES**

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### **OVERVIEW**

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As noted above, the Volcker Rule generally prohibits a banking entity from investing in or sponsoring hedge funds and private equity funds unrelated to the banking entity's bona fide trust, fiduciary, or investment advisory business. In implementing this prohibition, Agencies should consider addressing two key issues with respect to implementing the prohibition:

- the scope of the definition of “private equity fund” and “hedge fund”; and
- the restriction of existing investment authorities that currently allow banking entities to invest in third-party hedge funds and private equity funds.

### **ISSUES REGARDING IMPLEMENTATION OF PROHIBITED ACTIVITIES**

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#### **SCOPE OF PROHIBITED INVESTMENTS**

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The Volcker Rule defines a hedge fund and a private equity fund as any “issuer that would be an investment company . . . but for sections 3(c)(1) or 3(c)(7)” of the Investment Company Act or “such similar funds” as the federal banking agencies, the SEC and the CFTC shall determine.<sup>51</sup> In other words, under the Volcker Rule, hedge funds and private equity funds are defined only as issuers that rely on the exclusion from the definition of investment company under sections 3(c)(1) or 3(c)(7) of the Investment Company Act or such similar funds as Agencies determine.

Sections 3(c)(1) and 3(c)(7) of the Investment Company Act provide exclusions from the definition of investment company for an issuer that is not making and does not presently propose to make a public offering of its securities and either (i) has outstanding securities that are beneficially owned by not more than one hundred persons or (ii) has outstanding securities that are owned exclusively by qualified purchasers.<sup>52</sup>

Many hedge fund and private equity fund investments are made through an investment vehicle that relies on section 3(c)(1) or 3(c)(7) of the Investment Company Act.<sup>53</sup> However, these exclusions are used by a wide variety of funds

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<sup>51</sup> Id. at § 1851(h)(2).

<sup>52</sup> 15 U.S.C. § 80a-3(c).

<sup>53</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE. PUB. NO. GAO-08-885, PRIVATE EQUITY: RECENT GROWTH IN LEVERAGED BUYOUTS EXPOSED RISKS THAT WARRANT CONTINUED ATTENTION 39 n.59 (2003); *see also* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PUB. NO. GAO-09-677T, HEDGE FUNDS:

and other legal entities that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, including special purpose acquisition vehicles and certain ERISA qualified employee pension funds. Many commenters expressed the opinion that the statutory definition unintentionally includes corporate structures and entities that do not exhibit the characteristics of hedge funds or private equity funds, such as controlled subsidiaries and joint ventures used to hold ordinary course investments, or other investment vehicles.

Specifically, a number of commenters suggested that venture capital funds should be excluded from the Volcker Rule's definition of hedge funds and private equity funds because the nature of venture capital funds is fundamentally different from such other funds and because they promote innovation. The Council believes that the issue raised by commenters in this respect is significant. In connection with implementing an exclusion from registration for advisers solely to venture capital funds as provided under the Dodd-Frank Act, the SEC has recently proposed rules that distinguish the characteristics and activities of venture capital funds from those of other private equity funds and hedge funds. The Council recommends that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases.<sup>54</sup>

Conversely, not all investment vehicles that share the characteristics of traditional private equity funds or hedge funds rely on the exclusions contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act, such as commodity pools do not primarily hold or invest in financial instruments. Congress recognized this by giving Agencies authority to bring "similar funds" within the scope of the Volcker Rule's applicability. It is possible to create an investment fund pursuing a "hedge fund" or "private equity fund" strategy in reliance on other sections of the Investment Company Act which therefore would not necessarily be captured by the statutory definition of hedge fund and private equity fund.

Accordingly, the Council recommends that Agencies consider using their authority to expand the definition by rule to funds that do not rely on the section 3(c)(1) and 3(c)(7) exclusions, but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund. Agencies can bring such funds within the scope of the Volcker Rule by deeming them "similar funds" within the meaning of the statute. In determining which funds should be brought within the scope of the Volcker Rule as "similar funds," Agencies should consider the investment activities and other characteristics of such funds, including:

- ***Related compensation structure:*** Does the fund earn an allocation based on fund performance including both realized and unrealized gains?

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<sup>54</sup> 12 U.S.C. § 1851(d)(1)(J).



- **Trading/Investment strategy:** What trading or investment strategy does the fund utilize?
- **Use of leverage:** Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?
- **Investor composition:** Is the fund’s capital received from a broad group of unaffiliated investors?

## **IMPLEMENTATION OF PERMITTED ACTIVITIES**

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### **OVERVIEW**

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As referenced in the statutory overview above, Congress explicitly allowed certain permitted activities in recognition of the basic principle that banking entities should be able to continue their customer-focused advisory services.

### **ISSUES REGARDING IMPLEMENTATION OF PERMITTED ACTIVITIES**

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#### **THE “CUSTOMER” REQUIREMENT**

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The Volcker Rule provides that a banking entity is permitted to organize and offer and invest in a hedge fund or private equity fund if “the fund is organized and offered only in connection with the provision of bona fide trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity.”

The Volcker Rule does not, however, define the term “customers.” Historically, banking entities have raised commitments for hedge funds and private equity funds from existing customers as well as individuals or entities that have no pre-existing customer relationship with the banking entity.

Agencies should consider developing and issuing regulations to clarify the meaning of “customer” in the context of this permitted activity by banking entities. The statutory language suggests that there must be a “customer” relationship with a banking entity’s bona fide trust, fiduciary, or investment advisory business. There are analogous statutory definitions and regulatory concepts that seek to define a customer relationship in both banking law and securities law; a prescriptive definition such as “customer relationship” has been used in the context of a banking entity,<sup>55</sup> while a

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<sup>55</sup> “Customer relationship” defined as a continuing relationship between a consumer and the bank under which the bank provides one or more financial products or services to the consumer that are to be used primarily for personal, family, or household purposes. *See* 12 CFR 216.3 (i)(1).

much more nuanced definition such as “substantive and pre-existing relationship” has been used in the context of private placements.<sup>56</sup>

In determining the nature of a customer relationship that may constitute a permitted activity, Agencies should consider these existing authorities and should take into account the following potential considerations:

- ***Continuing relationship versus knowledge of financial needs:***
  - A continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the offering; or
  - A previous relationship that provided the banking entity with sufficient knowledge of the customer’s financial needs, risk tolerance, and qualifications.
- ***Direct versus indirect customer relationships:***
  - A direct and substantive relationship between the banking entity and a prospective customer; or
  - A relationship between the banking entity and the customer’s agent or advisor or investment vehicle.
- ***Relationship initiated by the potential customer versus banking entity:***
  - A relationship initiated by the potential customer or its agent to inquire about a product or service offered by the banking entity; or
  - A relationship initiated by the banking entity offering a product or service to the customer or its agent.

Moreover, in certain instances, the Volcker Rule refers to “clients,” a term which is not defined. Under the federal securities laws, who may be considered a client is a distinct concept from who may be considered a customer of the bank. Agencies should take into consideration these potential issues as part of their evaluation of permitted activities by banking entities in relation to customers and clients.

## FEEDER FUNDS

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Subject to the general conditions in the statute, the Volcker Rule permits banking entities, in the context of their customer-focused advisory services, to provide customers with access to third-party private equity funds and hedge funds through the organizing and offering of a hedge fund or private equity fund that makes

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<sup>56</sup> See e.g., Use of Electronic Media, Securities Act Release No. 7856 (Apr. 28, 2000) (citing Woodtrails-Seattle, Ltd., SEC No-Action Letter (Aug. 9, 1982), Bateman Eichler, Hill Richards, Inc. SEC No-Action Letter (Dec. 3, 1985) and Lamp Technologies, Inc., SEC No-Action Letter (May 29, 1998) (To be substantive, the relationship should involve a knowledge of the prospective investor’s financial sophistication, goals and objectives. To be pre-existing, a relationship should be in place before the terms of the offering are developed and the offering commences.)

investments in such third-party funds. Banking entities may organize and offer funds that act as typical feeder funds, arrangements in which one fund invests in the shares of another fund.

Many banking entities “organize and offer” feeder funds that pool customers’ capital investments in third-party hedge funds and private equity funds. In this structure, the risks associated with a permissible banking entity-managed feeder fund are typically borne entirely by the customers of the banking entity who are the investors in that feeder fund, and none of the banking entity’s assets are at risk.

However, conflicts of interest may arise where a banking entity directs a feeder fund or fund of fund investment to a third-party hedge fund or private equity fund with which the banking entity has other business relationships. In evaluating the appropriateness of such relationships, Agencies should consider:

- Whether the banking entity’s business relationships with the third-party fund should be subject to the Volcker Rule’s prohibition of “covered transactions” (e.g., making loans, purchasing assets, extending guarantees) as well as to the section 23B of the Federal Reserve Act “arm’s length” transactions requirements; and
- Subject to general conditions set forth in the statute, the extent to which such arrangements could create the opportunity and incentive for (i) banking entities to protect hedge funds and private equity funds from losses or (ii) for those funds to expose the banking entity to outsized risk.

The Volcker Rule does not place a limitation on a banking entity’s ability to be the investment adviser to a third-party hedge fund or private equity fund. However, a banking entity should not be able to make use of contractual arrangements to avoid the customer requirement for hedge funds and private equity funds that the banking entity organizes and offers as permitted under the Volcker Rule.

#### *DE MINIMIS* INVESTMENTS

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The Volcker Rule permits banking entities to take or retain a 3% or lower *de minimis* investment in a hedge fund or private equity fund that such entity organizes and offers, subject to certain conditions and limits. The amount of any *de minimis* investment should be “immaterial” to the bank and, in any case, at most represent up to 3% of each fund following an initial one-year “seeding” period during which banks can provide up to 100% of the capital of the fund.<sup>57</sup> Additionally, in no case can the aggregate of all of the interests of the banking entity in all such funds exceed 3% of the Tier 1 capital of the banking entity.<sup>58</sup>

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<sup>57</sup> 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

<sup>58</sup> *Id.* at § 1851(d)(4)(B)(ii)(II).

In addition, given the need to protect against risks with respect to even permissible hedge fund and private equity fund investments within the statutory limit, the Volcker Rule effectively requires Agencies to deduct the amount of these investments from the banking entity's capital. In addition, the statute requires that the deduction be increased commensurate with the leverage of the fund.

In providing a *de minimis* allowance for investments in hedge funds and private equity funds, the Volcker Rule permits banking entities to make certain limited investments in hedge funds and private equity funds while avoiding material conflicts of interest and any incentive or opportunity to "bail out" such funds. The proper implementation and enforcement of the Volcker Rule, which among other things seeks to align a banking entity's investments in a hedge fund or private equity fund with the interest of its customers, requires that the *de minimis* exemptions be connected to customer-related activities.

Because the Volcker Rule permits *de minimis* investments in hedge funds and private equity funds, Agencies should be careful to ensure that the statutory restrictions be carefully defined to ensure that these exceptions do not place banking entities at undue risk or provide loopholes for proprietary trading or other prohibited transactions. Agencies should consider rules that will:

- ***Avoid understating risk:*** Agencies should consider defining "investment" in a manner that will best capture the banking entity's true risk exposure.
  - **Invested vs. Committed:** In most private equity fund structures, investors commit to provide a certain amount of cash, which is called over time as the fund executes investments. Some commenters suggested that only the actual cash invested, rather than the commitment, should be counted in the 3% limit. Other observers argued that the cash commitment is a better measure of a banking entity's exposure, and therefore should be the amount included in the *de minimis* calculation.
  - **Carried interest:** Agencies should consider the proper treatment of carried interest for purposes of the *de minimis* calculation, including whether carried interest that remains in the fund, at the election of the party to whom it is allocated, should be treated the same or differently than carried interest that is removed from the fund when contractually allocated or earned.
  - **Synthetic Ownership Exposure:** Agencies should consider implementing the 3% *de minimis* investment and seed fund exceptions to prevent banking entities from subverting the intent of the legislation by structuring arrangements that technically comply with the 3% ownership limit while allowing banking entities to retain a synthetic or other interest in a fund, effectively exposing the banking entity to the risks and benefits of ownership otherwise prohibited under the Volcker Rule.

- Employee interests: Agencies should consider whether investments by directors and employees engaged in providing services to the fund, together with other investors who may be affiliated with the bank (such as non-ERISA qualified employee deferred compensation plans) should be included in the 3% cap on a banking entity's investment in a hedge fund or private equity fund.

The statute mandates that a banking entity's investment in a hedge fund or private equity fund not exceed 3% of the fund. In order to robustly monitor this limit Agencies should consider, among other factors:

- Whether the *de minimis* calculation of the banking entity's share of a fund should reflect changes in the investor base in the fund (e.g., redemptions or other changes in commitment levels) over time or whether a one-time test at the one-year mark or at the inception of a fund would be sufficient.
- If these changes result in a change in the ownership share above 3%, in what period of time should banking entities that have failed the test be required to sell down their interest to a compliant level?

#### PROHIBITING COVERED TRANSACTIONS

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As noted above, under existing law, section 23A of the Federal Reserve Act places strict quantitative and qualitative restrictions on covered transactions between a bank and an affiliate, and section 23B of the Federal Reserve Act requires almost all financial transactions between a bank and an affiliate to be on market terms. The adoption of these restrictions in part acknowledges that transactions with affiliates can entail significant risk to an insured depository institution.

Where these restrictions have been applied and supervised, they have been effective in limiting inappropriate conflicts of interest and helping to prevent the transfer of the benefits of deposit insurance and the federal safety net from insured depository institutions to unregulated entities. However, prior to the Dodd-Frank Act, not all hedge funds and private equity funds sponsored by a bank were treated as affiliates of the bank for purposes of these restrictions.<sup>59</sup> Going forward, all hedge funds and private equity funds organized and offered or advised by a banking entity will be subject to stricter limitations than those that exist prior to the effectiveness of the Volcker rule. Under the Volcker Rule, a banking entity will not just be restricted in the amount of "covered transactions" it can engage in with a hedge fund and private equity fund that it manages or sponsors, it will be prohibited from engaging in any such transaction. In addition,

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<sup>59</sup> Prior to the Dodd-Frank Act, many private equity funds, foreign investment funds, and commodities funds escaped treatment as an affiliate because they were not registered investment companies under the Investment Company Act and therefore, did not qualify as an affiliate for the purposes of sections 23A and 23B of the Federal Reserve Act unless the banking entity owned more than 5% of the capital of the fund.

where a banking entity has a direct or indirect interest in a hedge fund or private equity fund, all other transactions between the banking entity and a hedge fund and private equity fund will be required to be on market terms in accordance with restrictions under section 23B of the Federal Reserve Act.

## **CLARIFYING THE TERM “BANKING ENTITY”**

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The statute generally defines the term “banking entity” as:

[A]ny insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), 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 of 1978, and any affiliate or subsidiary of any such entity. (emphasis added).

Under the BHC Act, the terms “affiliate” and “subsidiary” are both defined terms. Under sections 2(d) and 2(k) of that Act, “subsidiary” and “affiliate” are both defined to include any company that a bank holding company or other company “controls.” Section 2(a)(2) of the BHC Act contains a definition of “control,” which the Board has implemented in its Regulation Y to include, *inter alia* (i) ownership, control, or power to vote 25% or more of the outstanding shares of any class of voting securities of a bank or other company, directly or indirectly or acting through one or more other persons; (ii) control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of a bank or other company; and (iii) the power to exercise, directly or indirectly, a controlling influence over the management or policies of a bank or other company, as determined by the Board after notice and opportunity for hearing. The “banking entity” definition contained in the Volcker Rule includes any affiliate or subsidiary of a banking entity which, arguably, creates a circular definition that would subject an advised fund (which is considered an affiliate) to the proprietary trading and hedge fund and private equity fund restrictions of the Volcker Rule, even though setting up an advised fund is an explicitly permitted activity.

Commenters argued that unless permitted hedge funds and private equity funds are excluded from the definition of “banking entity” the following would result:

- A banking entity could not operate a fund of funds business where the fund of funds invests in third party funds;
- Hedge funds and private equity funds that are controlled by a banking entity would not be permitted to make investments in other funds;
- Each fund in a family of controlled funds would be treated as a banking entity and an affiliate of each other, therefore requiring each fund to have a unique name;
- Companies (i.e., even non-financial companies) controlled by a hedge fund or private equity fund that is controlled by a banking entity would themselves become banking entities subject to the restrictions of the Volcker Rule; and

- SEC-registered investment companies that are controlled by a banking entity, would be subject to the Volcker Rule.

The Council recommends that the relevant Agencies carefully consider the impact of certain BHC Act definitions on the Volcker Rule’s definition of “banking entity” and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule.

## **MONITORING COMPLIANCE**

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### *PROGRAMMATIC COMPLIANCE*

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Similar to the programmatic compliance regime recommended for proprietary trading oversight, firms should be held accountable for compliance with the Volcker Rule’s restrictions on investments in and sponsorship of hedge funds and private equity funds. The programmatic compliance regime would have the following key attributes, including investment and risk oversight, public attestation of compliance by the CEO, and engagement by the Board of Directors.

### *INVESTMENT AND RISK OVERSIGHT*

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- The banking entity’s Board of Directors should approve the objectives, strategies, and policies governing permissible investments in hedge funds and private equity funds, including the necessary relationship for providing customer-focused advisory services, the type and nature of the investments, and other elements of sound investment management oversight.
- The banking entity’s approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all personnel involved in their implementation.
- The banking entity should actively monitor the performance and risk profile of private equity and hedge fund investments in light of the established objectives, strategies, policies, and procedures.
- The banking entity’s policies and procedures, with respect to permitted investments in private equity funds and hedge funds, should identify the aggregate exposure that the institution is willing and able, in light of the *de minimis* investment limitation, to accept by type and nature of investment. Adherence to such limits should take into consideration unfunded, as well as funded, commitments. Banking entities should have systems in place, consistent with applicable laws and regulations,

to ensure that impermissible investments in or transactions with hedge funds and private equity funds are prohibited.

- A system of internal controls, with appropriate checks and balances and clear audit trails, is critical to the effective conduct of investments in permitted private equity and hedge funds.

#### *MANAGEMENT AND PUBLIC ATTESTATION*

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- Permitted investments in hedge funds and private equity funds should be subject to active oversight by the banking entity and senior management. The CEO should be required to attest publicly to the ongoing effectiveness of the internal compliance regime.

#### *TRANSPARENCY*

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Given the important role that market discipline plays in controlling risk, Agencies should consider requiring banking entities to publicly disclose certain information regarding private equity funds and hedge funds that they are permitted to invest in, organize and offer, or sponsor so that markets and investors can better assess risk profiles and performance. For example, such information could include the type and amount of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital, to the extent consistent with applicable law.



## THE ACCOMMODATION OF THE BUSINESS OF INSURANCE

The statute requires the Council to put forth recommendations to “... appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system.” As discussed above, under the Volcker Rule, certain investments made by insurance companies for their general account are permitted activities, and thus generally exempt from the prohibitions of the Volcker Rule. Those activities, however, remain subject to the statutory backstop described above.

Insurance companies assume risk and collect premiums and, in turn, invest those premiums. Investment return contributes to the company’s net worth (i.e., policyholder surplus), which in turn supports underwriting and the payment of future claims to policyholders and claimants.<sup>60</sup> The investment activity of insurers is central to the overall insurance business model and could be unduly disrupted if certain provisions of the Volcker Rule applied. As such, Section 619 of the Dodd-Frank Act amends the BHC Act by adding Section 13(d)(1)(F), which provides specific permission for this investment activity:

“(F) The purchase, sale, acquisition, or disposition of securities and other specified instruments described in subsection (h)(4) by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate of such regulated insurance company, provided that such activities by any affiliate are solely for the general account of the regulated insurance company, if–

(i) the purchase, sale, acquisition, or disposition is conducted in compliance with, and subject to, the insurance company investment laws, regulations, and written guidance of the State or jurisdiction in which each such insurance company is domiciled; and

(ii) the appropriate Federal banking Agencies, after consultation with the Financial Stability Oversight Council and the relevant insurance commissioners of the States and territories of the United States, have not jointly determined, after notice and comment, that a particular law, regulation, or written guidance described in clause (i) is insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States.”<sup>61</sup>

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<sup>60</sup> Insurance companies also retain assets and earnings, and in the case of stock companies, may issue dividends to shareholders, or in the case of mutual companies, may provide dividends or other benefits to members.

<sup>61</sup> 12 U.S.C. § 1851(d)(1)(F).

## ELIGIBILITY

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Only two types of insurance companies are subject to the Volcker Rule: (i) insurance companies that are affiliates of insured banks or thrifts; and (ii) non-bank financial companies supervised by the Board. Among these companies, a subset is allowed to engage in certain permitted activities. In order to provide clarity for the banking entities that may engage in permitted activities and on the scope of those activities, Agencies should consider defining the following terms: (i) “regulated insurance company;” (ii) “directly engaged in the business of insurance;” and (iii) the “general account” of the company. In doing so, Agencies should consult relevant state insurance commissioners.

The term “regulated insurance company” could be defined to include entities that are subject to regulation by the state insurance regulatory agencies, such as licensed and admitted insurance companies, surplus lines insurance companies, and admitted reinsurance companies. For instance, Section 2(a)(17) of the Investment Company Act already includes a definition of insurance company consistent with this description. However, under such a definition, some banking entities might not qualify to engage in permitted activity.<sup>62</sup>

In interpreting “business of insurance,” Agencies should strive to be consistent with the term as already used and interpreted under the McCarran-Ferguson Act.<sup>63</sup> For purposes of authorizing insurance activities for bank holding companies, section (4)(k)(4)(B) of the BHC Act describes the following activities: “insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities and activity as principal, agent, or broker for purposes of the foregoing, in any State.”<sup>64</sup> Agencies, also should consider what “directly engaging” in the business of insurance means, which should distinguish between the insurance units and the holding company for purposes of compliance with the Volcker Rule.

The term “general account” is not a statutorily defined term but it is a fairly well recognized insurance accounting term of art. A general account represents all assets of the insurer that are available to satisfy its overall obligations. It does not include any separate account assets.<sup>65</sup>

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<sup>62</sup> Some commenters point to the phrase “State or jurisdiction” in Section 13(d)(1)(F)(i) of the BHC Act, 12 U.S.C. § 1851(d)(1)(F)(i), and question whether “jurisdiction” was meant to include other countries and, therefore, allow foreign insurers subject to foreign investment laws rather than domestic laws to also engage in permitted activity. Agencies should examine this issue and possible adverse effects carefully.

<sup>63</sup> 15 U.S.C. §1011, *et. seq.* For example, see *U.S. Department of Treasury v. Fabe*, 508 U.S. 491 (1993) (defining the “business of insurance” based on three factors: (1) whether the practice has the effect of transferring or spreading a policyholder’s risk; (2) whether the practice is an integral part of the policy relationship between the insurer and insured; and (3) whether the practice is limited to entities within the insurance industry).

<sup>64</sup> 12 U.S.C. 1843(k)(4)(B).

<sup>65</sup> A separate account is maintained by an insurance company and, in substance, is an investment funding mechanism. Assets held in separate accounts are legally segregated for the benefit of particular policyholder/customer.

## LIMITATIONS ON QUALIFIED ACTIVITY

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Activity under section 13(d)(1)(F) of the BHC Act<sup>66</sup> is permitted provided that (i) it is subject to and in compliance with insurance company investment laws, regulations and written guidance of each insurance company's domiciliary state or jurisdiction; and (ii) the appropriate federal banking agencies, after consultation with the Council and the relevant state insurance commissioners, not have jointly determined, after notice and comment, that such investment laws, regulations and written guidance are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States.

Insurance company investment is subject to relevant state investment laws which, while not uniform, are substantially similar and generally conform to standards set out in model laws and regulations developed by the National Association of Insurance Commissioners ("NAIC"). State investment laws aim at limiting the amount and type of investments insurers can make in order to limit their investment and counterparty risk exposures. For example, among other limitations, investment laws limit the amount of investment an insurer can make in equities, low-grade securities, or in the securities of any one issuer. The NAIC has developed two different models which handle the issue in different manners.<sup>67</sup>

State insurance company investment laws and regulations govern the type of investment, and extent of such investments, an insurance company can include as "admitted" assets on their balance sheet for the purpose of determining whether the insurer has the ability to discharge its obligations and meet capital and surplus requirements. Insurers can make certain otherwise non-prohibited investments, but such investments are not considered admitted assets and still have to be reported to state insurance regulators. State insurance company investment laws and regulations typically do not directly govern the terms and conditions of the transactions themselves.<sup>68</sup>

The activity for the general account is permitted if it is "conducted" in compliance with such investment laws, regulations and written guidance. State agencies monitor insurer investments, through reporting, valuation, and examination, to ensure that such investments are in compliance with state insurance investment laws, regulations, and guidance, and, even when insurers are otherwise in compliance to ensure that such investments do not threaten the solvency of the insurer. The federal banking agencies

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<sup>66</sup> 12 U.S.C. § 1851(d)(1)(F).

<sup>67</sup> The Defined Limits version establishes categories and limits the amount an insurer can hold of each category. The Defined Standards approach establishes more of a prudent person concept without having all of the explicit categories and defined limits. The majority of the states utilize an approach similar to the Defined Limits model. Others have adopted laws that incorporate both defined limits and prudent person concepts. This past year, the NAIC also adopted a model law on derivatives which requires the insurer to have a use plan for derivatives for the regulator to consider.

<sup>68</sup> Laws and regulations may encourage that certain assets be disposed of upon valuation and rating downgrade. Also, state insurance *insolvency* laws and regulations (which may or may not be viewed as investment laws and regulations), provide regulatory authority over such transactions in the case of conservatorship, rehabilitation, and liquidation.

and state insurance agencies should coordinate and enhance the examination of the investment activities of those insurance companies that might otherwise be subject to the Volcker Rule to ensure that they are compliant with state law and regulation. Another approach would be to require such insurance companies to certify that such activity is compliant followed by a later audit. Under the Volcker Rule, activity for the general account is permitted if the appropriate federal banking agencies, after consultation with the Council and the relevant state insurance commissioners, have not jointly determined that such investment laws, regulations and written guidance are insufficient to protect the safety and soundness of the banking entity, or of the financial stability of the United States.

At some point in the future, Agencies will need to consider the timing and approach to the assessment of the insurance company investment laws, regulations, and guidance from the states. Agencies should also consult relevant state insurance commissioners, not only before any joint determination is considered, but also with regard to the process. Should the appropriate federal banking agencies, after consultation with the Council and the relevant state insurance commissioners, jointly determine, that a particular state's insurance company investment laws, regulations and guidance – or some aspects thereof – are insufficient to protect the safety and soundness of a banking entity or the financial stability of the United States, the activity of all regulated insurance companies domiciled in that particular state could be affected. Safe harbor provisions for insurance companies, as well as an opportunity for a state to address the inadequacy of their law, regulation, or guidance should be considered.

## **SEPARATE ACCOUNT ASSETS**

Beyond the permitted activity under Section 13(d)(1)(F) of the BHC Act,<sup>69</sup> insurance companies also maintain investments in separate accounts that remain on the company's balance sheet but are legally separate from the assets of the insurance company itself. These accounts are not part of the insurance company's general account. Some commenters argued that the assets in these accounts are held for the benefit of particular customers, and therefore, investments tied to these separate accounts should be considered "permitted activity" under Section 13(d)(1)(D) of the BHC Act.<sup>70</sup> Agencies should consider how insurance companies invest separately on behalf of customers.

## **OTHER ISSUES RELATED TO THE BUSINESS OF INSURANCE**

Insurance companies interface with the Volcker Rule as market investors. However, they also provide products that are investment vehicles. The Volcker Rule may apply to banking entities' investment in insurance products.

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<sup>69</sup> 12 U.S.C. § 1851(d)(1)(F).

<sup>70</sup> *Id.* at § 1851(d)(1)(D).

Some commenters also expressed concerns that some separate account products could be included in the definitions of “hedge fund” and “private equity fund” not by virtue of their being “other similar funds,” but because the definition includes funds required to be registered under the Investment Company Act, but for the exclusions under Sections 3(c)(1) or 3(c)(7).<sup>71</sup> Agencies should examine this carefully so as not to preclude certain insurance products that may not have been intended to be limited by the Volcker Rule. One approach may be for Agencies to design, by rule, a process by which insurance companies can request an interpretative determination of whether particular separate accounts and products qualify under the definition of hedge or private equity fund. Another would be to determine whether the activity promotes the safety and soundness of the banking entity under Section 13(d)(1)(J) of the BHC Act.<sup>72</sup>

Finally and in general, the appropriate Agencies should carefully monitor fund flows between banking entities and insurance companies, to guard against “gaming” the Volcker Rule, whether it is through innovative insurance products and financial instruments, like Bank Owned Life Insurance, or use of separate accounts. Agencies should work with the state insurance agencies in monitoring activity of bank affiliate insurance companies and captive insurers.<sup>73</sup> To the extent such products become vehicles to enable impermissible activity, Agencies should consider procedures for designating such financial instruments under Section 13(h)(4) of the BHC Act.<sup>74</sup>

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<sup>71</sup> Insurance company separate accounts are exempted from registration due to those sections, as well as perhaps excepted from the definition of “investment company” under the Investment Company Act of 1940.

<sup>72</sup> 12 U.S.C. § 1851(d)(1)(J).

<sup>73</sup> A single-parent captive is a limited-purpose, wholly owned subsidiary that can be used to insure the captive’s parent or affiliates.

<sup>74</sup> 12 U.S.C. § 1851(h)(4).

## ANNEX A

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The Council's Notice and request for information, published in the Federal Register on October 6, 2010, stated the following:

“To assist the Council in conducting the study and formulating its recommendations concerning the Volcker Rule, the Council seeks public comment on the following questions:

1. Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to:

(i) Promote and enhance the safety and soundness of banking entities;

(ii) Protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;

(iii) Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;

(iv) Reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board,<sup>3</sup> and the interests of the customers of such entities and companies;

(v) Limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;

(vi) Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and

(vii) Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

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<sup>3</sup> The term “nonbank financial companies supervised by the Board” refers to those nonbank financial companies that may be designated by the Council under section 113 of the Act to be supervised by the Board and subject to enhanced prudential standards.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

- (i) ‘Banking entity’ [§ 619(h)(1)];
- (ii) ‘Hedge fund’ [§ 619(h)(2)];
- (iii) ‘Private equity fund’ [§ 619(h)(2)];
- (iv) ‘Such similar funds’ [§ 619(h)(2)];
- (v) ‘Proprietary trading’ [§ 619(h)(4)];
- (vi) ‘Sponsor’ [§ 619(h)(5)];
- (vii) ‘Trading account’ [§ 619(h)(6)];
- (viii) ‘Short term’ [§ 619(h)(6)];
- (ix) ‘Illiquid fund’ [§ 619(h)(7)];
- (x) A transaction ‘in connection with underwriting or market making related activities \* \* \* designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties’ [§ 619(d)(1)(B)];
- (xi) ‘Risk-mitigating hedging activities’ [§ 619(d)(1)(C)];
- (xii) ‘The purchase, sale, acquisition, disposition of securities or other instruments ‘on behalf of customers’ [§ 619(d)(1)(D)];
- (xiii) Investments in ‘small business investment companies’ and certain ‘public welfare’ investments [§ 619(d)(1)(E)];
- (xiv) A permitted activity by an insurance company [§ 619(d)(1)(F)]; and
- (xv) Such other activities as ‘would promote and protect the safety and soundness of banking entities and the financial stability of the United States’ [§ 619(d)(1)(J)];?

5. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should be taken into account as indicative that a transaction, class of transactions or activity:

(i) Would involve or result in a material conflict of interest between a banking entity (or a nonbank financial company supervised by the Board) and its clients, customers or counterparties;

(ii) Would result, directly or indirectly, in a material exposure by a banking entity (or a nonbank financial company supervised by the Board) to high-risk assets or high-risk trading strategies; or

(iii) Would pose a threat to the safety and soundness of a banking entity (or a nonbank financial company supervised by the Board)?

6. What factors and considerations should be taken into account in making recommendations on whether additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities or nonbank financial companies supervised by the Board engaged in activities permitted under the Volcker Rule?

7. With respect to proprietary trading and hedge fund and private equity fund activities, which practices, types of transactions or corporate structures in general have historically accounted for or involved increased risks or may account for or involve increased risks in the future?

8. With respect to proprietary trading and hedge fund and private equity fund activities, what practices, policies or procedures have historically been utilized that may have mitigated or exacerbated risks or losses? What practices, policies or procedures might be useful in limiting undue risk or loss in the future?

9. What factors and considerations should be taken into account in making recommendations to safeguard against evasion of the Volcker Rule?

10. How should the international context be considered when implementing the Volcker Rule? Are there any factors or considerations that should be taken into account regarding the application of the Volcker Rule to banking entities or nonbank financial companies that operate outside the United States? What issues does implementation of the Volcker Rule present with respect to the following:

(i) Domestic banking entities that have access to foreign exchanges,

(ii) foreign affiliates of domestic banking entities, and

(iii) foreign non-bank financial companies



11. What timing issues are raised in connection with the divestiture of illiquid assets affected by the prohibitions of the Volcker Rule, and how might such issues be appropriately addressed?

12. Commenters are generally invited to submit views with respect to any qualitative or quantitative factors that should be considered in connection with the Council's study of the Volcker Rule, as well as any analogous areas of law, economics, or industry practice, and any factors specific to the commenter's experience. Please comment generally and specifically, and please include empirical data and other information in support of such comments, where appropriate and available."